

**Request for a review of the Undertakings given by Centrica plc and Centrica Storage Limited pursuant to Section 88 of the Fair Trading Act 1973 in relation to Centrica plc's acquisition of Dynergy Storage Ltd and Dynergy Onshore Processing UK Ltd**

ME/4529/10

The OFT's advice to the Competition Commission on Centrica plc's request for a review of undertakings under section 88(4) of the Fair Trading Act 1973 given on 8 September 2010. Full text of advice published 8 November 2010.

---

**Please note that the square brackets indicate figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.**

**CENTRICA PLC'S ACQUISITION OF DYNERGY STORAGE LTD AND DYNERGY ONSHORE PROCESSING UK LTD**

**REQUEST FOR A REVIEW OF UNDERTAKINGS**

1. In this submission I advise under section 88(4) of the Fair Trading Act 1973<sup>1</sup> (the Act) on a request for a review of and release from the Undertakings given by Centrica plc (Centrica) and Centrica Storage Limited (CSL) to the Secretary of State for Trade and Industry pursuant to section 88 of the Fair Trading Act 1973. The Undertakings were given on 18 December 2003 following the Competition Commission's (CC) report<sup>2</sup> into the above merger (the Undertakings). The Undertakings were varied on 3 April 2006.
2. Centrica requests a review of and release from the Undertakings for the following reasons:

---

<sup>1</sup> Schedule 24, paragraph 16 Enterprise Act 2002 and section 88(4) of the Fair Trading Act 1973

<sup>2</sup> Competition Commission (2003), *Centrica plc and Dynergy Storage Ltd and Dynergy Onshore Processing UK Ltd: A report on the merger situation* (the 'CC 2003 Report').

- a change in market conditions since the CC report in 2003
  - a change in the legal framework as a result of the introduction of the new European Third Package requirements on storage operators.
3. Centrica's request is very broad in nature as it is seeking a review of all the undertakings rather than specific undertakings. Nevertheless, the OFT has received some evidence that there has been a change of circumstance since the Undertakings were accepted that warrant a review of the Undertakings.
  4. The advice first sets out the background to the Undertakings and Centrica's request for review. This is followed by a substantive assessment as to whether there has been a change of circumstances both in terms of market conditions and in the legal framework. The views of Centrica and third parties are considered as part of the assessment before the OFT concludes its advice.

## **BACKGROUND**

5. On 14 November 2002, Centrica, through its wholly owned subsidiary Centrica Storage Holdings Limited (CSHL), acquired the entire issued share capital of Dynergy Storage Limited and Dynergy Onshore processing UK Limited. The acquisition was referred by the Secretary of State for Trade and Industry (SoS) to the CC for investigation on 25 February 2003, under the Fair Trading Act 1973.
6. The effect of the transaction was to combine Centrica with two companies which owned and operated the Rough gas storage facility, the largest gas storage site in the UK, and associated assets.
7. The CC concluded in its report that, in the absence of further constraints, Centrica may have been expected to:
  - discriminate between customers in giving access to capacity at Rough
  - use to its advantage sensitive information gained from the operation of Rough
  - withhold information about the operation of Rough
  - be less innovative in marketing Rough products than another owner, and
  - invest less in expanding Rough's capacity than another owner.

8. The CC also believed that the merger would increase the uncertainty faced by other industry participants and potential entrants.
9. As a result of the above detriments, the CC considered that competition in the markets for flexible gas and domestic gas supply would be weakened, with the likely consequence that prices would be higher than in the absence of the merger. The CC also believed that innovation and investment at Rough would be lower than under another owner. The CC consequently found that the completed acquisition may have been expected to operate against the public interest.
10. In order to remedy the identified adverse effects of the merger, the CC requested a number of behavioural undertakings from Centrica. The major elements of the undertakings are that Centrica would:
  - sell Rough's full capacity on non-discriminatory terms, retaining the existing Storage Services Contract
  - 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
  - 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 disclose 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
  - arrange for an independent review of compliance with the undertakings by Centrica's Audit Committee, with annual reports to the OFT and Ofgem.
11. Pursuant to a request by the SoS, the OFT, in concert with The Office for Gas and Electricity Markets (Ofgem), consulted with Centrica and CSL with a view to obtaining from them undertakings in accordance with section

88(1) of the Act. The SoS accepted the Undertakings in accordance with section 88(2) of the Act on 18 December 2003.

12. On 3 April 2006, paragraph 5.3 (a) of the Undertakings was varied. The variation applied in respect of Centrica's wish, as part of an internal group restructuring, to establish a new intermediate holding company, Centrica Holdings Limited (CHL), within the Centrica Group.

### **CENTRICA'S REQUEST FOR REVIEW**

13. Centrica submitted a request on 28 April 2010 for a review of the Undertakings as they believe they are no longer required. Centrica identified two main changes of circumstance:

- i. changes in market conditions, and
- ii. changes in the legal framework.

Centrica also submitted that, in considering the case for removing the Undertakings, the costs of maintaining the Undertakings should not be ignored.

14. In Centrica's view, changes in market conditions have significantly affected Centrica's position in the flexible gas market compared to 2003, with a significant decline in Centrica's market share, and in ways not anticipated by the CC in its 2003 Report.
15. In relation to the legal framework, Centrica indicated that the introduction of the new European Third Package of legislation on the internal gas market<sup>3</sup> will replace the need for many of the requirements of the Undertakings,<sup>4</sup> because the new legislation addresses any potential concern remaining over Centrica's market position. Further, Centrica considered that the Third Package will make a number of provisions included in the Undertakings problematic against the requirements of the law.

---

<sup>3</sup> Directive 2009/73/EC and Regulation (EC) No 715/2009.

<sup>4</sup> The European Third Package of legislation has to be implemented in the UK by 3 March 2011.

## CHANGE OF CIRCUMSTANCES

16. Under change of circumstances the OFT has considered separately changes in market conditions and changes in the legal framework. The next section describes the alternative sources of flexible gas and then presents Centrica's and Ofgem's views before discussing the OFT's assessment in considering whether there has been a change of circumstances in market conditions. The following section describes the Third Package, presents the views of the Department for Energy and Climate Change (DECC) and Ofgem, and finally discusses the OFT's assessment in considering whether there has been a change of circumstances in the legal framework.

## CHANGE OF CIRCUMSTANCES 1: MARKET CONDITIONS

### Sources of flexible gas

17. Gas storage is used to balance peak daily and seasonal fluctuations in gas supply and demand. It would be uneconomic to have sufficient production and import capacity to meet the highest levels of winter demand, since that would entail operating at very low levels of utilization in summer.
18. Different storage facilities have differing technical characteristics – mainly injectability rate,<sup>5</sup> deliverability rate,<sup>6</sup> space<sup>7</sup> and duration<sup>8</sup> – which lead to different usage patterns.
19. According to their duration, storage facilities may be classified as follows:
  - **Long range storage facilities (LRS)** are facilities able to deliver gas from their maximum stock at full capacity for a duration of more than two months. As such, these facilities are particularly suitable to provide seasonal flexibility. Rough is the only facility of this type in the GB.
  - **Short range storage facilities (SRS)** are facilities with the capability to deliver gas from their maximum stock at full capacity for less than five days. In the GB, SRS are LNG storage facilities, which are able to provide a high rate of deliverability but have very low injection rates, and therefore are generally used for 'peak shaving' on the few coldest

---

<sup>5</sup> Rate at which the gas can be injected (GWh/day).

