7 Views of third parties

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Introduction

7.1. In this chapter we summarize the evidence that was put to us by third parties in written and oral submissions.

Gas and electricity suppliers

Innogy plc

7.2. Innogy said that the DGFT had advised that there was a possibility that Centrica's acquisition of the Rough gas storage facility would result in a substantial lessening of competition. Innogy said that it shared this view and believed that it would result in Centrica becoming dominant in the market for gas flexibility as well as supply. The acquisition of Rough storage would give Centrica significant horizontal market power in storage, as Rough provided over 30 per cent of storage deliverability and 75 per cent of space. Centrica already possessed vertical market power through its dominant position in domestic gas supply and large gas I&C and electricity supply businesses. Given Centrica's integrated position, the possible impact on competition could be manifested in either wholesale or retail markets. Innogy believed, however, that behavioural undertakings rather than structural remedies might address the competition concerns.

7.3. Access to flexibility—including storage, beach swing, Bacton interconnector flows and interruptible demand contracts—allowed shippers to balance their portfolios both within-day and seasonally. This was particularly important in the residential market, which was characterized by a seasonal, weather-sensitive demand profile. Centrica already had access to a significant percentage of beach swing from its Morecambe Bay fields, the volumes from which were at least equivalent to the capability of Rough. Its legacy LTI contracts provided significant swing (estimated at around 350 GWh a day for up to 45 days in a year) which other shippers/suppliers had had to buy in the market. When these sources were considered alongside its other interruptible contracts and interconnector capacity, Centrica dominated the market for both seasonal and daily flexibility.

7.4. This position needed to be considered against future developments in the gas market. The availability of high-swing, southern basin gas was in decline. The ownership and possibly the operation of the LNG storage facilities were due to change. There were proposals to withdraw LNG storage capacity from the Isle of Grain in advance of the development of an LNG import terminal. New arrangements for exit capacity were planned from 2004 and the consequent effects on the market for interruptible demand contracts were far from clear. If shorter gas-balancing periods were implemented, access to within-day flexibility would become increasingly important.

7.5. Innogy believed that the principal effects of the transaction would be to give Centrica the incentive to restrict beach capacity in order to increase wholesale gas prices and the value of Rough; and to reduce competition in supply markets by restricting access to flexibility. These, together with the means by which Centrica should access storage capacity, were the key issues to consider.

7.6. Innogy recognized that it could be argued that the availability of substitutes would act to constrain Centrica's behaviour. Substitutes did exist in both the daily and seasonal flexibility markets, although Centrica had a significant position in each. Innogy thought it was likely that Centrica would have considerable market power in the short to medium term and could effectively foreclose the market for flexibility and reduce other shippers' ability to acquire flexibility products. Existing shippers and new entrants would have little alternative but to procure flexibility from a major competitor. This could reinforce Centrica's already dominant position in the domestic supply market at the expense of both existing and new suppliers. One of Ofgem's solutions to address the concentration of flexibility was to compel Centrica to release the majority of Rough's capacity on long-term contracts. Innogy was not convinced that there would be much interest in long-term storage capacity rights and there was a danger that, without reserve prices, prices could fall to zero. Although this might be superficially attractive to customers, it might send incorrect investment signals, not only to Centrica but also to other developers of new storage facilities. As a general point, Innogy believed that contracts indexed to gas prices should be permitted as one way of procuring storage capacity and would offer potential buyers a way to manage their exposure.

7.7. Innogy did not wish to constrain Centrica's ability to develop innovative products and accepted that the method for releasing capacity should be Centrica's choice. However, it was hard to reconcile a regime based around non-discriminatory capacity release with one that would increasingly be based upon bespoke products and contracts. In Innogy's view this would lead to a reduction in transparency and make monitoring of capacity release and utilization much more onerous. There was clearly a balance to be struck.

7.8. Since the unbundling of storage from the monopoly transporter (Transco), there had been some new entrants and modest additional storage capacity brought to market. New storage projects required major investment. Potential new entrants needed to have confidence in the future operation of the storage and associated markets and a dominant provider should not be allowed to distort the market in order to discourage new capacity and extract economic rent. Innogy supported diversity of storage capacity, particularly as the UK would be growing increasingly dependent on gas imports. In line with the position in mainland Europe, storage might assume a much more strategic importance in the UK. There was currently an EC initiative being contemplated that would require governments to contract for and control strategic energy reserves. In the gas market, this would put further pressure on the availability of storage capacity as a tool for mitigating shipper risk.

7.9. Against this background of regulatory uncertainty and potentially declining availability of flexibility, Innogy believed that the CC should assess the transaction against both the current gas market and possible future developments. The potential impact on competition in retail and wholesale markets was clear. Longer term, however, Innogy would be concerned if Centrica's behaviour resulted in under-investment in additional storage capacity, which it would view as jeopardizing security and diversity of supply. Any remedies, including undertakings, which were implemented should have a duration that was consistent with investment timescales.

7.10. Centrica had a major requirement for storage flexibility itself and the way that its supply arm accessed that capacity could create market distortions. In general, Innogy was against introducing mechanisms that created artificial market conditions as these might give distorted price and investment signals. Any restriction would be based upon assumptions of Centrica's future supply market share and these assumptions might themselves influence the effectiveness of any limitations imposed.

7.11. Given Centrica's position, however, it might be preferable for a percentage of capacity to be reserved for Centrica. This might produce a more efficient primary allocation and, if the reservation was below Centrica's average requirement, encourage secondary trading. The alternative would be equal access to storage capacity for all system users with the capacity released on non-discriminatory terms, although Centrica's access to capacity could be capped. A robust 'use-it-or-lose-it' mechanism would ensure that all capacity came to market and would dilute any incentives for Centrica to overbid in the initial allocation. Financial separation of the storage business from other businesses would provide an even stronger incentive.

7.12. As regards remedies to address the potential detriments to competition, Innogy said that, as a minimum, Centrica's storage business should operate under a set of statutory undertakings which ensured that the maximum physical capacity was made available on non-discriminatory terms and that there was full separation, including systems, from all Centrica's other commercial activities. There should be physical separation of its storage and trading functions, the release of appropriate operational information to the market (including aggregate daily information on injection, withdrawals and inventory), and measures to monitor overall levels of capacity release and the extent of any capacity hoarding.

7.13. These undertakings should extend significantly beyond 2004, which was the end-date for the Dynegy undertakings. They should remain in place until some of the wider market developments (such as changes to the exit capacity arrangements) and infrastructure developments (such as increased interconnector compression) had been completed. Other developments that could inform the duration of the undertakings included the introduction of additional reverse flow interconnector capacity, a decline in the production from Morecambe Bay and the ending of the LTI contracts. An appropriate duration might be until 2009.

7.14. Innogy believed that Centrica's acquisition of Rough represented a major structural change in the UK gas market. Policy and competition objectives for the storage market could not be met without certain minimum undertakings.

London Electricity Group plc

7.15. LE Group said it believed that the acquisition highlighted some significant issues concerning the structure of the gas market. LE Group remained concerned about the dominance that Centrica had in all areas of the gas value chain. It believed that Centrica's purchase of Rough could increase its ability to withhold gas and increase prices in the wholesale market. This was less likely to happen, however, if appropriate undertakings were put in place to ensure that Rough was operated in a non-discriminatory manner.

7.16. Centrica was the most vertically integrated company in the UK gas industry, with activities offshore and at the terminals, and with gas shipping and supply to the majority of UK small and larger customers. While it could be considered that owning and operating Rough storage was a natural complement to its various other activities in the marketplace, it was important to consider the implications for competition in other parts of the value chain. For example, there appeared to be considerable scope for profits in one part of the value chain (perhaps storage) to be used to cross-subsidize another activity (perhaps domestic supply) and therefore to distort competition. It was the cumulative effect of Centrica's dominance in each market segment that was of concern.

7.17. LE Group believed that Centrica's position in the wholesale markets and its large share of the swing available would put it in a position to influence wholesale prices. This could apply to both gas and electricity markets through Centrica's ability to interrupt power stations on legacy LTI contracts and to arbitrage between the markets using its own power stations. LE Group believed that undertakings could be effective in addressing this problem but reiterated the importance of mitigating Centrica's potential for using swing in order to influence future market prices. This could be used to inflate its profits, not only under storage bilaterals, but for all future trades which were index-linked. The main specific points made by LE Group were as follows:

(a) The transaction highlighted the ongoing issue of Centrica's dominance in the UK gas market, especially in gas flexibility. LE Group believed that this market dominance had to be addressed in order to ensure that customers' interests were safeguarded. The impact of the transaction on other parts of the market, such as entry capacity, interruptible contracts and domestic supply, would need to be closely monitored.

(b) To control Centrica's market power in gas flexibility and hence the potential to influence market prices, LE Group believed that consideration should be given to requiring Centrica to divest some of its swing portfolio, starting with Morecambe Bay gas supplies, and to limit interruptions under the LTI contracts to Transco interruptions only.

(c) LE Group believed that the transaction should be allowed only if Centrica agreed to undertakings limiting the share of capacity at Rough that was reserved to Centrica.

(d) Centrica's storage business should be treated as a fully separate, regulated business for as long as Centrica dominated the flexibility and supply markets.

(e) With appropriate undertakings in place, LE Group believed that there should be no significant effect on prices either for the purchasers of Rough storage capacity or for end-users. It expected the quality of the storage service at Rough to improve under Centrica's ownership owing to its financial stability and operational capability.

7.18. LE Group had previously pointed out, in response to Ofgem's consultation, that the acquisition, together with Centrica's activities in other parts of the UK gas industry value chain, would make Centrica dominant in the provision of flexibility services. This included owning over 30 per cent of total UK storage capacity and over 50 per cent of deliverability, over 50 per cent of daily beach swing and over 50 per cent of day-to-day demand swing, not to mention its dominant share of the domestic supply market.

7.19. LE Group recognized that Centrica's high share of all the swing available on the system was at least in part accounted for by its high share of the domestic supply market, which drove the requirement for swing. Nevertheless, LE Group already had concerns about Centrica's ability to influence this market. It did not, however, have any direct evidence of market abuse. Indeed, one of the problems was that little of the information that would be needed to demonstrate market abuse was readily available. LE

Group believed that one possible remedy for the significant lessening of competition, if the transaction were cleared, would be the provision of much more information about Centrica's activities in the swing-related markets. It did not believe, however, that this would fully remedy the situation arising from the acquisition.

7.20. Ofgem had stated, in the summary of its views on the transaction published in February 2003, that Centrica should give undertakings to ensure fair access to Rough for other companies and to prevent competition from being undermined. LE Group said it agreed with that in principle and would like to see undertakings take the following form:

(a) no more than 15 per cent of capacity at Rough to be reserved to Centrica;

(b) 65 to 70 per cent of capacity at Rough to be offered on long-term contracts commencing storage year 2004/05, contract length to be three to five years' duration;

(c) 15 to 20 per cent of capacity at Rough to be offered on annual contracts to ensure that new entrants had access to Rough;

(d) the sale of capacity to be on non-discriminatory terms with indexation to UK or European gas prices if parties buying storage requested such contracts;

(e) holdings of capacity by any one party to be limited to 15 per cent (as in the original BG Storage undertakings);

(f) the 'use-it-or-lose-it' principle to apply to all capacity at Rough; and

(g) incremental expansion at Rough to be free from the undertakings regarding the sale of capacity in order to incentivize Centrica to make more capacity available.

7.21. LE Group also agreed with Ofgem that there should be strict separation between Rough and Centrica's trading arms, BGT and Accord. In particular, there should be no disclosure of information relating to the use of Rough by individual market participants, and no disclosure of aggregate information that was not at the same time available to the market as a whole.

7.22. LE Group noted that Centrica had indicated its willingness to pay market rates for its capacity at Rough as determined through the auctions. LE Group believed that it would be preferable for Centrica not to be able to bid directly in the auctions. Whilst it was happy for Centrica to pay market prices for the same product, it would not want the price to be artificially influenced by Centrica as a participant in the auctions. Centrica should indicate how much capacity it would need at any one time, in line with prevailing auction timetables, and pay the weighted-average price for capacity for the same product in the same period.

7.23. LE Group believed that an auction process was the best way for market participants to purchase Rough storage capacity. It envisaged that the prices set by auction would provide the baseline for the price to be paid by Centrica, and therefore believed that a substantial volume should be made available though this process. Indeed, it believed this to be Centrica's intention. Any bilateral sales should only take place after the auctions: this would prevent the auction price being talked up beforehand through the process of bilateral negotiations. This would also minimize the potential and incentive for Centrica to influence forward market prices in order to profit under its indexation deals, which would have been struck at current market prices. LE Group suggested that Centrica should not be able to use unsold capacity. This would encourage realistic reserve prices and the active selling in the bilateral market of any capacity available.

7.24. LE Group expected Centrica to be incentivized to develop the storage capacity at Rough provided incremental expansion was free from undertakings regarding the sale of capacity. This was necessary if the UK was to increase its storage capacity to around 20 per cent of national demand as recommended by the European Commission. LE Group did not believe that it was necessary for Centrica to sell down its holding in Rough storage below 100 per cent and believed that, if it was forced to do so, this might be to the detriment of the future development of Rough storage.

7.25. LE Group referred to the recent debate in the gas industry surrounding the title to gas in storage facilities in light of the demise of several gas shippers in the previous year. While LE Group was happy that Rough storage was in the hands of a creditworthy company like Centrica, it hoped that Centrica would continue the drive for shippers to have the total assurance of holding title to their own gas injected into storage facilities.

Powergen UK plc

7.26. Powergen said that as a major supplier of gas to the domestic market it was concerned that, without appropriate safeguards, Centrica's purchase of the Rough gas storage facility could adversely affect competition in the supply of gas and thus be against the public interest. This concern arose because the purchase significantly increased the amount of flexibility in the wholesale gas market that Centrica controlled.

7.27. In considering Centrica's purchase of Rough, both the ownership and availability of flexibility capability for the wholesale gas market needed to be considered.

7.28. As the UK's southern North Sea gas fields depleted, production was increasingly switching to the northern North Sea fields. These fields were far less flexible and hence the amount of flexibility from swing fields was reducing. Thus, the demand for flexibility from other sources, such as storage, was increasing.

