

ROUGH GAS STORAGE UNDERTAKINGS REVIEW

Summary of hearing with Ofgem on 17 February 2016

Scope

1. Ofgem agreed with the narrow scope of the review which focused on the changes in capability and the implications for capacity obligations rather than a broad review of the storage market and the need for the undertakings.

Change of circumstance

2. Ofgem generally agreed with Centrica Storage Limited (CSL) that the current technical issue and the general ageing of the asset could potentially represent a change in circumstances. Ofgem had not formed a view as to whether the current issue would be the type of change to justify triggering a change in the capacity sales obligations, although it would be an appropriate trigger to consider a change. Ofgem said that its understanding of the Maximum Allowable Annulus Surface Pressure (MAASP) testing CSL was carrying out indicated a change to its approach to managing risk as opposed to an actual problem or fault that had been uncovered.
3. Ofgem said that Rough was operating beyond its 25 year design life and there was the potential that, as Rough ages, there could be a greater risk of failure. Ofgem said they had no specific evidence to support this but that it was not an unreasonable assumption to make. Ofgem said it was difficult to conclude with certainty that ageing would necessarily lead to deterioration but recognised that if there were changes to capabilities, the current obligations may not be appropriate.
4. However, Ofgem also said there was likely to be a relationship between the level of maintenance and the rate of deterioration of the asset.

Proposed adjustment mechanism

Level of risk borne by Centrica Storage Limited

5. Ofgem said that the adjustment mechanism proposed by CSL had merit. However Ofgem noted that CSL's proposed principle that it should not be obliged to sell capacity which cannot be physically backed by Rough marked

a departure from the existing situation. It noted that aspects of CSL's proposed approach would have the impact of reducing the level of commercial risk that CSL faces when operating Rough at low stock levels.

6. Ofgem said that the existing structure of the Storage Services Contract (SSC) and the Standard Bundled Unit (SBU) meant that CSL had to offer capacity that may not be physically backed by Rough. The SBU was sold with a fixed withdrawal capability which was the level that could be sustained when Rough was full or nearly full. Therefore as the facility emptied, there would be a point at which CSL's contractual obligations were greater than Rough's physical capabilities. Ofgem said that it understood this had been the case since Centrica accepted the undertakings back in 2003.
7. Ofgem said that the benefit of continuing to oblige CSL to offer capacity that could not always be physically backed by Rough, (and taking on the associated risk) was that it maximised the capacity that could be made available to the market. Ofgem said that CSL had managed this risk historically, primarily by going into the market to meet customer nominations if necessary.
8. Ofgem were not aware that this had resulted in any detriment to Rough's physical condition. CSL operated Rough within its physical capabilities and managed any commercial exposure that went beyond those physical capabilities by going into the market. Ofgem acknowledged that market conditions had worsened and that in light of this, CSL could desire to reconsider arrangements and risk they found acceptable or commercially viable in 2003. However Ofgem said this did not necessarily relate to the current review.

Incentive on Centrica Storage Limited to reduce supply and investment

9. Ofgem said that it was important to be aware of CSL's possible incentives to reduce Obligated Capacity and how this could be facilitated by implementing an adjustment mechanism. Ofgem said that a reduction in Obligated Capacity could be achieved more easily, given that CSL's maintenance could have a bearing on future capacity, and given that CSL have discretion in maintenance expenditure. Ofgem said it would be useful for the CMA to consider whether the adjustment mechanism should take account of whether any change to physical capability was based upon intentional or unavoidable factors and, if so, whether it would be appropriate to adjust the obligations in any way (although it may be difficult to incorporate this into the mechanism).
10. Ofgem also said that CSL could argue for a reduction in the Obligated Capacity by taking different views on the risk they are willing to bear in offering capacity

that is not fully backed by Rough. Ofgem said that fundamentally, they wished for CSL to behave and make its decisions on maintenance and repair as if it was an independent separate storage operator. Therefore Ofgem said it would be important for any use of the adjustment mechanism to consider the extent to which CSL had spent a reasonable amount of money on maintenance and also to make provision for incentivising CSL to repair or return Rough to its previous capabilities, if it was economically sensible. Ofgem cited CSL's proposals around incremental capacity and Centrica's rights to capacity as a potential way of creating that incentive.

Centrica's access to Rough

11. Ofgem thought it important to consider whether it would be appropriate for changes to the undertakings to result in a more beneficial situation for Centrica. Ofgem thought that CSL's proposed arrangements for Centrica's accessed incremental capacity merited further consideration.