<sup>6</sup> Rate at which the gas can be withdrawn (GWh/day).

<sup>7</sup> Total amount of deliverable gas that the site can hold when full (GWh).

winter days.

- **Medium range storage facilities (MRS)** have characteristics which fall between those of Rough and the LNG storage sites and are defined as facilities with the capability to deliver gas from their maximum stock at full capacity for between five and 70 days.<sup>9</sup>

20. The storage of gas is one of several means by which flexibility can potentially be secured. Other potential sources of flexible gas in the UK may currently include:

- UK Continental Shelf (UKCS or Beach), the domestic offshore production<sup>10</sup>
- imports through:
  - the Interconnector UK (IUK), the Belgian-UK interconnector
  - the Balgzand Bacton Line (BBL), the Dutch-UK interconnector, and
  - pipelines from Norway, including the Langeled and Vesterled pipelines and the Tampen link
- LNG imports at various terminals, including Isle of Grain, Dragon, South Hook and Gas Port, and
- interruptible supplies to Commercial & Industrial customers and other demand-side responses (DSR), such as gas to oil switch in power generation in response to high gas prices.

21. Since the CC 2003 Report the relevance of each source in the supply of (flexible) gas has changed to some extent.<sup>11</sup> On the one hand, new

---

<sup>8</sup> Length of time for which gas can be withdrawn at maximum daily deliverability when the site is full.

<sup>9</sup> See Ofgem, EDF Energy Plc's application for an exemption from section 19B of the Gas act 1986, Consultation Document, December 2009 (the 'Hill Top Farm Consultation Document'), paragraph 3.17.

<sup>10</sup> The CC 2003 Report refers to 'beach swing' as the seasonal variation in supply contracts from domestic offshore production, which thus ensures some seasonal flexibility (CC 2003 Report, paragraph 4.70).

<sup>11</sup> Centrica indicated that, over the last nine years, the GB gas market has attracted over £10 billion of investment in infrastructure which has helped deliver a 500 per cent increase in the UK's import capacity and a 30 per cent increase in storage capacity (Centrica, based on National Grid's 2009 Ten Year Statement).

facilities have started operating (notably the BBL<sup>12</sup> and the LNG import terminals) and pipeline and LNG imports have significantly increased their role in the overall gas supply.<sup>13</sup> On the other hand, the UKCS's contribution to the overall gas supply has continued to decline<sup>14</sup> and long-term interruptible (LTI) sale contracts are less important than they once were.

22. The OFT also notes that further changes in the mix of (flexible) gas sources may occur in the future. Future demand for flexibility is uncertain and there is a significant number of proposed new storage and LNG import projects, but the extent to which all of these will be built is still uncertain. Centrica indicated that the evidence suggests that the market is trying to respond to the likelihood of increased future demand for flexible gas in the UK, with around 20 BCM<sup>15</sup> of new storage capacity planned, several new LNG import projects planned and options to expand import pipelines including the IUK and BBL.
23. Therefore, it is clear from the limited investigation undertaken by the OFT that there has been a significant change in the sources of (flexible) gas since the CC Report in 2003.

### **Centrica's View**

24. Centrica considers that market conditions have changed significantly since the CC 2003 Report. In particular, it argues that the decline in gas indigenously sourced from the UKCS and an increased role for pipelines and LNG imports have led to a substantial change to the gas flexibility market and, in particular, to a significant decline in Centrica's market share.
25. As regards the definition of the flexible gas market, Centrica considers that a number of new sources of flexible gas have become available to the market, providing both seasonal shape and short term flexibility in competition with gas storage and UKCS sourced flexible gas. On the supply-side, these new sources include Norwegian pipeline imports; the

---

<sup>12</sup> BBL started its operations in November 2006.

<sup>13</sup> Centrica indicated that the three main new gas sources – that is, Norwegian imports, BBL and LNG imports – account for over 40 per cent of the maximum daily supply capacity of the British gas market.

<sup>14</sup> Centrica indicated that peak deliveries from the UKCS have declined from around 345 million cubic meters (mcm)/day in 2000/2001 to less than 200 mcm/day in 2008/2009 (Centrica, based on National Grid data).

<sup>15</sup> Billion cubic meters.

IUK;<sup>16</sup> the BBL and the LNG import facilities. On the demand-side, a new source of flexible gas arises from the ability of gas-fired power generators to switch from gas to oil generation in response to high gas prices.<sup>17</sup>

26. Centrica, in particular, considers that there is no firm divide between daily and seasonal flexibility sources and consequently adopts a wide definition of the gas flexibility market. In this respect, it submitted that it considers the CC's 2003 approach to product market differentiation, using daily and seasonal measures of flexibility,<sup>18</sup> to be the more appropriate one and Ofgem's exclusion of major sources of flexibility (such as Norwegian gas and BBL) in its recent nTPA<sup>19</sup> exemption decisions (see paragraph 33 below) as particularly inappropriate.
27. As regards the determination of its share of the flexible gas market, Centrica considers that the long-term capacity rights (bookings) it holds in the Isle of Grain LNG import terminal, at IUK and BBL<sup>20</sup> do not give it the ability to withhold capacity from the market and, due to the terms of its import contracts, would not generate any extra profit for Centrica if the price of flexible gas (that is, winter-summer spread) were to increase. The latter consideration applies, in Centrica's view, to its LNG supply contracts (based on spot cargoes) and to the supply contracts it has with Gas Terra<sup>21</sup> (Norwegian imports) and Statoil<sup>22</sup> (BBL imports). As a consequence, Centrica does not consider these sources of supply to contribute to its market share.
28. Centrica considers that its position in the flexible gas market has developed since 2003. In particular: (i) Centrica's UKCS sources (most notably the

---

<sup>16</sup> Centrica considers that in 2003 the IUK was still a fairly young facility and had not established a very clear pattern of operations. Since then, increased imports from other sources have supported the continued contribution of the IUK to flexibility, in that the interconnector has been exporting higher quantities in summer than in winter (effectively giving additional shape to the levels of gas consumed in GB) and has been able to respond to short term variations in the supply/demand balance on each side. Centrica estimates the maximum IUK deliverability at 512 GWh/day, based on IUK's maximum historical inflow observed on 22 February 2006.

<sup>17</sup> To note that, in contrast with the CC 2003 Report, Centrica does not include LTI contracts within the DSR relevant to the definition of the flexible gas market.

<sup>18</sup> See Appendix 1, paragraph 4.

<sup>19</sup> Negotiated third party access.

<sup>20</sup> [ ]

<sup>21</sup> The contract is for the supply of 270 GWh/day in winter and 161 GWh/day in summer (Centrica's response to the OFT questions dated 15/6/2010, Q.12).

