

October 2001

**Dynegy's proposed acquisition of
BG Storage Ltd**

A consultation paper

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1. Summary

Purpose of this document

- 1.1 This document seeks the views of interested parties on the proposed undertakings that Ofgem believes should be sought from Dynegy Europe Limited ('Dynegy') by the Secretary of State for Trade and Industry ('the Secretary of State') in lieu of referring its proposed acquisition of BG Storage from BG Group ('BG') to the Competition Commission.

Background

- 1.2 On 23 July 2001, Dynegy notified the Office of Fair Trading ('OFT') of Dynegy's proposed acquisition of BG Storage and its associated assets from BG. On 10 September 2001, the Minister for Competition, Consumers and Markets announced on behalf of the Secretary of State, that following advice from the DGFT, the Secretary of State had asked the DGFT to seek suitable undertakings from Dynegy in lieu of a reference to the Competition Commission, to address competition concerns if the acquisition were completed. The DGFT's advice to the Secretary of State was informed by advice from Ofgem.¹
- 1.3 The Secretary of State was concerned that without suitable undertakings from Dynegy, it would not be possible to ensure that all gas storage capacity is released to the market on non-discriminatory terms, and to ensure that the commercially confidential and market sensitive information available to a storage owner cannot be misused by any affiliated trading businesses.
- 1.4 Ofgem has agreed with the OFT that it would consult on the appropriate form of such undertakings and then provide advice to OFT, who would report back to the Secretary of State. This consultation includes two proposed sets of undertakings that we would like respondents to consider. Appendix 1 sets out the undertakings proposed by Ofgem. Appendix 2 sets out the undertakings proposed by Dynegy.

¹ "Dynegy Inc's proposed acquisition of BG Storage Ltd, A consultation document", Ofgem, August 2001.

Proposed undertakings

- 1.5 The main parts of Ofgem's proposed undertakings are very similar in form to the current non-statutory assurances given by BG to Ofgem.²
- 1.6 It is important to note that while BG's assurances are usually referred to as 'undertakings' (and this is reflected in the use of this term in this document), they do not have the statutory force of the undertakings being sought by the Secretary of State with respect to Dynegy's proposed acquisition.³ To the extent that the proposed undertakings and the BG 'undertakings' differ, the differences are minor in nature and reflect developments since the undertakings were given.
- 1.7 The existing undertakings were entered into by BG at the time to address Ofgas' concerns about the potential abuse of market power by BG Storage in the transition to a competitive storage market. Ofgas' principal policy objectives, which the undertakings were designed to achieve, were to ensure that all storage capacity was released to market on non-discriminatory terms and that any confidential information about customers' storage interests were not used inappropriately by BG Storage or its affiliates.
- 1.8 The existing undertakings expire in 2005. In assessing the effects of the proposed acquisition, Ofgem believes that it remains appropriate to ensure that any undertakings entered into continue to meet its two policy objectives, outlined above. Ofgem does not believe that the proposed acquisition raises any new or additional concerns over and above those that were identified at the time the existing undertakings were agreed.
- 1.9 In proposing undertakings, Ofgem has therefore tried to largely maintain the existing undertakings agreed by BG. Where the proposed undertakings that would apply to Dynegy differ from the existing undertakings, we have highlighted these differences in the document and set out an explanation for these differences.

² Review of the supply of gas storage and related services. Decision document. Ofgas, February 1999.

³ The undertakings being sought by the Secretary of State would be enforced through the Secretary of State's powers under the Fair Trading Act 1973.

Auctioning of capacity

- 1.10 Following discussions with current and potential storage customers, Dynegy believes that the current arrangements are in some areas too restrictive and may actually frustrate the achievement of Ofgem's objectives. Dynegy has, in particular, suggested that the current arrangements for auctioning storage capacity prevent innovation by the Storage Operator and may not be in customers' interests.
- 1.11 Ofgem has stated on a number of occasions that we believe auctions to be the best method of ensuring that all capacity is made available to the market on non-discriminatory terms, and also to facilitate the development of an efficient and competitive market for storage services. Therefore, Ofgem's proposed undertakings include a specific requirement for Dynegy to make available to the market the maximum physical capacity of the Rough and Hornsea storage facilities, through auctions, consistent with the process currently followed by BG Storage. This includes the requirement to publish auction procedures, a storage services contract and a future operations statement.
- 1.12 Dynegy's proposed undertakings refer to a requirement for it to 'offer for sale' the maximum physical capacity on non-discriminatory terms, but does not include a specific requirement to achieve this through auctioning all capacity. Also, while paragraph 4 of Dynegy's proposed undertakings states that *'The contract terms for the firm rights offered for sale pursuant to these undertakings will be published and made available to customers upon request'*, no reference is made as to the procedure for future changes to these published terms.

Access to confidential information

- 1.13 Ofgem continues to believe that it is necessary to have a provision in the undertakings to ensure that Dynegy does not misuse any commercially confidential and/or market sensitive information about storage customers in its trading activities. Consistent with Ofgas' statement⁴ when BG gave its undertakings, about the absolute requirement for BG to maintain a separate

⁴ "Review of the supply of gas storage and related services, A decision document", Ofgas, February 1999.

storage company, Ofgem believes that there should be an absolute requirement in Dynegy's undertaking to maintain this separation.

- 1.14 Dynegy's proposed undertakings do not include such an absolute requirement to maintain a separate storage company, as it believes that such a requirement is unnecessary and more onerous than that currently given by BG Storage. Its undertakings instead include a requirement to use reasonable endeavours to maintain a separation between storage and its other business activities.

