



Centrica Storage Ltd
Venture House
42-54 London Road
Staines
Middlesex
TW18 4HF

Telephone 0845 072 4649
Facsimile 01784 415 318

Ian Marlee
Partner, GB Markets
Ofgem
9 Millbank
London
SW1P 3GE

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Email: GB.markets@ofgem.gov.uk

Dear Ian,

Centrica Storage Ltd's (CSL) Response to Ofgem's Consultation "Guidance on the Third Party Access Arrangements for Gas Storage Facilities in Great Britain"

CSL welcomes the opportunity to comment on the above consultation.

CSL's response is structured in two parts; first we offer some general observations on Ofgem's proposals followed by responses to the questions raised in the document. CSL's response is non confidential and therefore can be placed in the public domain.

General observations

CSL believes that Ofgem's consultation provides a useful contribution to the development of the arrangements that storage system operators (SSOs) will be required to comply with under the Third Package negotiated third party access (nTPA) regime for gas storage facilities.

CSL notes that the proposed arrangements for capacity purchases by related undertakings in the primary market appear to recognise the concerns raised by SSOs in response to Ofgem's preliminary views letter published on 18th May 2010.

However, CSL would like to express its disappointment with the level of regulatory uncertainty that continues to surround certain aspects of Ofgem's guidelines which could have been addressed in this consultation. First, CSL is disappointed with the lack of detail of how Ofgem intends to assess pivotality; what different supply sources should be included, what capacity factors should be applied and over what timeframes. CSL urges Ofgem to publish its pivotality model to allow market participants to assess whether or not they risk being caught by the additional

regulatory burden that Ofgem propose should be applied to SSOs that possess significant market power (SMP). CSL believes that publication of Ofgem's model would be in accord with the Cabinet Office's principles of good regulation¹.

Secondly, CSL is disappointed with Ofgem's continued presumption that auctions should be the primary mechanism to achieve non discriminatory allocation of standard services; this creates some real risks of inefficiency in the allocation and pricing of storage if there is insufficient demand for that product or at that time (e.g. because the product does not best meet rapidly changing demand, or because indications given during market testing are not backed up by real demand for the products requested). Further, an auction with reserve price set only at SRMC could result in storage being sold to parties who value it at much less even than its intrinsic value: resulting in more general distortions to the gas flexibility market.

The uncertainty that currently surrounds Ofgem's views on nTPA arrangements for gas storage is particularly unhelpful given that a number of developers are in the process of seeking project sanction; CSL recommends that Ofgem recognises this issue and makes every effort to minimise this uncertainty.

CSL response to Ofgem's questions

Chapter 3: Access to Gas Storage and Market Power

1. Should pivotal gas volume be used when assessing SMP? If no, please explain why.

In CSL's view pivotality is a reasonable measure to use, as one of a suite of measures, in assessing whether a player is likely to have SMP. Although the measure was initially developed for use in electricity rather than gas markets, there is no inherent reason why it should not be used in a gas market context. In particular, the measure is useful in that it captures not only the relative size of different players' positions, but also the degree of spare capacity in the market – and recognises that a given market share will be less of a concern where there is significant spare capacity than when the market is tight.

In this regard, Ofgem's application of a "capacity factor" to supply capacities for the purposes of calculating pivotality is of some concern. Clearly if the true capacity of a facility is lower than its "nameplate" capacity then it is appropriate to adjust capacity to the true measure. However, if capacity is adjusted to match expected supply, then by definition expected supply must equal expected demand, and the player's pivotal share becomes simply its market share. Therefore the references in Appendix 2 to the use of "likely flow rates" over the winter period are of concern, and suggest that in fact Ofgem may be implementing a ten per cent market share threshold, rather than a true pivotality measure.

It is crucial that firms understand whether they are likely to be seen as having SMP or not – and therefore Ofgem should release its model so that firms can judge their position against Ofgem's methodology. CSL believes that publication of Ofgem's model would be in accord with the Cabinet Office's principles of good regulation. If this cannot be done, Ofgem will at the very least need to clarify its position in relation

¹ <http://www.bis.gov.uk/policies/better-regulation>

to these capacity factor calculations (e.g. by providing worked examples of how it would implement these adjustments in practice).

