8 Views of Ofgem

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Introduction

8.1. Ofgem initially provided us with the report on the advice which it had submitted to the OFT in January 2003 concerning substitutes for Rough, the effects of the transaction on competition and the potential remedies that would be required. It subsequently attended two hearings and submitted written comments on our issues and remedies statements and on some of Centrica's submissions to us, including the Lexecon analysis of Centrica's incentives (see Appendix 5.5). The views which Ofgem provided in these ways are summarized in this chapter and in Chapter 5.

Ofgem's advice to the OFT

Substitutes for Rough

8.2. Ofgem noted that there were several ways in which Rough provided services to the gas market. The two most important of these were as a source of winter gas (reflecting the much higher demand for gas in winter than summer) and in providing daily (including within-day) flexibility.

8.3. Ofgem had analysed the response of the various potential substitutes to changes in demand and to the daily price of gas. In particular, the analysis looked at the response of the potential substitutes to seasonal variations in demand levels, shorter-term changes in the gas price, and supply and demand shocks. The extent to which other facilities were effective substitutes for Rough was different for seasonal and daily uses.

8.4. In the market for winter gas, the conclusion of Ofgem's analysis was that:

— the Morecambe gas fields and other beach supplies were reasonably close substitutes for Rough;

— the Bacton interconnector was also a reasonably close substitute; and

— interruptible supply contracts were likely to act as a constraining factor on Rough only in cold winters.

8.5. In the market for daily and within-day responsiveness, the conclusion of Ofgem's analysis was that:

— the Morecambe gas fields were a good substitute for Rough;

— the interruptible supply contracts were good substitutes;

— Hornsea was a good substitute; and

— the Bacton interconnector was a reasonably close substitute.

Centrica's position with respect to these substitutes

8.6. Centrica had significant positions in these substitutes for winter gas and daily flexibility—in particular the Morecambe gas fields and interruptible contracts. Market share could be calculated on the basis of either maximum observed historical flows or the theoretical maximum capacity. On the basis of maximum observed historical flows, prior to the transaction and excluding Centrica's short-term contractual position, Centrica's market shares were estimated at 37 per cent for winter gas and 43 per cent for daily flexibility. Following the acquisition, Centrica's market share was estimated on this basis to be 43 per cent for winter gas and 75 per cent for daily flexibility.

8.7. On the basis of theoretical maximum flows, prior to the transaction and excluding Centrica's short-term contractual position, Centrica's market shares were estimated at 38 per cent for winter gas and 21 per cent for daily flexibility. Following the acquisition, Centrica's market share was estimated on this basis to be 42 per cent for winter gas and 39 per cent for daily flexibility. The increase in market share for winter gas could understate the effect on Centrica's market power given that the winter gas figures included ‘flat gas’. There were a number of different methodologies that could be applied to estimate the market shares on this basis. Ofgem estimated that Centrica’s market share before the transaction was around 60 per cent, rising to at least 74 per cent when all Rough flows were allocated to Centrica.

8.8. Barriers to entry were high and there was no prospect of these market share figures being significantly eroded for at least the next seven years.

Detriments

8.9. Ofgem said that, in the absence of undertakings, the analysis showed that the transaction could be expected to lead to the following detriments:

— the incentive and ability to restrict capacity to increase wholesale gas prices—this arose in particular from the combined ownership of Rough and the Morecambe gas fields;

— the possible incentive and ability to restrict capacity to reduce competition in downstream supply markets—this was of particular concern given Centrica’s strong market position in the domestic gas market and the fact that all suppliers needed access to flexible gas supplies;

— reduced incentives to innovate or invest at Rough;

— access to commercially valuable confidential information; and

— reduced liquidity in the traded market.

Addressing the detriments

8.10. Ofgem said that, in the absence of undertakings, these detriments represented a substantial lessening of competition. Ofgem considered that the following undertakings would be able substantially to address the identified detriments:

— 70 per cent of capacity at Rough to be offered on six-year contracts commencing storage year 2004/05;

— 20 per cent of capacity at Rough to be offered on annual contracts;

— 10 per cent of capacity at Rough to be reserved to Centrica, with Centrica forbidden from participating in the primary sale of remaining Rough capacity;

— sale of capacity on non-discriminatory terms achieved primarily by auction;

— the ‘use-it-or-lose-it’ principle to apply to all capacity at Rough;

— incremental expansion at Rough to be free from the undertakings regarding the sale of capacity;

— separation of CSL, and possibly Morecambe, from the rest of Centrica; and

— undertakings to last seven years.