Availability of one year rights in each of the remaining two storage years

- 1.15 As more than 50% of the storage facilities have been booked on a long term basis, the current undertakings given by BG would allow BG Storage to sell the remaining capacity for terms of rights of whatever period it decides, providing it is for a minimum of one year. Previously, customers have expressed concern to Ofgem that if no capacity is made available for term of rights of only one year, this might have a detrimental effect on the ability of some small shippers to obtain sufficient capacity to meet their requirements, given the limited development of a secondary market. This might not be such a concern given the provision of use-it-or-lose-it services at Rough and Hornsea. Therefore, subject to this consultation, Ofgem does not propose to include a requirement in the undertakings to be sought from Dynegy requiring it to sell a minimum amount of capacity for a one-year term of rights.
- 1.16 Dynegy believe that any such requirement would unnecessarily restrict its commercial freedom, without providing any additional protection for customers.

Views invited

- 1.17 This document seeks comments from interested parties on the undertakings that should be sought from Dynegy in lieu of a reference to the Competition Commission, to address the competition concerns identified by the Secretary of State. In particular, Ofgem would welcome comments on whether the undertakings proposed by Ofgem or Dynegy best address the competition concerns identified by the Secretary of State, with particular reference to the three issues discussed above:

- ◆ how best to ensure that all available capacity is made available to the market on non-discriminatory terms;
 - ◆ the form of the undertaking restricting access to confidential information about storage activities from Dynegy's trading activities; and
 - ◆ the availability of one year rights in the remaining two storage years to which these undertakings would apply.
- 1.18 Ofgem would also welcome comments on any other issues related to the storage market, which respondents believe may affect the form of undertakings that should be sought from Dynegy.
- 1.19 After taking account of responses to the consultation, Ofgem will advise the DGFT as to the form of the undertakings that should be sought from Dynegy by the Secretary of State.
- 1.20 Responses will normally be available in the Ofgem library unless there are good reasons why they must remain confidential. Respondents should mark any part of their response, which is to remain confidential, and where possible should put any confidential material in appendices.
- 1.21 Responses should be sent by 29 October 2001 to:

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Outline of this document

- 1.22 Chapter 1 explains the main details of the proposed acquisition, describes the main features of the market for storage and related products in Great Britain, and the process that was followed before the Secretary of State's decision. Chapter 2

explains the form of the undertakings that Ofgem believes should be sought from Dynegy to address the competition concerns identified by the Secretary of State, and seeks the views of interested parties on these proposals. Chapter 3 explains the next steps that will be followed to allow Ofgem to provide advice to the DGFT as to what undertakings he should advise the Secretary of State to seek from Dynegy.

- 1.23 Appendix 1 sets out in full the undertakings that Ofgem believes should be sought from Dynegy to address the competition concerns identified by the Secretary of State. Appendix 2 sets out in full the undertakings that Dynegy proposes it should give to the Secretary of State. Appendix 3 explains the background, in detail, that led to the agreement of the existing undertakings between BG and Ofgem. Appendix 4 sets out in full BG's current undertakings, given to Ofgas.

2. Background

Proposed acquisition

- 2.1 On 23 July 2001, Dynegy notified the Office of Fair Trading (OFT) of Dynegy's proposed acquisition of BG Storage and its associated assets from BG Group. The associated assets were the partially depleted Rough offshore storage facility in the Southern North Sea, the nine salt cavities in Hornsea, east Yorkshire, and a 73% shareholding in the Easington onshore gas processing facility.
- 2.2 Dynegy's purchase would also include the planning permission that BG Storage had received to develop six salt cavities at Aldborough in Yorkshire, the remaining 27% interest in the Easington onshore gas processing terminal, which is owned by another BG Group subsidiary, and the Amethyst gas processing and condensate transportation agreement.
- 2.3 Dynegy's proposed acquisition also involves BG's wider interest in Block 47/3d, which as well as the Rough field, contains prospects and extension of the York discovery.

The storage market and recent developments

- 2.4 Rough, Hornsea, and the five Liquefied Natural Gas facilities⁵ are the major sources of physical gas storage in Great Britain ('GB'). Originally, all these facilities were owned and operated by British Gas plc. However, through a process of de-merger, separation and the introduction of competition in the storage market, Rough and Hornsea are now owned and operated by BG Storage (a ring-fenced subsidiary within BG) and the LNG sites are owned by Transco LNG (a ring-fenced subsidiary within Transco).
- 2.5 The reasons for and the process that led to the separate ownership of these storage sites and the subsequent undertakings given by BG to Ofgas in respect of the operation of the Rough and Hornsea facilities is described in Appendix 3. The main provisions of the undertakings given by BG are described later in this chapter, and the undertakings are set out in full in Appendix 4.

⁵ The five facilities, at Avonmouth, Dynevor Arms, Glenmavis, Isle of Grain and Partington, are owned and operated by Transco.