Another important area of clarification is to understand which sources will be counted towards a given player's pivotal share. For example, the guidance paper makes clear that this is seen as a measure of ability to withhold: yet some sources (e.g. production of gas associated with oil production) may not be possible to withhold in practice. Similarly the treatment of contracted sources should be clarified: will these count towards the share of the owner of the capacity, or its contractual purchaser? Will this depend on the duration of the contract terms, or the pricing terms (in particular whether the seller or the buyer of the capacity would benefit from an increase in the value of flexible gas induced by any capacity withholding?).

Clearly no single measure will accurately capture whether a given player has the ability and/or incentive to withhold output/raise price – and as Ofgem correctly points out, pivotality is closer to a measure of ability than incentive. For example, a player that is not pivotal (as Ofgem points out) may nonetheless have the ability and incentive to restrict output and raise price (particularly if it controls sources of supply close to the margin, which may therefore be relatively inexpensive to withhold).

However, it is also important to recognise that a player that is pivotal may have no such incentive. For example, if a player needs to withhold a significant proportion of its supply in order to have any impact on price, or if all its sources are low cost and would therefore incur a very high opportunity cost of withholding, then the costs of doing so may well outweigh the benefits. CSL assumes that Ofgem will take these considerations into account in its market power assessments, rather than taking a purely mechanistic approach. In this regard Ofgem's reference to pivotality above ten per cent tallying with a clear incentive to raise price for reasonable demand elasticity estimates does not seem correct (see paragraph 3.21): any such calculation will clearly depend not only on market demand elasticities and pivotal share, but also on the cost of withholding supply and the likely strength of response of rivals (i.e. how much would prices need to rise to bring each rival source to market). Therefore, while a higher pivotal share may raise the prospect of SMP, it should not be seen as definitive evidence of such (as with any simple concentration measure).

2. Is the proposed figure of ten per cent of pivotal gas volume an appropriate threshold for defining SMP? If no, what is an appropriate threshold?

Clearly in reality the question of "significant market power" is a question of degree. In real world markets there are very few cases of "textbook" perfect competition, and therefore the question is whether a firm or firms have sufficient market power that they have a significant ability and incentive to influence prices by a significant amount. This ability and incentive cannot be captured by any single measure of concentration (whether market shares, HHI or pivotality). CSL assumes that Ofgem will use such measures as a starting point for analysis rather than a simple "cut-off" (as is done in other contexts and in other areas of modern competition and regulatory policy). The precise level chosen is therefore less important than the understanding that any such threshold should be one where the question of SMP is raised – but this should not become an un-rebuttable presumption.

3. Is it appropriate to also consider market outcomes to assess whether a market player may have SMP at lower levels of pivotality?

As discussed above, CSL assumes that Ofgem will not use any concentration-measure threshold as a hard cut-off, but rather as a starting point for a further investigation of concerns.

As such, concerns could arise below the threshold – or may be found not to arise even above the threshold. In particular, CSL would note that pivotality is not, as Ofgem appears to suggest, inherently an understatement of market power. To the extent that it “assumes” that rivals produce at full capacity (subject to the comments on “capacity factor adjustments” already made above), it also “assumes” that the player in question would fully withhold. Clearly both these assumptions are extreme in opposite directions (one potentially overstating the likely capacity withdrawal, and one potentially overstating the likely rival response).

This tallies with the measure being primarily a measure of ability rather than incentive to withhold, and implies that any such measure can only be the starting point for further investigations in respect of any particular complaint or concern.

4. Are there any additional factors that should be used when considering if a market player has SMP?

As discussed above, CSL believes that SMP should be assessed using a range of available concentration measures – but also taking account of the actual ability of a player to remove flexibility from the market (e.g. taking account of associated gas constraints and contractual constraints), as well as whether the firm in question has any incentive to do so.

