Centrica plc
and
Dynegy Storage Ltd and
Dynegy Onshore Processing UK Ltd

A report on the merger situation

COMPETITION COMMISSION

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Presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty
August 2003

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Members of the Competition Commission as at 4 July 2003

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[1]These members formed the Group which was responsible for this report under the chairmanship of Mrs D P B Kingsmill. In addition, Mr N C L Macdonald, a member of the CC's specialist utilities panel, and as such eligible to serve on a merger inquiry, was a member of the Group.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which she considers would not be in the public interest to disclose and which, in her opinion, would seriously and prejudicially affect certain interests.

The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.

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Summary and Conclusions

1 Summary

1.1. We were asked to report on the acquisition by Centrica plc (Centrica) from Dynegy Inc (Dynegy) of two companies which owned and operated the Rough gas storage facility and associated assets: see Appendix 1.1 for our terms of reference. Rough, a partly depleted offshore gas field, is by far the largest gas storage site in the UK.

1.2. Centrica was formed by the 1997 demerger of British Gas plc into two parts—Centrica and BG plc (BG—now BG Group plc (BG Group)). At the time, Centrica was mainly involved in retail gas supply but it also owned the large Morecambe Bay gas fields. It has since diversified, in particular by entering the UK electricity industry. Its core strategy is to sell a range of essential services to domestic customers. In 2002 it reported turnover of £14.3 billion and operating profits of £932 million.

1.3. Dynegy, a US energy company, acquired Rough from BG Group in 2001. It then ran into financial difficulties. During 2002 and the first part of 2003 it divested its European assets in order to improve its financial position and focus on its core business in North America. As part of this process, Centrica acquired Rough from Dynegy in a private sale for £316 million, including £12 million in respect of net working capital. The turnover of the acquired business in 2002 was £87 million.

The regulatory background

1.4. At the time of the 1997 demerger, the storage operations of the former British Gas plc passed to BG and were regulated under its transportation licence. Following a review by the regulator, price controls on the Rough business were lifted in favour of a set of informal undertakings given by BG. The main elements of these undertakings were that BG would offer the full capacity of Rough to potential users on non-discriminatory terms under the provisions of a standard storage services contract (SSC); sell all capacity by an auction procedure agreed with Ofgas; auction at least half the capacity for periods of not less than five years and the remainder for periods of not less than one year; facilitate the development of a secondary market in storage services; and maintain full separation between the storage operation and the rest of BG.

1.5. When Dynegy acquired Rough it gave statutory undertakings in lieu of the acquisition being referred to the CC. These incorporated the main elements of BG's undertakings, save that Dynegy was allowed to sell capacity by means other than auctions.

The relevant markets

1.6. Storage is used to help deal with fluctuations in gas supply and demand and the associated movements in gas prices. Variations in demand are particularly pronounced in relation to domestic customers. Rough is used primarily for seasonal storage since it can deliver a substantial amount of gas—equivalent to about 7.5 per cent of Great Britain peak demand—for 67 days, a period equating broadly to the January to March winter quarter. Hence gas is injected into Rough in summer, when prices are low, and withdrawn in winter when prices are high. There are other means by which the industry secures flexibility: variations in UK gas production, known as beach swing; supplies from mainland Europe received via an interconnector; and interruptible supply contracts.

1.7. These various sources of physical flexibility are linked through the forward market for gas. Transactions in the forward market can be a substitute for physical sources of flexibility. Hence there is an interaction between forward prices for gas, which are influenced by the expected availability of physical flexibility, and the prices of physical flexibility, which are themselves influenced by forward gas prices.

1.8. The price of Rough's capacity is closely related to the differential between the forward prices for gas in summer and in the first quarter of the following year, reflecting its prime use as a source of seasonal (rather than short-term) flexibility. All sources of flexibility contribute to some extent to this differential but in assessing the merger's effects we took account of the fact that some sources are much weaker substitutes for Rough than others.

