10/03 4th April 2003

CENTRICA/DYNERGY MERGER INQUIRY: ISSUES STATEMENT

The Competition Commission has sent an issues letter to the main party, Centrica plc, in its inquiry into Centrica's acquisition of Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd which took place in November 2002.

The Commission has identified a number of issues that it wishes to consider, arising from the information received to date from Centrica, from other interested parties and from other sources. Analysis of these issues — and any others which may be identified as the inquiry proceeds — will help the Commission reach conclusions on the question whether the merger operates, and/or may be expected to operate, against the public interest.

An issues letter is always sent to main parties before the Commission has reached any conclusions and is designed to highlight those matters which have been identified by the investigating group for further consideration, and to ensure that nothing significant has been missed. The purpose of making the statement of issues public is to inform all interested parties and give them an opportunity to raise any further points with the Commission. The Commission would be grateful to receive any written views which interested parties may wish to put forward by **25 April**.

The issues the Commission has identified are set out below.

Jurisdiction

1. The Competition Commission notes that the merger qualifies for investigation because the gross value of the assets acquired substantially exceeds the £70 million threshold in the Fair Trading Act 1973. The Commission is not minded, therefore, to assess whether the merger satisfies the alternative share of supply test.

Market definition

2. As is evident from the published statements of Ofgem[1] and the OFT[2], the definition of the ***product market*** in this case is complex. At this stage of their inquiry, the Group would like to discuss Ofgem's analysis, the conclusions of which may be summarised as follows:

(a) The Rough storage facility, which together with the related Easington onshore terminal is the main asset acquired by Centrica through the merger, provides various services to the GB gas market, of which the most important are:

— a source of winter/summer flexibility, reflecting the much higher demand for gas in winter than in summer; and

— a source of daily, including within day, flexibility at any time of year, reflecting daily fluctuations in the demand/supply balance (e.g. due to unexpected variations in the weather or supply problems).

(b) In the supply of winter/summer flexibility:

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[1] *Centrica's completed acquisition of Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd. Summary of Ofgem's views on the transaction.* 25 February 2003.

[2] *Completed acquisition by Centrica plc of Dynegy Storage Ltd and Dynegy Onshore Processing. A report under section 125(4) of the Fair Trading Act 1973 on the advice of the Director General of Fair Trading, given on 11 February 2003, to the Secretary of State for Trade and Industry under section 76 of the Act.*

— the Morecambe gas fields and other beach swing supplies (that is, variable supplies from other offshore fields) are reasonably close substitutes for Rough;

— the Bacton/Zeebrugge interconnector is also a reasonably close substitute; and

— interruptible supply contracts are likely to act as a constraining factor on Rough in a cold winter.

(c) In the supply of daily flexibility:

— the Morecambe gas fields are a relatively close substitute;

— the interruptible supply contracts are relatively close substitutes;

— the Hornsea storage facility recently acquired by Scottish and Southern Energy from Dynegy is a good substitute; and

— the Bacton interconnector is a reasonably close substitute.

3. The Group also wish to consider the extent to which other existing and proposed storage sites and Transco's facilities (particularly its liquefied natural gas (LNG) storage sites), act or would act as a substitute for Rough.

4. Transactions on forward and spot gas markets would be an obvious trading substitute for purchasing capacity at a storage facility (selling gas for the forthcoming summer and purchasing gas for the following winter may be a substitute for capacity at Rough as a source of winter/summer flexibility, while spot market transactions may be a daily flexibility substitute). However the relevant gas price differentials (e.g. winter/summer) are themselves influenced by the physical sources of flexibility. Thus Ofgem's analysis of physical substitutes appears to be an appropriate starting point for the analysis of the merger's effects.

5. The Group will want to assess not only current conditions in the market(s) for gas flexibility but also the likely effects of foreseeable developments in the next few years, e.g.:

— the expected decline in beach swing as gas fields on the UK continental shelf become depleted;

— the prospect of GB becoming a substantial net importer of gas;

— the extent to which new storage facilities will be brought on stream;

— developments in the capacity and use of the Bacton interconnector;

— the expiry of Centrica's long-term interruptible contracts.