Chapter 4: Capacity allocation and congestion management procedures

1. What factors should be taken into consideration when defining the maximum capacity of a group of facilities?

The maximum storage capacity should be the sum of the maximum storage capacity (taking account system integrity and operation) for each of the individual facilities in that group. Although extra capacity may be made available from time to time by virtue of a combination of operating a portfolio of facilities and the SSO managing risk, this additional capacity must not be captured in the defined maximum capacity. It is important to recognise that commercial and operational risk appetite is variable, as is the method of portfolio utilisation and optimisation, all of which must be determined by the SSO at its sole discretion.

2. What concerns, if any, do market participants have with Ofgem's preliminary views on capacity allocation? What concerns, if any, do storage users have with the use of allocation mechanism other than auctions to allocate capacity, particularly standard services?

CSL believes that auctions and bilateral negotiations are equally effective in delivering non-discriminatory capacity allocation. CSL has run a bilateral sales process supported by sufficient systems which deter and detect discrimination (e.g. call / email / msn recording, audited, effective sales policy) for the past 8 years and has not been subject to any customer complaints or adverse regulatory findings. Bilateral negotiations importantly provide market participants with flexibility as to when and at what price they purchase their storage capacity, thus assisting in the liquidity of the market, as well as providing better opportunities for market participants to hedge their positions.

3. Does the use of auctions provide market participants with sufficient safeguards that any market player with SMP will provide standard services to the market on a non discriminatory basis? What other measures/safeguards in relation to how any market player with SMP allocates capacity could be considered?

CSL believes that the use of auctions is one allocation mechanism that will provide sufficient safeguards to ensure that market players with SMP provide services on a non discriminatory basis; CSL also believes that this can be equally achieved through bilateral negotiations if accompanied by appropriate safeguards. For example, to ensure non discriminatory allocation of services for Rough, CSL has adopted the following service allocation process:

- A sales policy that clearly sets out processes to be followed to ensure capacity is allocated on a non discriminatory basis,
- Recording of all customer contact including Messenger, Email and telephone
- A system that records all bids received and all offers made with a date and time stamp
- Regular audit by a compliance manager.

CSL has been successfully providing bilaterally negotiated services, on a non discriminatory basis, since 2002 without a single complaint being raised. The Third Package concern lies in the potential for discriminatory behaviour in the allocation of storage services; as long as the market player can demonstrate non discrimination in its allocation mechanism there should not be the presumption that auctions should be the primary allocation mechanism.

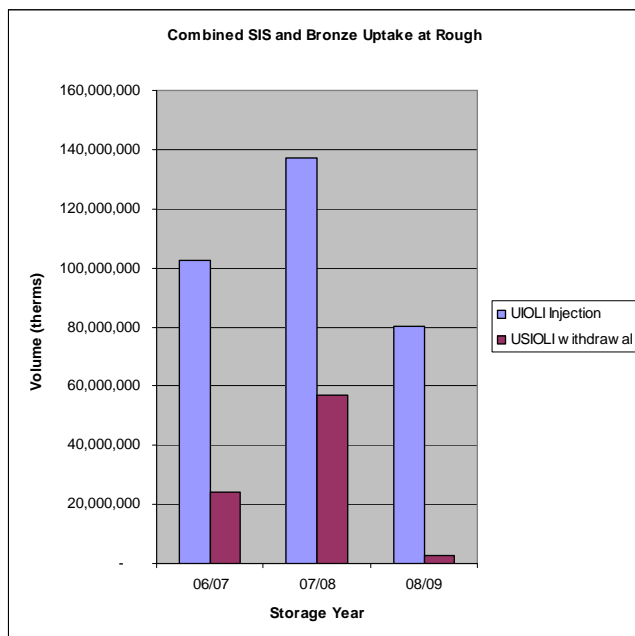
4. Do market participants consider that the prevailing anti-hoarding arrangements currently in place at GB storage facilities that are subject to the TPA regime are appropriate and compatible with the requirements of the Gas Regulation? If no, please explain why.