- 2.6 Ofgem's 'A review of the development of competition in the gas storage market', published in October 2000, detailed a number of recent developments, which were likely to have the potential to increase competitive pressures on BG's storage facilities. However, as the document made clear, these developments are at an early stage. In particular, actual new entry into the storage market represented only 3% of space capacity and 2% of deliverability. Rough and Hornsea still accounted for 86% of storage space and 43% of deliverability. While significantly less important in terms of space (10%), Transco's LNG facilities still accounted for 55% of storage deliverability.
- 2.7 Under recent market conditions, holders of capacity at Rough and Hornsea appear to have used the facilities to perform different functions. Patterns of use suggest that Rough is predominantly used for seasonal balancing, while Hornsea provides an important source of within-day flexibility for shippers. A planned storage facility at Aldbrough is of a comparable size to Hornsea, with similar operating capabilities, and when operational, may provide a significant source of competitive pressure for within-day flexibility.
- 2.8 An additional source of within-day flexibility could come from auctions of linepack. Presently Transco uses linepack to provide itself with operational flexibility, but essentially it is a form of storage that could be made available to shippers. As part of the ongoing reform of the gas trading arrangements⁶ it is envisaged that Transco will make linepack available on a commercial basis. Ofgem has proposed that linepack should be unbundled from transportation and sold via a non-discriminatory price auction. Transco will auction both LNG and linepack under rules that would prevent any discrimination or abuse of market power. If a linepack service were to be provided it could represent a significant competitor to Hornsea, LNG and other flexibility instruments.
- 2.9 The Bacton interconnector, and the increasing sophistication of flexibility tools, including virtual storage, also offers potential alternative competing sources of flexibility. However, as yet, there is limited evidence on the impact of these developments and it should be noted that virtual storage services do not actually result in additional physical gas.

- 2.10 As expected at the time of Ofgas' storage review in 1998 that led to the existing undertakings being agreed, there are clear signs of the development of increasing competition, and this is encouraging. As was also expected in the storage review, and as was reflected in the five-year commitment to capacity auctions, the transition to a more competitive market is taking some time. As yet, there is little direct evidence of any substantial impact on storage prices from the various influences described above. The sensitivity of gas market prices to changes in the supply position, indicated by price movements in traded markets this summer, suggests that the capacity of the BG Storage and Transco LNG sites continue to provide those businesses with a significant ability to influence gas prices (should they decide to pursue more restrictive policies).
- 2.11 Thus, in our October 2000 review, we concluded that good progress has been and is being made, but that there is still some way to go before all major issues concerning significant market power are satisfactorily resolved.

The purpose of the undertakings

- 2.12 BG Storage's current undertakings followed Ofgas' conclusion that with respect to ownership and operation of storage facilities, the arrangements were not operating in the public interest and that, '*BG Storage possessed significant short-term market power*'.
- 2.13 The undertakings, were put in place for the five-year period up to April 30 2004, and were intended to govern conduct in relation to the Rough and Hornsea facilities in the transition to a competitive storage market.
- 2.14 The principal objectives of the undertakings during this transition period was to:
- ◆ ensure that all storage capacity at Rough and Hornsea was made available to the market on non-discriminatory terms; and
 - ◆ ensure the robust separation of the storage business from the rest of BG plc's business units, so that should BG want to book capacity at Rough and Hornsea, it should do so on the same basis as other purchasers and that it should not obtain an unfair advantage by virtue of its ownership of

⁶ The New Gas Trading Arrangements. A review of the new arrangements and further development of ten

the storage facilities. This was also intended to ensure that other parts of the BG Group could not trade on the basis of what could potentially be market sensitive information regarding the facilities.

- 2.15 Additionally, the undertakings included arrangements designed to facilitate the development of a secondary market in storage services.
- 2.16 The auction arrangements agreed as part of the undertakings provide a transparent basis by which Ofgem can effectively monitor that all capacity is being made available on non-discriminatory terms, without the need for detailed scrutiny and oversight. The existing arrangements also address potential concerns about hoarding of capacity by providing for a daily interruptible 'Use-It-Or-Lose It' ('UIOLI') service in relation to all capacity against which a nomination has not been made.
- 2.17 The undertakings constrain BG Storage to operate the facilities in a manner consistent with general competition law (including the caveat that any reserve prices are set on an appropriate basis and do not effectively withhold capacity from the market).
- 2.18 The undertakings require the consent of the Authority before the disposal of the storage facilities, and specifically state that an equivalent set of undertakings should apply to a new owner if the facilities are sold.

BG Storage

- 2.19 The Rough field can store approximately 30 TWh. It has a high deliverability rate of 455 GWh/day. There are nine man-made salt cavities at the Hornsea storage facility located in East Yorkshire. The usable space is 3.5 TWh and the cavities can deliver gas at the rate of 195 GWh/day.
- 2.20 Rough and Hornsea account for approximately 86% (33,829 GWh) of storage space and 43% (643 GWh/d) of deliverability capacity in GB. The withdrawal

regime. A review and decision. Ofgem July 2000.

lead times vary from half an hour to twelve hours and injection lead times from two hours to twelve hours.⁷

- 2.21 The Rough and Hornsea sites were originally developed for seasonal storage purposes, although they do have relatively short lead times in higher states of readiness, so they can be used to balance supply and demand over shorter periods, including for daily balancing purposes.

Dynegy

- 2.22 Dynegy's principal business segments include energy convergence (wholesale power and natural gas, coal, emission allowances, weather derivatives and broadband to transportation, gathering and processing of natural gas liquids), midstream services, transmission, and distribution. Dynegy is a leading energy merchant and power generator in North America, UK and continental Europe. The company is based in Houston.
- 2.23 Through Dynegy Europe Ltd (Dynegy Europe), Dynegy has been an active participant in UK energy markets since 1994. In 1999 Dynegy Europe entered the Nord Pool electricity market and the England and Wales electricity market.
- 2.24 Dynegy UK Ltd, which is a subsidiary of Dynegy Europe, holds a gas shipper licence.