7.29. Although there were a number of storage options in the UK wholesale gas market, each one had very different characteristics, for example in size, duration and deliverability. Thus, the flexibility they gave when run optimally was very different. It was also worth noting that storage availability had remained broadly constant over the last decade, with few significant new facilities coming on to the market. There were a number of sites with planning permission for new facilities to be built. However, few of these, if they came to fruition, would have similar characteristics to Rough and so they would not deliver comparable flexibility to the market. Consequently, the degree of substitution for Rough from other storage facilities at present and in the near future appeared limited. Powergen believed that the only existing close substitute for Rough was Centrica's own Morecambe gas fields.

7.30. The common ownership of these two close substitutes raised the potential for distortion of competition in the market for flexibility. As well as controlling a significant proportion of this type of flexibility, Centrica was the largest supplier to the domestic gas market. This was a market where, because of the large seasonal swings in demand and limited ability to interrupt consumption, access to flexibility by suppliers was particularly important. On high-demand days, a shortage of flexibility could exacerbate any potential price spikes. Any actions by Centrica that limited the availability of flexibility to the market could distort competition to its advantage. Therefore, it was important that flexibility, whether from storage or swing fields such as Morecambe Bay, was not unreasonably withheld from the market on high-demand days.

7.31. Powergen believed that there should be undertakings by Centrica to ensure that it did not distort competition through its ownership of both Rough and the Morecambe Bay fields. The common ownership of those two assets meant that any undertakings needed to go further than those agreed with Dynegy, the former owner of Rough. Powergen believed that the following undertakings would provide safeguards:

(a) an undertaking on the availability of capacity to ensure that all suppliers could compete for the Rough storage rights. Centrica should therefore:

   (i) make the Rough storage facility available on non-discriminatory terms;

   (ii) offer the capability on standard terms approved by the Secretary of State with a variety of contract lengths, some of which should extend beyond five years;

   (iii) ensure that a minimum of 25 per cent of storage capacity was reserved for annual sales rounds;

   (iv) limit its shipping businesses to a maximum of 25 per cent of Rough's deliverability, including from any existing holdings. While Centrica's shipping businesses would be prohibited from purchasing in the primary market (hence limiting their influence on price signals) it would still be able to procure additional storage in the secondary market;

(v) ensure the continued use of the 'use it or lose it' clauses in the storage services contract, but with the modification that the offering of day-ahead interruptible services would be by a day-ahead auction that had no reserve price and carried a limit on Centrica's purchases. Using an auction in this way should prevent Centrica from pricing interruptible capacity at levels that restricted gas deliveries from Rough; and

(vi) ensure that its storage business bought and sold gas only for operational purposes associated with management of the storage facility;

(b) an undertaking on the independence of the storage business. To support the competitive use of the storage facility, the Rough storage business needed to operate independently of Centrica's supply, shipping or production businesses. To ensure this independence there needed to be:

(i) full business and legal separation of CSL from Centrica's business operating in competitive markets, whilst remaining within the same group; and

(ii) confidentiality requirements to prevent the disclosure of commercially sensitive competitor information to other supply, shipping or production businesses, including Centrica's own;

(c) an undertaking on the transparency of market information to help prevent any unreasonable withholding of storage capacity, or gas held in such storage, from the market. Centrica could achieve this by adopting the current market information obligations in Dynegy's undertakings; and

(d) undertakings to prevent the unnecessary withholding of flexibility capacity from the system on high-demand days. To this end, Centrica should undertake that when predicted daily demand levels were greater than a certain level, possibly 4,000 GWh, it would use all reasonable actions to ensure that:

(i) all capacity from Morecambe and any other swing fields which Centrica controlled was available to the market; and

(ii) physical output from Rough equalled the aggregate of the customers' nominations.

Scottish Power plc

7.32. ScottishPower said that it believed operators of storage facilities in the UK should not be subject to undertakings for a prolonged period as this had the potential to discourage new market entrants, which would subsequently lessen competition in the storage market. Further, it was confident that the existing legislative framework relating to competition, and the powers available to Ofgem and the OFT, would be sufficient to ensure that market dominance or abuse did not occur in a competitive market. However, as a transitional measure until such time as more storage sites in the UK became operational, and hence a more competitive market was created, the dominant market player—in this case the owner of Rough—should continue to be subject to some form of undertaking.

7.33. Through the acquisition of Rough, Centrica had placed itself in the advantageous position of controlling 80 per cent of Great Britain gas storage, capable of supplying 10 per cent of peak demand, in addition to its existing capacity to supply 8 per cent of peak demand via its Morecambe Bay operations. This put Centrica in a strong upstream position from which it had the potential to influence both the short-term market for gas and the acquisition and retention of customers.

7.34. ScottishPower commented that, in order to compete effectively in the retail market, suppliers had to be able to source swing gas through the purchase of storage services, flexible supply contracts or an interruptible customer base. Centrica already had significant access to the latter two methods through its legacy contracts and assets. The acquisition of Rough, alongside Centrica's ownership of the Morecambe Bay gas fields and its interruption rights under the LTI contracts, could prevent other suppliers from competing effectively with Centrica in the retail market. In particular, whilst increases in wholesale prices would affect all suppliers, they would affect Centrica to a disproportionately lower extent, providing it with the potential for greater margins at the wholesale end of the value chain and the ability to undercut competitors at the retail end as other suppliers were forced to increase prices to cover their wholesale costs.

7.35. The addition of Rough to Centrica's asset base could also adversely affect the operation of the market in electricity. Volatility in wholesale gas prices, and in particular any constraint on access to flexibility, would influence the operation of individual generators. With access to a large interruptible generating customer base there was increased potential for Centrica to distort the electricity market, a particular concern given Centrica's growing electricity retail customer base.

7.36. ScottishPower said that it agreed with Ofgem's analysis that the acquisition could lead to a substantial lessening of competition in all areas where short-term supplies of gas were demanded. It believed that if this were to be remedied solely by means of undertakings imposed for a transitional period, any such undertakings would need to be framed in a manner that ensured that they did not impact on operators of smaller storage facilities—ie the only competition. They would need to support competition across the full gas supply value chain, from production field to end-consumer.

7.37. Ofgem, in its consultation paper on the merger, had stated that any undertakings required of Centrica would have to be more onerous than those previously given by Dynegy. ScottishPower was unclear how this could be achieved, as the undertakings imposed on Dynegy had been severe, requiring 100 per cent of capacity to be put on the market and the storage operation to be ringfenced from the trading business.

7.38. If it was considered that the imposition of undertakings would provide sufficient protection across the market, then ScottishPower would suggest the following additional measures:

(a) There should be a complete separation of the storage business from the commercial and trading part of Centrica. Without this separation Centrica would have access to market-sensitive information about customers' injection and withdrawal patterns and so would have the potential to manipulate the market. This was an undertaking imposed on Dynegy, and ScottishPower believed that it should remain.

(b) As regards availability of capacity, Centrica was proposing to retain 25 to 30 per cent of Rough for its own use and to offer the remainder to the market on a non-discriminatory basis under terms similar to Dynegy's undertakings (ie through auctions or bilateral agreements). ScottishPower would find this arrangement satisfactory if the retained capacity was transparently fixed in line with Centrica's current use and was publicly advertised at that level. ScottishPower would wish to review Centrica's detailed proposals in order to comment further regarding pricing and the mechanism by which capacity would be offered. If new storage facilities entered the market, this should become less of an issue in relation to flexible gas supplies.

7.39. If the CC believed that undertakings were sufficient to ensure that the merger was not against the public interest, then ScottishPower would ask us to urge Ofgem and the OFT to use their full range of powers under UK competition law to police the undertakings. ScottishPower suggested that it might be appropriate for undertakings to be applied to Centrica's Morecambe Bay operation as it was the cumulative effect of the combined ownership of Rough and the Morecambe Bay fields that gave rise to competition concerns.

7.40. ScottishPower commented that there were not enough new entrants to provide a fully competitive storage market in the UK and thus reduce the risk of market dominance by one individual player. It agreed with Ofgem's assessment that 'regulatory solutions are not as effective in protecting customers' interests as is the operation of effective competition', and it would continue to seek Ofgem's assistance in developing a fully competitive storage market. In the meantime it believed that, as a minimum, some form of regulatory solution needed to be imposed on the dominant market player.

Gas and electricity traders

Duke Energy International Trading and Marketing (UK) Limited

7.41. Duke Energy International Trading and Marketing (UK) Limited (Duke Energy) said that it was an active gas trader within the UK wholesale gas market. Without having storage assets, Duke Energy was dependent on non-discriminatory access to storage facilities within the UK. At a time when the UK was moving towards becoming a net gas importer and when the future of nuclear and coal power was unknown, the dependence on gas had become crucial from a short- and long-term perspective. In this respect, access to storage facilities was essential to all market players, in particular because the UK gas storage market was currently under-supplied.

7.42. Through the acquisition of the Rough storage facility, Centrica held about 95 per cent of UK gas storage capacity. Centrica was also the owner of the most important swing field in the UK, namely Morecambe Bay. In short, Centrica would now control 980 GWh of fully flexible gas—not counting all the other smaller North Sea production fields that Centrica controlled.

7.43. At a time when UK North Sea production was slipping into decline, the available physical flexibility was being reconcentrated in the hands of one company. This would mean that Centrica would be the most dominant player with the potential abilities for misuse of that position. That said, Duke Energy did not oppose Centrica's acquisition. However, it felt that it was important to ensure that the UK gas market continued to be competitive and did not return to the days when the former national monopoly British Gas plc was dominating the market.

7.44. Duke Energy believed that the following remedies would be essential to maintain competitiveness:

(a) Centrica should be obliged fully to unbundle its storage facilities, ie to make them available to all market players. This unbundling should be fundamental, transparent and not limited to the extent that it had been under previous owners. Centrica should therefore be offering both very short- (within a day) and very long-term services into the market, not limited to the relatively inflexible bundles that BG Storage and Dynegy offered.

(b) Centrica should offer at least 70 per cent of its entire storage units to third parties and in so doing should offer more flexible unit auctions with a market-based price and not a 'floor price'. Centrica should not be allowed to use more than the capacity that it had utilized in the previous two or three years.

(c) All capacity sales needed to be based on a public and regulated auction procedure (preferably via the Internet). The outcomes should be published afterwards.

(d) Centrica should be obliged to keep Chinese walls between trading and storage. These should be regulated vigorously. The previous owners of Rough had nothing like the leverage that the current owner did. Failure to comply with this regulation would amount to misuse of dominant market position.

(e) Centrica should give equal access to storage information to all market players at the same time. If Centrica did not fulfil this obligation it should be made liable for all damages that this might have caused to third parties.

(f) All these procedures needed to be regulated by Ofgem and made public.

7.45. Duke Energy felt that, through the introduction of these remedies, the UK gas market would continue to be competitive and the consumer would benefit.

Entergy-Koch Trading Europe Limited

7.46. Entergy-Koch Trading Europe Limited (EKTL) said it considered that the acquisition of the Rough and Easington assets by Centrica raised sufficient competition issues to be subject to regulatory remedies. The key issues related to the changing market power in the relevant markets, the operation of the assets in this new environment, and the internal organizational arrangements.

7.47. EKTL considered that the relevant market was the gas flexibility market. This included storage, demand-side participation and swing capability in fields and interconnectors. Centrica's acquisition represented a significant increase in its share of the flexibility market. EKTL made the following points:

(a) The size of the flexibility market had not altered significantly since it was previously examined when Dynegy acquired Rough and Hornsea. There were plans for some additional storage and interconnector assets, but these were either relatively small projects or would take some considerable time to complete.

(b) New storage projects were likely to face tougher planning environments and would not benefit from the favourable financial arrangements that had encouraged the building of the Rough storage facility and the Morecambe Bay swing fields.

7.48. The demand for storage services had increased in recent years as fields in the southern North Sea gas basin had decreased in flexibility, there had been an increase in the number of gas marketers and there was some fragmentation in offshore field ownership. These changing structural factors increased the role of trading for intermediary activity and hence the value of storage and flexibility services.

7.49. Centrica had offered some initial views on remedies that were related to the organizational structure and the level of its own use of Rough services. EKTL considered that these measures were inadequate and not well defined:

(a) Centrica should not be allowed to reserve significant amounts of capacity, as this placed an immediate squeeze on the supply available to other storage users. Centrica should be competing with other users for access to storage services (although there would have to be close scrutiny of deals to ensure that Centrica did not inflate values, knowing that its own costs would simply be intra-group transfers).

(b) Centrica would have the opportunity to build on its primary purchases of storage services through the secondary market. Reservations of significant amounts of primary capacity would only act to reduce Centrica's secondary market activity, to the detriment of trading liquidity.

7.50. EKTL believed that Centrica must be required to have a high level of separation of the storage business from its other business activities. This would provide some assurance that commercially confidential information held by the storage business was not shared with the trading arm of Centrica. The way the assets were operated was also important. Storage customers needed to be confident that they would have access to the assets on a non-discriminatory basis and that the products were designed to allow secondary market trading. The storage operator had a role in promoting a secondary market in storage services by using standardized contracts and providing systems and arrangements to facilitate trading.

7.51. EKTL noted Centrica's obligations under the statutory third-party access requirements to offer storage services on a non-discriminatory basis. It believed that Centrica should be able to sell services on a bilateral basis, as long as any unsold services were offered via a clearing mechanism such as an auction.

7.52. EKTL suggested that its experience in conducting bilateral contract negotiations for storage services might be helpful to our considerations. It had found that Centrica promoted storage services on either a fixed price or index-based approach, plus a factor relating to the optionality in the service. The index price was calculated as a summer versus Q1 basis, but Centrica had proposed that the Q1 calculation be based on a shortened period covering only February and March. EKTL, in discussing storage beyond 2003/04, had asked for the index to be based on the spread between the entire winter and entire summer periods, but Centrica had sought to insist on its preferred approach. EKTL had concerns about this, as a price index was far easier to manipulate when it was based on short periods. Following the announcement of the referral to the CC, Centrica had contacted EKTL to say that it was more relaxed about the choice of index period after 2003/04 (subject to some change to the multiple).

7.53. The key concern from a trading perspective was that the marketing of the Rough services was clearly designed to remove much of the available rent from storage services acquired for trading purposes. This, in addition to the retreat of some trading companies from the market, had potentially changed the mix of storage users.