<sup>22</sup> The contract is for the supply of 148 GWh/day, flat across the year (Centrica's response to the OFT questions dated 15/6/2010, Q.12).

Morecambe fields<sup>23</sup>) have declined and its flexible Sean supply contract will expire on 1 October 2011;<sup>24</sup> and (ii) its long-term interruptible sale contracts (LTI), which were considered to provide significant short-term contractual flexibility, are all expired or close to expiry (with the last contracts expiring in 2010/11).

29. As a result of these developments, Centrica estimates that its shares of the flexible gas market<sup>25</sup> have fallen significantly since 2003. In terms of peak daily flexibility, the share is estimated to fall from 34.2 per cent (according to the CC 2003 Report, see Table 4) to [15-20] per cent in 2010/2011 ([15-20] per cent in 2009/2010, see Table 1). In terms of winter flexibility, the share is estimated to fall from 46.3 per cent (according to the CC 2003 Report, see Table 4) to [15-20] per cent in 2010/2011 ([15-20] per cent in 2009/2010, see Table 2).
30. Looking forward, Centrica considers that, even taking into account the new gas storage projects that Centrica may pursue (that is, Caythorpe, Bains and Baird projects), and taking a conservative view on the likely development of rival sources of flexibility, Centrica's share is not expected to return to anything close to the levels of 2003.<sup>26</sup>

### **Ofgem's View**

31. Ofgem considers that industry conditions have changed since the Undertakings were implemented, with declines in indigenously sourced gas in the UK and an increased role for pipeline and LNG imports, and that Centrica's market share has decreased since 2003. However, it does not

---

<sup>23</sup> [ ]

<sup>24</sup> [ ]

<sup>25</sup> Centrica's methodology to calculate its shares of the flexible gas market, in terms of maximum daily flexibility and maximum winter flexibility, is based on an estimation of the maximum market/Centrica's deliverability on a peak day and on a typical winter day for each source of flexible gas. The aggregate (that is, across all sources) daily deliverability estimates are then compared with the aggregate average daily supplies across the year to get a measure of peak day and winter flexibility. For the purpose of winter flexibility calculation, Centrica introduced an assumption over the duration of storage sources that takes account of their 'ability to cycle'. This assumption is considered to capture the fact that partially depleted storage facilities can be refilled even in winter, so that the total delivery of a gas facility over time can be greater than its total capacity (that is, space). The duration of each storage source is, in particular, calculated assuming that the facility is cycled 'as much as possible' over the winter period (Centrica's response to the OFT questions dated 15/6/2010, Q.9). In what follows, we will refer to this assumption as 'cycling' (footnote 51).

<sup>26</sup> Based on estimates provided by Centrica, in 2014/2015 its share of peak daily flexibility will be 20.5 per cent and its share of winter flexibility will be 18.9 per cent.

agree with Centrica as to the size of the change and considers that Centrica continues to have market power and will do so in the future.

32. In particular, Ofgem indicated that Centrica's analysis uses a very broad definition of the flexibility market and, in contrast, uses a narrow definition of the sources of supply that should contribute to its market share. As a result, Centrica's market share estimates are lower than those which Ofgem believes are appropriate.
33. As regards the definition of the flexible gas market, Ofgem does not believe it is appropriate to include sources of supply such as pipeline imports from Norway, the BBL and DSR as these sources are not substitutable for storage at Rough.<sup>27</sup>
34. As regards the competitive assessment, Ofgem considers that, given the considerable difficulties in accurately defining the flexibility market, the informative value of market shares as a measure of market power can be diminished. [ ]<sup>28</sup> [ ].
35. Ofgem's market share analysis indicates that, under a range of scenarios and definitions of the flexibility market, Centrica's market share remains at over [ ] per cent in coming years and it will be significantly above the current levels from 2013 onwards. Ofgem considers that such market shares indicate that Centrica still has market power and that its market power is expected to increase.
36. [ ]<sup>29</sup>

---

<sup>27</sup> See Appendix 1, paragraph 7 (ii) for a more detailed discussion of Ofgem's recent approach to market definition.

<sup>28</sup> [ ]

<sup>29</sup> [ ]

## OFT assessment

### Methodology

37. The OFT assessment of changes in market conditions focused on an analysis of market indicators, namely changes in Centrica's shares of supply in the flexible gas market. At this stage, the OFT has not undertaken a comprehensive competitive assessment, analysing changes in the competitive constraints on Centrica and in its ability/incentives to exercise any market power in the flexible gas market. The OFT notes that a full competitive assessment might benefit from the use of new approaches [ ].
38. The analysis of shares of supply involves two steps: (i) the definition of the flexible gas market; and (ii) the determination of Centrica's share of the flexible gas market.
39. At this stage the OFT has not reached a conclusive view regarding the more appropriate definition of the flexible gas market and the appropriate way to determine Centrica's shares of supply. The approach is rather to consider alternative methodologies – both in terms of definition of the flexible gas market and determination of Centrica's share – and to calculate Centrica's shares of supply according to each of these. Typically the market definitions range from a 'wider' Centrica definition to a 'narrower' Ofgem one.
40. Further details of the methodology used in the assessment can be found in Appendix 1.

### Results

41. In what follows, the OFT presents Centrica's shares of supply in 2009/2010 calculated according to the alternative methodologies described in Appendix 1 – both in terms of definition of the flexible gas market and determination of Centrica's share – and compare them with the 2002/2003 figures in the CC 2003 Report.
42. The evidence presented has been provided by Centrica, in its submission and further information requests, except for the share of supply figures related to the CC 2003 Report. These have been sourced directly from the

CC 2003 Report. To note, in relation to the shares of supply in 2002/2003 the figures reported in the tables are based on both the CC 2003 Report and Centrica's estimates, provided in the current investigation, using the different methodologies described in Appendix 1. Although the latter allow a 'like with like' comparison of Centrica's market position in 2009/2010 and 2002/2003, we consider that the main reference for us to assess the change in market conditions is the CC 2003 Report.

43. Tables 1 – 3 show Centrica's shares of supply in 2009/2010 in terms of maximum daily flexibility, maximum winter flexibility and winter flexibility usage in the last three years respectively. Table 4 displays Centrica's shares of supply in 2002/2003 post-merger (that is, including Rough). The results are discussed in more detail below.

Table 1 - Centrica's share of supply of maximum daily flexibility in 2009/2010

	Centrica case (per cent)	Centrica case + bookings (per cent)
Scenario 1 – Centrica	[15-20]	[20-25]
Scenario 2 - Ofgem		
- 0% LNG	[40-45]	[40-45]
- 50% LNG	[30-35]	[35-40]
- 100% LNG	[25-30]	[30-35]
Note: Ofgem's scenarios assume Centrica's share of flexible beach at [ ] per cent.		
Source: Centrica.		

