



Making a positive difference  
for energy consumers

Adrian Leigh  
Competition and Markets Authority  
Victoria House  
37 Southampton Row  
London WC1B 4AD

Phone: 020 7901 7000

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Dear Adrian,

## **Review of the Rough Undertakings given by Centrica Storage Limited and Centrica – Ofgem response to Statement of Issues**

Ofgem welcomes the opportunity to comment on the CMA's issues statement. We broadly agree with the issues identified. In this letter we set out detailed comments on these issues and the variations to the Undertakings proposed by Centrica Storage Limited (CSL) and Centrica. As set out in our response to the Invitation to Comment, given we agree that the capacity limitation could constitute a change in circumstances, we support the decision to open a review.

### **Current technical issue at Rough**

CSL set out in its application for a variation to the Undertakings limitations which are currently affecting Rough's operation. At present, Rough's maximum operating pressure has reduced the maximum volume that can be stored at Rough and Rough's injection performance at high levels of fill. When initially imposed, this limit translated to a maximum reservoir volume of 29-32 TWh (compared to a previous maximum of 41 TWh) and reduced physical injection rates as stock levels approached this limit.

Subsequently, CSL has obtained consent from the Oil and Gas Authority (OGA) to increase the operating envelope of Rough, and so convert 4.62 TWh of cushion gas into working gas. This has mitigated some of the impact of the technical constraint. The net effect is that Rough's maximum reservoir volume is currently limited to around 33.5 – 36.5 TWh. As CSL set out in their application, this increase in space is counter-balanced by a decrease in withdrawal capability at low stock levels as the reservoir pressure decreases.

CSL have announced that it is currently carrying out a programme of testing, expected to be completed around September-December 2016, after which it will know more about the nature of the current issue. One possible scenario is it may be able to take a decision to increase the maximum operating pressure (i.e., to potentially lift the current restriction). If the maximum operating pressure was increased to previous levels, the addition of the OGA consent would mean an increased maximum reservoir volume of around 45.5 TWh – 48.5 TWh.

### **Scope of issues to be considered**

The recent technical issue could act as an indication that the performance of Rough may become more variable in the future, consistent with the increasing age of the asset. It also

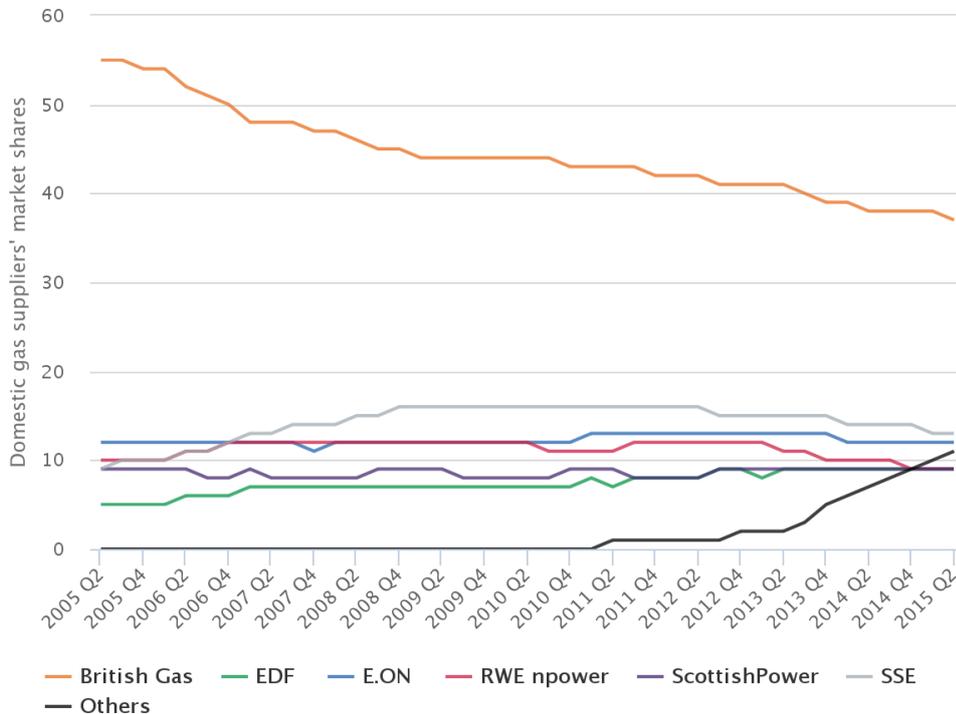
demonstrates that changes to physical capabilities are likely to have effects on space, withdrawal and injection capability, which may not be proportional to each other.