7.54. A reduced emphasis on trading companies could change the way in which storage services were used. Whilst traders would sell into markets at peak prices and buy back at low prices, leading to a more steady price regime, some other storage users might have different motivations for not dampening prices through the release of storage gas.

7.55. EKTL considered that there could be a range of appropriate remedies. Undertakings could include:

(a) appropriate levels of business separation, which would contribute to confidence over the protection of commercial information. Any consideration of separation should include an assessment of the relationship between Centrica and Accord;

(b) a limit on Centrica's own use of Rough, with specifications about the minimum type of services that it had to offer. Whilst EKTL would not expect Centrica to move away from the concept of SBUs, it would be comforting for Centrica to provide more detail on the services it expected to offer; and

(c) some way of assessing whether Centrica was aiding the development of the secondary market. Ofgem should be able to monitor whether Centrica was creating unnecessary barriers that might artificially restrict the available supply. Artificial barriers might relate to business processes such as enabling systems for trading and product design.

Stronger undertakings could include:

(d) either physical or contractual divestment of some flexibility services by Centrica. Flexibility services could include Rough storage and beach swing services. For example, Centrica might be required to offer a certain amount of swing services from its Morecambe fields;

(e) Centrica to be prohibited from reserving capacity at Rough. Centrica should procure storage services on an arm's length basis in competition with other storage clients. Transparency in procurement would create more confidence that the services were being offered on a non-discriminatory basis; and

(f) close monitoring of potential index-priced storage manipulation.

Gasunie Trade & Supply

7.56. Gasunie Trade & Supply said that its parent company (NV Nederlandse Gasunie) had no objections to or comments on the merger.

Sempra Energy Europe Limited

7.57. Sempra Energy Europe Limited (Sempra) said that it had concerns about the potential for the behavioural remedies being proposed to distort the Great Britain gas market and stifle innovation. In particular, it believed that undertakings to control the way Centrica nominated the output of the other fields under its control would only be partially effective and would represent a retrograde regulatory step. Sempra much preferred a structural solution to competition issues, as this tended to be more permanent and less distorting. Sempra agreed with Ofgem's view that divestment would be a more appropriate response to the detriments raised by the transaction.

7.58. Sempra said that each time the Rough storage facility had been sold, first by BG Group and latterly by Dynegy, it had been by private sale rather than an open tender. Sempra had no complaint about this, as a private company was entitled to sell its assets by any means it wished. However, it was important to stress that Sempra believed there were other financially strong companies (including Sempra) which would be interested in owning Rough and for which any potential conflict with their other business interests would be minimal.

Gas transporter

National Grid Transco plc

7.59. NGT said it did not consider that ownership of Rough by Centrica as opposed to Dynegy was likely to be against the public interest, but rather that safeguards should be put in place which sought to ensure that any owner did not abuse the market power associated with ownership of Rough.

7.60. The key issue for NGT was whether or not the merger might be expected to affect NGT's ability to meet its obligations. Above all, NGT would wish to ensure that it could continue to operate its gas transmission and distribution networks safely and securely, while also seeking to meet its obligations with respect to economic and efficient system development and operation. Against this background, the two relevant issues were NGT's requirement for storage services and its role as residual system balancer.

7.61. NGT's requirement for storage services arose from its obligations to maintain safe and secure gas supplies. This led to it holding gas in reserve which could be injected into the system at short notice should the need arise. The two classes of reserve gas held by NGT were known as Operating Margins and Top-up, with Rough generally being used primarily for Operating Margins purposes.

7.62. Operating Margins was gas held in store for the express purpose of managing the security of the system if certain unusual, yet specific, events were to occur. These included:

(a) circumstances where the system could not be kept in balance through use of the market mechanisms generally relied on for this purpose;

(b) major offshore gas supply failure;

(c) failure of any plant or equipment on NGT's network; and

(d) a need to maintain safe operating pressures in the event of an emergency where the system was required to be run down in an orderly fashion.

7.63. The Operating Margins requirement was calculated by assessing the impact and probability of a combination of scenarios which could lead to a national gas supply emergency, and the potential duration of a combination of the specific events identified above. The most appropriate mix of services was selected and procured at a number of sites in order to provide diversity in security of supply. These included the Rough, Hornsea and LNG storage sites.

7.64. Where gas shippers had not filled or booked sufficient storage capacity to ensure that their collective firm demand could be met under severe demand conditions, NGT was obliged to top up the supplies in store to ensure that, in aggregate, there was sufficient gas available to satisfy the projected severe demand. The scale of this obligation could therefore vary from time to time, but no top-up gas was held in Rough at the present time.

7.65. NGT believed that it was important for it to be able to continue to procure the services it needed to meet its obligations from as wide a range of suppliers as possible. In terms of Operating Margins and Top-up, Rough was an important part of the potential market. Transco would, therefore, have concerns were the merger to lead to storage capacity being withheld from the market, ie if capacity was not offered in a manner which might be expected were the market competitive.

7.66. The commercial arrangements which applied in the Great Britain gas market were designed to provide incentives for all players to balance their inputs to and offtakes from NGT's network. However, precise and continuing physical balance of the network was not necessarily achieved. NGT therefore had a role as residual system balancer. In this capacity, it was an active market player, taking actions to ensure that its network could be expected to operate within acceptable physical limits which did not threaten the safety or security of the network.

7.67. A key feature of the competitive UK gas market was the NBP market. NBP trading provided a high degree of liquidity and transparency to all market players. This benefited all gas users—large I&C loads as well as smaller consumers—since gas shippers and suppliers had ready access to gas at competitively determined prices, and gas producers had ready access to a market for their product. However, one feature of this market (and other UK gas-related markets such as that for entry capacity) was the notional nature of the underlying commodity, ie NBP gas was a paper right rather than physical gas. Whilst this had undoubted benefits for gas shippers (and by implication their customers), it did cause some difficulties for NGT.

7.68. The NBP market contrasted with the situation NGT faced on its electricity transmission system. NGT had direct commercial tools which it could deploy to deliver physical decreases or increases in the production of, or demand for, power. However, the notional nature of the markets in gas (especially for NBP gas) meant that, day to day, there was minimal direct control that Transco could exert, commercially or operationally, when seeking to retain system balance.

7.69. NGT sought instead to balance the system (ie match supply and demand to the extent that shippers failed to do so) through the purchase and sale of gas on the OCM. These purchases were of ‘title’ gas, ie notional gas as seen at the NBP. For example, if the system was short, NGT would seek to buy gas. This resolved the imbalance in two ways: by buying the volume directly and by causing market prices to rise, thereby increasing the incentives on shippers to balance. The movement in market price encouraged ‘short’ shippers to acquire extra gas from other parties, to bring more gas on to the system themselves, or to instigate demand management measures. Rough was an important contributor of the flexibility needed to respond to the incentives and ensure appropriate balance. It was the largest gas storage facility in the UK and was sufficiently flexible to make it one of the loads which was most responsive to changes in OCM prices.

7.70. If NGT was to be able to continue to rely on the OCM as the primary means through which its residual system balancer role was fulfilled, a number of competing market participants must have load/production that they could increase or decrease at short notice. Other than in respect of small quantities of ‘reserve’, the UK gas regime did not provide for NGT to hold storage or gas to balance the system—shippers alone did this. NGT would therefore be concerned if the merger were to constrain the number of shippers/traders that held Rough capacity and were able to nominate and deliver large load changes on a fully market-responsive basis.

7.71. Thus NGT considered that the merger could operate against the public interest if it were to lead to constraints on parties’ ability to access and use Rough. However, NGT considered that the ownership of Rough was not critical in this respect, but rather that safeguards should be put in place to ensure that any owner did not abuse the market power associated with ownership of Rough. Extension of the safeguards previously agreed by both BG Storage and Dynegy would seem appropriate, ensuring that Rough capacity was available to all market participants on non-discriminatory terms, both on a forward basis and particularly on an interruptible basis for short-term optimization.

7.72. NGT said that it had noted the suggestion in the remedies statement (see Appendix 2.2) that Centrica might reserve up to 20 per cent of the nominal capacity for its own purposes. NGT said that the CC might consider extending this such that no single party could initially acquire more than 20 per cent of the nominal capacity, with any further holdings having to be acquired in the secondary markets. The remedies statement also suggested that CSL might retain the SSC and either alter its terms only with the agreement of a majority of users, or regularly review with all users the terms of services offered with a view to agreeing amendments to the SSC. NGT believed that the SSC was a useful vehicle for ensuring that Rough capacity was available to all market participants on non-discriminatory terms. NGT would be concerned if it were possible for these terms to be altered by users of Rough without due regard being paid to the interests of potential competitors. As an additional safeguard, the CC might like to consider whether it would be appropriate for Ofgem to be given a right to veto any proposed changes to the SSC.

Large energy customers

Corus UK Limited

7.73. Corus UK Limited (Corus) said that Centrica’s purchase of the Rough gas storage field and the Easington gas processing facility from Dynegy represented a substantial lessening of competition.

7.74. Corus did not believe that a suitable regulatory remedy would be achieved by obliging Centrica to give the same undertakings as had been given by Dynegy (ie an obligation to offer 100 per cent of the storage capacity available to market participants, combined with an undertaking to establish a clear separation of the storage business from other parts of the group). Centrica’s market position in the UK was very different from what Dynegy’s had been at the time it purchased the Rough storage facility, especially taking account of Centrica’s ownership of the Morecambe gas fields and its position in the domestic gas and electricity supply markets.

7.75. Corus was sceptical as to whether any long-term separation of the storage business from Centrica’s other trading business could be achieved. From a regulatory perspective, the separation of the storage business from the rest of Centrica’s business would have to be absolute. If the Chinese walls were to fail for any reason, the result could be detrimental to competition. Corus was also mindful of a previous MMC recommendation which, in order to facilitate competition, called for the legal separation of the storage business from the rest of British Gas plc.

7.76. Another reason for not supporting a regulatory solution was that undertakings did not always endure. For example, Powergen had given an undertaking in 1996 to the Secretary of State that it would not acquire or exercise material influence over Midlands Electricity Board Limited. Subsequently, in 2002, Powergen sought, and was granted, leave to be released from its undertakings. As a result, Corus was concerned that Centrica might similarly provide undertakings to the Secretary of State to remedy competition concerns in its purchase of Rough, only to seek, at a later date, dilution or waiving of the undertakings.

7.77. For the reasons given above, Corus said that consideration should be given to requiring Centrica to divest itself of the storage assets recently acquired from Dynegy, or possibly of other swing assets, for example the Morecambe gas fields.

NHS Purchasing and Supply Agency

7.78. NHS Purchasing and Supply Agency said that it purchased over 6.4 TWh of gas a year and had over half of that figure on monthly contracts tied to the performance of the spot market. It considered that the acquisition by Centrica of storage assets presented a potential for abuse under present rules.

7.79. NHS Purchasing and Supply Agency said that it had proposed to Ofgem in the past that if information on levels of storage were readily accessible to all parties, as was the case in a number of international gas markets, the potential for abuse would be considerably diminished.

Northern Ireland Electricity plc

7.80. Northern Ireland Electricity plc (NIE) said that it owned and operated Northern Ireland's electricity transmission and distribution system and also acted as an electricity supplier to the franchise and eligible markets within Northern Ireland. NIE's Power Procurement Business had a portfolio of Power Purchase Agreements with privately-owned generators and the costs of these agreements were recovered via its regulated Bulk Supply Tariff, which was largely charged to suppliers of smaller franchise customers. The largest generator under contract to NIE was Premier Power Ltd, which owned and operated Ballylumford power station. This station was primarily fuelled by gas supplied under an LTI gas supply contract with Centrica. However, this contract did not cover all the gas requirements at the site and NIE, in conjunction with Premier Power Ltd, made arrangements for additional spot-market gas delivery. The spot gas purchases were managed to ensure that, over the year, gas was made available as cost-effectively as possible.

7.81. Whilst a large proportion of NIE's gas requirements were supplied under the LTI contract with Centrica at largely predetermined prices, NIE still bought gas in the market and the interruptibility of the LTI contract could be exercised more frequently if gas prices were to increase. NIE was concerned that the proposed merger could have a serious impact on competition within the relevant product and geographic markets; on the level of spot-gas prices incurred by NIE as an end-user and ultimately by its customers; and on the quality of service under the LTI contract.

7.82. NIE said that there could be no doubt that reducing the competitive tension within the gas storage market would create a significant risk that Centrica would be able to exploit its dominant position and market power in both the supply and storage markets. This risked distortion of the market, particularly in relation to the price of gas on the spot market.

7.83. Over the course of winter 2002/03, NIE's LTI contract had been interrupted for 26 days (out of a maximum of 55). Whilst the number of interruptions did not give NIE undue cause for concern as regards maintaining generation and ensuring security of supply (since NIE had heavy fuel oil as back-up), the duration of interruption and cost implications did. Centrica had interrupted supplies when the spot market price had been lower than the LTI price. NIE was concerned that Centrica was interrupting earlier and sustaining interruptions longer in order to fill gas storage and maximize its opportunities for selling stored gas when the prices were higher. In addition, other interruptions had coincided with periods when the market price was higher than the LTI price. In such circumstances Centrica could have received additional revenue by immediately selling the gas into the market.

7.84. NIE was concerned that, as Centrica increased its storage capacity, it might interrupt the LTI contract more often and also force spot prices higher. This would have a significant impact on electricity customers in Northern Ireland, and it was for this reason that NIE had substantial concerns about the merger. NIE supported the proposed remedies which the Office for the Regulation of Electricity & Gas had proposed (see paragraph 7.154). In addition, NIE said that a provision in the LTI contract which prevented the gas supplied from being traded on into the wider market was no longer appropriate and limited the scope to mitigate the excess costs imposed by the contract. NIE invited us to consider recommending a modification of this provision in order to prevent Centrica from abusing a position of dominance.

Oil and gas producers

Eni UK Limited

7.85. Eni UK Limited (Eni) said that it did not oppose the Centrica/Dynegy merger but believed that a number of safeguards were needed to ensure that it did not result in any erosion or stifling of competition in the UK gas market.