The merger process

- 2.25 The transaction met the criteria for investigation under the mergers provisions of the Fair Trading Act 1973 (FTA). The Secretary of State for Trade and Industry could therefore refer the transaction to the Competition Commission for investigation if, in her opinion, it gave rise to significant competition concerns.
- 2.26 It is the responsibility of the Director General of Fair Trading (DGFT), to advise the Secretary of State as to whether the transaction should be referred to the Competition Commission. In accordance with the concordat between the OFT and Ofgem, the OFT consulted Ofgem before the DGFT advised the Secretary of State. Where the OFT advises that the transaction should be referred to the

⁷ For more details see 'Review of the supply of gas storage and related services. The Director General's Initial Proposals', Ofgas, June 1998.

Competition Commission, the OFT may in lieu of such a reference advise that the Secretary of State invites binding undertakings from the parties to the transaction which would remedy any adverse effects on competition identified by the OFT.

- 2.27 Dynegy Europe Ltd notified its proposed acquisition to the OFT on 23 July 2001 by way of a statutory Merger Notice. This meant that the Secretary of State was required to reach a decision whether to refer the proposed acquisition to the Competition Commission or not within 20 working days from the first day after receipt of the case (by 20 August 2001). However, the OFT was free to seek to extend this 20 working day period by a further 15 working days, so that the total period for consideration would be 35 working days.
- 2.28 Such an extension was granted in this case, and as a result the deadline for the Secretary of State to reach a decision was 10 September 2001. Ofgem was required to provide its advice to the OFT to suit the above timetable.

Ofgem's initial consultation

- 2.29 Ofgem issued a consultation paper in August 2001 seeking views on Dynegy's proposed acquisition of Rough and Hornsea, as it has done in previous mergers and acquisitions involving gas and electricity companies.
- 2.30 Ofgem explained that the main issue at stake was the extent to which the concerns that had led Ofgas to seek undertakings from BG would be similarly applicable given Dynegy's potential ownership and operation of Rough and Hornsea. Therefore, the consultation document requested respondents' views on how Ofgem's policy objectives could be addressed following any acquisition. The first issue was how to ensure that all capacity was made available on non-discriminatory terms, and whether this could be ensured in the absence of explicit capacity auctions. The second issue concerned how to ensure the safeguarding of operational information and whether this would require the separation of Dynegy's trading and proposed storage business.
- 2.31 The document also considered whether BG's current undertakings should apply to Dynegy, and whether any additional undertakings ought to be sought as a pre-condition of the acquisition proceeding.

- 2.32 Ofgem received twenty responses to the consultation document. The majority of respondents considered that the storage market had thus far not changed in ways that had not been anticipated at the time that BG gave the undertakings. New storage operators and alternative flexibility sources have emerged, but these had already been anticipated at the time of the undertakings and, in any case, they only form a small part of the market. Additionally, concerns were raised as to the actual substitutability of some of the alternative flexibility sources.
- 2.33 Seven companies explicitly said that no undertakings were required, including BG Group (sellers of BG Storage) and Chevron (26% owners of Dynegy). Both companies' responses are non-confidential. They took the view that competition law was sufficient to guard against anti-competitive practices and that any extra regulation might stifle innovation.
- 2.34 The other thirteen respondents all considered some form of undertakings were necessary. Ten of these argued for BG Storage's current undertakings should remain in place until the end of the storage year 2003/04 as originally envisaged. These respondents indicated that the storage market has not changed significantly since the undertakings were agreed. They also questioned the extent to which other sources of flexibility were effective substitutes for Rough and Hornsea. Four respondents went on to say that Ofgem should at least conduct a review of the storage market prior to the termination of the undertakings in April 2004.
- 2.35 Three other respondents also stated the need for some form of amended undertakings. One explicitly indicated that such undertakings should address the separation of the storage and trading functions, ensure that capacity was not withheld, and allow Ofgem to amend these undertakings in the event of shorter balancing periods.
- 2.36 Five respondents explicitly identified a UIOLI service as a means by which fears of capacity hoarding could be eased. One respondent commented that with respect to any new services, apart from a UIOLI commitment, the '20% rule' should apply and there should not be any reserve prices for auctions that might take place.

- 2.37 In the absence of any concrete proposals regarding the services that Dynegy intends to offer, it should be noted there could be some doubt as to the extent to which Dynegy can offer new services. This is because users have already bought capacity under the current Storage Services Contract and Dynegy's new services might breach the terms of this agreement. This, however, could be viewed as a future contractual issue between Dynegy and existing capacity holders.
- 2.38 In general, those respondents who stated that no undertakings were required also indicated that they believed that there were no information issues or any need for ring-fencing. Ten respondents referred to explicit information issues. Moreover, these respondents had also either directly or indirectly argued for the separation of Dynegy's trading and storage functions. In a wider sense, respondents who had raised information issues felt that the information should be made available simultaneously to both Dynegy trading and the rest of the market.
- 2.39 One respondent had argued for full separation but stated that as a minimum information should be provided to correct any imbalance. Another said that there should be full separation but if Dynegy were developing new products, better information would allow the market to determine whether all capacity was being brought to the market. Also, another respondent also argued for full separation but conceded that if this were not possible in the short term, it would be looking for full disclosure of information instead.
- 2.40 One respondent commented that information on the STORIT system was only available to storage customers. Another commented that Dynegy should adhere to previous comments regarding information disclosure and make data as widely available as possible.
- 2.41 Non-confidential responses to the consultation are available from the Ofgem library.

Ofgem's advice to the DGFT

- 2.42 Ofgem concluded that Dynegy's acquisition of Rough and Hornsea raised significant competition and regulatory issues with respect to both making all capacity available on non-discriminatory terms and the separation of the storage

business from any trading activity by Dynegy. This formed the basis of our advice to the OFT.