Table 2 - Centrica's share of supply of maximum winter flexibility in 2009/2010

	Centrica case (per cent)	Centrica case + bookings (per cent)
Scenario 1 - Centrica		
- cycling	[15-20]	[20-25]
- no cycling	[15-20]	[20-25]
Scenario 2 - Ofgem		
- 0% LNG	[45-50]	[50-55]
- 50% LNG	[30-35]	[35-40]
- 100% LNG	[25-30]	[30-35]
Note: Ofgem's scenarios assume Centrica's share of flexible beach at [ ] per cent and 'no cycling'.		
Source: Centrica.		

Table 3 - Centrica's share of supply of winter flexibility usage in last three storage years

	Centrica case (per cent)	Centrica case + bookings (per cent)
2007/2008	[35-40]	[40-45]
2008/2009	[20-25]	[25-30]
2009/2010	[30-35]	[30-35]
Source: Centrica.		

Table 4 - Centrica's shares of supply in 2002/2003 (per cent) - post-merger

	Maximum daily flexibility	Maximum winter flexibility	Winter flexibility usage		
			2000/2001	2001/2002	2002/2003
CC 2003 Report					
- including SRS/interruptions	34.2	46.3	70.8	59.0	62.3
- excluding SRS/interruptions	52.0	53.0			
Scenario 1 - Centrica					
- cycling	42.8	63.5			
- no cycling		65.2			
Scenario 2 - Ofgem					
- 0% LNG	58.1	61.6			
- 50% LNG					
- 100% LNG					
Notes: (*) For both Centrica and Ofgem scenarios, Centrica's estimates of maximum daily/winter flexibility show no difference between the 'Centrica case' and the 'Centrica case + bookings'.					
(**) Ofgem's scenarios assume Centrica's share of flexible beach at [ ] per cent and 'no cycling' in relation to the maximum winter flexibility.					
Source: CC 2003 Report and Centrica.					

Comparison of shares of supply of **maximum daily flexibility** in 2009/2010 and 2002/2003

44. As regards the maximum daily flexibility, the estimates of Centrica's share of supply in 2009/2010 (Table 1) range from [15-20] per cent (according to Centrica's methodology with bookings excluded) to [40-45] per cent (according to Ofgem's methodology under the assumption that zero per cent of the LNG imports is flexible and including Centrica's bookings). Taking the view that LNG imports contribute to some extent to the supply

of flexible gas, Centrica's share of supply would be [35-40] per cent (according to Ofgem's methodology under the assumption that 50 per cent of the LNG imports is flexible and including Centrica's bookings).

45. The estimates of Centrica's share of supply in 2002/2003 according to the CC 2003 Report (Table 4) range from 34.2 per cent (when SRS and interruptions are included in the relevant market) to 52 per cent (when SRS and interruptions are excluded from the relevant market).
46. By comparing Centrica's share of supply under the 'wide' definitions of the market according to the CC 2003 investigation and the present investigation respectively, the share has fallen from 34.2 per cent in 2002/2003 (according to the CC 2003 Report when SRS and interruptions are included in the relevant market) to [15-20] - [20-25] per cent in 2009/2010 (using Centrica's methodology, without and with bookings respectively). Under these scenarios, the decline in Centrica's share since 2002/2003 has been of approximately [10-15] percentage points.
47. By comparing Centrica's share of supply under the 'narrow' definitions of the market according to the CC 2003 investigation and the present investigation respectively, the share has decreased from 52 per cent in 2002/2003 (according to the CC 2003 Report when SRS and interruptions are excluded from the relevant market) to [30-35] – [35-40] per cent in 2009/2010 (using Ofgem's methodology under the assumption that 50 per cent of the LNG imports is flexible, without and with bookings respectively). Under these scenarios, the decline in Centrica's share since 2002/2003 has been of almost [15-20] percentage points.
48. Overall, this evidence shows that Centrica's share of supply of maximum daily flexibility has declined since 2002/2003, but the size of the reduction greatly depends on the assumptions underlying the estimation.

Comparison of shares of supply of **maximum winter flexibility** in  
2009/2010 and 2002/2003

49. The share of supply of maximum winter flexibility may be a better measure to assess the competitive constraints on Rough than the share of supply of maximum daily flexibility.<sup>30</sup>

50. The estimates of Centrica's share of supply of maximum winter flexibility in 2009/2010 (Table 2) range from [15-20] per cent (according to Centrica's methodology, with bookings excluded, but assuming 'no cycling') to [50-55] per cent (according to Ofgem's methodology under the assumption that zero per cent of the LNG imports is flexible and including Centrica's bookings). Taking the view that LNG imports contribute to some extent to the supply of flexible gas, Centrica's share of supply would be [35-40] per cent (according to Ofgem's methodology under the assumption that 50 per cent of the LNG imports is flexible and including Centrica's bookings).
51. The estimates of Centrica's share of supply in 2002/2003 according to the CC 2003 Report (Table 4) range from 46.3 per cent (when SRS and interruptions are included in the relevant market) to 53 per cent (when SRS and interruptions are excluded from the relevant market).
52. If we compare Centrica's share of supply under the 'wide' definitions of the market according to the CC 2003 investigation and the present investigation respectively, the share has fallen from 46.3 per cent in 2002/2003 (according to the CC 2003 Report when SRS and interruptions are included in the relevant market) to [15-20] – [20-25] per cent in 2009/2010 (according to Centrica's methodology, without and with bookings respectively, but assuming 'no cycling'). Under these scenarios, the decline in Centrica's share since 2002/2003 has been of approximately [25-30] percentage points.
53. If we compare Centrica's share of supply under the 'narrow' definitions of the market according to the CC 2003 investigation and the present investigation respectively, the share has decreased from 53 per cent in 2002/2003 (according to the CC 2003 Report when SRS and interruptions are excluded from the relevant market) to [30-35] – [35-40] per cent in 2009/2010 (according to Ofgem's methodology under the assumption that 50 per cent of the LNG imports is flexible, without and with bookings respectively). Under these scenarios, the decline in Centrica's share since 2002/2003 has been of approximately [15-20] percentage points.
54. Overall, this evidence shows that Centrica's share of supply of maximum winter flexibility has declined since 2002/2003, and in particular it has declined more than the share of maximum daily flexibility. However, as

---

<sup>30</sup> See Appendix 1, paragraph 9.

noted above, the size of the reduction greatly depends on the assumptions underlying the estimation.

#### Comparison of shares of supply of **winter flexibility usage** in 2009/2010 and 2002/2003

55. The use of a measure based on actual use rather than on maximum capacity, such as the share of supply of winter flexibility usage, may be problematic when comparisons over time have to be drawn.<sup>31</sup> For completeness, however, we have presented the relevant estimates.
56. The estimates of Centrica's share of supply of winter flexibility usage in the three winters from 2007 to 2009 (Table 3) range from [20-25] per cent (in 2008/2009 when bookings are excluded) to [40-45] per cent (in 2007/2008 when bookings are included).
57. The estimates of Centrica's share of supply of winter flexibility usage in the three winters from 2000 to 2002 according to the CC 2003 Report (Table 4) range from 59 per cent (in 2001/2002) to 70.8 per cent (in 2000/2001).
58. Overall, this evidence shows that Centrica's share of supply of winter flexibility usage has declined since 2002/2003.