Incidents that would lead to triggering the mechanism

12. Ofgem said that the adjustment mechanism should be used in response to substantial events with substantial impact. Ofgem did not envisage an adjustment mechanism being something that would address relatively short-term and minor issues. As regards within-year issues, Ofgem said that once CSL sold their capacity for the year, they had contractual obligations to their customers which were separable from the obligations in the undertakings on offering for sale capacity ahead of the storage year.
13. Ofgem said that the onus and the burden of proof that an event was substantial should be on CSL.
14. Ofgem said it was relevant to consider the distinction between events that might trigger consideration of the issue and events that might actually trigger a decision to make the change to the obligation.
15. Ofgem said they would expect CSL to raise issues that had the potential to occur in preliminary discussions. However Ofgem said that it would be odd for the regulator to make a decision to vary Obligated Capacity, due to the impact of a potential event, unless there was near-certainty of the event happening.

Responsibility for function

16. Ofgem were open to considering whether Ofgem could be a named decision-taker in the undertakings.

17. Ofgem said that in considering their feasibility for overseeing the mechanism, they would focus on whether the role was practicable and appropriate and would likely be more comfortable if the role was similar to roles that Ofgem already performed concerning the undertakings.
18. Ofgem said that they relied on their general functions under section 34 of the Gas Act and the Utilities Act to carry out their existing roles in the undertakings. Ofgem said there was not a legal issue in taking on extra responsibility but that Ofgem's powers were intended to be incidental.
19. Ofgem explained that under their existing powers in the undertakings, they took decisions within the framework of the undertakings themselves. For example, when approving contract changes Ofgem would judge whether those changes maintained an equivalent level of protection under the framework of the undertakings. Ofgem said that it seemed more appropriate for changes which could fundamentally alter the functioning of the undertakings, to be administered by the CMA than by Ofgem.
20. [✂]
21. Ofgem said that it would be difficult for both CMA and Ofgem to play roles and would be better for one to be responsible, but whichever party was decision-making, Ofgem would anticipate a level of involvement from both Ofgem and the CMA.

Features/considerations of the adjustment mechanism

22. Ofgem said it was important to allow the regulator to trigger a review of the Obligated Capacity using the adjustment mechanism, and for third parties to have recourse to the regulator, if they wished Obligated Capacity to be varied.
23. Ofgem said it was sensible for any independent experts needed to assess the case for a reduction in Rough's capacity, to be paid for by CSL, but to report to the regulator. As regards the evidence to be provided, Ofgem said it might be helpful for the assessor to consider how CSL's forecasted maintenance expenditure would be likely to impact Rough's capability and lifetime.
24. Ofgem raised the concern that an issue could affect different aspects of Rough's capability in different ways. Ofgem said the current issue, had affected the Rough's space substantially much more than it had affected injection and withdrawal rates. Ofgem said that because capacity was mostly sold in bundled units, there was a large volume of injection and withdrawal which was no longer captured under the Obligated Capacity. Ofgem were concerned that this could be treated as incremental capacity which had no restrictions on Centrica's ability to purchase or requirements to sell in

advance. Ofgem said it was important that the adjustment mechanism considered the impact of changes to injection and withdrawal, as well as space.

Storage contracts

25. [✂]

26. [✂]

27. Ofgem said it was worth exploring the extent to which CSL could accommodate certain levels of capacity variability within their contractual arrangements, and whether this would help in determining a minimum level of capacity change that would trigger a review of Obligated Capacity. Ofgem also said that CSL had several tools to manage within-year variability such as using the market or buying back capacity from customers.

28. Ofgem explained that the process of changing contracts from Ofgem's side, required a few months of informal engagement with Ofgem, a month-long consultation on proposed changes to the contracts, and then a month for Ofgem to decide whether or not to veto any change. Ofgem's understanding was that a large amount of time in the process was spent by CSL independently assessing the feasibility of their contract proposals.

[✂]

29. [✂]

30. [✂]

31. [✂]

Monitoring and compliance

Undertaking 9

32. Ofgem said that undertaking 9 had two parts. The first was an obligation on CSL to report the highest and lowest volumes of storage for the previous year. Ofgem said that CSL report daily stock levels separately through transparency requirements The second part of the undertaking obliges CSL to provide Ofgem with any information Ofgem needs to verify levels of Additional Space and Further Additional Space (which perhaps overlapped with separate requirements to provide information to Ofgem). Ofgem did not think that the

undertaking necessarily constituted an additional burden on CSL, they could not imagine using different powers to request the same information twice.

Undertaking 10

33. Ofgem said that monthly Individual Capacity Sales reports provided by CSL under undertaking 10 were useful. Ofgem said that included bids and offers for capacity as well as concluded deals which was useful information when checking that capacity has been sold on a non-discriminatory basis.
34. Ofgem said that CSL's suggestion to provide an additional annual report on Rough's capabilities was a sensible suggestion and that the report could be included as part of the annual compliance reporting. This report could be helpful in helping the CMA and Ofgem understand how Rough's capabilities had changed over time and whether there was potential for the need for the adjustment mechanism to be used to adjust the obligations.

CSL's proposed central compliance function

35. Ofgem said that CSL's compliance officers had access to sensitive information and it would be important to consider the protections in place such that sensitive information, would be appropriately safeguarded and not in a position where it might be accessed by other parts of Centrica.