

3 November 2005

Ms S Brown
Director, Wholesale Markets
Ofgem
9 Millbank
London SW1P 3GE

Dear Ms Brown,

Consultation on the proposed treatment under section 19A of the Gas Act 1986 of gas storage facilities with split ownership

We refer to your letter dated 22 September 2005 addressed to "Shippers, relevant gas transporters and other interested parties".

The Ofgem website contains the following information under Ofgem priorities:

"Creating and sustaining competition

Gas and electricity costs make up most of household and business energy bills, 40 per cent and 75 per cent respectively.

Both wholesale and retail markets for gas and electricity are now fully competitive. Effective competition helps keep the pressure on costs, to the benefit of customers.

Competition also helps promote more diversity in gas and electricity supplies and a greater choice of tariffs and services for customers.

Our priority is to help markets operate transparently and effectively, remove barriers which may prevent this - and, when necessary, use our powers to tackle anti-competitive behaviour or practices."

We share your concern at the significant gas price rises already announced to consumers for this winter (linked to the rise in the wholesale price of gas); no doubt there will be further significant price rises next year also, as current retail prices remain well below the underlying wholesale price.

We respectfully suggest that the energy markets are not yet fully competitive, especially regarding gas supply to the retail market, and that the current operation and control of gas storage in the UK is one of the principal factors preventing effective competition.

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Our observations which follow may go beyond the strict scope of the consultation you have launched, but are clearly relevant to the issue you are considering.

It is our belief, based on the experience we have gained as one of the few genuinely new market entrants, that effective competition requires (for the reasons set out below) all UK gas storage to be made available on a non-discriminatory basis to all licensed UK suppliers, pro-rata to their market share. Whilst this would be a significant change to the current regulatory environment, it should neither prevent nor slow investment in new storage facilities (which are of course highly desirable) provided the return on capital allowed is set at a reasonable level.

Ofgem and the other regulators who monitor the operations of the gas market from time to time, e.g. the Competition Commission, have historically focussed on Centrica and the former regional electricity supply companies (who in many cases subsequently merged with each other and entered the gas supply market), and therefore failed to appreciate how certain key market elements are biased against new market entrants.

I believe we should legitimately question how the wholesale gas market can possibly be operating efficiently, if the Q1-06 price can rise to approximately £1 per therm in July 2005 and then fall back to approximately 65p per therm by mid-October 2005? Or if the day-ahead price on cold days last winter can exceed £1 per therm when there is in reality no shortage, giving suppliers no alternative but to pay whatever price is being requested to meet the additional demand of their customers.

The only “winners” in this situation are producers, speculators and companies owning storage exceeding the amount needed to supply their own customers. The true losers are of course the customers, who indirectly meet these costs through higher prices.

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Our primary concern is therefore less with regard to availability of gas storage facilities (irrespective of ownership), but more with the pricing mechanisms under which storage is made available to the market. In particular, the pricing structure of Centrica's Rough Storage facility (which accounts for approximately 75% of the UK current gas storage capacity) is a major issue. They may be indeed be required to make 50% available to other suppliers, but without any regulated pricing mechanism this requirement has no teeth, nor does it provide any commercial benefit.

As gas prices rose earlier this year, and the differential between winter and summer prices increased, the price charged by Centrica for the capacity it is required to make available also rose. We did a careful analysis of the benefits from purchasing storage capacity, using the pricing formula they apply, which showed virtually no commercial benefit to a bona-fide purchaser like ourselves in taking storage from them, although there may indeed be attractions for speculative investors or hedge funds.

The reality is that the cost to Centrica of operating Rough remains the same irrespective of the underlying price of gas or the differential between summer and winter prices. It is a massive distortion to effective competition for them to be able to continue pricing storage in the current way. It potentially enables them to use their "super-profits" on the part of Rough they sell-off, (combined with the fact that they incur a much lower internal cost themselves on the part of Rough retained for their own use), to cross-subsidise their retail supply business.

As evidence that this may be taking place, they are currently offering to freeze consumer prices for 4 years at below the wholesale market price of gas for this period, ignoring all the administration and other costs in their domestic gas supply business or the need to generate any profit.

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For the last 3 years we have consistently provided domestic users with the UK's cheapest domestic energy, and we now supply almost 200,000 households with some (or all) of their utilities. Our business plan was based on the assumption that in a truly competitive and liberalised market environment, our greater operating efficiencies and lower customer acquisition costs (compared with the former monopoly suppliers) would enable us to compete effectively, provided we could purchase the underlying commodities (gas and electricity) at similar prices to our competitors. If the market were truly competitive, this would indeed have been a reasonable assumption. In practice, we are incurring substantial losses in respect of our gas supply business.

I believe it is no co-incidence that 7 years after deregulation took place, we are the only remaining independent player (excluding the former regional electricity distribution companies) to have entered the UK domestic market in a meaningful way.

If, as demonstrably the most efficient player in the market we are unable to compete, then there must be something fundamentally wrong with the market. Unless we (and potential new entrants) can purchase their energy on a non-discriminatory basis in future, with access to storage and other infrastructure on equal terms to the former monopoly suppliers, the UK will end up with a complex monopoly rather than a liberalised market, and customers will be the ultimate losers through the higher prices they will end up paying.

Linked to the pricing of storage is a similar problem with the lack of any apparent regulatory control over pricing of the Zeebrugge interconnect. The cost of buying capacity is linked to the differential between Zeebrugge and NBP prices. So for example, when the forward price for this winter was 50p in Zeebrugge and 70p in the UK, we were unable to purchase Zeebrugge gas to meet our customers' needs for this winter because the cost of buying capacity on the interconnector had gone up to 20p (from its usual price, based on the cost of operating the interconnector, of less than 1p).

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We would ask you to consider a radical re-assessment of your role and the current regulatory position in relation to both the pricing and access of gas storage and also the operation of the Zeebrugge interconnector, to give genuine competition in the UK domestic market the opportunity to emerge.

We accept that Centrica, Scottish Power and others should make a fair and proper return on their investment in and management of gas storage. Given however the scarcity of these resources, and how effective competition cannot exist without access to such resources being available on a non discriminatory basis, it seems clear that this area needs urgent attention from yourselves.

Our suggestion that all storage facilities should be offered to all UK gas suppliers, proportionate to their market share (adjusted annually), and priced to provide their owners with a reasonable return on their investment, would be one possible solution. There may well be others. What is clear however is the current system isn't working.

We urge you to use your powers to tackle this situation.

Yours sincerely,

Charles Wigoder
Chief Executive