#### **Conclusion**

59. The OFT notes that industry conditions have changed since the CC 2003 Report, in particular with declines in indigenously sourced gas in the UK and an increased role for pipeline and LNG imports. Further, based on the evidence and analysis presented in the previous sections, the OFT considers that Centrica shares of supply of flexible gas have decreased since 2003 in almost all scenarios.
60. However, the extent of the change is not clear cut. The analysis shows that Centrica's shares of supply significantly depend on the scenarios and assumptions underlying the estimation and this produces a broad range of market shares.

---

<sup>31</sup> See Appendix 1, paragraph 10.

61. Furthermore, the OFT is conscious that market shares are only an indicator used to assess market power and it has not concluded on whether Centrica continues to have market power. Indeed, the OFT believes that a full competitive assessment is necessary to determine the significance of the market changes upon Centrica's ability and incentives to exercise any market power it may have and that the CC is best placed to undertake such an assessment.
62. Finally, the OFT believes that the CC will also be in a better position to consider in the competitive assessment future changes in the gas flexibility market.
63. Therefore, in conclusion, the OFT considers that, based on the evidence available, there has been a change in circumstance with regard to market conditions and a review of the Undertakings is appropriate.

## **CHANGE IN CIRCUMSTANCES 2: THE LEGAL FRAMEWORK**

### **The Third Package**

64. The EU Third Energy Package ('The Third Package') came into force on the 3 September 2009 and furthers the development of an open and fair internal energy market established through previous EU legislation. Key intentions are to enhance consumer protection, improve the functioning of the energy markets, enhance cross-border co-operation, and strengthen the role of independent regulators.
65. The Third Package comprises two Directives and three Regulations. The relevant legislation regarding the Undertakings are:
  - Directive 2009/73/EC (the 'Gas Directive'), and
  - Regulation 715/2009 (the 'Gas Regulation').
66. The requirement of the Directive must be transposed into domestic legislation by 3 March 2011. The Regulation is directly applicable.
67. Whilst the Government considers that the GB market framework is essentially compliant with the requirements of the Third Package, there are new requirements on Storage System Operators and LNG undertakings,

including legal and functional unbundling, confidentiality of information and third party access.

### **Centrica's View**

68. Centrica considers that the introduction of new legislation through the EU Third Energy Package will introduce elements that are incompatible with the operation of the existing Undertakings, and will introduce new general safeguards for access to flexibility that remove the need for specific undertakings in relation to Rough.
69. Centrica has considered, as set out below, each of the CC concerns identified in its 2003 report and refer to provisions of the Third Package which they argue now make many of the Undertakings redundant.
70. **Potential for Centrica to discriminate between customers in giving access to capacity at Rough:** Centrica considers that the Third Package ensures non-discrimination and equivalence of contract terms amongst customers<sup>32</sup> and non-discriminatory and transparent capacity allocation mechanisms must be published.<sup>33</sup> It also ensures the maximum storage facility capacity is made available to market participants.<sup>34</sup> A compliance programme has to be established which sets out measures taken to ensure that discriminatory conduct is excluded.<sup>35</sup>
71. **Potential for Centrica to use to its advantage sensitive information gained from the operation of Rough:** Centrica considers that the Third Package ensures the separation of storage from activities not related to storage - legally, financially and in organisation.<sup>36</sup> Further, commercially sensitive information must be protected and not disclosed in a discriminatory manner.<sup>37</sup> The establishment of the compliance programme will, Centrica argue, also deliver this requirement.<sup>38</sup>
72. **Potential for Centrica to withhold information about the operation of Rough:** Centrica considers that the Third package ensures that information

---

<sup>32</sup> The Gas Regulation Article 15(1a), the Gas Directive Article 13(1b).

<sup>33</sup> The Gas Regulation Article 17(2).

<sup>34</sup> The Gas Regulation Article 17(1).

<sup>35</sup> The Gas Directive Article 15(2d).

<sup>36</sup> The Gas Directive Article 15 & 31(2).

<sup>37</sup> The Gas Directive Article 16(1).

<sup>38</sup> The Gas Directive Article 15(2d).

on contracted and available storage facility capacities, amount of gas in store, inflows and outflows are made public.<sup>39</sup>

73. **Potential for Centrica to be less innovative in marketing Rough products than another owner:** Centrica considers that the Third Package ensures the existence of a secondary market for storage capacity<sup>40</sup> and ensures capacity rights are freely tradable.<sup>41</sup>
74. **Potential for Centrica to invest less in expanding Rough's capacity than another owner:** Centrica considers that the Third Package ensures the maximum storage facility capacity is offered to the market in a way that provides the appropriate economic signals for the efficient and maximum use of capacity and which therefore facilitates investment in new infrastructure.<sup>42</sup>
75. Further, Centrica considers that a number of the Undertakings become problematic against the requirements of the Third Package. These are:
76. **Undertakings 3.1, 3.2, 3.3, 15:** CSL is currently able to reserve up to 15 per cent of Rough's standard capacity and all incremental capacity but may not participate in the primary sales process for capacity. Article 17 of the Gas Regulation states that the maximum storage facility capacity shall be made available to market participants and that the system operator shall implement and publish non-discriminatory and transparent capacity allocation mechanisms. Centrica considers that this requirement will prevent it from having any access to capacity at Rough (as all capacity would be offered in the primary market – in which Centrica can not participate). CSL is seeking certainty around which regime will be applicable in order to plan the product range on offer for storage year 2012/13 from Rough.
77. **Undertakings 3.4, Annex 2 1.2:** The Undertakings require CSL to offer all capacity remaining unsold one month before the start of the storage year in an auction with zero reserve price. Centrica considers that the provisions of Article 19(2) of the Gas Regulation, where CSL has to publish the volumes of capacity sold and unsold on a regular and rolling basis, will (in

---

<sup>39</sup> The Gas Regulation Article 19.

<sup>40</sup> The Gas Regulation Article 17(3).

<sup>41</sup> The Gas Regulation Article 22.

<sup>42</sup> The Gas Regulation Article 17

conjunction with the Undertakings) change customer buying behaviour and may result in gaming/distortion of the sales process.

78. **Undertaking 5.3 (b):** As part of the acquisition from Dynergy, CSL acquired an interest in the York field which it intends to develop as a producing asset. Article 15(1) of the Gas Directive requires storage activities to be legally and financially separated from production activities and therefore CSL intends to transfer ownership of the asset to another part of the Group. However, the Undertakings currently prevent this.
79. CSL considers that the different regulatory regimes act as a double jeopardy and creates material uncertainty for the market around the future operation of Rough.