- 2.43 Dynegy had indicated to Ofgem that it did not want to be subject to BG's current undertakings, arguing that general competition law would be sufficient to guard against anti-competitive practices. In response to Ofgem's concerns, Dynegy stated that the way in which it intended to operate the sites and the types of products on offer, should address the two main concerns regarding making capacity available and information separation, that originally gave rise to Ofgas seeking undertakings from BG. Ofgem noted that Dynegy had offered a specific undertaking to keep customer nominations information separate from its trading function and to increase the amount of information and frequency with which it is released to the market.
- 2.44 Ofgem considered that Dynegy had not provided sufficient detail against which its proposals could be judged. Moreover, Ofgem had been unable to consult even on these general proposals with storage users and the industry at large to assess whether Dynegy's proposed undertakings would address the concerns raised by respondents. As such, Ofgem was not convinced that it would be appropriate to relax or remove the current undertakings at the present time. We believed that these issues could be best addressed through the transfer of the existing time limited undertakings between Ofgem and BG to Dynegy on completion of the transaction. Subject to Dynegy agreeing to enter into these undertakings, Ofgem did not consider that the transaction should be referred to the Competition Commission for further investigation.
- 2.45 Ofgem also believed that these undertakings should initially remain between the Gas and Electricity Markets Authority ('the Authority') and Dynegy. This would have allowed Ofgem to continue to consult with Dynegy, storage customers and other interested parties on whether any alternative undertakings Dynegy proposed would adequately address the concerns that Ofgem and other respondents have highlighted. Ofgem believed that the flexibility provided by such an approach would help ensure the development of a competitive storage market, and therefore ultimately protect customers' interests. In the event that Dynegy were to breach the undertakings, Ofgem would consider (as is the case

now with BG Storage) whether to use its powers under the Fair Trading Act, the Gas Act and / or Competition Act 1998, if appropriate.

Secretary of State's decision

- 2.46 If Dynegy's proposed acquisition of BG Storage were referred to the Competition Commission, the Competition Commission would have had to consider whether the transaction operated, or was likely to operate, against the public interest.
- 2.47 If the Competition Commission found that the acquisition did not, or was not likely to, operate against the public interest, the Secretary of State would have to clear the transaction. However, if the Competition Commission made an adverse finding, the Secretary of State might (but would not have to) take remedial action.
- 2.48 On 10 September 2001, the Secretary of State announced her decision following advice from the DGFT.⁸ The Secretary of State stated that, *"There are currently in place assurances to Ofgem from the BG Group that ensure that all gas storage capacity is released to the market on non-discriminatory terms, and to ensure that the commercially confidential and market sensitive information available to a storage owner cannot be misused by any affiliated trading businesses. These assurances would lapse if the merger went ahead, and the DGFT has advised me that this raises sufficient competition concerns to justify a reference to the Competition Commission.*
- Ofgem have advised that Dynegy are willing to provide assurances to address these concerns and the DGFT advises me that such assurances should be reinforced by means of undertakings in lieu of reference. I have therefore asked the DGFT to seek suitable undertakings. In the first instance Ofgem will consult publicly on the form which undertakings and assurances from Dynegy might take. I have asked the DGFT to report back to me, in the light of the Ofgem consultation, by 23 October."*
- 2.49 Ofgem is now conducting this further consultation in line with the Secretary of State's decision that Dynegy should be asked to provide undertakings given

⁸ The full text of the DGFT's advice can be found at www.of.gov.uk/html/mergers/dynegy.htm.

statutory force under the FTA 1973 as part of its acquisition of BG Storage and the associated assets.

3. The form of undertakings to be given by Dynegy to the Secretary of State

- 3.1 In accordance with the Secretary of State's decision to seek undertakings from Dynegy in lieu of a reference to the Competition Commission, Ofgem has developed undertakings to address the competition concerns identified by the Secretary of State. Dynegy has also proposed a set of undertakings that it believes would similarly address any concerns.
- 3.2 In developing its proposed set of undertakings, Ofgem took account of the views expressed in response to our August consultation document and further discussions with both Dynegy and other interested parties. The main parts of Ofgem's proposed undertakings are very similar in form to those currently provided by BG, and to the extent that the undertakings differ, the differences in form are of a minor nature, and reflect developments since the undertakings were given. These differences are explained later in this chapter. As explained in Chapter 1, the undertakings eventually given by Dynegy would be of a statutory nature as compared to the informal assurances that were given by BG to Ofgas.
- 3.3 The two main concerns that originally led Ofgas to seek undertakings from BG would, in Ofgem's view, remain significant issues under Dynegy's proposed acquisition of BG Storage. These concerns are to ensure that all gas storage capacity is made available on non-discriminatory terms, and that commercially confidential and market sensitive information available to a storage owner cannot be misused by any affiliated trading businesses. These are the two competition concerns identified by the Secretary of State and the high-level policy aims that Ofgem has sought to address in its proposed undertakings. That is, to ensure that all storage capacity was released to market on non-discriminatory terms and that any confidential information about customers' storage interests were not used inappropriately by BG Storage or its affiliates.
- 3.4 Ofgem believes that there are three main issues relevant to the consideration of any undertakings that should be sought from Dynegy. These affect how best to address the competition concerns identified by the Secretary of State. Ofgem

would, therefore, particularly welcome respondents' views on the three issues set out below:

- ◆ how best to ensure that all available capacity is made available to the market on non-discriminatory terms;
- ◆ the form of the undertaking restricting access to confidential information about storage activities from Dynegy's trading activities; and
- ◆ the availability of one year rights in the remaining two storage years to which these undertakings would apply.