7.86. Eni largely agreed with Ofgem's initial views that the merger represented a substantial lessening of competition in the UK gas market. It made the following observations in support of that view:

(a) As outlined in the Ofgem consultation paper, Centrica's position in the UK market was already far more dominant than Dynegy's had been during the period when Dynegy was actively trading in the UK. Centrica had a dominant or significant position in gas production, shipping, trading and customer supply. The addition of 85 per cent of UK gas storage to its portfolio would complete Centrica's dominant position across the whole of the UK gas trading industry.

(b) The importance of gas storage in the UK market was set to increase over time as North Sea swing fields declined. This decline would reduce the availability of peak capacity gas in which Centrica already had a strong position through its ownership of the Morecambe Bay gas fields. Hence Centrica's position as the owner of Rough would become even more significant.

(c) Access to storage or other peak capacity supply was essential for supplying domestic and other small customers in the UK gas market, as their demand was mainly weather-driven. For Centrica to maintain a dominant position in storage and peak capacity supply would hinder others' ability to supply domestic customers competitively. The end result would be higher gas prices for end-users.

7.87. Eni believed that the following undertakings by Centrica would be needed in order to address the competition issues surrounding its ownership of Rough:

(a) continuation of Dynegy's previous undertaking that 100 per cent of storage capacity be put into the market;

(b) continuation of Dynegy's previous undertaking with respect to a robust separation of the storage business from the trading business. This should include physical separation of the offices;

(c) a significant proportion of storage capacity to be made available in annual auctions;

(d) minimum volumes of 20 per cent of capacity to be made available on a one-year basis through an auction process on a standard storage contract. Having only small volumes of unsold storage available through auction caused the auction results to be artificially high and reduced transparency;

(e) an additional 30 per cent of capacity to be available through the auction process and sold for periods up to five years;

(f) the remainder of capacity to be available for sale through bilateral contracts either as SBUs or shorter/longer-duration contracts. Any capacity remaining unsold should be included in auctions

each year. Any elements of capacity (injection, withdrawal, space) remaining that could not be made into a bundled unit because of non-standard contracts previously sold should be auctioned each year after the auctions for SBUs;

(g) anonymous results of auctions, including amount sold, minimum paid, maximum paid and weighted average price, to be made publicly available;

(h) no storage contracts to be sold on index-related prices, as index-related prices would allow the possibility of market manipulation by Centrica;

(i) a maximum of 20 per cent of capacity to be held by internal customers of Centrica on firm contracts;

(j) all unused injection and withdrawal on a day to be made available on an interruptible basis to storage customers on a non-discriminatory basis. Interruptible space also to be made available, on a similar basis;

(k) incremental expansion at Rough to be subject to all undertakings by Centrica. Centrica was already incentivized to examine the possibility of expanding capacity at Rough due to the extra tariff income generated by expansion of capacity. Hence no further incentive for Centrica (such as being free from these undertakings) was necessary to encourage Centrica to expand the facilities; and

(l) all undertakings given by Centrica should continue in perpetuity. The increasing importance of gas storage in supplying the UK gas market meant that transparency of storage transactions and access to gas storage by all market participants was vital to competition and efficiency in the market. It would, therefore, be undesirable for Centrica's undertakings to expire in the future. Ofgem had suggested that six years would be sufficient, this being the time that Centrica's position with respect to substitutes for Rough could be expected to last. Whilst this might be the case, the Morecambe gas fields' depletion, along with the expected overall supply deficit in the UK, meant that Rough storage would become even more important in the market. In Eni's view, this made it desirable for Centrica to be bound by undertakings for an extended period.

7.88. Eni believed that these measures would provide a practical and pragmatic solution to the potential problems resulting from the merger.

Amerada Hess Limited

7.89. Amerada Hess Limited (Amerada) said that it neither participated in the UK's downstream gas market nor had any requirement for gas storage services, and therefore it did not seem appropriate for it to comment on certain competition issues. However, it had an interest in the York gas field, which was situated in the southern North Sea, adjacent to the Rough storage facility. The York gas field had lain dormant for some ten years since it was first discovered. The historical relationship between Rough storage and the York gas field, both technically and commercially, required the full cooperation of the owners of Rough storage before any development of the York gas field could proceed. Accordingly, Amerada had a direct interest in the ownership of Rough storage and could comment on the effect of the merger on future development of the facilities acquired and capital structure and financing.

7.90. Centrica had indicated its interest in expanding Rough storage by increasing the facility's capacity and deliverability. Centrica held equity in the York gas field and Amerada had already held positive discussions with it, which had resulted in the conclusion of a cost-sharing agreement and budget. The aim was to conclude a development plan by mid-2003.

7.91. Amerada was keen to see an expeditious conclusion to the regulatory approvals process so that Centrica could fully commit itself to the evaluation of the various technical and commercial development options for the York field. The evaluation would include detailed discussions with owners of infrastructure in the area, including the Rough facility.

7.92. If the acquisition received regulatory approval, Amerada would like to see Centrica given the appropriate degree of commercial flexibility to incentivize the expansion of the Rough facilities and the development of the York gas field. Whether expansion of the storage capacity was for Centrica's own benefit or to increase the prospect of third-party access, any undertakings required should allow Centrica to make a commercial rate of return on the acquisition and on future incremental investment.

7.93. If the acquisition failed to secure regulatory approval, the expansion of Rough storage and the development of the York gas field were unlikely to proceed in the foreseeable future. Furthermore, it might not be easy to identify an alternative buyer, in today's depressed energy market, for a regulated facility valued at over £300 million.

7.94. Amerada commented that Centrica had experience of UK offshore operations (for example, Morecambe Bay) and had the financial strength to fund the acquisition and finance the expansion of Rough storage and the development of the York gas field. Centrica had experience of conducting operations in a regulated environment and appeared well suited to owning and managing the UK's largest gas storage facility.

BP Gas Marketing Limited

7.95. BP Gas Marketing Limited (BP) said that it believed the issue of gas storage was critically important for the UK as it moved to an era of import dependency and a growing deficit of swing production to meet UK peak day requirements.

7.96. In view of the nature of Centrica's business interests in the UK, BP considered that the merger raised a number of important issues of concern. The scope of Centrica's activities, particularly its gas supply position, meant that the merger must be considered holistically and not as an isolated acquisition of storage assets. For example, one important issue was the potential impact of the acquisition on the competitiveness of the domestic gas supply market. BP was reassured that Ofgem, in its analysis, had recognized the conflict between Centrica's ownership of Rough and the Morecambe gas field and the potential impact which this might have on the provision of flexibility services to the wider market.

7.97. BP was confident that Centrica had the commercial and technical expertise to manage Rough in a safe and proficient manner but believed that there were potential conflicts with its other business activities. All existing and prospective users of Rough required assurance that they would continue to have access to storage on a fair and non-discriminatory basis and that there would be full legal and operational separation of the new entity.

7.98. Rough was the provider of the majority of the UK's seasonal storage capacity. Whilst BP was starting to see a number of new storage products and services being developed, none of these was sufficiently material to challenge the key position enjoyed by Rough. It was doubtful that Rough would face competition from any new UK seasonal sites for some time. One major reason for this was the cost of developing new facilities. It was estimated that the capital costs incurred at Rough had been of the order of £750 million plus the significant additional costs of cushion gas. It was unlikely therefore that many players would currently undertake such an investment, to convert depleted fields, on the basis of a perception of future spot and seasonal price variations.

7.99. In view of Centrica's pivotal position resulting from the merger, BP believed it was imperative that the level of protection offered to users of Rough should not be diluted. It considered that there were strong arguments for the undertakings given by Dynegy to be reviewed, strengthened and extended.

7.100. BP was concerned to note that Centrica had proposed to reserve, for its own use, between 25 and 30 per cent of total Rough capacity. BP did not believe that any user should enjoy any preferential access to these storage services. On the contrary, its view was that any user should be required to participate, along with others, in transparent and non-discriminatory auctions as the primary method of capacity release and that the rules for those auctions should be modified only with the agreement of Ofgem and after discussion with users of the services.

7.101. BP did not believe, however, that Centrica should be constrained from developing a wider range of storage products and services to meet the future needs of its storage customers. The existing undertakings expired at the end of the storage year beginning on 2 May 2003 and BP did not think that the storage market would have developed sufficiently in a competitive manner to obviate the need for further undertakings beyond that date. It was vital therefore that Ofgem initiated its proposed review of the gas storage market so as to lessen any uncertainty for users beyond the end of April 2004.

7.102. BP said that, whilst the issue of ‘title to gas in store’ remained unresolved, it believed that Centrica was sympathetic to the concerns of users and would therefore be keen to seek a speedy and mutually satisfactory resolution to the matter. The concern arose from the fact that under the SSC, which all storage users had to sign, the operator of the facility was given title to the gas while it was in storage. It was then obliged to return that gas in accordance with the users’ nominations. The concern had been that, in the event that the storage operator encountered financial difficulties, a liquidator or administrator could exercise rights to ignore the contractual obligation to return the gas and might sell the gas to third parties. BP said that it would like to see a commitment from Centrica that all future storage contracts would be restructured so that its customers took title to their gas while it was in storage.

7.103. The wide scope of Centrica’s commercial activities reinforced BP’s view that it was essential that there was full operational separation of both Centrica’s storage and onshore processing businesses from the rest of its businesses. This would provide assurance to users of those services that none of Centrica’s other entities would have access to commercially sensitive information and would not then be in a position to exploit or abuse a privileged position. Whilst BP recognized that Centrica would be subject to general competition law in its activities, it would nevertheless like to know how Ofgem intended to monitor Centrica’s behaviour on an ongoing basis.

Marathon International Petroleum (GB) Limited

7.104. Marathon International Petroleum (GB) Limited (Marathon) said it considered that the merger would be acceptable subject to the following points. Following the merger, there were two operators of natural gas storage in the East of England compared with one before the merger took place, as Dynegy had sold Hornsea to another UK utility. An important question was the amount of gas storage available relative to other countries in Europe. This was important as the UK would begin to face shortages of domestic gas relative to its daily use in the future. With indigenous fields on the decline, and with the need for imported gas growing rapidly, the need for new investment in gas storage capacity had become apparent. Marathon believed that investment in new storage or in existing storage should be encouraged. This had been borne out by figures from Lambert Energy Advisory showing that the UK had only a quarter of the natural gas storage facilities of its comparable gas-importing neighbours.

7.105. Marathon said that its views on the specifics of the merger were as follows:

(a) As to competition within relevant product and geographic markets, Rough currently represented 76 per cent of UK storage capability, with delivery capacity of nearly 30 per cent of total current storage deliverability. It was, therefore, clearly strategically significant in the current UK storage portfolio. Until such time as sufficient new investment in storage (or other load-balancing mechanisms) had emerged, Rough would remain a dominant element of the UK storage services market. It was important, therefore, to have a regime for access to storage services which was open, transparent and non-discriminatory. As a condition of the merger, adequate undertakings should be sought to achieve these access objectives in respect of uncontracted storage space.

(b) With regard to the effect on customers, any potential adverse impacts could best be avoided by ensuring equitable access to storage services by all competing players. Physical separation of the storage management function from other Centrica activities was essential.

(c) The merger should have little effect on the level of imports as this was a function of the open market. It was true that the UK would have to import a large amount of natural gas beginning seasonally in 2005 (according to the DTI), but this was unrelated to any effect of the merger. Furthermore, Rough could be considered to be in competition with European storage via the Bacton interconnector. The overall UK balance of supply and demand would in practice, however, drive the level of UK imports and exports so that the merger would not in itself be significant.

(d) With regard to the effects of the merger on level of prices, quality of service and development of assets, a non-discriminatory access regime would enable prices for storage services to reflect market conditions in competition with other load-balancing mechanisms such as storage in mainland Europe, beach swing, interruptible supplies and related fuel switching (including the impact of power generation fuel switching). Marathon thought that we should consider recommending undertakings on minimum quality of service, perhaps in the form of minimum standard

contract terms for non-discriminatory access purposes incorporating 'use-it-or-lose-it' principles to help stimulate secondary markets in Rough storage. Market forces should be the driver of any further development of these and other storage/load-balancing facilities. Marathon believed that, in the future, a number of new storage fields would be proposed.

(e) Given its strategic significance, Rough was an important contributor to security and reliability of gas supplies. Whilst the proposed merger should not in itself have an adverse effect on this, steps should be taken to ensure that this position was not undermined.

Petro-Canada UK Limited

7.106. Petro-Canada UK Limited said that it had no objections to the merger.

Statoil (UK) Limited

7.107. Statoil said that it was responsible for the marketing in the UK of potential supplies of its parent company's Norwegian equity gas and the Norwegian state's equity gas. The UK market was of great interest to Statoil because of its size, its proximity to Norway and its prospective gas supply shortfall in the next few years. Statoil believed that the merger was significant to the gas industry and that it would affect the role of storage in that industry. Storage was of key strategic importance in managing the potential shortfall of gas supplies. Because the Rough facility represented 85 per cent of storage in the UK, appropriate regulatory safeguards should be put in place, irrespective of who owned it, to ensure that it was managed in a way that would promote competition.

7.108. In Statoil's opinion there was unlikely to be much competition with Rough from other storage facilities. The position of storage in the UK had changed little since the last review of storage by Ofgas in 1998. New storage facilities were small and did not perform the same functions as Rough, and any further new storage facilities were unlikely to be ready for some time. Whilst Statoil did not object in principle to Centrica's purchase of Rough, it considered that it would be appropriate for statutory undertakings to be required and that any such undertakings should be in place beyond the expiry date for previous undertakings of April 2004.

7.109. Expanding on its main points of concern, Statoil said that Rough had a unique position in the UK as a long-duration storage facility, which was designed and built as an integral part of the supply/demand match in the UK. It had been assumed that, in order to achieve such a match, Rough would provide support in periods of sustained high demand. Furthermore, the main sources of competition for Rough storage did not provide the same service: Rough was sufficiently distinct from other forms of flexibility that ownership of a significant proportion of the facility should cause competition concerns. Rough provided a long-duration service of up to 67 days' withdrawal when the site was full. No other storage facility in the UK had similar capabilities to this. It provided a seasonal storage service which enabled users to manage their exposure to demand swings and gas prices across the year between winter and summer. Although other sites could provide some seasonal storage, they tended to cycle more frequently and benefited from different patterns of use from those of Rough. They were also considerably smaller. Although the percentage of the overall market accounted for by Rough might reduce in future as other sites were commissioned, Statoil did not think that there would be any sites of significant size to challenge the dominance of this facility or its uniqueness.