#### **DECC's & OFGEM's Views**

80. The OFT has received views from DECC and Ofgem on the introduction of the Third Package.
81. DECC has responsibility for the implementation of the requirements of the Third Package<sup>43</sup> and confirmed that it includes the expansion of the regulation of gas storage and LNG undertakings. However, a decision has yet to be made regarding the framework of regulation of these facilities, that is, whether a new licence regime will be introduced to replace the current negotiated Third Party Access framework. Nevertheless, the Gas Regulation will be directly applicable and does not need to be transposed into UK Law in the same way as the Directive. The Gas Regulation is a minimum regulation<sup>44</sup> and therefore more stringent requirements under the Undertakings may not be incompatible with the Gas Regulation.
82. While the Regulation does not apply until 3 March 2011, it came into force on 3 September 2009 and therefore DECC considers it equivalent to a change of circumstance.
83. DECC considers that excluding Centrica from the primary sales process, as stated in paragraph 15 of the Undertakings, is in breach of Article 17(1) of

---

<sup>43</sup> In April 2010, DECC issued a 'Call for Evidence' regarding the implementation of the Third Package [www.decc.gov.uk/en/content/cms/consultations/eu\\_energy\\_mkt/eu\\_energy\\_mkt.aspx](http://www.decc.gov.uk/en/content/cms/consultations/eu_energy_mkt/eu_energy_mkt.aspx); In July 2010 DECC issued a Consultation on the implementation of the Third package [www.decc.gov.uk/en/content/cms/consultations/imp\\_eu\\_third/imp\\_eu\\_third.aspx](http://www.decc.gov.uk/en/content/cms/consultations/imp_eu_third/imp_eu_third.aspx).

<sup>44</sup> The Gas Regulation Article 26.

the Gas Regulation. Further, the reservation of up to 15 per cent of capacity to Centrica is inconsistent with Article 17(2) which refers to a non-discriminatory and transparent capacity allocation mechanism.

84. DECC confirmed that, subject to confidentiality, Article 19 of the Gas Directive will require CSL to make public information on contracted and available storage.
85. Ofgem, while recognising some of Centrica's concerns, considers that there is uncertainty over how elements of the Third Package will be transposed into domestic legislation. Therefore, Ofgem considers it premature to reach a firm conclusion as to whether there are material inconsistencies between the Undertakings and the Third Package until DECC's processes have been completed. However, Ofgem concluded that they believe that once the Third Package is reflected in domestic law, there is likely to be some inconsistency between the legislation and the Undertakings and therefore support a referral to the Competition Commission.

#### **OFT Assessment**

86. The OFT notes DECC's view that, while the Third Package does not apply until 3 March 2011, it will represent a 'change of circumstance'. The OFT also considered Ofgem's view that it is premature to speculate on the extent to which the Third Package requirements remove the need for the Undertakings until these requirements are transposed into legislation by DECC.
87. The OFT is conscious that the full extent to which the Third Package requirements remove the need for Undertakings is currently uncertain. Nevertheless, the OFT considers that the coming into force of the Third Package in 2009 may represent a 'change of circumstance'. Our assessment, therefore, focused on the Gas Regulation as this will be directly applicable to UK law. In this regard, the OFT agrees with views expressed by Centrica and DECC that the capacity allocation mechanism as set out in the Undertakings<sup>45</sup> is inconsistent with the Gas Regulation.

---

<sup>45</sup> The mechanism allows CSL to reserve up to 15 per cent of storage capacity to Centrica Group but prevents Centrica from participating in the Primary Sales Process

88. Centrica expressed concern that the commercial information required to be made public under Article 19 of the Gas Directive could potentially lead to gaming/distortion of the market. Centrica argue that the zero reserve price of the auction as set out in Annex 2 of the Undertakings will facilitate this behaviour. However, as set out in paragraph 3.4 of the Undertakings, the auction procedure may be varied with the agreement of the OFT. Therefore, it is not apparent that the Undertakings are inconsistent with the Gas Regulation in this regard. Nevertheless, it may be appropriate that the auction mechanism be included in a wider review of the Undertakings resulting from changes in market conditions that have been discussed above.
89. The OFT considers that CSL's interest in the York field (a production site) is inconsistent with Article 15 of the Gas Directive which requires the unbundling of storage from other non-storage related activities. At present, at paragraph 5.3(b), the Undertakings prevent CSL from selling/transferring ownership of the field to Centrica. The OFT is not aware of the timescale for Centrica's planned development of the York field but is of the view that the Undertakings currently prevent Centrica from taking such action.
90. Overall, there is uncertainty over the potential inconsistencies between the Undertakings and the Third Package and these will remain until DECC has completed its consultation.

### **Conclusion**

91. The legal test the OFT must consider is whether, by reason of any change of circumstance, an enforcement undertaking is no longer appropriate such that it needs to be varied or superseded by a new enforcement undertaking (section 88(4) of the Act). In this regard, the inconsistency between Article 17 in the Gas Regulation and the Undertakings in relation to the allocation mechanism appears to meet the test. However, the degree to which the Undertakings as a whole will be unnecessary or no longer proportional following the introduction of the Third Package remains uncertain.
92. Nevertheless, given that a review of the Undertakings in relation to the allocation mechanism is thought necessary, a wider review of the Undertakings may also be appropriate at this time.

## **THIRD PARTY VIEWS**

93. An invitation to comment notice was issued on 17 May 2010 inviting interested third parties to make comments to the OFT. Only one response was received. The third party did not believe a review of the Undertakings was warranted as Centrica's unique market position had not altered significantly since 2003: Centrica continues to have 44<sup>46</sup> per cent of the domestic gas market and Rough continues to be the UK's only long range gas storage facility. Further, given Centrica's unique position in the GB gas market, the third party did not believe that the requirements of the Third Package would be sufficient on their own to prevent competition in the markets for flexible gas and domestic gas supply being weakened with the likely consequence that prices would rise.
94. Views provided by Ofgem and DECC have been discussed throughout the document.

## **CONCLUSION**

95. Pursuant to section 88(4) of the Act, the OFT shall consider whether by reason of any change of circumstances the Undertakings are no longer appropriate and need to be varied or superseded and shall give such advice to the CC as it thinks proper in the circumstances where it appears that an undertaking needs to be varied and superseded.
96. The OFT believes that there is evidence that there has been a change in circumstances since the Undertakings were accepted that may warrant a review of the Undertakings sought by Centrica. Principally this is based on a change in market conditions, evidenced by a decline of Centrica's shares of supply in the gas flexibility market under almost all scenarios, and a change in the legal framework with the introduction of the Third Package which will result in inconsistencies with some provisions of the existing Undertakings.

---

<sup>46</sup> Third Party reference to Datamonitor figures to 31/01/10.

97. The analysis undertaken on market conditions focused on changes in Centrica's shares of supply in the flexible gas market. The OFT considers that industry conditions have changed since the Undertakings were implemented and the analysis shows a fall in Centrica's shares of supply in almost all scenarios. However, due to difficulties in accurately and uniquely defining the gas flexibility market, the size of the fall is far from clear. Further, as the analysis did not include a competitive assessment, the OFT has not concluded on whether Centrica continues to have market power and on the extent to which any market power may change in the future. Nevertheless, on the basis of the evidence, the OFT considers that there has been a change in circumstances with regard to market conditions.
98. Similarly, whilst there remains uncertainty regarding the impact of the introduction of the Third Package on the Undertakings, it is accepted that some aspects of the Undertakings will no longer be necessary or proportional. Further, the inconsistency surrounding the allocation mechanism needs to be resolved by the date the Third Package comes into force. On this basis, the OFT considers that there has been a change in circumstances with regard to the legal framework.
99. Therefore, the advice of the OFT is that this review request should be granted.

