

Centrica plc's acquisition of Killingholme

Report to the Office of Fair Trading

On 8 June 2004 Centrica plc announced its acquisition of the 652MW CCGT Killingholme power station. The purpose of this note is to set out Ofgem's views on this transaction, in accordance with the Concordat between our two offices, so that you may take them into account in deciding whether the merger may result in a substantial lessening of competition.

Consultation

On 11 June 2004, Ofgem placed an overview of the acquisition on its website, and invited views on the issues raised by the acquisition. Ofgem opted for this approach to consultation to give parties more time to respond and because Ofgem's initial view was that there were no obviously significant competition concerns stemming from the transaction.

Ofgem received one response expressing the view that the acquisition should be referred to the Competition Commission. The main concern was that as a gas producer with a number of long-term interruptible contracts, the acquisition of more gas-fired generation would lead Centrica to increase interruptions of gas supply to competitors when gas prices were high. Ofgem has considered whether the acquisition gives rise to any significant competition issues such as market foreclosure or anti-competitive behaviour by virtue of Centrica's vertical integration.

Ofgem's views

Centrica is a vertically integrated company and has significant interests in the supply of gas and electricity, gas production, gas shipping, and gas and electricity trading, gas storage assets as well as electricity generation in Great Britain.¹

Killingholme is a gas CCGT power station located in North Lincolnshire with a capacity of 652MW. Therefore the activities of Centrica and Killingholme overlap in the market for the generation of electricity.

Relevant Markets

The wholesale electricity market arrangements in Scotland are currently different from those operating in England and Wales, although the two systems are interconnected. From April 2005, subject to a Go-Live decision by the Secretary of State, a common system is to be implemented across the whole of Great Britain. Since Centrica does not own any power stations in Scotland and both the asset being acquired as well as the assets currently owned are located in England and Wales - the effect of the transaction would normally be assessed on an England and Wales and on a GB basis (reflecting the probable move to a unified market). However, for simplicity, the analysis focuses on England and Wales market on the basis that if competition concerns are not met within an England and Wales (E &W) market (including imports from Scotland) then there will

¹ Information from www.centrica.com

not be competition concerns within a Great Britain-wide market. Ofgem have not considered it necessary to form a definitive view on market definition in this case.

Due to Centrica's interests, the transaction could potentially have an effect on competition in a number of markets related to electricity generation, including: gas production; gas shipping and supply; gas trading; electricity supply and electricity trading. A full assessment of the impacts of this transaction would, at a minimum, involve a consideration of all of these areas of Centrica's portfolio.

However, to reflect the size of this merger, we have focused our analysis on the effect on the electricity generation market and on the proportion of gas supplied by Centrica to the power station sector.

Market Share

Market share in electricity generation can be measured either in terms of installed capacity owned or in terms of the metered volume of output from the generator.

Position pre-acquisition: Capacity

Centrica's generating interests are 5 wholly and 1 partially owned gas CCGT plants in England and Wales and no plants in Scotland. These are: Roosecote (229 MW), Barry (245 MW), Brigg (268 MW), Kings Lyn (340 MW), Peterborough (405 MW) and Humber (771 MW)².

Position pre-acquisition: Output

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Impact of the acquisition

Killingholme is a gas CCGT plant with a capacity of approximately 652MW, which represents approximately 0.8 % of total capacity in E&W. Ofgem does not, therefore, consider the acquisition will lead to a significant increase in Centrica's market power or give rise to competition concerns. Ofgem also notes that the HHI indices post-acquisition remain below the 1000 threshold.

Vertical issues- effect on the gas fired generation

Acquisitions by vertically integrated firms, such as Centrica, who have a presence in upstream markets (gas production) can raise concerns regarding their ability to exert influence on prices in downstream markets (gas-fired electricity generation). Centrica supplies gas to all six of its own CCGT stations and has long term contracts to supply gas to other CCGT stations (some of these contracts are interruptible) in E&W. As Killingholme accounts for a small share of the market, Ofgem does not consider that as a result of this acquisition, there will be a significant increase in interruptions to competitors' gas supply.³ The acquisition will lead to a marginal increase in the total capacity and output of gas fired power stations supplied by Centrica.

² See www.centrica.com. Centrica owns a 60 per cent share of the Humber plant, which has a capacity of 1285 MW.

³ Under long term contracts there is a limit to the number of interruptions Centrica can make in a year. Generators entered into these contracts in return for a known pricing formula and may have other commercial arrangements to source gas when prices are high.

One respondent raised specific concerns about the ability of Centrica to manipulate the gas and electricity markets using LTI contracts. Ofgem does not have detailed information about the LTI contracts. However, in principle, if these contracts do not confer any rights to *physically* control non-Centrica generation units and they do not prevent the generating stations from procuring replacement gas under other contracts and/or the spot market, Ofgem is not currently aware of any reason why these contracts would enable Centrica to influence the availability of the generators or the relative gas and electricity price (“spark spread”) at which they will choose to generate. Therefore, on the basis of the information available, Ofgem does not consider that the effects of this acquisition are materially affected by the existence of Centrica’s LTI contracts.

Fast response services

Killingholme is not contracted to NGC for services such as fast response, and it does not play a significant role in providing services through the balancing mechanism. Therefore, Ofgem does not consider the acquisition raises concerns in relation to the provision of ancillary services to NGC.

Conclusion

Ofgem considers the electricity generation sector in GB to be competitive at present. Ofgem has noted previously⁴ in its advice to the OFT regarding the proposed arrangements between International Power and Drax that the market shares that may be likely to give rise to competition concerns in the electricity generation sector may be lower than in other markets, due to the inelastic nature of short-run supply and demand for electricity. Nevertheless, on the information available, Ofgem’s view is that there are no competition concerns arising from this transaction.

⁴ Proposed arrangements between International Power plc and Drax Holdings Limited – Report to the Office of Fair Trading, October 2003.