CSL believes that the anti hoarding arrangements in place at Rough are compliant with the Gas Regulation and are in line with market requirements. CSL has operated use it or lose it arrangements at Rough throughout its ownership of the facility, as well as a market for the trading of capacity and gas in store. CSL sees considerable

uptake of unused capacity by storage customers. CSL sells UIOLI capacity in the form of two products; Secondary Interruptible Service (SIS) and Bronze. The volume of capacity released is derived from consideration of the aggregate nominations of customers and the running pattern of the plant, and commercial incentive naturally dictates that the volume to be released is released without material delay. CSL operates an interruption ranking on both products, with Bronze being interrupted before SIS. The price of SIS therefore is higher than Bronze, the price of each thus reflective of the probability of interruption.

In order to demonstrate the effectiveness of the anti hoarding arrangements, CSL offers the following figures:

Uptake of UIOLI Capacity at Rough (Secondary Interruptible Service (SIS) and Bronze Services)



5. Do market participants consider that the mix of interruptible and firm storage services is appropriate and compatible with the requirements of the Gas Regulation? If no, please explain why.

CSL believes that the mix of interruptible and firm storage services offered at its Rough storage facility is appropriate and compatible with the requirements of the Gas Regulation.

CSL’s primary market product offering largely consists of firm products, although bespoke interruptible products are available on request. Further interruptible capacity is offered on a UIOLI basis where sold firm capacity is not being used by the capacity holder. Each year, CSL’s firm product offering sells out by 1st of April, and interruptible capacity utilisation over each year is as set out in the above chart.

CSL believes that the demand demonstrated for its products is reflective of CSL having an appropriate balanced product offering.

6. Do market participants consider that the existing arrangements for the secondary trading of storage capacity are appropriate and compatible with the requirements of the Gas Regulation? If no, please explain why.

CSL believes that the existing arrangements for the secondary trading of storage capacity offered at its Rough storage facility are appropriate and compatible with the requirements of the Gas Regulation.

CSL operates a secondary market for capacity, although utilisation is typically low, with customers preferring to trade gas in store to create the effect of trading capacity. CSL believes the reasons for this to be associated with the desire to protect optionality and to protect market sensitive information. Nevertheless, CSL's arrangements are compliant with the Gas Regulation.

Chapter 5: Main commercial conditions and service specification

1. What levels of consultation should SSOs undertake when developing main commercial conditions for the first time and when proposing amendments to the standard terms and conditions?

Based on purely commercial considerations, any SSO will wish to respond to market demand in order to achieve the best possible value from their assets, and therefore will wish to research the product offerings which generate demand from market participants, identify how the asset base would best facilitate delivery of these products and market them competitively. CSL has in the past pursued this approach in order to develop the V Store, C Store and I Store products.

Therefore it is reasonable to expect to see a significant degree of consultation in the design of new products and the amendment of existing terms and conditions – particularly for new assets where there is no history of sales and the full volume of the asset is concerned. However, there should also be the ability to test new products through trial and error – particularly where more modest volumes are concerned (e.g. where only part of the asset is to be sold under a new contract structure or product type). Most crucially, any regulatory oversight should seek to be sufficiently flexible and fast that it does not slow down the ability of SSOs to respond to changes in market demand as patterns of demand change over time (e.g. due to the demands likely to be placed on the system by increased use of wind powered generation), or to rival innovations.

2. Are there aspects of an SSO's main commercial conditions where small changes are likely to have a significant impact on system users?

CSL believes that every contractual condition serves to shape the relationship between the SSO and the customer, and to single certain conditions out as having additional importance is inappropriate. All conditions should be capable of being modified freely through a transparent and consultative change process in order to ensure that the opinion of the market is taken into account alongside that of the SSO.

- 3. Should SSOs be expected to formally consult or test the market before changing existing services or offering any new services to the market? If no, please explain why.**

Article 33(3) of the Gas Directive sets out the requirement for SSOs to consult system users when developing the conditions for contracts for access to storage. CSL envisages that this will be transposed into UK law. In this light, CSL expects to consult with its customers as required.

- 4. Should SSOs be expected to offer a minimum threshold of capacity on a short term basis? How should SSOs determine the minimum proportion of capacity that should be sold on a short term basis?**

SSOs should be free to respond to market demand. Market demand should determine the time span over which capacity contracts should be offered. Further, developers may underpin investment in new storage products using long term capacity contracts. A mandatory requirement to offer short term capacity should not undermine this practice.