## Appendix 1: Market Conditions – Methodology of OFT Analysis

1. The analysis of shares of supply involves two steps: (i) the definition of the flexible gas market; and (ii) the determination of Centrica's share of the flexible gas market. Both these steps entail some difficulties.
2. In what follows, we describe the alternative methodologies – both in terms of definition of the flexible gas market and determination of Centrica's share – according to which Centrica's shares of supply have been calculated.

### Market definition

3. The definition of the market for flexible gas is not straightforward and the hypothetical monopolist test cannot be carried out easily. As discussed (main body, paragraph 20), there exist many potential sources of flexible gas. However, these sources are differentiated and each exerts constraints of varying degrees on the others. Further, not all sources of flexibility (for example, UKCS and interconnector flexibility) are sold as products as it is the case for storage.<sup>47</sup> The identification of the closest substitutes for Rough is thus complex and entails examining the purposes for which Rough is used and the other means which could and would be used for these purposes.
4. The CC 2003 Report, while acknowledging that sources such as LNG storage and interruptible supply contracts are weak substitutes for Rough, considered that there was no firm basis for excluding any sources from the market definition adopted.<sup>48</sup> The CC 2003 Report, however, calculated Centrica's shares of supply also excluding LNG storage and interruptions from the relevant market.<sup>49</sup> Further, it used different measures of gas flexibility in the determination of the shares of supply to try to capture the differentiation between sources that are relatively more important in addressing seasonal variations in demand and those that are relatively more

---

<sup>47</sup> See CC 2003 Report, paragraphs 2.48 and 5.42.

<sup>48</sup> See CC 2003 Report, paragraphs 2.49, 2.51 and 5.43-5.44.

<sup>49</sup> See CC 2003 Report, paragraph 5.50.

important in dealing with short term fluctuations<sup>50</sup> (paragraphs 8– 9 below).

5. As explained (main body, paragraph 26), Centrica considers the CC's approach to product market differentiation to be the appropriate one and suggests an updated 'wide' definition of the relevant market.
6. At this stage we have not reached a conclusive view regarding the more appropriate definition of the flexible gas market. Our approach is rather to consider alternative possible definitions of the market and to determine Centrica's shares of supply according to each possible definition.
7. The definitions of the flexible gas market we consider are the following:
  - i. Centrica's definition – 'Scenario 1' (main body, paragraph 25);<sup>51</sup> and
  - ii. definitions based on Ofgem's nTPA exemption decision for the Hill Top Farm storage facility<sup>52</sup> – 'Scenario 2' – as it follows:
    - LRS + MRS + Flexible Beach<sup>53</sup> + 43% IUK<sup>54</sup> + 0% LNG<sup>55</sup>
    - LRS + MRS + Flexible Beach + 43% IUK + 50% LNG

---

<sup>50</sup> See CC 2003 Report, paragraphs 2.53 and 5.49.

<sup>51</sup> Centrica's share of maximum winter flexibility under Scenario 1 has been determined under either the 'cycling' assumption, used by Centrica in its submission (footnote 25), or under the 'no cycling' assumption, as it is consistent with the CC 2003 Report (paragraph 18). All sensitivities have been provided by Centrica.

<sup>52</sup> See Ofgem, Hill Top Farm Consultation Document, paragraphs 3.18-3.21, footnotes 24-27, Table 3 and footnotes 29-31.

<sup>53</sup> 'Flexible Beach' is the flexible gas available from the UKCS. This is the 'beach swing' the CC 2003 Report referred to (see footnote 10). Given the limited information available regarding the scale of such flexibility, in the Hill Top Farm case Ofgem uses the peak combined deliverability of the Morecambe and Sean fields as a conservative proxy for the flexible gas available from the UKCS (see Ofgem, Hill Top Farm Consultation Document, paragraph 3.17). Following our questions during the current investigation regarding the scale of flexible beach, Ofgem indicated that it estimates total beach flexibility for 2009/2010 at [ ] GWh/day declining to [ ] GWh/day following the expiry of the Sean contract. Ofgem explained that these figures take into account its estimate of the Sean's field deliverability and additional sources of flexibility held by other market participants.

<sup>54</sup> Ofgem considers that only a proportion of the IUK should be included in the gas flexibility market, corresponding to 325 GWh/day. This figure is based on a maximum IUK import level of 30mcm/day (out of 70mcm/day total capacity) based on NGC's preliminary assessment of the maximum winter capacities for 2009/2010 (see Ofgem, Hill Top Farm Consultation Document, paragraph 3.20).

<sup>55</sup> Ofgem considers that, given the recent completion of significant LNG import terminals (namely, South Hook and Dragon) but also the level of uncertainty associated with LNG flows, it is appropriate to consider alternative scenarios for the role of LNG imports, where zero per cent,

- LRS + MRS + Flexible Beach + 43% IUK + 100% LNG.<sup>56, 57</sup>

#### Determination of shares of supply

8. Following the CC 2003 Report, we consider three indicators:
- i. share of supply of maximum daily flexibility, that is, the maximum that can be made available in a single day<sup>58</sup>
  - ii. share of supply of maximum winter flexibility, that is, the maximum that can be made available during the main winter months (December to March, 121 days)<sup>59</sup> and
  - iii. share of supply of flexibility actually used in the three most recent winters.
9. The first two indicators are capacity-based measures of flexibility, while the latter is a usage-based measure. As regards the capacity-based measures, the CC 2003 Report indicates that to assess the competitive constraints on Rough it may be appropriate to put more weight on the share of supply of

---

50 per cent and 100 per cent of the LNG import capacity is included in the definition of the flexible gas market (see Ofgem, Hill Top Farm Consultation Document, paragraph 3.20).

<sup>56</sup> Ofgem does not include in the relevant definition of the flexible gas market the following sources: SRS facilities; BBL; and Norwegian pipeline imports. As regards SRS, it considers that such facilities are only likely to be used on the highest demand days of the year (see Ofgem, Hill Top Farm Consultation Document, paragraph 3.17). It should be noted that the focus of Ofgem's Hill Top Farm analysis is on a MRS facility. However, we consider that similar considerations may apply in this case, where the focus is on a LRS facility. As regards the BBL, Ofgem considers that, since coming on-line in November 2006, the interconnector has run essentially base-load, although it recognises that it is likely to have the ability to behave more flexibly in the future (see Ofgem, Hill Top Farm Consultation Document, paragraph 3.17). Finally, as regards Norwegian imports, Ofgem indicates that analysis from the 2008/2009 shows that these pipelines have run essentially baseload. In particular, while such supplies are variable on a day to day basis, they should not be considered as flexible in the sense of being responsive to demand or price signals in the UK (see Ofgem, Hill Top Farm Consultation Document, paragraphs 3.17 and 3.19). Ofgem also excludes from the relevant market definition demand-side responses on the basis that such responses often involve actions taken on account of locational constraints and/or security of supply measures.