8.11. Ofgem said that these requirements represented the minimum that, in its view, needed to be achieved in undertakings, recognizing that there might be trade-offs between certain of the relevant parameters, in particular between long-term capacity rights from Rough and other sources of flexibility from Centrica’s portfolio such as Morecambe. Further work would be required on the precise formulation of the wording of the undertakings to ensure, so far as was possible, that they would have the effects intended. It noted that policing of behavioural undertakings could involve significant ongoing scrutiny of Centrica’s operations, particularly, for example, relating to the separation of Rough and Morecambe from the rest of Centrica, and the restriction on Centrica participating in the primary auctions for capacity at Rough.

Conclusion

8.12. Ofgem said that, without undertakings, Centrica's purchase of Rough represented a substantial lessening of competition. A significant element of the detriment to competition associated with the transaction resulted from the combined ownership and operation of Rough and Centrica's other sources of winter gas and daily flexibility. Ofgem considered that undertakings as described above would go most of the way to addressing the identified detriments.

Subsequent developments

8.13. This initial advice to the OFT was later modified. For example, after discussions with Centrica Ofgem came to the view that 15 per cent of capacity at Rough, rather than 10 per cent, could be reserved to Centrica.

Views expressed at a hearing with the CC in March 2003

8.14. At the hearing, Ofgem said that the 1998 review of storage by Ofgas had led to a position where BG Storage was ring-fenced from the rest of BG's operations, including its trading activities. In exchange for the removal of storage (other than LNG) from control by licence, BG had given a series of informal undertakings to Ofgas regarding its conduct of the storage businesses at Rough and Hornsea.

8.15. Ofgem said that there were a number of similarities between Dynegy's operation of Rough and BG's operation of Rough. One difference was that, since most of the capacity at Rough until April 2004 had been sold by BG Storage via the one-year and five-year auctions, Dynegy was given the freedom to sell the remainder by bilateral agreements or by tender, as well as by auction. However, there was still an obligation on Dynegy, when selling by means other than auctions, to ensure that this was carried out on non-discriminatory terms.

8.16. Ofgem said that the summer/winter spread in wholesale gas prices had increased substantially over the last four or five years and Rough prices had doubled. However, capacity utilization had also doubled: Rough used to be half empty and now was full. Ofgem said that allowing tradeable storage rights was one way that the undertaking had allowed the market to generate a solution.

8.17. Concerning the future investment that would be needed as the UK became increasingly dependent on imported gas, Ofgem said that a second interconnector might come from Holland, and there might also be an interconnector from Norway. However, these interconnectors might be for baseload supply rather than providing a source of flexibility. Similarly it appeared that the LNG import terminals that were planned might be for baseload rather than flexible supplies. Nevertheless, the general view was that it was not worth building another Rough at the present time. Ofgem said its view was that, when the market demonstrated a need for new physical storage, someone would build it. At the present time, the market did not believe that the UK needed gas storage equivalent to 20 per cent of demand, as seen in France and Germany.

8.18. Ofgem said it accepted that the undertakings that it had put forward with regard to Centrica looked quite onerous, particularly compared with those which Dynegy and BG had given. This reflected the different market positions of Centrica compared with Dynegy and BG. Ofgem had decided that, if Centrica was content with the undertakings as a means of regulating Rough, this would be preferable to forcing Centrica to divest. Nevertheless, Ofgem regarded the use of undertakings as a second-best solution: the best solution would have been for Centrica not to own Rough. But Ofgem (and its predecessors) had not generally stopped a company altering its company structure or merging. Ofgem's role was to address any effect on the gas market. Undertakings would be the way Ofgem would address the effects.

8.19. Ofgem told us that, in monitoring the operation of the competitive energy markets, it did not think there was any company over which it had the same level of concern as Centrica. This was because of the size and range of Centrica's interests. As regards Rough, Ofgem said that the DTI had worked carefully at ensuring that adequate arrangements were put in place for the special operational requirements of this partially depleted gas field, but from a competition point of view Ofgem had no concerns about the financial bidder for Rough as potential owner. Ofgem told us that it would have concerns if certain other trade buyers bought it, but Centrica, because of its downstream market share and its control of Morecambe and the LTIs, fell into a special category of concern.