Auctioning of capacity

Ofgem's initial view

- 3.5 Ofgem has stated on a number of occasions that we believe auctions to be the best method of ensuring that all capacity is made available to market on non-discriminatory terms, and also to facilitate the development of an efficient and competitive market for storage services. Ofgem has considered this matter carefully, taking into account the views expressed in response to our initial August consultation document. It is Ofgem's view that, subject to responses to this consultation, Dynegy should be required to auction the maximum physical capacity for the duration of the undertakings, as agreed in BG's undertakings.
- 3.6 Therefore, Ofgem's proposed undertakings include a requirement for Dynegy to make available to market the maximum physical capacity of the Rough and Hornsea storage facilities, through auctions, consistent with the process currently followed by BG Storage. This includes the requirement to publish the auction procedures, a storage services contract and a future operations statement in line with BG's current undertakings. The proposed undertakings also require Dynegy to seek the consent of the DGFT before varying the existing contracts and agreements. We believe this is important because it would otherwise be possible for Dynegy to materially change its standard contract terms and the auction procedures ahead of the next set of auctions, without breaching the undertakings.

- 3.7 Dynegy's draft undertakings state that it would *'offer for sale'* the maximum physical capacity of the storage facilities on non-discriminatory terms, but do not require Dynegy to do this through auctions. Attachment 1 of Dynegy's proposed undertakings sets out the basis on which it would auction capacity, if it were eventually required to do so. Dynegy's proposed undertakings include an obligation to provide a storage services contract detailing the terms on which firm rights would be offered for sale. Dynegy's undertakings do not, however, make any reference to the auction procedures currently in place, which were agreed between BG and Ofgas, nor to any publication of a future operations statement.
- 3.8 As Dynegy's proposed undertakings only require it to *'offer for sale'* the maximum physical capacity of the storage facilities, it could choose to meet its contractual obligations through other sources of gas, e.g. beach swing. Ofgem is concerned that the withholding of the maximum physical capacity from the storage facilities, combined with any use of substitutes, could increase the price of storage and related products, to the ultimate detriment of consumers. BG Storage currently only uses substitute products to meet contractual requirements for operational rather than commercial reasons, e.g. failures at the facilities.

Views invited

- 3.9 Ofgem would welcome respondents' views on whether it is necessary to require Dynegy to *'make available'* the maximum physical capacity of the storage facilities, or if it is sufficient for Dynegy to *'offer for sale'* this capacity.
- 3.10 Ofgem would welcome respondents' views on how best to ensure that storage capacity is offered on non-discriminatory terms by Dynegy, and in particular, the extent to which there should be an explicit obligation to hold auctions for the duration of the undertakings. To the extent that respondents believe that such a requirement is necessary, Ofgem would also welcome views on whether the undertakings proposed by Ofgem or Dynegy setting out how auctions would be carried out, best address the competition concerns identified by the Secretary of State and Ofgem's high-level policy aims. In particular, Ofgem would welcome comments on whether there should be a continuing requirement to publish auction procedures, a storage services contract, and a future operations

statement, and the requirement for any changes to these agreements to be approved by the DGFT.

Access to confidential information

Ofgem's initial views

- 3.11 BG's current undertakings include the requirement to use 'all reasonable endeavours to complete a robust internal physical, financial, informational and systems separation of the storage business from all other commercial activities'. This provision was further explained in Ofgas' document,⁹ which stated that to comply with the undertaking, BG must set up a fully separate company to carry out its storage operations. Consequently, BG set up a fully separate subsidiary company called 'BG Storage' to carry out its storage activities.
- 3.12 Ofgem noted in its August consultation document that although independent storage providers form a growing part of the storage market, in percentage terms they remain a small part of it. The size of the Rough and Hornsea facilities is such that any operator may have access to information that has the potential to have a significant market impact. Concerns arise both in relation to access to such information earlier than other market participants, such as in relation to plant failure, or aggregate nomination and flow rates, and to information regarding the activities of particular storage customers.
- 3.13 To address these concerns, Ofgem believes that it is necessary to have a provision in the undertakings to ensure that Dynegy does not misuse commercially confidential information about storage customers in its trading activities. Consistent with Ofgas' statement about the absolute requirement for BG to maintain a separate company, Ofgem believes that any separation undertaking on Dynegy must be an absolute provision. Ofgem's proposed undertakings require that Dynegy should '*maintain*' a separate storage business.
- 3.14 In its proposed undertakings, Dynegy has suggested an alternative drafting for this part of the undertakings that it believes would offer adequate safeguards to ensure that commercially confidential information about storage customers is not made available to any of Dynegy's trading businesses. Dynegy has argued that it is only customer nominations and holdings that are potentially valuable. Dynegy has argued that as all storage customers receive information on

⁹ "Review of the supply of gas and related services, Decision Document", Ofgas, February 1999.

aggregate injections and withdrawals to the facilities, it is only customer specific information that is available exclusively to the storage operator/owner and not market participants more generally.

3.15 Dynegy's proposed undertakings state that:

'Dynegy shall use all reasonable endeavours to keep separate from any of its affiliates engaged in the business of buying or selling gas in the United Kingdom, any confidential information that Dynegy receives from a customer of the storage business.'

Views invited

3.16 Ofgem would welcome respondents' views on which of the two proposed forms of undertaking best address the competition concern identified by the Secretary of State and Ofgem's high-level policy aim, to ensure that Dynegy's trading activities cannot misuse commercially confidential and market sensitive information obtained by Dynegy as a storage operator. In particular, Ofgem would welcome respondents' views on whether an absolute requirement for the continued separation of the storage activities from Dynegy's trading activities is required and if so, why.