<sup>57</sup> From the discussion above, it should be noted that Ofgem's methodology to determine the size of the flexible gas available from sources such as UKCS, IUK and LNG imports differs from the methodology used by Centrica (footnote 25). Rather than estimating flexibility by subtracting annual daily average deliveries from maximum (peak and winter) daily deliveries, Ofgem directly estimates the proportion of each source's deliverability that can be considered 'flexible'.

<sup>58</sup> See CC 2003 Report, paragraph 5.47.

<sup>59</sup> See CC 2003 Report, paragraph 5.47.

maximum winter flexibility, which is less influenced by LNG storage sites than the share of supply of maximum daily flexibility.<sup>60</sup>

10. As regards the usage-based measure, the CC 2003 Report notes that, while such a measure has the disadvantage of reflecting weather conditions in particular years, it has the advantage of reflecting market decisions and of excluding capacity for which customers are unwilling to pay.<sup>61</sup> However, given that the main purpose of this analysis is to assess the changes in Centrica's shares of supply since 2002/2003, the fact that shares of supply of winter flexibility usage heavily depend on the specific weather conditions in the three considered winters appears to be particularly problematic. We therefore believe that in the present analysis more weight should be put on capacity-based measures.
11. The determination of Centrica's shares of supply in the flexible gas market is not straightforward. The shares of supply need to reflect Centrica's position as a 'supplier of gas flexibility' for each source, having some control over the associated capacity and supply of gas.<sup>62</sup> In particular, two issues came out during the present investigation, namely in relation to Centrica's holding long-term capacity rights (bookings) in IUK, BBL and at the Isle of Grain LNG import terminal<sup>63</sup> and in relation to Centrica's equity/contractual position in UKCS sources.
12. As regards long-term capacity rights/bookings, the CC 2003 Report states that the calculations of Centrica's shares of supply are based on the flexibility that is available to Centrica through ownership or long-term contracts, but exclude short-term contractual rights.<sup>64</sup> In particular, the CC 2003 Report indicates that this includes Centrica's equity and contractual share of beach swing, its long-term rights to use the interconnector<sup>65</sup> and its share of interruptible capacity from its interruptible supply contracts.<sup>66</sup>

---

<sup>60</sup> See CC 2003 Report, paragraph 5.49.

<sup>61</sup> See CC 2003 Report, paragraph 5.52.

<sup>62</sup> This control would enable Centrica to withhold capacity in order to affect the price of flexible gas.

<sup>63</sup> See footnote 20.

<sup>64</sup> See CC 2003 Report, paragraphs 2.57, 5.48 and 5.53.

<sup>65</sup> IUK.

<sup>66</sup> The CC 2003 Report also noted that as far as Centrica booked capacity at third party's storage facilities, that is, Rough (pre-merger), Hornsea and LNG storage sites, its position is that of customer (CC 2003 Report, paragraph 5.48).

13. Centrica did not entirely agree with the CC 2003 approach<sup>67</sup> and it presented to us in the current investigation arguments similar to those it raised at the time of the CC merger investigation. Centrica's view is that, for all these sources, it should be seen as a customer of flexible gas, which does not have a significant hedge against an increase in the price of flexible gas (main body, paragraph 27).
14. At this stage, without reaching a final view on the role played by long-term capacity rights/bookings, we consider it informative to determine Centrica's shares of supply of gas flexibility using alternative methodologies, namely:
  - i. Centrica's methodology – 'Centrica case' (paragraph 27) and
  - ii. including, besides Centrica's share of equity, its long-term capacity rights/bookings in each source – 'Centrica case + bookings'.
15. We apply the two methodologies to the different definitions of the market referred to as Scenario 1 and Scenario 2 (paragraph 7).<sup>68</sup>
16. As regards Centrica's equity/contractual position in UKCS sources, the difficulties are related to the fact that both UKCS supplies and Centrica's own supplies are in decline and so is the flexibility available from these sources. Further, some fields (such as Centrica's Sean and Morecambe) appear to offer a more flexible supply than others, but only limited information is available regarding the scale of this flexibility.<sup>69</sup>
17. To determine Centrica's shares of supply of gas flexibility we use Centrica's own estimate of its share of maximum beach deliverability when considering Centrica's definition of the flexible market (that is, Scenario 1) and Ofgem's estimate when considering Ofgem's definitions of the flexible market (that is, Scenario 2). The latter has been estimated by Ofgem at approximately [ ] per cent before the expiry of the Sean contract in 2011 and at approximately [ ] per cent afterwards.<sup>70</sup>

---

<sup>67</sup> See CC 2003 Report, paragraphs 2.57 and 5.53.

<sup>68</sup> [ ]

<sup>69</sup> See Ofgem, Hill Top Farm Consultation Document, paragraphs 3.17.

<sup>70</sup> Ofgem told us that the total beach flexibility for 2009/2010 has been estimated at [ ] GWh/day, declining to [ ] GWh/day following the expiry of the Sean contract. Ofgem indicated that these figures take into account Ofgem's estimates of the Sean field's deliverability and of additional sources held by other market participants (see email dated 13/08/2010).

18. Finally, in relation to the determination of Centrica's share of supply of maximum winter flexibility (that is, Centrica's flexibility and market flexibility), we noted that Centrica introduced a 'cycling' assumption, not used by the CC in the 2003 Report, to determine the 'effective' duration of storage facilities (footnote 26). In order to facilitate a comparison with the figures derived by the CC in 2003, however, we consider it easier at this stage to focus on the 'no cycling' assumption and the related figures.<sup>71</sup>

## ENDNOTE

1. With reference to paragraph 27, Centrica clarified that the second sentence should read, 'These considerations also apply, in Centrica's view, to its LNG supply contracts (based on spot cargoes) and to the supply contracts it has with Gas Terra<sup>72</sup> (BBL imports) and Statoil<sup>73</sup> (Norwegian imports).'
2. With reference to paragraph 83, DECC clarified that it considers that excluding Centrica from the primary sales process, as stated in paragraph 15 of the Undertakings, may be in breach of Article 17(1) of the Gas Regulation. Further, the reservation of up to 15 per cent of capacity to Centrica is probably inconsistent with Article 17(2) which refers to a non-discriminatory and transparent capacity allocation mechanism. This clarification does not impact on the OFT's advice.
3. With reference to paragraph 12 in Appendix 1, Centrica clarified that in relation to the sources of flexible gas identified, Centrica is a customer not a supplier, and that these sources do not contribute to Centrica's hedge.

---

<sup>71</sup> Therefore, in the presentation of the evidence, while when we consider Centrica's definition of the flexible market (that is, Scenario 1) we will report shares of supply under both assumptions, 'cycling' and 'no cycling', when we consider Ofgem's definitions of the flexible market (that is, Scenario 2) we will only report figures under the 'no cycling' assumption.

<sup>72</sup> The contract is for the supply of 270 GWh/day in winter and 161 GWh/day in summer (Centrica's response to the OFT questions dated 15/6/2010, Q.12).

<sup>73</sup> The contract is for the supply of 148 GWh/day, flat across the year (Centrica's response to the OFT questions dated 15/6/2010, Q.12).