8.20. Ofgem told us that, before Centrica had acquired Rough, Ofgem had intended to conduct a review in 2003 of the regulation of storage. On the basis of what had happened since storage was deregulated in 1998, and if Dynegy had still owned Rough, there was a question as to whether Ofgem would have seen a need for any undertakings beyond April 2004. Ofgem told us that it would probably have decided that some undertakings were still required, given the importance of storage, but that these would have been lighter than those which had existed before.

8.21. Ofgem said that Centrica had said that it had bought Rough because it wanted to obtain long-term rights to use the facility without having to buy them in the market. Once Centrica had secured its own use of Rough, Ofgem could not see that Centrica benefited from being innovative with the rest of the capacity. Centrica would be happy to sell it into the market on a standard basis but there seemed no incentive to be creative.

Ofgem's response to the issues statement

8.22. Responding to the issues statement which we published in April 2003 (see Appendix 2.1), Ofgem reiterated the public interest issues which concerned it. These largely follow those set out in Ofgem's advice to the OFT.

8.23. Ofgem said that one aspect of Centrica's position that was not explicitly referred to by the CC was Centrica's wholesale electricity position. Ofgem noted that Centrica supplied gas to a significant proportion of the gas-fired power stations (in particular via the LTIs); owned power stations (its latest purchase, Roosecote, a power station also supplied under an LTI, had just been announced); and purchased electricity from power stations. In addition, Centrica had a significant wholesale electricity trading position. It was possible that, as a result of the Rough transaction, Centrica's increased market power in wholesale gas could have negative impacts on competition in the wholesale electricity market. Ofgem considered that the CC could usefully explore this issue.

8.24. Ofgem said that the CC had identified two possible benefits. Ofgem noted that neither of these constituted a benefit to competition resulting from the transaction. Nevertheless, Ofgem's comments on these possible benefits were as follows:

— *Observation of high standards in the operation and maintenance of Rough:* Ofgem was not aware that Centrica was any better or worse than any other offshore operator in this respect.

— *Confidence among users resulting from Rough being in the hands of a financially strong company which is expected to be a long-term player in Great Britain's energy markets:* Ofgem said that if users were not confident of using the Rough facility due to the financial standing of the owner, this could have a detrimental effect on competition. However, Ofgem did not consider that Centrica was the only party that fulfilled this criterion. Further, it understood that the financial remedy put in place by Dynegy to address the 'title to gas' issue had been retained by Centrica.

8.25. Commenting on the CC's initial thoughts about possible remedies for any adverse effects from the merger, Ofgem said it did not consider that allowing Centrica to sell Rough capacity on terms related to gas prices addressed the detriment resulting from Centrica's incentive and ability to manipulate wholesale gas prices. Ofgem also noted that Centrica had claimed that part of the rationale for purchasing Rough was to hedge against Centrica's exposure to volatility in the price of gas flexibility. Indexation would explicitly result in exposure to movements in the relevant index remaining with Centrica.

8.26. Ofgem said that no more than 15 per cent (see paragraph 8.13) of Rough's capacity should be reserved for Centrica. Ofgem agreed that Centrica should be required to facilitate the efficient operation and development of a secondary market in Rough capacity.

8.27. The CC had proposed as a hypothetical remedy that relevant information, for example on the aggregate daily utilization of Rough capacity, should be published in order to give users and other interested parties equal access and help create confidence in the operation of this important part of the wholesale gas market. Ofgem said that information publication would be a useful way of giving users confidence in Centrica's usage of Rough, and, if appropriate, other sources of Centrica flexibility.

8.28. Ofgem said that the CC had asked whether undertakings could be given with respect to Centrica's operation of the Morecambe gas fields, the LTIs or its other sources of flexibility. In its report to the OFT on the transaction, Ofgem had indicated that there could be trade-offs between the undertakings suggested for Rough and Centrica's other sources of flexibility. However, it noted that the definition of capacity availability with respect to Centrica's other sources of flexible gas would not be straightforward, and would amount to an extension of regulation into currently unregulated activities.

8.29. An example of the difficulty of extending regulation to other sources of Centrica flexibility could be seen from the differing forecasts, over time, of Morecambe deliverability. When assessing the potential importance of flows from the Morecambe fields over time, it was important to recognize that peak capability of the Morecambe fields was, at least to some extent, a variable that for Centrica as owner was controllable. Ofgem's records of past forecasts of Morecambe peak capability levels indicated that forecast peak levels and the forecast speed of decline had changed over time, in some cases significantly. These points highlighted the difficulty of coming to a clear regulatory view on the peak capabilities of Morecambe over time, and strongly indicated that the level of these capabilities should be understood as a control variable for Centrica.