The CMA issues statement outlines that neither CSL, Centrica nor respondents to the Invitation to Comment have suggested that there has been a material change in competitive conditions in the gas storage market since the Undertakings were last reviewed in 2011. In the absence of such evidence, the CMA considers that the review should be focussed on addressing the specific issue of capacity obligations in the context of potential increasing variability of the physical performance of Rough.

We are supportive of the CMA’s initial position to carry out a targeted and focussed review. There have been some changes affecting gas storage and Centrica since 2011, set out below for your consideration.

As shown in Figure 1 below, Centrica’s position in the domestic retail gas market has continued to decline (from 43% to 37%), though they remain over 2.5 times the size of their nearest competitor.

**Figure 1 - Gas supply market shares by company: Domestic (GB)**

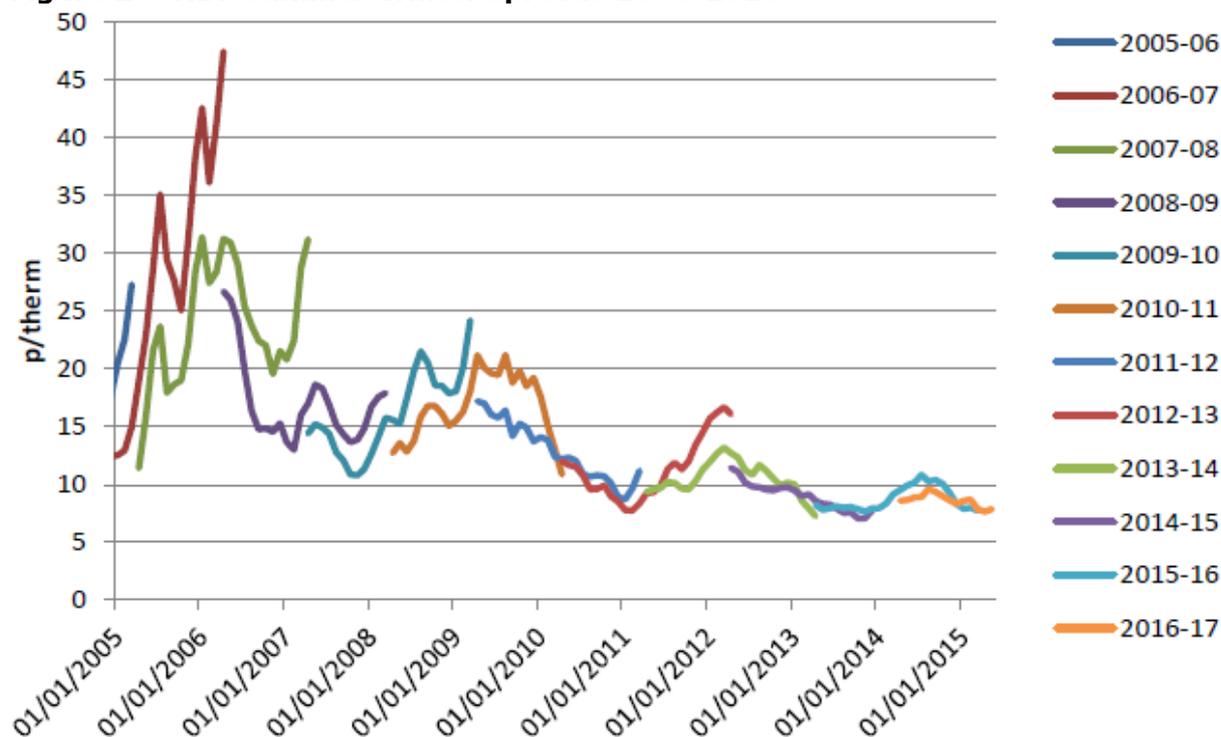


Source: Ofgem analysis of gas distribution network reports from Xoserve

In addition, as Figure 2 shows, seasonal spreads<sup>1</sup> are currently low, which impacts on the value of Rough storage capacity. There has been some variation year-to-year. However, spreads have remained around the level they were at the time of the most recent review of the Undertakings, though significantly below 2005-2009 levels.