- 5. Should SSOs be expected to offer bundled capacity as part of their 'standard services'? Should SSOs be expected to also offer unbundled capacity as part of their 'standard services'? Please explain your views.**

There is no inherent reason why an SSO should be forced to sell capacity in either a bundled or unbundled fashion. Unbundled services provide greater flexibility by allowing changes to be made to the "shape" of a bundled product by adding injectability, space or deliverability. Bundled services provide customers with a standard product which offers familiarity and ease of use. CSL believes that competition between flexibility providers together with product consultation will identify the correct balance that reflects customer demand; failing to find the correct balance will result in value destruction for the SSOs.

Chapter 6: Transactions with related undertakings

- 1. What factors should Ofgem take into consideration when assessing a market player's flexible gas requirements and, in particular, need for storage services?**

CSL notes that the proposed arrangements for capacity purchases by related undertakings in the primary market appear to recognise the concerns raised by SSOs in response to Ofgem's preliminary views letter published on 18th May 2010.

CSL believes that when considering bookings by a related undertaking to the SSO, it will be relevant to take account of that undertaking's own flexibility requirements – driven by the requirements of their own final customers and particularly residential consumers of gas, who tend to have a highly variable consumption pattern.

However, it may also be the case that related undertakings may wish to purchase capacity for resale in a way that adds value. This legitimate activity should not

prohibited and therefore any investigation should investigate concerns over withholding directly – with the key question being whether behaviour stopped the flexibility associated with the storage facility from being available (and used) to meet the needs of final consumers, rather than precisely to whom and how it was packaged and sold. As long as the principle of non-discrimination in the primary sales process is followed, and any attempt at hoarding is pursued, there should be no need to make specific pronouncements on how much a related undertaking may book.

Chapter 7: Transparency and information sharing arrangements

1. Do SSOs provide sufficient information on the services they offer and the terms and conditions of access? Is any further information required? Are there any improvements that could be made to how information is provided by SSOs?

CSL believes that its transparency offering in respect of services offered and terms and conditions of access is above and beyond that required by the Gas Regulation. CSL publishes in a clear and user-friendly manner on its website, inter alia, the following information:

- Description of products offered
- Information on the sales process
- Contracts and contract summary information
- Technical configuration of products
- Indicative prices
- Information on how to become a customer

Given that CSL markets its capacity at Rough in a large flexibility market where other sources of flexible gas are competing for CSL's customers, an informative and transparent approach is of significant importance. CSL's sales process also therefore involves presentations and information sharing sessions with its individual customers, thus achieving, in CSL's view, the most transparent customer experience in Europe.

2. Do SSOs provide sufficient information on the maximum capacity and the level of utilisation? What further information is required? Are the current timeframes for providing this information appropriate?

CSL believes the transparency requirements in the Gas Regulation are appropriate and that they provide the correct balance between transparency and preservation of commercial confidentiality. CSL's current practice by virtue of the Rough Undertakings goes beyond that in the Gas Regulation in that aggregate nominations are published five times daily. CSL recommends that Ofgem does not require SSOs to publish more information around levels of utilisation than that set out in the TEP.

3. Should SSOs publish the information required under section 19(4) on their website or should NGG undertake this role for all SSOs?

CSL supports GSOG's proposal for NGG to publish on its website the information required under Article 19.4 of Regulation 715/2009 on behalf of SSOs. CSL believes that the centralised publication on NGG's platform will increase the ease of access to

such information by market participants. The proposed arrangement shall also minimise the cost of implementation and it shall avoid inconsistencies among published data.

This response has been copied to John Havard at DECC given his interest in this matter.

I hope Ofgem finds CSL's comments helpful and if you would like to discuss any of the points raised in more detail, please do not hesitate to get in contact.

Yours sincerely,

A handwritten signature in black ink that reads "Roddy Monroe". The signature is written in a cursive, slightly slanted style.

Regulatory Manager
CSL

CC John Havard, DECC