8.30. Ofgem said it did not consider that the hypothetical undertakings outlined by the CC in the issues statement were necessarily excessive but recognized that they represented an increase in storage regulation. Ofgem had not yet reached a view as to whether they fully addressed the possible adverse effects.

8.31. Ofgem said it considered that the issues raised by the merger could be substantially addressed without the need for the divestment of Rough. The undertakings which Ofgem had proposed in its advice to the OFT, in particular the requirement for a specified amount of capacity to be sold on a long-term basis, could be understood as a form of semi-structural remedy. Whilst Centrica would retain full ownership of the facility, the undertakings would substantially reduce Centrica's financial interest in, and effective control of, Rough for a defined period.

8.32. In reaching this view, Ofgem had aspired to balance the fact that competition was superior to regulation against the wish not to stand in the way of appropriate industry restructuring. However, this was a finely balanced judgement, and account needed to be taken of the potentially detrimental effects that the resulting level of regulation might have on competition.

8.33. If the CC were to consider that divestment was a necessary remedy, the specific approach taken could have a significant impact on its effectiveness. Full divestment would put Centrica's position back to its pre-merger state but there might be detailed issues, for example concerning the timescale and what restrictions, if any, should be placed on the form of sale.

8.34. The divestment of part of Rough, so that it operated as a joint venture, potentially raised a number of problematic issues. The central issues concerned the extent to which any particular form of partial divestment addressed concerns that resulted from the transaction in relation to Centrica's ability and incentive to raise relevant prices.

8.35. In summary, Ofgem said that it would support the CC exploring structural remedies as an alternative way to address the issues arising from the merger.

The Lexecon report

8.36. Ofgem said that the report which Lexecon had produced on Centrica's incentives (see Appendix 5.5) only addressed Centrica's ability to restrict capacity in winter and hence increase wholesale gas prices. This was only one of the sources of potential detriment which Ofgem had highlighted. Moreover, the hypothetical nature of the study meant that there were inevitably a number of limitations of the analysis.

Consideration of Centrica's incentives

8.37. Ofgem said that the Lexecon report failed to consider properly the incentives on the Centrica group as a whole. For example, the analysis treated the price paid by Centrica to CEMG for the gas delivered from the Morecambe fields as an internal transfer. However, it was reasonable to assume that increases in the costs of procuring gas on the wholesale market would be passed on to customers, by both

Centrica and its competitors. Therefore, the level of gas prices affected Centrica's profits through its effect on the existing long-term purchase contracts, including Centrica's equity interests. An increase in the gas price raised the value of these contracts and the value of the gas delivered from, for example, the Morecambe fields. Consequently, higher gas prices appeared to be in Centrica's financial interest. The Lexecon report disagreed with this analysis. But when account was taken of the impact of higher prices on the value of Centrica's intra-group sales, the report provided strong indication that a withholding strategy was likely to be profitable for Centrica. Ofgem noted that the equity analysts tended to agree with the Ofgem view that high gas prices were beneficial for Centrica as a whole.

Impact on downstream markets

8.38. Ofgem said that the analysis failed to consider the impact of higher prices for flexibility on the downstream market. It was important to consider the extent to which Centrica was exposed to movements in the wholesale gas price and the price of flexibility, relative to its competitors.

8.39. If an increase in the wholesale gas price affected all participants equally, then, ignoring the financial impacts under long-term contracts and equity interests, this increase in costs would be passed through to customers, leaving profit largely unaffected. However, Ofgem believed it was reasonable to assume that Centrica was less exposed to increases in the wholesale price than its competitors, partly because of the contracts vested to it at the time of Centrica's demerger from BG in 1997. Related to this point was Ofgem's view that Centrica was, generally, long in gas. Centrica's own analysis showed that it was a net seller in all winters other than a severe one, and that it would contract for its requirements ahead of the winter. It followed that in most winters Centrica would wish to see higher prices for wholesale gas. As a consequence of this relative exposure to increases in the wholesale gas price, Centrica could increase the costs of its competitors relative to its own. Centrica could thus increase its margin in the retail market, reduce competition and generate higher future profits through the reduction in competitive constraints.