6. The Group's provisional view is that the ***geographical market*** is currently no wider than Great Britain because the capacity and flexibility of the interconnector linking GB at Bacton with mainland Europe at Zeebrugge are limited. (Capacity is limited by the physical dimensions of the pipeline and the current compression facilities, and flexibility is limited by the time taken to move from exporting to importing mode and vice versa and by the fact that, when the interconnector is operating at full capacity in either export or import mode, flexibility is only one way.) The Group would nevertheless, as noted above, like to explore the significance of the Bacton interconnector in linking the GB wholesale gas market to gas markets in mainland Europe and thus potentially providing a source of flexibility to the GB market. They would also like to consider the possibility that the sources of flexibility for GB are providing flexibility for the gas market in Northern Ireland via the Irish interconnectors. The Group currently see no need, in assessing this merger, to consider local markets within GB as competition is on a GB-wide basis (most gas market transactions are made at a notional National Balancing Point on the National Transmission System).

Centrica's position

7. Centrica has significant positions in all the forms of flexibility listed in paragraph 2 above, as set out in the DGFT's advice to the Secretary of State (see footnote 2). Rough itself is said to represent 85% of storage space and 70% of deliverability of all gas storage in GB, excluding Transco's storage facilities which on Ofgem's analysis are not a substitute for Rough. Consequently the merger adds substantially to Centrica's position in the supply of flexible gas (both winter and daily). This creates the possibility of adverse effects on competition of a horizontal nature, that is, resulting from increased concentration in the given market.

8. In addition, Centrica has important positions in other, related energy markets:

(a) it is easily the largest retail supplier of gas to domestic customers in GB, with some 65% of the total number of customers;

(b) it is among the biggest retail suppliers of electricity to domestic customers in GB, with some 20% of the total;

(c) it has smaller but significant shares of the retail supply of gas to industrial and commercial customers;

(d) it is a substantial trader of wholesale gas in GB; and

(e) it has significant gas production and electricity generation assets.

This creates the possibility of adverse effects on competition of a vertical nature, that is, resulting from the links between markets at different levels of the supply chain.

The counterfactual

9. In order to assess the effects of the merger, the Commission has to take a view on what would have been likely to happen in the absence of the merger (the counterfactual). It is known that Dynegy put up Rough for sale because it was withdrawing from European energy markets, and that parties other than Centrica were interested in acquiring Rough. The Group therefore consider that, in the absence of

the merger, Rough would have been acquired by a new owner other than Centrica. It is unlikely to be possible to reach a firm view on who the new owner would have been, or even whether it would have been another company active in GB energy markets or, for example, a financial buyer. However no other company has such a strong position in the various sources of gas flexibility, nor is as vertically integrated in GB gas and electricity markets, as Centrica. It is likely, therefore, that the acquisition of Rough by any other buyer(s) would have been less problematic for competition in those markets than the merger.

Public interest issues

10. Against this background, the Group would like to explore the following issues:

(i) whether, as a result of the merger, Centrica has the incentive and ability to withhold Rough capacity and/or other sources of flexibility from buyers of flexible gas, with the effects e.g. of increasing prices of flexibility and reducing liquidity in gas trading;

(ii) whether Centrica has the incentive and ability to discriminate between customers in the terms on which it makes Rough capacity available;

(iii) the effects of (i) and (ii) above on wholesale gas prices (effects may include increasing average winter prices, increasing price spikes at times of particularly high demand, and reducing summer prices);

(iv) whether Centrica's access to operational and customer information concerning Rough give it an unfair advantage in the market(s) for flexible gas and in downstream markets;

(v) whether, as a consequence of Centrica's ownership of Rough in addition to its control of other sources of flexibility, there is — or could be — insufficient information available to other companies to enable them to operate efficiently within downstream markets;

(vi) whether Centrica would lack the incentive to innovate in the management of Rough, e.g. in the range of products and type of contracts offered to customers;

(vii) whether Centrica would lack the incentive to invest in increasing capacity at Rough, whether in injection or delivery rates or in amount of storage space;

(viii) whether the merger would increase the risks and uncertainty faced by Centrica's competitors, and by potential entrants, in gas storage and downstream markets;

(ix) whether competition, or the lack of it, in downstream markets is such that Centrica would be able to pass on to customers any increases in the wholesale price of gas;

(x) whether, alternatively or additionally, Centrica would be able to put a margin squeeze on its less vertically integrated competitors, particularly in the retail supply of gas to domestic customers, and whether any such squeeze would also restrict entry into downstream markets;

(xi) whether any competition issues arise as a result of Centrica's acquisition of the Easington terminal;

(xii) whether any of the possible adverse effects listed above would be exacerbated by developments such as those outlined in paragraph 5 above.