3.17 In particular, Ofgem would welcome views on what information that is potentially of value commercially is available to the storage owner/operator and not the market more generally.

Availability of one year rights in each of the remaining two storage years

Ofgem's initial views

3.18 Under the current undertakings BG Storage is obliged to make a specified minimum volume of capacity at each site available on a long-term basis. This obligation meant that at least 50% of such capacity was auctioned for a five-year term of rights in 1999. Any unsold capacity was carried forward to auctions in subsequent years and would have been made available as long term capacity rights of declining terms, i.e. four year rights in 2000, etc. In addition, capacity

that was not offered or unsold in the long-term auctions was made available on a one-year basis.

- 3.19 As more than 50% of the facilities has now been booked on a long term basis, the current undertakings would allow BG Storage to auction the remaining capacity with terms of rights of whatever period it decides, providing it is for a minimum of one year. Therefore, Ofgem's proposed undertakings for Dynegy similarly do not restrict Dynegy's ability to auction the remaining capacity for terms of rights of more than one year.
- 3.20 Concern has, however, been expressed to Ofgem that if no one year capacity rights are made available, this might have a detrimental effect on the ability of smaller shippers to obtain sufficient capacity to meet their requirements in the absence of use-it-or-lose-it services and a well developed secondary market for storage. Ofgem would welcome comments on the extent to which these concerns remain, bearing in mind developments in the provision of storage and related services.
- 3.21 Subject to respondents' views on the significance of this concern, Ofgem does not propose to include a requirement in the undertakings to be sought from Dynegy requiring it to sell a minimum amount of capacity with a one-year term of rights.

Views invited

- 3.22 Ofgem would welcome views as to whether the undertakings should include a requirement for Dynegy to make some capacity available on a one-year basis in both of the storage years beginning 1 May 2002 and 2003 and if so how much. Alternatively, should Dynegy be free to auction all remaining capacity on a two year basis, as BG Storage currently could.

Minor differences between the current undertakings on BG and those proposed by Ofgem for Dynegy

- 3.23 The main parts of Ofgem's proposed undertakings are very similar in form to those currently provided by BG, and to the extent that the undertakings differ, the differences are minor in nature, and reflect developments since the

undertakings were given. As explained in Chapter 1, the 'undertakings' that would be given by Dynegy to the Secretary of State would have statutory force under the FTA, while BG's 'undertakings' are non-statutory assurances given to Ofgas. The minor differences between the undertakings are that:

- ◆ the DGFT rather than the Authority, will be directly responsible for enforcement and amendment of the undertakings, but will seek advice from the Authority;
- ◆ the drafting of the undertakings has been updated to take account of the fact that we are in the third storage year covered by the undertakings;
- ◆ the requirement for an annual review of the auctions has been removed, as there will be sufficient statutory powers through undertakings to the Secretary of State to address any concerns that previously would have been addressed by such a review;
- ◆ the Competition Act 1998 came into force on 1 March 2001, and any storage operator must comply with these provisions, therefore explicit reference to competition law has been removed from the undertakings;
- ◆ the top-up gas obligation resides with Transco, and these provisions will not be acquired by Dynegy, so specific reference to top-up gas obligations has been removed from the undertakings; and
- ◆ the provisions of the FTA should address any competition concerns arising from a future disposal by Dynegy of any of the Rough or Hornsea facilities, and therefore, specific requirements to seek the approval of the Authority for any disposal have been removed from the undertakings.

3.24 Ofgem would welcome views on whether any of the minor changes outlined above significantly affect the ability of the undertakings to address the competition concerns identified by the Secretary of State.

Summary

3.25 Ofgem would welcome respondents' views on whether the proposed undertakings address the competition concerns identified by the Secretary of

State and Ofgem's two main concerns. In particular, Ofgem would welcome comments on the three issues discussed above:

- ◆ how best to ensure that all available capacity is made available to the market on non-discriminatory terms;
- ◆ the form of the undertaking ensuring separation of storage activities from Dynegy's trading activities; and
- ◆ the duration of the terms of rights to be sold by Dynegy.

3.26 Ofgem would also welcome comments on any other issues related to the storage market, which respondents believe may affect the form of undertakings that should be sought from Dynegy.

4. Way forward

- 4.1 Ofgem is seeking the views of all interested parties on the undertakings as set out in Appendix 1, which Ofgem believes should be given by Dynegy to the Secretary of State in accordance with the provisions of the Fair Trading Act 1973 in lieu of a reference by the Secretary of State to the Competition Commission. In particular, Ofgem would welcome views on the issues raised in Chapter 3, and on whether these proposed undertakings are sufficient to address the competition concerns identified by the Secretary of State and Ofgem.
- 4.2 After taking account of responses to the consultation, Ofgem will advise the DGFT as to the form of the undertakings that Dynegy should give to the Secretary of State.