<sup>1</sup> the price differential of gas between summer (Q2+Q3) and winter (Q1)

**Figure 2 - NBP summer-winter spreads 2005-2015**



Source: ICIS, Ofgem analysis

**CSL’s proposed amendments**

*Changes to volume of obligated capacity*

The Undertakings oblige CSL to offer for sale a minimum volume of capacity before the start of the storage year. This obligated capacity is made up of a Minimum Rough Capacity (MRC) of 455 million bundled units (known as SBUs) and Additional Space of at least 1534 GWh. CSL have proposed to introduce a mechanism to allow the volume of obligated capacity to be varied.

The current level of MRC and the minimum level of Additional Space are fixed in the drafting of the Undertakings. Consequently, they can only be varied through a review of the Undertakings. Introducing a mechanism to allow these to be varied in response to changes in Rough’s physical capabilities could reduce unnecessary costs to regulators and CSL. If introduced, we think the CMA should consider what criteria such a decision would be based on, in order to increase transparency.

As noted above, changes in the capability of Rough (such as the current issue) may affect different aspects of Rough’s capability more than others. For example, an issue may affect achievable injection rates proportionately more than achievable withdrawal rates. As MRC is specified in bundled units, changing the level of MRC to reflect changes in one aspect of capability (for example, injection rates) may lead to an excess of another aspect of capacity.

Furthermore, non-obligated capacity (known as Incremental capacity) is subject to fewer restrictions. Significantly, there are no restrictions on the volume of incremental capacity that can be sold to the rest of Centrica Group. Therefore, changes to MRC and Additional Space would affect the level of capacity which could be sold intra-group.

We note CSL’s view that changes to obligated capacity should take into account incentives to invest in Rough. We think the CMA should also give consideration to whether changes to MRC might affect incentives (or lack of incentives) on CSL to repair Rough and if any consumer detriment might arise from this.

We also note that in CSL's proposed drafting investment is not defined. The CMA may want to consider this further to provide clarity on what actions taken by CSL or Centrica constitute investment – to provide clarity on the circumstances where MRC could be raised.

We suggest the CMA consider potential implications of changes that adjust the balance between obligated and incremental capacity. This should include the interactions with the specified capacity restrictions on sales to the rest of Centrica Group. A mechanism to adjust volumes focussed solely on changes to the MRC volume may have unintended consequences. This might include a greater volume of some aspects of capacity not being subject to the restrictions that apply to obligated capacity.

However, it is also important to recognise that alternative approaches (such as changing the parameters of an SBU) might be more complex to administer. For example, they might require consequential changes to the SSC, and we recognise CSL's concerns that changing the contractual terms of existing contracts could prove problematic.

Given the current CSL testing programme, there is a probability that the current technical limitation could be resolved shortly after the current review timetable envisages revised Undertakings may be put in place. As a result, there is a potential that changes made as part of this review are not required to address the consequences of the current technical limitation. We would encourage the CMA to consider potential future scenarios to ensure any changes are sufficiently adaptable to a range of possible changes in Rough's capability, looking beyond the current technical issue.

#### *Removal of definition of Further Additional Space*

The Undertakings include a definition of capacity as Further Additional Space. It is defined as capacity that comes available within year and which was not created through CSL's investment in Rough. CSL have proposed to remove from the Undertakings this definition, and associated references. This would mean that all capacity sold within year would be treated as incremental capacity.