7.110. It would therefore be appropriate to ensure that any owner of Rough was subject to statutory regulation, controls and monitoring until effective competition existed in UK long-term storage.

7.111. Statoil commented that Centrica was a significant player in many areas of the market, including wholesale trading through Accord and BGT and in the supply market at both domestic and I&C level. Furthermore it had upstream resources including deliveries through the Barrow terminal, which provided substantial levels of swing. If Centrica were to control 85 per cent of the storage market there would be a perception that opportunities might exist for it to use this dominant position to influence the market, whether this was actually the case or not. Statoil suggested that the perception of dominance could deter competition in a market as much as the actual conduct of market participants. It was, therefore, advisable for preventive measures to be in place to provide sufficient safeguards for competition and to ensure that market participants were comfortable with the rules governing access to storage and protecting those rights already held in storage. Statoil believed that the statutory undertakings given by Dynegy should be transferred to Centrica storage. However, given Centrica's position in the market and the specific nature of the Rough facility, Statoil considered that further undertakings were needed.

7.112. Statoil said that information about the activity of Rough and the requirements of those who used it was sensitive and commercially important. It was essential that the storage business should be legally, robustly and physically separated from any trading activity within the Centrica group. This would remove concerns of other companies using Rough storage and trading with Centrica about the information advantages which their counter-party might hold, for example about their commercial positions with regard to the price at which storage was purchased and the nominations of gas from day to day.

7.113. Centrica had confirmed that it currently contracted for approximately 25 per cent of the storage sold in Rough. Statoil agreed that these contracts should be honoured: under a fully separated company this would not be an issue, as any Centrica company would access storage on the same basis as other users. However, should Centrica wish to contract further for storage, or when it renewed its existing requirements, Statoil considered that it should be required to purchase storage under the same terms as other participants, through a standard contract. It should be required to offer 100 per cent of maximum physical capacity and to compete on equal terms with all other parties interested in purchasing storage products.

7.114. The definition of the maximum space in Rough had remained the same as that defined in the 1998 review of storage. Statoil thought it was appropriate to reassess the level of space available, taking account of any changes in the pattern of use of the facility since 1998, in order to establish if the current maximum capacity figure was still valid. Statoil said that the amount of space in Rough might have increased as a result of use of cushion gas from the facility.

7.115. In conclusion, Statoil said that it did not object to the merger in principle, but it believed that suitable undertakings were needed to ensure that competition in both storage and other markets was not affected.

Trade associations and other representative bodies

Energy Information Centre Ltd

7.116. Energy Information Centre Ltd (EIC) said that it was important to recognize that the merger might lead to Centrica holding a dominant position in the supply of gas from storage. Given that Rough accounted for approximately 80 per cent of the country's gas storage capacity, Centrica would have the potential to withhold gas at peak times to drive up prices, leading to a substantial lessening of competition.

7.117. EIC's concern was exacerbated by Centrica's market power in the supply of peak flow gas, not only through its ownership of Rough, but also as a result of its ownership of the Morecambe Bay gas field with its high degree of flexibility. As the UK was likely to become increasingly reliant on imports over the course of the next decade, the importance of gas in storage would increase substantially. Centrica's position might cause concern for the state of retail competition and the prices that both domestic and industrial consumers might have to pay in the future.

7.118. EIC believed that not only should a strict Chinese wall be established to prevent any misuse of the storage facility, but Centrica should also be prevented from reserving capacity at the storage facility. It would otherwise have an unfair competitive advantage over other suppliers and could cause further consolidation in an already shrinking retail supply sector.

7.119. In commenting on the CC's Issues Statement dated 7 April 2003 (see Appendix 2.1), EIC said that it believed Centrica had both the incentive and ability to withhold storage at Rough or its other sources of flexibility. The incentive to withhold storage might not be clear in the short term but the potential impact that such a strategy might have on its competitors in downstream markets in the long term would provide Centrica with a strong incentive to withhold storage. Centrica also had the ability to withhold storage or other sources of flexibility, as the majority of gas fields were not as flexible as

Morecambe Bay and the capacity of the interconnector was limited, especially at short notice. It was also the decision of Transco, not Centrica's competitors, whether the safety of the system had been compromised and whether interruptible contracts should be exercised.

7.120. As Centrica had both the incentive and ability to withhold storage and other sources of flexible gas, this could have an impact on wholesale prices. Centrica's argument that the costs of any such strategy would outweigh the benefits did not hold up when considering the potential impact on competitors and the barriers to entry that high winter prices and increasing price spikes would bring. Higher wholesale prices would bring greater pressure on competitors, particularly smaller competitors with no upstream assets, and create barriers to entry for potential competitors. Because of Centrica's dominant position downstream and in related markets, EIC believed that far stricter measures should be placed upon Centrica than previous or prospective future owners.

7.121. Solely as the purchaser of Rough, Centrica would have the same incentives as any other owner to invest or innovate in the management of Rough. Because its wider interests gave it the incentive to withhold storage and affect wholesale prices, however, it followed that Centrica would also have an incentive (and the ability) to ensure that it did not invest in additional capacity if required and did not offer a wide range of products and contracts.

7.122. EIC believed that one foreseeable development that should be considered was the ongoing negotiations between Transco and Ofgem over changes in interruptible contracts. It was believed that Transco currently had too great an incentive to use interruptible contracts, rather than invest in the network, and that these discussions might lead to less emphasis being placed upon interruptible contracts as a source of flexibility, except when the integrity of the network was under threat. This should be borne in mind when considering whether interruptible contracts were a close substitute.

7.123. EIC believed the following were the minimum necessary remedies:

(a) none of Rough's storage should be allowed to be reserved solely for the use of Centrica or any affiliates;

(b) all capacity should be sold on non-discriminatory terms;

(c) transparent publication and reporting arrangements should be required, including the appointment of a senior level compliance officer to ensure that no abuse of this position was taking place;

(d) there must be strict financial, legal and physical separation between the storage operation and all other parts of Centrica's business;

(e) a burden of proof must be placed upon the company's board to attest that there would be no undue discrimination against third parties;

(f) similar separation must be undertaken in the operation of the Morecambe fields;

(g) the existing 'use-it-or-lose-it' provisions should remain in place; and

(h) a minimum proportion of capacity should be sold on long-term contracts.

EIC believed that such measures would not constitute excessive regulation but would provide competitors and customers in downstream markets with a reasonable degree of protection.

Association of Electricity Producers

7.124. The Association of Electricity Producers (AEP) said that the Rough facility was a significant asset in the Great Britain gas market. It supported flexible gas supply contracts as a provider of swing gas and made an important contribution to security of supply. Given that Centrica also had access to a number of other sources of flexible gas supply, AEP believed that, without the application of stringent undertakings, the merger would be against the public interest.

7.125. As Centrica already had a significant position in the existing alternatives to Rough storage, the addition of the Rough facility gave Centrica a dominant position in the market for flexible gas supplies and lessened competition. As a result, Centrica might be able to manage capacity in such a way as to increase wholesale gas prices to its own advantage.

7.126. AEP had particular concerns over the impact on flexible gas supplies to power stations and the interaction with the electricity market. Gas-fired generators required increasingly flexible gas supply arrangements in order to manage their operations in the electricity market. Within-day and day-on-day flexibility were both required.

7.127. With the flattening of gas supply profiles at the beach in coming years, parties wishing to offer flexible supplies to customers (not only power stations) would increasingly need to secure within-day and day-on-day flexibility from other sources. The main source of such flexibility, other than beach gas, was storage and the Rough facility was by far the largest in terms of space, deliverability and duration. Through acquiring the Rough facility, Centrica would potentially have a price-setting role in the market for flexible gas supply, either directly or indirectly through other suppliers. Gas customers could face the consequences of this through increased prices, which would ultimately be reflected in electricity prices as well.

7.128. AEP said that the impact on the operation of existing LTI contracts and consequential effects on the electricity market were less direct but potentially significant. Electricity generators had, for some time, been concerned about the ownership and operation of these LTI contracts by Centrica and there had been correspondence and meetings between AEP and Ofgem on this subject. The LTI contracts had been struck with British Gas plc when it was an integrated gas supply and transportation company; this was also at a time when there were few alternative suppliers available to power stations. The contracts, which provided gas for around 5 GW of electricity generation, contained interruption terms which provided for the management of transportation constraints and supply/demand on peak days. At the time of the British Gas plc demerger, these contracts were assigned to Centrica, but the interruption terms were not altered. This had not been an issue until the concept of 'commercial interruption' emerged, when Centrica acquired the ability to interrupt the contracts for purely commercial reasons. It was unlikely that generators would agree such terms if these contracts were being negotiated today.

7.129. AEP said that in recent years Centrica had also acquired equity interests in several gas-fired power stations, predominantly those with LTI contracts, and now had an active interest in the electricity market, amounting to some 1,850 MW. This in itself raised competition concerns as Centrica essentially controlled the gas supplies to some of its direct competitors, which it might interrupt to its own advantage in the electricity market.

7.130. AEP therefore expected that stringent conditions should be applied to Centrica regarding the use of capacity at the Rough facility, in order to ensure that Centrica did not withhold capacity from the market that would force up the price of flexible gas and that it was incentivized to invest further in the facility. AEP believed, however, that wider competition issues should also be considered, including the effects on LTI contract holders and the electricity market. For example, Centrica might seek to offset any restrictions placed on its own use of capacity at Rough by interrupting LTI contracts more frequently. This would have a detrimental effect on the contract holders (Centrica's competitors), might cause short-term fluctuations in electricity prices that Centrica's own generating assets would be well placed to exploit and could affect the security of electricity supplies. AEP believed, therefore, that an additional measure was needed to address wider competition concerns. This might provide that Centrica could interrupt LTI contracts only when Transco required the specific sites to be interrupted in order to manage transportation constraints on the gas network.

7.131. AEP expected that a range of undertakings deeper and wider than those agreed by Dynegy would be required of Centrica in order to address the impact on competition that the merger would have, given Centrica's position in the energy market compared with that of Dynegy. AEP hoped that such undertakings could be monitored effectively, allowing Centrica to enjoy the proper benefits of its acquisition but without reducing competition in the gas and electricity markets.

Chartered Institute of Purchasing and Supply

7.132. The Chartered Institute of Purchasing and Supply (CIPS) said that it had considerable concerns for the future of a 'non-manipulated' gas market if the merger were allowed to stand.

7.133. The CIPS believed that Centrica was growing fast through acquisition and that this merger would almost certainly enable it to have excessive power in the gas market. Centrica's dominance of gas storage capacity, linked to its high customer base, could have the effect of holding the market to ransom and drive the market price of gas upwards at times when volume was tight.

7.134. The CIPS was also concerned about the regulation of offshore storage. Whilst the major part of Centrica's business was onshore and within the Ofgem-regulated gas market, the storage of gas had an integral part to play in the supply and price of the consumed gas, and yet was regulated by the DTI. The CIPS would like to see more involvement from Ofgem in this area.

7.135. The CIPS would like to see strong safeguards put in place to prevent or minimize the effects of commercial gaming with an asset which was likely to become increasingly important as stocks in the North Sea diminished and the UK was forced to rely more on imported gas.

Bodies representing energy consumers

Energywatch

7.136. Energywatch is a non-departmental public body that represents consumer interests, both upstream and downstream of the gas and electricity markets, as part of the UK's gas and electricity regulatory framework introduced by the Utilities Act 2000.

7.137. Energywatch said that it had particular concerns about the potential impact of the merger on competition in the downstream I&C and domestic markets, particularly because of the increased importance of storage in future energy markets and Centrica's unique dominance of the gas markets as a result of vertical integration. Energywatch said that Centrica's position created dominance for flexible gas; impacted on wholesale prices and on different classes of consumers; had a potential impact on the electricity markets; and would ultimately deter new entrants from entering the retail markets.

7.138. Energywatch said that traditionally the case for storage had been focused around achieving two commercial objectives: first, to offset winter gas prices and thus maintain long-term balance; and second, for within-day balancing actions to avoid exposure to potentially punitive cash-out prices. Energywatch commented that there were new pressures to develop storage as a result of increased importation of gas from mainland Europe. The UK had only six days of storage capacity and the EC Directive talked of six weeks being the minimum standard. Storage would therefore be strategically important in ensuring security of supply in the event of interruption for technical or even geopolitical reasons.

7.139. The UK would need to develop towards the Continental model of storage, where there was a reliance on imported gas. For example, France imported 95 per cent of its gas and in turn relied on 52 per cent of its gas from storage on a very cold winter's day.

7.140. Energywatch suggested that, given its vertical integration and wide-ranging activities, Centrica's position in the energy markets presented the CC with a unique set of problems. The merger gave Centrica dominance not only in a narrow definition of the market for storage but also for close substitutes that together comprised the market for flexibility.

7.141. On the narrow market definition, the acquisition of Rough strengthened Centrica's dominance in the market for storage in terms of deliverability. Energywatch agreed with Ofgem's analysis that LNG was more costly than Rough and suffered constrained availability and hence was not an effective substitute.

7.142. Energywatch said that it could be argued that increasing production of gas in the North Sea was an effective substitute for storage. This was true to the extent that the gas could be landed. It was important to note that Centrica was a significant producer of gas and could use this as an important source of swing gas in an uncongested terminal (Barrow) with historically lower capacity charges than others, for example St Fergus.

7.143. Demand-side reduction could be an important source of flexibility as it ultimately reduced the need to land gas in the first place. Interruptible contracts themselves had inbuilt flexibility to the extent that they could quickly reduce demand. The existing LTI contracts were a historical legacy from the demerger of Centrica and BG. They were originally designed for balancing purposes, though it was possible that they could be invoked for commercial reasons.

7.144. The Bacton interconnector was a source of flexibility, and the trade press had suggested that Centrica had contracts to flow in both directions between Bacton and Zeebrugge.

7.145. In Energywatch's view, Centrica's dominance in the storage market potentially allowed it to insulate itself from increased storage prices. Storage was an internal transfer cost to Centrica with the underlying costs remaining constant regardless of its value to distressed shippers. Energywatch said that Centrica could not argue that keeping storage in-house was an opportunity cost, as the cash-out prices for being out of balance would more than offset any benefit of selling capacity.