Incentives to expand capacity at Rough

8.40. The Lexecon report considered the incentives to restrict Centrica's existing holdings of flexibility from the market by use of its own holding of capacity. This ignored the detrimental effect that the merger had on the incentives to expand capacity at Rough. An expansion of capacity at Rough would reduce the value of the existing capacity, increasing the marginal cost to Centrica of any expansion. This would be experienced by any owner of Rough. However, the reduction in the value of flexibility would also affect Centrica's wider portfolio, reducing the value of the Morecambe fields and its LTI contracts, in particular.

Option value of flexibility

8.41. Ofgem said that the value of storage, and other sources of flexible gas (including the Morecambe fields), had two key components: the expected arbitrage value (which was the differential between injection and withdrawal prices) and the option value. The latter was the value derived from holding rights to gas that could be employed flexibly as a hedge against extreme prices, whether or not these prices were realized. Ofgem said that the analysis did not consider this option value. The expectation of volatile prices would tend to increase the option value of capacity. Importantly, the option value could be increased through the expectation of price manipulation on a relatively small number of days.

Expectations of price manipulation

8.42. The Lexecon report argued that the strategy to withhold flexibility would have to be implemented consistently in order to influence forward prices for Rough storage. Forward prices were driven by the expected value in the spot market. Consequently, forward prices for Rough, and for flexibility in general, could be increased by the expectation that Centrica was, or indeed might be, following a strategy of withholding flexibility from the market. Therefore, Centrica would not need to establish a pattern of historic conduct for the strategy to be profitable, the strategy would only need to be credible. Therefore, Centrica would not need to incur costs in establishing a pattern of consistent conduct.

Use of historic prices

8.43. Ofgem said that the Lexecon report used historic prices, rather than those that would be expected to prevail in a severe winter—this was a largely unavoidable simplification. The forward price of flexible gas supplies would depend upon the weighted expectation of the prices that would prevail under all possible weather out-turns. In a severe winter, gas prices would tend to be high and supply would tend to be more inelastic than in a moderate winter. Therefore, the analysis had not incorporated the disproportionate effects of the expectation that Centrica would withhold flexibility from the market in a severe winter, when supply was more inelastic than in the scenario presented in the Lexecon report.

Ofgem's response to the CC's remedies statement

Summary

8.44. Ofgem said that it had concerns about the effectiveness and implications of the undertakings suggested by the CC in its remedies statement (see Appendix 2.2). Ofgem considered that the suggested undertakings would need to be strengthened in order to address the detriments resulting from the transaction. In addition, it considered that the nature of some of the suggested undertakings would unnecessarily and artificially distort Great Britain's gas market, including by extending the scope of regulation. Ofgem therefore concluded that complete divestment would be a more appropriate response to the detriments raised by the transaction.

8.45. Ofgem said that it agreed with many of the individual points concerning possible undertakings in the statement but had significant reservations about the package as a whole.

Provision of flexibility to the market

8.46. Ofgem considered that the transaction had enhanced Centrica's market power in the market for flexible gas and that its control of Rough, together with other sources of flexible gas, would lead to an increased incentive to withhold gas from the market. Ofgem noted that this issue was difficult to address with behavioural remedies given the interactions between Rough capacity and the other sources of flexible gas which Centrica owned or in which it had a long-term contractual position, and the problems associated with seeking remedies with respect to a reduced incentive to expand capacity.

8.47. With regard to paragraph 1(a)(ii) of the remedies statement, Ofgem agreed that it was preferable for Centrica to reserve a proportion of capacity for its own storage requirements rather than participating in the primary sale of capacity. However, Ofgem considered that the amount of capacity Centrica was able to reserve should be set at a level materially below its likely requirements. Such a restriction would provide Centrica with a greater incentive to seek expansion of capacity at Rough, as well as providing it with an incentive to safeguard development of the secondary market.

8.48. In order to ensure that this incentive was effective, Ofgem considered that the ceiling on the proportion of capacity Centrica could reserve should be set at least ten percentage points below its recent historic requirements for Rough capacity. On this basis Ofgem believed that an upper limit of 15 per cent should be placed on the amount of capacity Centrica should be able to reserve for itself. This limit would not prevent Centrica increasing its bookings through purchases in the secondary market, and Ofgem did not propose a limitation on Centrica's overall bookings. Ofgem did not consider that a reservation of 20 per cent would provide Centrica with an adequate incentive to consider expanding capacity or an adequate incentive to participate actively in the secondary market.