In our view, CSL's proposal does not clearly demonstrate why this definition should be removed as a result of the potential for variability in the future capability of Rough. We understand the logic that the definition of Further Additional Space will be zero if Rough's capability is below that which prevailed when Centrica purchased the facility. However, we do not think CSL have adequately explained why this definition cannot be left and allowed to fall to zero. In addition, if Rough's capability rises back above the level that prevailed when it was purchased by Centrica, then the definition would once more become valid.

CSL point out that the difference between the treatment of Further Additional Space and Incremental Capacity is minimal, and highlight that the only time it draws a distinction is in meeting reporting obligations under paragraphs 9 and 10. We would add to this that paragraph 4 sets out an added requirement to offer for sale Further Additional Space in accordance with paragraph 2.2(c) which does not apply to incremental capacity. We would encourage the CMA to explore CSL's justification for this suggested change as part of their consideration of this review.

#### *Changes to Specified Capacity*

CSL have proposed to introduce an additional trigger in the case of changes to MRC or Additional Space that would allow Centrica Group to apply to Ofgem, or Ofgem to initiate, a change to the specified capacity (the amount of MRC and Additional Space that can be sold to Centrica).

If a mechanism is introduced to allow the variation of obligated capacity, then we agree it may be sensible to include scope to make consequential adjustments to specified capacity

in order to maintain the effect of the Undertakings. This may be a possible route to address some of the issues we outline above in relation to changes to the obligated capacity.

#### *Changes to definition of Additional Space*

CSL's proposed drafting introduces changes to the definition of Additional Space. Under the current version of the Undertakings, Additional Space is defined as:

*"that space into which gas can be injected over and above the Minimum Rough Capacity, which has been created as the result of the operation of Rough by its previous owners and which can be quantified before the beginning of the Storage Year following observations on the pattern and extent of customer withdrawal nominations in the previous Storage Year, but which in any event will be no less than 1534 GWh"*

CSL have proposed to introduce changes to the definition such that Additional Space is fixed at 1534 GWh. This may have the effect of allowing a significantly increased volume of space that may be sold ahead of the storage year as Incremental Capacity. This has consequential impacts as it could reduce the volume of space CSL is required to sell ahead of the storage year, and to which restrictions on sales to the rest of Centrica Group apply. In our view, this could represent a loosening of the Undertakings in this area. We note that CSL has not provided justification for this change in their application, and urge the CMA to explore the reasons for this suggested change in drafting.

#### *Additional potential changes*

Finally, we think there are some aspects of the Undertakings that the CMA may wish to take the opportunity to update as part of this review. These include:

- A change to the definition of Gas Day – which was changed to mean a period of twenty-four consecutive hours commencing at 5.00am on a given calendar day and ending at 5.00am on the following calendar day;
- References to named individuals at CSL and Ofgem who are no longer employed by these organisations; and
- References to the OFT.

#### **Monitoring and compliance**

Ofgem has a general function under section 34 of the Gas Act 1986 of keeping under review gas storage and collecting information about gas storage and storage operators. Section 34 also gives Ofgem the general function of providing information, advice and assistance to the CMA. We use this latter function to assist the CMA in monitoring compliance with CSL's Undertakings.

Ofgem also has powers to enforce gas storage requirements stemming from the Third Energy Package (e.g. relating to the independence of storage facilities, restrictions on disclosure of information, third party access, and transparency). The relevant requirements relating to gas storage are listed in Schedule 4B, paragraph 7 to the Gas Act.

Compliance is CSL and Centrica's responsibility, and they provide annual reports on both their compliance with the Undertakings and aspects of the Third Energy Package. The Undertakings also provide Ofgem with a specific role in some areas, such as the approval of changes to the SSC.

There is significant overlap between monitoring activities carried out by Ofgem under the Gas Act, and monitoring of the Undertakings. Given this, we agree with the CMA that it would be prudent to consider these arrangements, to ensure they remain fit for purpose.

We remain committed to providing ongoing advice and support to the CMA throughout this review process. If you have any questions about this response, please contact my colleague Thomas Farmer in the first instance.

Yours sincerely

**Frances Warburton**  
**Partner, Wholesale Markets**