1.9. Centrica has other sources of flexibility available to it through ownership or long-term contracts. Looking at shares of the maximum flexibility that can be made available over the winter, Centrica had 34 per cent of the total and the merger—attributing the whole of Rough's capacity to Centrica—increased this to 46 per cent. Centrica's share of flexibility actually used in the last three winters ranged from 40 to 51 per cent, which Rough's usage would have increased to 59 to 70 per cent. The share of flexibility represented by Centrica's existing sources is likely to decline over the next few years but will still be substantial.

1.10. In the retail supply of gas Centrica's share of supply to non-domestic customers is around 20 per cent. Its share of supply to domestic customers—a market that was not fully open to competition until May 1998—is far higher, around 63 per cent. (Hence it is to be expected that Centrica will have a high share of the sources of flexibility.) Centrica's only significant competitors in this market are five companies which all have their origins in the publicly-owned electricity industry. Just as they have entered the domestic gas supply market, Centrica has entered the domestic electricity supply market, in which it is now the joint leading supplier with about 22 per cent of customer accounts. Supply to domestic gas and electricity customers appears to be converging towards a single market.

Public interest issues

1.11. A major issue for the inquiry was whether, as a result of the merger, Centrica would be likely to withhold sources of flexible gas in order to force up wholesale gas prices. It appeared to us that Centrica had the ability to do this, and that such a strategy could be profitable if most of the resulting increase in wholesale prices were passed on to domestic customers, although the potential gain would be modest in relation to the costs involved and subject to uncertainty. We noted, however, that the reputational risk if it were demonstrated that the company had manipulated the market in this way would damage the British Gas brand and would be likely to trigger a significant loss of domestic customers, as well as adverse regulatory consequences. For Centrica to engineer an increase in wholesale prices and pass on the increase to domestic customers would also be inconsistent with its pricing behaviour over the last few years. We consider that there is not a sufficient basis for concluding that Centrica may be expected to withhold capacity, as a result of the merger, in order to increase wholesale prices.

1.12. We have, however, concluded that, in the absence of further constraints, Centrica may be expected:

(a) to discriminate between customers in giving access to capacity at Rough;

(b) to use to its advantage sensitive information gained from the operation of Rough;

(c) to withhold information about the operation of Rough;

(d) to be less innovative in marketing Rough products than another owner; and

(e) to invest less in expanding Rough's capacity than another owner.

We also believe that the merger will increase the uncertainty faced by other industry participants and potential entrants.

1.13. We consider that, as a result, competition in the markets for flexible gas and domestic gas supply will be weakened, with the likely consequence that prices will be higher than in the absence of the merger. We also believe that innovation and investment at Rough will be lower than under another owner. There is some benefit to the public interest in Centrica, as owner of Rough, being a known quantity with regard to operational experience, reputation and financial strength, whereas the alternative to the merger is uncertain. We do not consider that this benefit outweighs the adverse effects which we have identified, and we therefore conclude that the merger may be expected to operate against the public interest.

Remedies

1.14. We consider that the adverse effects which we have identified can be remedied by Centrica giving statutory undertakings regarding its behaviour as owner of Rough. The major elements of the undertakings we recommend are that Centrica would:

— sell Rough's full capacity on non-discriminatory terms, retaining the existing SSC;

— auction all capacity remaining unsold no less than 30 days before the start of each storage year, with no reserve price;

— not participate in the primary sale process but reserve no more than 20 per cent of Rough's existing nominal capacity for itself in the first year (2004/05) falling to 15 per cent over five years and remaining at that level thereafter: this is to give Centrica an incentive to invest in expanding Rough's capacity, in that Centrica would be able to retain any incremental capacity for its own use;

— maintain legal, financial and physical separation between its storage business and all other parts of the group; ensure that no commercially sensitive information arising from the operation of Rough is passed to other parts of Centrica; and make any disclosure of information relating to the storage operations to all market participants simultaneously;

— facilitate the efficient operation and development of the secondary market in Rough capacity;

— offer at least 20 per cent of Rough's capacity on annual contracts; capacity should also be offered on a range of other durations and with the possibility of fixed or indexed pricing; and

— arrange for an independent review of compliance with all undertakings by Centrica's Audit Committee, with annual reports to the Office of Fair Trading and the Office of Gas and Electricity Markets.

Divestment of the assets acquired remains a possible remedy if Centrica is not prepared to give the full set of undertakings that we recommend.