8.49. With regard to 1*(a)*(iii) of the remedies statement, Ofgem said it had proposed that any expansion of capacity at Rough could be retained by Centrica, for its own use, without the constraints of undertakings relating to the sale of capacity. Ofgem said that it accepted there might be benefits in placing a limit on the period for which such capacity could be withheld from the market. Ofgem noted, however, that this would further dull the incentive on Centrica to expand capacity and make it even more important that such an incentive was sufficiently strong in the first place. Ofgem said that this illustrated how difficult it was to address some of the detriments associated with this transaction by means of behavioural remedies.

8.50. With regard to 1*(c)* of the remedies statement, Ofgem's analysis had concluded that, with respect to winter gas and daily flexibility, Centrica had long-term assets or contracts that could be substituted for Rough. Ofgem considered that these included the Morecambe gas fields, interruptible contracts and interconnector capacity. Ofgem's report on the transaction had indicated that there could be trade-offs between the undertakings suggested for Rough and Centrica's other sources of flexibility but that these presented difficulties (see paragraph 8.26).

8.51. Ofgem considered that the proposal that there could be a commitment to nominate maximum take from certain fields (including Morecambe and Sean) on particular days according to the demand or forward price in the market would be a retrograde step in the development of the UK gas market. Such artificial and mechanistic triggers were prone to causing unwanted market distortions, and Ofgem had spent considerable time, with the support of shippers and customers, encouraging a move away from such artificial gas market distortions. Ofgem also considered that such measures would, in the present case, be ineffective at addressing the detriment, leaving market power in the hands of Centrica, and therefore would be unlikely to solve the problem of interactions between the sources of flexibility.

Non-discrimination between customers

8.52. With regard to 2*(b)* of the remedies statement, the sale of capacity had to be on non-discriminatory terms. Ofgem said that it supported an undertaking which required the sale of capacity by auction. However, sale by auction required an agreement on an appropriate reserve price. The setting of this (other than at zero) was not straightforward. In the past, Ofgem had suggested that a reserve price be set to reflect the avoidable costs incurred by sale of additional capacity.

8.53. With regard to 2*(c)* of the remedies statement, Ofgem did not consider that Centrica should be allowed to control the method of sale unless an auction was available as a backstop. Ofgem also noted that it would be more difficult and costly to regulate a proposal which allowed Centrica to control the method of sale, even if it required publication of up-to-date prices on offer and the prices agreed for individual sales.

Information available to the market

8.54. With regard to 3*(a)*, Ofgem considered that robust separation was essential in any package of remedies. Ofgem said that it would support the CC's suggestion that there should be strict legal, financial and physical separation between Centrica's storage operations and all other parts of its business, up to main board level. Ofgem noted that Centrica had already moved the storage business into a Centrica building, and that the executive responsible for the storage business was not on the Centrica board. Neither of these organizational decisions by Centrica appeared to be compliant with the level of separation suggested by the CC.

Certainty provided to competitors and potential entrants

8.55. Ofgem considered that a significant proportion of capacity should be made available on long-term contracts. Ofgem noted that such a requirement was not only necessary in order to provide certainty to competitors and potential entrants, but also had a crucial part to play in addressing the incentive to withhold capacity from the market. In particular, the requirement for a specified amount of capacity to be sold on a long-term basis could be understood as seeking to provide a kind of semi-structural remedy for the detriments arising from the transaction. The intention should be that, whilst Centrica was allowed to retain full ownership of the facility, the undertakings would substantially reduce Centrica's financial interest in, and effective control of, Rough for a defined period. If this was not achievable, Ofgem would question whether a set of behavioural undertakings could be put in place to address the detriments.

8.56. Ofgem said it was important that long-term contracts for Rough capacity were for a sufficient period of time to make this contractual solution effective. The weighted average of long-term contract sales would therefore have to be at the middle to upper end of the three- to seven-year spread proposed by the CC. Ofgem said that three years would not be adequate.

8.57. Ofgem noted the CC's provisional decision that prohibiting indexed contracts would not be appropriate as it would reduce customer choice. This diminished the purpose of using long-term contracts as a way of reducing Centrica's incentive and ability to manipulate wholesale gas prices.