11. The Group would also like to consider whether there are benefits arising from the merger, e.g.:

— observation of high standards in the operation and maintenance of Rough;

— confidence among users resulting from Rough being in the hands of a financially strong company which is expected to be a long-term player in GB energy markets.

Note that, like the possible adverse effects, any benefits need to be assessed by comparison with the counterfactual (see paragraph 9 above).

Hypothetical remedies

12. On the hypothesis that the Commission might conclude that the merger is against the public interest because of some or all of the possible adverse effects listed in paragraph 10 above, the Group would like to explore the following points in relation to possible remedies.

13. First, could any adverse effects be remedied fully by Centrica giving some or all of the following undertakings:

(a) Rough's full capacity would be made available to users;

(b) "use it or lose it" provisions would continue to apply to Rough capacity in order to ensure that capacity was used and not hoarded;

(c) capacity would be sold through auctions with no reserve price, in order to ensure that there was no discrimination between customers or manipulation of the price by Centrica;

(d) prices would not be indexed to wholesale gas prices, or to the differential between summer and winter prices, in order to avoid giving Centrica an incentive to force up the index;

(e) a specified minimum proportion of capacity should be offered on long-term contracts (say up to five years), and a specified minimum to be offered on annual contracts;

(f) Centrica would not bid in the primary auctions for the sale of existing Rough capacity (since it would have no incentive to bid low) but would reserve a specified maximum share of capacity for itself at the average prices emerging from the auctions for contracts of the relevant period, and buy any additional capacity it wanted in the secondary market; your views are invited on what the specified maximum reservable for Centrica should be, and whether it might be set below Centrica's expected requirement in order (1) to oblige it to buy some of its requirements in the secondary market and (2) to give it an incentive to develop additional capacity;

(g) Centrica would facilitate the efficient operation and development of a secondary market in Rough capacity;

(h) Centrica would maintain a strict legal, financial and physical separation between its storage operations and all other parts of its business, and ensure that no privileged information passed from the storage operation to other parts of the group;

(i) relevant information, e.g. on the aggregate daily utilisation of Rough capacity, would be published in order to give all users and other interested parties equal access and help create confidence in the operation of this important part of the wholesale gas market and in the effectiveness of the undertakings given by Centrica?

14. Second, should Centrica also give undertakings concerning:

(a) the operation of the Morecambe fields;

(b) its use of long-term interruptible contracts;

(c) its other sources of flexibility; and

(d) the publication of information about any of (a), (b) or (c) to prevent those sources of flexibility being manipulated in order to force up the price of flexibility to other users and/or to reduce the responsiveness of the market.

15. Third, for what period should any such undertakings apply?

16. Fourth, would undertakings on the lines outlined above:

(a) constitute excessive regulation, creating distortions and preventing the market in flexible gas from evolving in response to market signals; and/or

(b) fail to address fully the possible adverse effects, e.g. Centrica's lack of incentive to innovate and develop Rough to its full potential?

17. In that case should a structural remedy be applied, whether:

(a) divestment of part of Rough so that it was operated as a joint venture;

(b) divestment of the whole of Rough, including the Easington terminal; or

(c) divestment of other sources of flexibility available to Centrica?

In the case of (a), should Centrica's interest be set at a level which:

— broadly equates to the share of Rough capacity which it uses (currently 25-30 per cent); or

— at such a level, probably below 25 per cent, that Centrica would exercise neither control nor material influence over the management of Rough?

Notes to Editors

1. The reference concerning the completed acquisition by Centrica Plc of Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd was made under the Fair Trading Act 1973 on 25 February 2003 (see DTI press notice P/2003/115).

2. Further information will be provided on the Commission's website http://www.competition-commission.org.uk/inquiries/cent.htm

3. Inquiries should be directed to: Francis Royle, Press Officer, tel: 020 7271 0242