7.146. Energywatch said that Centrica's vertical integration gave it the ability to take profits upstream or downstream. If wholesale prices rose, it could simply pass on the costs to the consumers and take the profit from the wholesale operation.

7.147. Energywatch said that the merger reinforced Centrica's considerable market power in the downstream market. It was the largest domestic gas supplier with over 65 per cent share of supply to the domestic market. With this supply portfolio it was able to enter into long-term contracts with producers, thus hedging its position with respect to other suppliers.

7.148. The key characteristic of the domestic supply market was fluctuations in demand both seasonally and within day. It followed that access to storage was vital for those wishing to enter the market. Energywatch commented that if storage was made available, then a new entrant would almost inevitably have to contract with its biggest competitor, Centrica.

7.149. If the flexibility market failed to function effectively it would not only increase storage prices but also have an impact on wholesale and, in turn, domestic prices. Large I&C consumers were often on contracts indexed to the wholesale market. It was likely that this group would bear the brunt of the increased prices. If higher prices were sustained for a long time, it was likely that large and medium-sized users would experience price rises when their contracts came up for renewal. Given the contractual nature of this market, Energywatch could see the introduction of specific pass-through clauses to include storage costs. Although domestic consumers were the most insulated from price rises, it was the fuel poor who would experience the most difficulties in paying for their energy.

7.150. Centrica's contractual acquisition of gas-fired generation allowed the potential for arbitrage between gas and electricity markets given its dominance of the flexibility market. Its vertical integration and contractual position could theoretically allow it to interrupt its competitors' generation on days of high demand, thus exposing them to punitive charges for being out of balance.

7.151. Energywatch said that undertakings had been needed for Dynegy's acquisition of BG Storage and at least the same restrictions should apply to Centrica. It would expect there to be a wide-ranging set of undertakings that covered all the areas in which Centrica could abuse its dominance of the flexibility market. Energywatch would like to see the following addressed:

(a) the future strategic development of storage for security of supply: there was a case for an undertaking that Centrica would not develop or acquire any further storage facilities;

(b) internal transfers of storage capacity being limited to a predefined volume expressed in percentage terms;

(c) a requirement for the non-discriminatory disposal of the remaining capacity;

(d) a 'use-it-or-lose-it' requirement to avoid capacity being withheld; and

(e) a complete separation of the storage business from other Centrica businesses.

7.152. Energywatch said that if its analysis of Centrica's dominance of the flexibility market was accepted, then two further issues should be considered in the undertakings:

(a) the use of the Morecambe Bay fields for flexible gas. Morecambe could function not only as a production facility but also as an important source of flexibility. Energywatch would need to be certain that Centrica could not use the resource for anti-competitive purposes; and

(b) the use of LTI contracts, and an assurance that Centrica would not be able to use this advantage in both gas and electricity markets.

Office for the Regulation of Electricity & Gas

7.153. The Office for the Regulation of Electricity & Gas, the energy regulator in Northern Ireland, said that it wished to draw the CC's attention to the LTI contract that Centrica had for the supply of gas to Ballylumford power station. This contract allowed Centrica to interrupt up to 55 times a year. When it was signed, it was on the basis that Centrica might be obliged to interrupt for technical or supply reasons. Instead, it appeared that interruptions had occurred mainly as a result of the unforeseen ability of Centrica to interrupt when the price of gas was higher than the contract price.

7.154. Centrica's ability to obtain financial benefit from commercial interruption would be increased if its control of flexibility products was increased. Interruptions imposed a burden on electricity customers in Northern Ireland and this would be greater in future as the alternative fuel for the new power plant at Ballylumford was distillate. Potential remedies that would remove the problem of abuse of dominance could include forbidding interruption for commercial reasons; requiring a scaling back of the volumes flowed under the contract; and requiring the contract to be restructured so that Centrica would supply gas at spot prices.

Government departments

Department of Trade and Industry (Energy Markets Unit)

7.155. The DTI Energy Markets Unit (EMU) in its capacity as sponsor directorate for the energy industries said that it considered the merger gave rise to competition concerns. It said that it had concerns about Centrica's overall position in the energy market, particularly in the domestic gas supply sector. The acquisition of Rough enhanced Centrica's position in the energy market, particularly in the domestic gas supply sector, because:

(a) domestic gas supply was the area which gave most demand to peak capacity;

(b) Rough provided 75 per cent of deliverability of the storage market;

(c) the volatility of gas prices, coupled with a less seasonal variation in prices, had resulted in increased use of the storage market and the DTI anticipated that Great Britain would need more storage as it moved to becoming a net importer; and

(d) Centrica produced 90 per cent of the market for Great Britain's swing capacity (gas that could be turned on and off like a tap) from its Morecambe Bay field.

7.156. Centrica's proposed undertakings included the creation of a separate company within Centrica—Centrica Storage Holdings Ltd—which, whilst being co-located with other Centrica personnel, would reside in different offices within the same building. Centrica had also produced a code of conduct for staff in respect of controls on information flows and non-discrimination in the provision of storage services. The EMU's view was that these undertakings would not go far enough to remedy the detriment to competition if the merger was allowed to proceed. The minimum undertakings the EMU would wish to see would be separate trading operations and information flows and separate management and physical location of offices. Centrica was also proposing two ways of addressing any perceived detriment to competition: one was to apply a cap on the amount of Rough storage it could bid for at primary auctions; the other was for Centrica to auction gas which exceeded its own supply needs to other players. The EMU said that these options needed to be examined.

7.157. Storage was important for security of supply, safety and operational functions, but it was also necessary for providing physical hedging and flexibility in trading. The use of storage had been changing in recent years. Traditionally storage had been a seasonal issue whereby capacity was injected in the low summer months and withdrawn in the winter to cope with the high demand. However, the increase in liberalization of the market had resulted in increased volatility of gas prices and this, coupled with a less seasonal variation in prices (due to the growing importance of associated gas fields and European arbitrage), had led to a rise in the use of storage facilities and in particular an increase in frequency and volume of injections and withdrawals occurring. Storage capacity had been sold out in recent auctions suggesting that the storage market was becoming tighter. The EMU also anticipated that Great Britain would need more storage as it moved to becoming a net importer.

7.158. Centrica was the dominant player in the UK domestic gas sector and had one of the largest shares of the UK domestic electricity sector.

7.159. The EMU said that as far as the UK I&C electricity supply sector was concerned, Centrica was some way behind the leading players but it had a significant share of the industrial gas supply market.

Trade unions

Amicus-MSF

7.160. Amicus-MSF (Amicus) said that it represented over 100 employees of CSL who were employed at the Easington gas terminal and on the Rough field in the southern North Sea. Amicus said that its members, over the last two years, had been suffering from neglect and changes in ownership, first from BG Storage to Dynegy, and now to Centrica. Amicus said that its members required some stability in their employment.

7.161. The reference to the CC of Centrica's purchase of Rough and Easington brought yet more uncertainties to Amicus' members. The last thing they wanted to see was a further sale to another party, causing further confusion and upset with regard to their remuneration and, more importantly, their pension arrangements. Amicus therefore supported Centrica in its purchase of the Rough and Easington facilities.

GMB

7.162. The GMB said that it seemed to be accepted by the majority of the players that any issues arising from the merger would be capable of resolution through undertakings. In addition, it appeared that Ofgem and Centrica had come close to agreeing those undertakings, which suggested that there were no issues of principle at stake. It was therefore important to move quickly to establish the nature of the undertakings that would remove regulatory uncertainty over this important national asset.

7.163. In the meantime there should be a 'business as usual' approach to the operation of the facility to ensure that service was maintained to customers during the inquiry. Any undertakings that were developed needed to be set in the context of the competitive position of the UK gas market. Competition was well established in all aspects of the gas chain. The relevant sector of the market in this context was the flexibility market. Alternative sources of competitive flexibility included beach swing gas, the Bacton interconnector (with important import enhancement from 2005), interruptible gas supplies and other storage facilities.

7.164. There was also growing evidence, highlighted in a recent Government/Ofgem report, of considerable investment activity that would bring forward new competing sources of flexibility, including LNG imports. These projects were now well advanced. Added to this, the decline of the Morecambe asset must also be considered. Given this position, it was important that a careful market analysis should be undertaken, considering these new developments as well as the current position.

7.165. There were also wider issues at stake. Rough was a critical asset for UK security of supply. It was important for the nation that it was maintained to the highest standards. In the past the HSE had raised serious issues about the safety of the facility under former owners. It was reassuring that Centrica's early decisions implied a commitment to improving the operation and safety of the asset. It had made a welcome commitment to tackle maintenance backlogs.

Others

John Hall Associates

7.166. John Hall Associates (John Hall) said that the merger would not improve competition in the UK gas market, and indeed, unless strenuous efforts were made, there was a possibility that it would lead to a reduction in competition. The acquisition would give Centrica major stakes in storage, supply and production markets, and would appear to be a step back towards the old monopoly situation that existed before privatization. In the course of its own work, John Hall was aware of vertical consolidation across the utilities market and the impact this was having in terms of reduced competition.

7.167. If the merger was to gain approval, strenuous efforts would be needed to ensure that Centrica could not in any way abuse its market position. Access to the facility should be open to all on a non-discriminatory basis, given the importance of the storage capacity within the wider context of security of supply. As well as this, the owners of this storage facility would have access to confidential information and if, as in Centrica's case, the company was vertically integrated, this could give it an unfair competitive edge. This needed to be avoided at all costs.

7.168. John Hall said it would expect Ofgem and the Government to ensure that Centrica could not use its dominance in the market to the detriment of existing and new entrants to the gas market.

Company A

7.169. Company A said that it welcomed the decision by the Secretary of State to refer the merger to the CC for investigation since it believed that the merger would result in a substantial lessening of competition that was against the public interest.

7.170. In particular, Company A was extremely concerned that Centrica's acquisition of the Rough storage facility would further entrench Centrica's dominance of the wholesale gas market and specifically the market for flexible gas, given its ownership of Morecambe Bay gas fields and its interruption rights under the LTI contracts. The ability of competing suppliers to source flexible gas was central to the maintenance and development of supply competition in gas and, indirectly, electricity. Company A, therefore, believed that Centrica's acquisition of the Rough storage facility would effectively foreclose the retail energy market to new entrants and would significantly inhibit the ability of existing suppliers to compete with Centrica.

7.171. Company A believed that the acquisition would result in Centrica owning 85 per cent of all Great Britain stored gas and more than half of the market for flexible gas, compared with around 25 per cent before the acquisition. The lessening of competition in the flexibility market would inevitably lead to a lessening of competition in the gas supply market and potentially the electricity supply market.

7.172. In considering the effect of the acquisition, Company A believed that the relevant product and geographic market was the market for gas flexibility within Great Britain. It was therefore necessary to consider the four main sources of flexibility, namely storage, beach swing, interruption and the Bacton interconnector.

7.173. A significant source of supply flexibility was provided by gas storage facilities. The major gas storage sites in Great Britain were the Rough offshore facility, the Hornsea facility and the five LNG facilities which together accounted for 95 per cent of total Great Britain storage space and 93 per cent of daily deliverability.

7.174. Centrica's acquisition of Rough had resulted in it owning 30,000 GWh (76 per cent) of storage space and 455 GWh a day (29 per cent) of the associated deliverability. Although Transco's five LNG sites had a higher deliverability than Rough, Company A agreed with Ofgem's analysis that the short duration of LNG, the operational issues in terms of injection and cost, and the constrained availability of LNG meant that, in effect, LNG was not an effective alternative to Rough for swing gas. Taking this into account, Centrica's acquisition of Rough resulted in it owning 85 per cent of all gas storage in Great Britain, which was clearly a dominant position.

7.175. The potential to increase supplies of gas from beach terminals at times of high demand/price provided a valuable source of flexibility. Although market information relating to an individual company's upstream interests and the associated flexibility was not easily accessible, industry figures that were available showed that Centrica was the third largest gas producer in the UK. Furthermore, Centrica had stated in its 2002 interim results that production levels of its major gas fields could be altered in response to variations in demand quantities or market movements. The majority of this flexibility came from the Morecambe Bay fields which were a key source of UK beach swing.

7.176. Ofgem had also stated, in its consultation on Centrica's acquisition of Rough, that the Morecambe Bay fields were considered to be relatively high-swing fields that had recently delivered at peak around 450 GWh a day. Furthermore, Ofgem had reported that in 2000/01 the maximum daily throughput at Barrow was 550 GWh a day. The Barrow terminal was used almost exclusively by Centrica to bring Morecambe Bay gas ashore. From this information Company A concluded that Morecambe Bay had at least a flexibility of 100 GWh a day (being the maximum of 550 GWh a day less the underlying average of 450 GWh a day).

7.177. In addition to the flexibility that was provided by the supply of gas, flexibility could also be provided by demand-side interruption. The primary mechanism by which demand-side responsiveness contributed to supply/demand balancing was through the use of interruptible contracts. In considering the extent of demand-side interruption as a source of swing, it was possible to consider two scenarios: first, Transco's interruption rights in respect of its management of supply/demand fluctuations under its role as residual system balancer and its management of transportation constraints; and second, shippers' contractual rights to interrupt demand for their own commercial benefit (for example, the supply of gas to one large demand site might be curtailed in order to make the gas available to domestic customers). It was the latter, commercial form of interruption that was relevant for the purposes of considering the market for gas supply flexibility.

7.178. In terms of commercial interruption, Company A considered that Centrica had a unique and distinct advantage over its competitors by virtue of its inherited LTI contracts. These gas contracts had been entered into with British Gas plc in the early 1990s before the market was open to competition. The interruption rights were originally intended to be a tool for transportation system management purposes. However, at the time of the British Gas plc demerger in 1997 the LTI contracts had been handed to Centrica. Although, since the demerger, Transco was able to require interruption for transportation purposes under these contracts, in the main Centrica had been able to interrupt the gas supply to numerous power stations at short notice, for entirely commercial reasons, on up to 45 days a year.

7.179. The final main source of gas flexibility in the market could be attributed to the Bacton interconnector. At the extremes of its operational capabilities Ofgem believed that there was a potential swing capacity of 899 GWh. However, operational and contractual difficulties suggested that the actual flexibility was significantly lower, with the highest observed daily increase in flows on to the NTS from the interconnector since it became operational being 191 GWh a day.