Structural remedy

8.58. Although Ofgem believed that a set of undertakings could be arrived at that would substantially address the detriments that had arisen, it did not consider that such a package was contained within the possible remedies that were presented within the CC's remedies statement. In particular, Ofgem considered that:

(a) Centrica should be permitted to reserve no more than 15 per cent of capacity;

(b) indexation of contracts undermined the long-term capacity remedy;

(c) the proposed undertakings on Morecambe, Sean and other Centrica gas contracts would distort Great Britain's gas market; and

(d) long-term contracts of below five years would not address the detriments.

8.59. Ofgem said that it had also highlighted the complexity of introducing behavioural remedies to address the detriments that resulted from this particular transaction. In particular, Ofgem was concerned about the increase in the regulatory burden associated with monitoring such a set of undertakings, the implications this might have for future regulation of the storage industry, and the potential distortions that might be introduced into the wider gas market.

Hearing with Ofgem on Monday 19 May

8.60. Commenting further on the Lexecon report, and specifically on the extent to which Centrica would be able to pass through to domestic customers an increase in the wholesale price of gas, Ofgem agreed that Centrica's competitors were likely to be partly hedged against increases in wholesale gas prices, and that Centrica would therefore be able to pass on only part of an increase in wholesale prices straight away. However, Centrica was in a different position from other suppliers because of the length of its protection from full exposure to the NBP resulting from the contracts it had inherited and in particular because of its Morecambe fields. Ofgem doubted that other suppliers would be shielded from increases in the wholesale price as much as Centrica was.

8.61. Commenting on the domestic gas supply market, Ofgem said that Centrica had a choice of strategies open to it. It could seek to impose a margin squeeze in order to deter entry and perhaps reduce the number of existing suppliers with a view to making the market vulnerable to coordination; or it could raise prices in order to boost profits.

8.62. On the former possibility, Ofgem noted that the six existing large suppliers were not all active in every part of the country. Suppliers had the ability to target their marketing efforts in a regionally differentiated way, creating an infrastructure which could be used to coordinate behaviour. At present, however, there were several indicators of a reasonably healthy market—a high level of switching by customers, a good level of discounting, innovation in the form of new contract types—and Ofgem's view was that the market was still competitive.

8.63. In Ofgem's view, therefore, it was more likely that Centrica would raise its prices. Experience over the last two years suggested that, if it did so, other suppliers would follow. Following the adverse reaction to Centrica's price increases in early 2002, Centrica had rebuilt its ability to win new customers.

8.64. On the question of possible remedies, Ofgem made the following points in amplification of the views expressed in its written response to our remedies statement:

(a) With regard to long-term contracts for Rough capacity, Ofgem said that there were two possible approaches: to require that a specified proportion of capacity had to be sold on long-term fixed-

price contracts, at whatever price it took, or only that such contracts should be offered. If the view was taken that the former would be unduly penal on Centrica, given the apparently low demand for such contracts, the question would arise of what reserve price Centrica might be permitted to set in offering contracts. This was a difficult issue. In principle, if the aim was to give signals for possible investment in new storage facilities, a reserve price based on long-run marginal cost, that is a relatively high price, might be appropriate. If the aim was to guard against the hoarding of capacity by Centrica, a reserve price based on short-run avoidable cost (a low price) would be preferable. Since the main aim in the present situation would be to ensure that capacity was put in the hands of players other than Centrica, the appropriate basis might be avoidable cost even for auctions of long-term capacity.

(b) Although the nominal capacity of Rough, as reflected in the structure of 455 million SBUs, did not accord with the actual capacity, Ofgem saw no strong need to review the definition of the capacity which Centrica should be required to offer.

(c) With regard to the possibility of a remedy requiring Centrica to produce maximum output from Morecambe in specified circumstances, Ofgem said that it was open to Centrica to control that variable. Experience showed that Centrica's forecasts for Morecambe deliverability consistently underestimated the true position.

(d) Ofgem acknowledged that, before the reference was made to us, it had proposed to the OFT that Centrica be allowed to sell Rough capacity by means other than auctions. It had expected that a mechanism, based on transparency or reporting to the regulatory authorities, could be established that would ensure that sales by means other than auctions were made in a non-discriminatory way. When Dynegy had owned Rough, Ofgem had received information on the timing, volume and price of all sales. It had received and investigated one complaint about Dynegy's sales and had concluded that there had been no discrimination in that case.

D KINGSMILL *(Chairman)*

J COLLINGS

B LYONS

N MACDONALD

R FOSTER *(Secretary)*

4 July 2003