7.180. Although at the time of writing Company A did not know the extent of Centrica's access to flexibility through the interconnector, Company A knew from its web site that BGT, a subsidiary of Centrica, held forward flow capacity (Bacton to Zeebrugge) and an appropriate proportion of reverse flow capacity (Zeebrugge to Bacton). For the purposes of this analysis, Company A assumed that Centrica had access to around 20 per cent (38 GWh a day) out of the total interconnector flexibility of 191 GWh a day.

7.181. Taking account of these various sources, Centrica's acquisition of Rough placed it in a position of dominance with a 55 per cent share of Great Britain flexible gas. This compared to Centrica's 25 per cent share of flexible gas before the acquisition. An analysis of market concentration suggested that Centrica's acquisition of Rough had increased the HHI from 1,950 to 3,450. Company A said that it did not believe it was in the public interest for such a high proportion of the market to be held by one participant.

7.182. There were three main ways in which Centrica's dominance of the market for flexible gas would adversely affect competition in the retail gas supply market.

7.183. First, putting aside the acquisition of Rough, Company A had a number of concerns about Centrica's conduct in the wholesale and retail gas markets. In particular, it was concerned that the unique vertical integration of Centrica in the gas supply market was an unhealthy market structure. Since the introduction of gas supply competition, Centrica had retained its position as the dominant gas supplier with around 65 per cent of all domestic customers. Given this position, Centrica ought to bring considerable pressure on gas producers to keep gas prices low. However, as a gas supplier, its purchase costs were not affected by higher or fluctuating gas prices since in the short to medium term it was fully contracted.

7.184. In contrast, Centrica's downstream competitors did not have its upstream affiliation, nor did they have the stability associated with its unique market share. These suppliers were therefore unable to benefit from entering into long-term gas contracts that protected them from the high and fluctuating NBP gas prices. Against this background, an increase in wholesale prices would undermine the ability of new entrant suppliers to undercut Centrica.

7.185. Moreover, as a gas producer, Centrica clearly benefited more directly if wholesale gas prices were higher as it would receive a greater return from the output of its upstream gas assets—such as Morecambe Bay. Of all gas suppliers, Centrica alone benefited from high wholesale prices. Indeed, if gas wholesale prices were high and/or volatile it was in a win-win position. It therefore had a clear incentive to manipulate wholesale gas prices. Company A did not believe that this was a healthy market structure and it noted that wholesale gas prices had almost doubled in the last two years. It was clear that Centrica's ownership of Rough would enhance Centrica's incentive and opportunity to increase wholesale gas prices.

7.186. Second, Company A believed that Centrica's dominance of the market for gas flexibility would create a barrier to entry. Demand fluctuations were particularly pronounced in relation to domestic customers. Domestic suppliers therefore required access to flexible gas in order to meet these fluctuating demands and hence compete in that market. Given that Centrica's acquisition of Rough had resulted in it owning around 55 per cent of the market for flexible gas, new entrant suppliers would have little opportunity but to trade with Centrica to secure the majority of their flexible gas. The ability of competing suppliers to undercut Centrica's gas prices to final customers would therefore be determined by the price and terms offered by Centrica for flexible gas. Company A believed that, as a matter of principle, a de facto requirement for new entrant suppliers to trade with Centrica would be an institutional barrier to entry into the retail market.

7.187. Third, Centrica's ownership of upstream assets together with dominance of the retail supply market gave it significant advantages in respect of commercially valuable information. For example, if its upstream gas production was interrupted within day, its downstream business would be able to respond in advance of its competitors. This informational advantage was significantly enhanced by Centrica's acquisition of Rough.

7.188. Over the past year, Centrica had steadily acquired an electricity generation portfolio. These acquisitions had resulted in Centrica having a total gas-fired generation capacity of 1,849 MW, with a combined output of around 10 TWh a year. In addition, from 2004 Centrica would, at the very least, have the entire output from a new 860-MW gas-fired generating station at Spalding. Company A believed Centrica's recently announced acquisition of the Roosecote power station would further entrench its unique dominance of the energy market. Roosecote was a combined cycle gas turbine generator which was supplied by an LTI contract and the acquisition would therefore provide yet further opportunities for Centrica to manipulate both gas and electricity wholesale markets.

7.189. It was evident that a gas-fired generator which had access to flexible gas supplies could readily arbitrage between the gas and electricity markets. Significantly, however, a proportion of Centrica's swing gas was available to it by virtue of the LTI contracts. Under these contracts Centrica was able to interrupt gas supplies to its immediate competitors for the generation of electricity. Clearly, therefore, ownership of the LTI contracts coupled with its dominant position in respect of access to swing gas placed it in a unique position within the two markets. It also provided Centrica with unique opportunities to manipulate wholesale prices and those opportunities would clearly be exacerbated by the acquisition of additional flexible gas from Rough storage.

7.190. Company A said that Centrica's use of the LTI contracts also had significant security of supply implications. Under these contracts Centrica was most likely to interrupt when gas prices were high, thereby enabling it either to extract value from the contracts or to divert the gas to its own power stations to maximize the possibilities for arbitrage between gas and electricity. However, high gas prices were most likely to occur on days of high demand, ie during cold weather and/or when there was a shortage of gas. Company A believed that the prospect of such commercial interruption on days when the system was short had substantial implications for security of supply of both gas and electricity.

7.191. Company A believed that Centrica's dominance of the flexible gas market would foreclose the gas supply market to new entrants. Furthermore, the complex and opaque interactions between its existing wholesale and retail operations would provide Centrica with an opportunity to manipulate both the gas and electricity markets. This position was unacceptable and, Company A believed, would lead to a lessening of competition in both the gas and electricity supply markets that would be directly contrary to the EC objective of actively increasing competition in the energy markets. Lessening of competition in any market restricted customers' choice and as a rule resulted in escalating prices and less innovation.

7.192. Company A believed that the merger was against the public interest and that safeguards should be sought to mitigate its effects. The question therefore arose as to whether there were any regulatory remedies that could mitigate the adverse effects on competition and customers.

7.193. Although storage was no longer a licensed activity, prior to its acquisition by Centrica the operation of Rough had continued to be regulated by virtue of formal undertakings given to the Secretary of State. The undertakings entered into by Dynegy were to provide assurance that it would make all of the storage capacity available to the market on non-discriminatory terms and that information available to its storage business would be treated as confidential (ie separate from its other activities). Company A suggested that an alternative to formal undertakings would be to relicense the Rough storage facility along similar lines to the situation some years before when all storage was owned by British Gas plc.

7.194. However, Company A did not believe that either equivalent undertakings to those given by Dynegy or formal licensing would adequately address the fundamental issues associated with Centrica's position in the market for flexible gas combined with its dominance of the domestic supply market.

7.195. Company A said that in its 1993 report[1] the MMC had been concerned that the ownership of storage should be completely separate from British Gas plc's trading and supply business. Company A saw no reason to believe that these underlying concerns were any less relevant today than they had been in 1993 given Centrica's position in the market. Company A therefore believed that it would be a major backward step in the development of retail supply competition for the Rough storage facility to be owned once again by the incumbent dominant supplier, especially since Centrica would own the majority of all flexible gas sources.

7.196. Company A said it did not believe that formal regulation of Rough storage would provide adequate protection for competition and customers for the following reasons:

(a) competing suppliers would be reliant on sales of flexible gas by Centrica;

(b) formal regulation of Centrica would be difficult to monitor and enforce effectively; and

(c) the risks to the policy gains arising from competition in the supply of gas were too great to rely on undertakings or new licence conditions.

7.197. Company A therefore considered that behavioural remedies (as opposed to structural remedies) would not be sufficient to address the adverse effects of the acquisition.

7.198. In commenting on the CC's issues statement dated 7 April (see Appendix 2.1), Company A said that, in its view, a structural remedy should be applied that eliminated Centrica's dominance of the flexible gas market and mitigated Centrica's incentive and ability to manipulate wholesale prices. In order to achieve this, Company A believed the structural remedy must include a requirement to divest Rough. The structural remedy must also prevent Centrica from using the LTI contracts for commercial interruption since, in addition to providing a significant source of flexible gas, the LTI contracts gave Centrica a unique opportunity to manipulate the demand for, and price of, flexibility which in turn influenced the price of wholesale gas and electricity.

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[1]See footnote to paragraph 2.16.

7.199. However, in the event that undertakings were considered to be an appropriate route to pursue, Company A believed that stringent measures should be taken to address the same concerns. Therefore, at the least, the undertakings should include the following:

(a) *Equivalent Dynegy undertakings:* As a starting point, the provisions of the formal undertakings entered into by Dynegy should apply to Centrica in full.

(b) *Restriction on sales to Centrica:* Company A believed that there should be a formal restriction on Centrica's own ability to acquire Rough storage capacity (space and deliverability) to a maximum of, say, 20 per cent. Centrica should not be able to bid in the primary auctions for the sale of existing Rough capacity but should reserve specified volumes at a weighted average price based on that of capacity sold by auction.

(c) *Price:* In the absence of auctions, capacity should be sold on non-discriminatory terms and with the prices and terms paid by Centrica made available to other shippers. Furthermore, to dilute any incentive for Centrica to manipulate the wholesale gas prices, contract prices should not be allowed to include indexation to UK or European gas prices.

(d) *Capacity availability:* Centrica should be required to offer for sale a high proportion of Rough capacity under long-term contracts while ensuring that, say, 20 per cent was offered on an annual basis to ensure that new entrants had access to Rough.

(e) *Use it or lose it:* 'Use-it-or-lose-it' provisions should be put in place to ensure that all capacity came to market.

(f) *Business separation:* There should be total managerial, legal, financial, physical and operational separation of Centrica's storage business from Centrica's other commercial activities in both the gas and electricity markets.

(g) *Extension beyond 2004:* Company A believed that the undertakings should be open-ended (ie should not expire after April 2004), given that the acquisition by Centrica raised unique competition issues that would not otherwise arise.

(h) *Licensing of Rough:* Company A believed that formal licensing of Rough should be considered, rather than undertakings.

(i) *LTI contracts:* Centrica should be required to undertake contractual amendments in respect of the inherited interruption rights under the LTI contracts. In particular, it should agree that it would not interrupt gas supplies to power stations under these contracts unless instructed to do so by Transco for transportation purposes.

(j) *Regulation of Morecambe Bay:* Centrica's Morecambe Bay facility should also be exposed to similar formal regulation as Rough and its activities separated from Centrica's other commercial activities.

Company B

7.200. Company B said that it believed the merger would lead to a lessening of competition in the UK gas market. It commented that when the demerger of British Gas plc was agreed it had been considered essential for storage to be separated from supply. Whilst the market had developed since then, the overall size of Centrica, together with its control of Morecambe, its take-or-pay contracts and its overall dominance of swing within the market, meant that it was still incorrect to allow the merger of the storage and supply businesses.

7.201. Company B did not believe that a continuation of the previous undertakings given by Dynegy would be sufficient. At the time of the approval of Dynegy's acquisition of BG Storage, Company B had expressed significant concerns about the suitability of those undertakings: it believed that stronger undertakings were required. Neither did it support Centrica's proposal to reserve for itself a percentage of the Rough storage and auction the remainder, paying the market price (as determined by the auctions) for the capacity it had reserved. Company B believed that, regardless of any financial separation for accounting purposes, Centrica's supply business would be insensitive to the storage price. At the same time, supply competitors would see increasing storage prices, directly affecting their ability to compete. The alternative of Centrica participating fully in auctions on a non-discriminatory basis was no better as the supply business would still not be price sensitive, particularly when the Morecambe swing capability was taken into account. A further concern was whether or not Centrica would have any real incentive to maximize the storage capacity that it sold to the market.

7.202. If the acquisition was to be allowed, Company B considered that the storage business should be price regulated, with allowed revenue based on the acquisition price. The regulation should continue until Centrica could demonstrate that significant changes had taken place in either the UK supply or storage markets that lessened its overall market-dominant position. A least-favoured alternative would be for Centrica to retain a percentage (say up to 30 per cent) of Rough storage but with the operation and the remaining storage space being put up for sale again to a separate storage operator.

7.203. Company B was also concerned about the potential for the misuse of confidential information. It believed that there must be rigorous separation (both operational and financial) between the storage business and any of the other Centrica businesses. Similarly, no operational or market data should be allowed to flow between the storage business and the remainder of the Centrica operation.

7.204. In Company B's view, a mandatory change to the standard Rough contract should be sought through industry consultation. Recent attempts had been made with Dynegy to update and improve the contract to give greater clarity of the ownership rights to gas while in store.

7.205. Company B suggested that the provision of information by the storage business should be improved to include:

(a) disclosure of net storage inventories (on a daily basis);

(b) timely notification of operational problems; and

(c) summaries of storage injection and withdrawal activity on an hourly basis.

7.206. Company B said that, whatever undertakings were required of Centrica, no end date should be set. Instead the onus should be on Centrica to demonstrate that sufficient changes had taken place in either the supply or storage markets for the undertakings to be reconsidered.

Company C

7.207. Company C said that it was a major player in the international energy markets and traded energy products worldwide. It was a new entrant to the UK gas market.

7.208. Company C said that Rough represented one of the key European storage assets and was a pivot of gas trading in the UK—the price-setter for the Continental markets. Company C said that it had made a bid to acquire Rough. It had intended to invest in the plant to ensure reliability, and to improve deliverability and injectability in order to maximize the utilization of Rough. Company C had a track record of developing market-orientated products which met the demands of customers. Company C had intended to expand the Rough space, to consider developing Easington as a landing point for new offshore supplies and to improve the information availability to the market. Company C said that it remained interested in acquiring Rough, should it become available.

Company D

7.209. Company D told us that it was a firm with peripheral interest in the UK gas market, but it had considered opportunities in midstream energy services in the UK. As part of its business activities, Company D had carried out some due diligence work on storage assets and kept asset sales and developments in the market under review.

7.210. Company D said that it believed the acquisition of Rough by Centrica was an adverse development for the UK gas market, for two main reasons:

(a) Centrica would not have the necessary incentive to develop an asset like Rough, indeed its ownership of the facility was detrimental to the development of an open, transparent and active market in storage.

(b) The acquisition created an environment in which new entrants would be reluctant to develop other storage assets.

Therefore, from the perspective of new market entrants the acquisition was against the public interest in both the short and medium term. Furthermore, Company D did not believe that regulation in any form would be a sufficient or appropriate remedy.

7.211. Company D said that it believed there was probably potential for the development of Rough. A more dynamic management and marketing of the facility would help the development of an active market in storage products, which in turn would help to highlight the value of storage.

7.212. The UK would have an increasing need for storage as the North Sea gas reserves were depleted. As well as the development of new assets, it would be in the public interest to make best use of the existing assets, requiring additional investment by the owners. Another owner of Rough, with the maximization of the asset's potential as its key business driver, would be more likely to develop Rough than Centrica. These developments were likely to include improving the technical operation of Rough (capacity, deliverability and injectability). An independent owner would also enhance the commercial exploitation of Rough by developing a range of storage products more suited to diverse market demands. Company D emphasized the following points:

(a) Centrica did not have the same incentives to increase the reliability of Rough as it had other assets (like Morecambe) that it could use to manage reliability risk.

(b) Unlike previous owners, Centrica was only offering to make a proportion of the capacity in Rough available to the market.

(c) When Dynegy had purchased storage, Centrica had suggested that it should release additional capacity, but Centrica was now offering to release less capacity than Dynegy had done.

7.213. The gas market had developed substantially over the last five to ten years and Company D expected that, even with the departure of major US traders such as Enron and Dynegy, the market would continue to broaden and deepen. New trading companies and banks were entering the market alongside gas suppliers (including Centrica) and producers. Company D saw the development of the storage market as critical for the development of the wider gas-trading market.

7.214. Centrica's asset portfolio and relative market power offered it no incentive to promote the development of the storage market, and therefore of the wider traded market in gas. Further, Centrica's ownership of Rough would have an adverse impact on the traded market for the following reasons:

(a) The flexibility inherent in the assets Centrica now controlled could be used to distort prices.

(b) Centrica had substantial access to information, which would directly confer an advantage in terms of trading.

(c) Centrica would have the ability (explicitly or implicitly) to cross-subsidize across its assets and businesses—other traders did not enjoy this flexibility. In essence, Centrica could cross-subsidize between its activities as a competitor to other traders and as supplier of services to those same traders.

7.215. Company D noted that Centrica proposed to withhold capacity in Rough for itself, rather than be exposed to participating in a market allocation process (for example, auctions) or buying storage capacity in the secondary markets. The non-participation of Centrica, the largest user of storage, in the auctions of capacity at Rough would have a substantial negative impact on the development of that market.

7.216. Companies could only enter the UK gas market successfully if it was open, competitive and not subject to market distortions created by rules, regulation and/or dominance. In the storage market, Centrica's ownership of Rough reduced incentives for independent investors to build new storage capacity or develop existing facilities.

7.217. In summary, Company D believed that the ownership of Rough by Centrica would operate against the public interest for the following reasons:

(a) It had incentives to withhold capacity at Rough.

(b) It had less incentive to develop the assets or related assets.

(c) The flexibility inherent within its assets could be used to distort prices.

(d) Ownership of flexibility tools by one dominant player was open to abuse.

(e) The transaction would create barriers to entry in gas trading, shipping, supply and storage.

7.218. Company D noted that there was a possibility of using undertakings to address these issues. However, it believed that, in the case of Centrica, these would have to be far-reaching and significantly more onerous than those placed on BG and Dynegy.

7.219. Company D agreed with the principle, as expressed in the Utilities Act 2000, that the best way to protect the interests of customers was to promote effective competition. Regulation was not an adequate substitute for competitive pressures in bringing about reduced prices and enhanced, consumer-focused services.

7.220. The focus of past MMC inquiries into the gas market had been the reduction of vertical integration and the separation of storage from other activities. Company D believed this was a correct approach. Therefore, the only way to address the potential detriments to the public interest was to require Centrica to divest Rough or Morecambe, the two biggest swing assets in the UK gas market, and possibly a proportion of its supply portfolio. The principle of separate ownership of storage, as originally proposed by the MMC, was the best way to increase competition and to promote the development of the UK gas market.

7.221. Company D believed that any attempts to overcome public interest concerns through enforced separation and stringent regulatory controls would fail. It believed that the public interest would always be compromised by the fact of common ownership, while Rough was owned by a player with a dominant position across the whole gas market.

7.222. In commenting on the CC's remedies statement (see Appendix 2.2), Company D said that the CC's proposed incentives could not reproduce market drivers, because:

(a) The primary incentive remained to invest only in what Centrica needed, not in what was possible and/or economic.

(b) The undertakings did not counter Centrica's incentive to restrict capacity availability.

(c) Centrica could purchase other flexibility tools to cover its requirements (for example, capacity in the second interconnector and swing gas at Easington) diminishing the investment incentive.

7.223. Company D said that the remedies proposed were insufficient to discharge the CC's duties under the FTA:

(a) The remedies did not take account of the possibility that additional supplies from Norway, or elsewhere, would access the UK market through Easington, increasing Centrica's control of physical swing.

(b) The remedies did not prevent Centrica from purchasing additional flexibility products, further increasing its dominance, and did not cover its use of its other existing flexibility tools (LTIs and interconnector flows).

(c) Long-term contracts would not mitigate Centrica's market power or its control of the physical swing provided by Rough and Easington.

7.224. Company D said that the remedies statement did not address the York field as a potentially important option for storage-related investment. An independent owner intent on maximizing individual asset value (rather than an integrated portfolio spanning the gas value chain) would be more incentivized to undertake the considerable up-front cost associated with developing York. It was questionable whether, over and above its own flexibility requirements, Centrica would plan to divert capital away from its stated focus on consumer businesses in favour of such a project.

7.225. Company D said that any package of remedies needed an effective regulator to monitor and enforce the undertakings. Ofgem itself was of the view that regulation did not provide a robust solution and would be to the public detriment. There were a number of factors that made it evident that regulation of Centrica would not be effective:

(a) Ofgem's remit was only onshore (the DTI was the offshore regulator), so review of terminal operations, Morecambe and Sean all fell outside its legal remit.

(b) Without 'prospective powers', Ofgem would only be able to act when it believed a breach had occurred, which meant abuse of the market could occur for two years before remedial action was taken.

(c) Ofgem would have to have powers to request and monitor all of Centrica's contracts to be able to ensure compliance with the undertakings.

(d) Ofgem did not have the commercial or technical expertise to understand the operation of Centrica's integrated businesses and their facilities.

(e) Ofgem was unlikely to be able to hire enough staff with the necessary expertise to work full time on monitoring and such dedicated teams risked regulatory capture.

7.226. Centrica's proposed undertakings to operate its fields at Morecambe and Sean at a time of high system demand provided the most compelling argument for divestment of Rough. This highlighted the extent of Centrica's control of sources of flexibility. Such undertakings would have an even greater negative impact on the UK gas market. With one player committed to flow gas at peak times or at set prices, gas prices would become driven by regulatory requirements and not by competitive pressures.

7.227. The CC's proposals for regulating storage contracts, whilst necessary, required regulation that was against the public interest. It would be preferable to have an independent storage provider responding to market needs, ultimately driven by the requirement to deliver competitively-priced gas to end-users.

7.228. Operational separation was required to ensure that Centrica could not abuse its informational advantage and should happen as soon as possible. Effective separation should include full separation of Morecambe from storage (including no ability for either to subcontract to the other) and shipping from trading.

7.229. The extent of the undertakings proposed in the remedies statement would distort the UK gas market and therefore could not be expected to operate within the public interest. The level of regulation involved in implementing the proposed undertakings acted against the public interest by creating a barrier to new storage build and the development of further flexibility tools. Company D agreed that partial divestment was not a workable solution. At the same time, it believed that there were a number of well-qualified parties interested in the purchase of Rough which would add to competition in the UK gas market. Full divestment of Rough was possible and would maximize the benefit of UK gas customers.

Mr A N Other

7.230. Mr A N Other (Mr Other) said that he felt there were a number of issues relating to Centrica's purchase of Rough/Easington that required examination.

7.231. Mr Other said it had been suggested that Centrica should be restricted from owning more than 20 per cent of Rough capacity and prohibited from competing in the primary sales processes for the remaining 80 per cent. Unfortunately it was easy for Centrica to go to a third party company and ask it to bid on its behalf, thus getting round such restrictions. This had happened before at Rough when customers wanted to buy more capacity than BG (the owner at the time) was prepared to sell to them. It would be difficult to monitor such behaviour other than by requiring Centrica (and its trading affiliates) and CSL to submit all data regarding transactions for the purchase of capacity (space, withdrawal, injection) as and when they occurred to Ofgem (or another agency that could monitor such transactions). Even then it would be relatively easy to mask such transactions.

7.232. Mr Other said that if the intention was to give an incentive to Centrica to expand capacity, it could be limited to 20 per cent of the rated capacity (ie 20 per cent of 455 million SBUs). At the same time Centrica should be prohibited from buying any capacity in the secondary market. It should be noted that this would not stop Centrica from buying virtual storage, storage-look-a-like or other flexibility services from third parties, which would then be forced to buy storage capacity to mitigate their risk. It was practically impossible to stop Centrica from effectively controlling more than 20 per cent of capacity. Even worse, by buying physical or virtual capacity through third parties, Centrica could drive prices for storage much higher, as a third party would be the de facto buyer of such high-priced services (albeit transferring them directly to Centrica for a small brokerage charge).

7.233. Essentially, through using third-party veils to buy physical, virtual and flexibility services, Centrica could in theory drive storage prices so high as to make it not worthwhile for other customers to buy it.

7.234. At present there was nothing that would oblige CSL to market incremental space and it could, in theory, either hold it off the market or retain it for its own use. Retaining it for its own use would essentially double the amount of space that it held. This would further incentivize CSL to price its interruptible injection and withdrawal capacity in such a way as to ensure that no other user would buy it, thus allowing Centrica to monopolize the use of injection and withdrawal capacity that other customers were not using on any given day (unless customers were willing to pay the SIS price as detailed in the SSC).

7.235. Mr Other proposed that CSL should not only be forced to market at least 600 million cubic metres of this incremental space annually, but also that Centrica be restricted from owning more than 10 per cent of the 600 million cubic metres. Furthermore, Centrica should be prohibited from purchasing incremental space in the secondary market. Once again, however, this would not stop Centrica from buying virtual services, which would be impossible to monitor.

7.236. Although it was proposed that Centrica should make more information available to the market (which the marketplace would generally welcome), this was not the critical issue relating to information flows concerning Rough and Easington. Centrica controlled a huge part of the UK gas flexibility market through its ownership of Rough/Easington, Morecambe Bay and LTI gas supply contracts, and through an overwhelming dominance of the wholesale and retail gas markets. The value to Centrica of the real-time and stock level information flow at Rough/Easington was incalculable. Although on a peak day Rough supplied in the region of 10 per cent of the UK's gas requirements, it was not the peak days that were of relevance. At full output, Rough would go from full to empty in 67 days. It was from around day 15 to day 67 that information flows from Rough become critical. On these days, demand would be high (probably above 370 but below 400 million cubic metres) but not viewed as peak. If it could be seen that Rough was producing at full flow, or was ramping up to produce at full flow, it would be easy for other gas producers to reduce their own gas flows to keep prices high. Rough was one of the biggest swing gas providers in the winter. The danger was not just that Morecambe Bay might be ramped down but that other North Sea gas producers or interconnector users might ramp down flows to support high prices. This was the danger of making real-time information available to the market in general, let alone to Centrica alone. Obviously, with non-integrated ownership of Rough, these issues, and the capacity issues outlined above, did not arise.

7.237. Mr Other said he understood that Centrica's Director of Operations for Morecambe Bay held the same position in relation to Rough/Easington. Clearly this situation (and any other 'cross-pollination' of workforce between these two assets) was potentially a source of information leaks, whether deliberate or accidental. The operational side of Rough and Easington needed to be as ring-fenced as the commercial side given the importance of the information flows to the market. Such ring-fencing should be to as high a level as was proposed for the commercial side and all staff should be subjected to the same rigorous requirements regarding information.

7.238. The CC should note that various long-term contracts existed between Centrica and Statoil and between Centrica and Gasunie. There was already an agreement in place with Statoil that a new pipeline be built into Easington to provide the gas. It was known that Gasunie was contemplating the construction of an interconnector to supply its gas. If one or both of these pipelines were built into Easington, it would provide an enormous informational advantage to Centrica.

7.239. Although it would not be desirable to prohibit the construction of new supply pipes, nor to prescribe where they might or might not make landfall, it was a further point to take into consideration when discussing Centrica's dominance of the UK gas market. Moreover, in order to maximize the efficiency of their pipeline construction costs, both Statoil and Gasunie might require significant volumes of storage capacity. Mr Other said that, given the nature of the contractual relationship between Centrica and these companies, it would be difficult to keep separate the commercial gas supply contracts with Centrica and any potential storage bookings with CSL. For example, it was possible that Centrica could increase the value of the gas supply contracts to subsidize Gasunie and Statoil (and indeed any other counterpart or customer) in buying storage capacity. It should be noted that Gasunie on its own could, in theory, buy 70 per cent of Rough SBUs to maximize the construction efficiencies of its proposed interconnector.

7.240. Mr Other said his understanding was that the management of Rough currently reported to the Managing Director of CEMG, which also contained Centrica's trading units. Mr Other said that there was potentially a conflict of interest here. Furthermore, the person concerned was not a director (with accompanying legal responsibilities) of Centrica. It was essential that ultimate responsibility for Rough/Easington resided at main board level and that all reporting should be made direct to this level.

7.241. If undertakings were chosen as the preferred solution, any revocation of such should not be a matter of whether Centrica had significantly increased the capacity available at Rough. Due to its size, Rough would always be a major swing gas provider during the winter. As demand continued to increase, Rough's importance would increase as more and more days saw demand in excess of 400 million cubic metres. It was possible that by 2005/06, Rough's gas flows (or lack thereof) would have a direct impact on gas pricing for the highest 90 demand days in the winter period. It was hard to envisage a situation where undertakings on Centrica should be reduced in these circumstances.

7.242. Mr Other said that he believed it would be potentially prejudicial to the efficient and competitive operation of the UK gas market to allow Centrica to continue to own and/or operate an asset as important as the Rough storage facility and Easington terminal without significant divestment and/or renegotiation of other assets or contractual agreements. He therefore urged the CC to recommend that Centrica be required to divest the assets as the only effective means of protecting the public interest.