Appendix 1 The form of Undertakings that Ofgem proposes should be given by Dynegy to the Secretary of State

PROPOSED ACQUISITION BY DYNEGY EUROPE LIMITED OF BG STORAGE LIMITED

PROPOSED UNDERTAKINGS TO BE GIVEN BY DYNEGY EUROPE LTD TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY PURSUANT TO SECTION 75G(1) OF THE FAIR TRADING ACT 1973

Introduction

Whereas:

1. (a) on 16th July 2001, Dynegy Europe Limited agreed to acquire the entire issued share capital of BG Storage Limited (which is to be renamed Dynegy Storage Limited) from BG Energy Holdings Limited (the "acquisition");
- (b) it appears to the Secretary of State that as a consequence there is a merger situation qualifying for investigation ("merger");
- (c) the Secretary of State has the power to make a merger reference to the Competition Commission under section 64(1) of the Fair Trading Act 1973 ("the Act");
- (d) the Director General of Fair Trading (the "Director") has made a recommendation to the Secretary of State that such a reference should be made and has given advice to the Secretary of State specifying the particular effects adverse to the public interest which in his opinion the merger situation qualifying for investigation may have or might be expected to have;

- (e) and the Secretary of State, instead of referring the merger under section 75 of the Act, may under section 75G of the Act accept undertakings which he considers appropriate to remedy or prevent the effects of the merger adverse to the public interest specified in the Director's advice; and
- (f) the Secretary of State considers the undertakings given below by Dynegy appropriate to remedy or prevent the effects adverse to the public interest specified in the advice given by the Director.

Now therefore with effect from the completion of the acquisition, Dynegy Europe Limited, as the owner of Dynegy Storage Limited ("Dynegy") which in turn owns and operates the Rough and Hornsea gas storage facilities, gives the following undertakings to the Secretary of State in the form set out below pursuant to section 75G of the Act:

Interpretation

- 2. In these undertakings unless the context otherwise requires:

"affiliate" of any entity means any holding company or subsidiary company of that entity or any company which is a subsidiary company of any holding company of that entity and the expressions "holding company" and "subsidiary" shall have the meanings respectively given to them by section 736 of the Companies Act 1985.

"auction procedures" means the document to be drawn up by Dynegy pursuant to paragraph 3 as modified from time to time.

"firm rights" means rights to have gas injected into storage, to keep gas in storage or to have gas delivered from storage, each of which rights shall be exercisable in priority to any interruptible right.

"future operations statement" means the statement to be prepared by Dynegy pursuant to paragraph 4.

“Hornsea Facility” means the gas storage facility at Hornsea in Yorkshire as at the date of these undertakings.

“maximum physical capacity” means in respect of each of the Rough Facility and the Hornsea Facility the maximum physical capacity for the injection of gas, the storage of gas and the delivery of gas which can be safely and economically provided at each facility at the date of these undertakings and which is understood to be not less than the capacities set out in the following table:

	Rough Facility	Hornsea Facility
Injectability	160 GWh/day	21.6 GWh/day
Storage Space	30,300 GWh	3,500 GWh
Deliverability	455 GWh/day	195 GWh/day

“Rough Facility” means the offshore gas storage facility in the Rough gas field as at the date of these undertakings.

“storage business” means the activities from time to time of Dynegey in the administration, maintenance, and operation of, and sale of physical storage injectability, space and deliverability in the Rough and Hornsea facilities.

“storage services contracts” means the documents to be drawn up by Dynegey pursuant to paragraph 6 as modified from time to time.

“Storage Year” means each of the 12-month periods starting on 1 May 2002 and 2003 and “2002 and 2003 Storage Years” shall mean both of such 12-month periods.

“term of rights” means the period of years in respect of which firm rights to capacity are to be offered for sale pursuant to these undertakings.

Making Storage Capacity Available

3. Dynegey shall ensure that the maximum physical capacity of the facilities is made available to the market on non-discriminatory terms.

Auction Process

4. Dynegy shall conduct the 2002 and 2003 auctions in accordance with the arrangements set out in the document prepared by BG dated 17 February 1999 (as currently interpreted) entitled the "auction procedures".
5. Prior to the 2002 auctions Dynegy will make available documentation setting out its intention with regard to the operation of the storage business ("the future operations statement") until the end of the Storage Year beginning on 1 May 2003.
6. Dynegy shall publish the auction procedures, the future operations statement and the storage services contracts and send a copy of the auction procedures, the future operations statement and the storage services contracts free of charge to any person who asks for such copies.

Storage Services Contracts

7. Dynegy will offer to enter into a contract with each successful bidder in each auction on the terms and conditions set out in the documents which have been approved by the Director for that purpose.
8. Dynegy will sell to each successful bidder firm rights to have gas injected into storage, to keep gas in storage and to withdraw gas from storage in each of the Rough Facility and the Hornsea Facility in the following proportions (as set out in the auction procedures):

	Deliverability (kWh/Day)	Storage Space (kWh)	Injectability (kWh/day)
Hornsea Facility	1	17.948718	0.110769
Rough Facility	1	66.593407	0.351648

9. In respect of the 2002 and 2003 storage years, Dynegy shall offer for sale by auction firm rights to any proportion which remains unsold of the maximum physical capacity of the Hornsea Facility and of the maximum physical capacity of the Rough Facility.
10.
 - (a) The auctions shall be conducted according to the auction procedures modified only (other than in accordance with paragraph 10(b) below) to take account of the change of year. Except with the consent of the Director, which will not be unreasonably withheld so far as concerns modifications which facilitate the separate auctioning of the rights referred to in paragraph 7 above, the firm rights offered for sale in those auctions shall be the rights defined in the auction procedures and the storage services contracts.
 - (b) The auction procedures and the storage services contracts shall not be modified, other than by agreement between the Director and Dynegy.

Capacity not sold at auction

11. In any Storage Year up to and including the Storage Year starting on 1 May 2003:
 - (a) except with the consent of the Director, Dynegy shall offer for sale any firm rights to any proportion of the maximum physical capacity of the Rough Facility or of the Hornsea Facility in respect of that Storage Year which remain unsold at the start of that Storage Year at a price equal to the reserve price in respect of the most recent auction of firm rights to capacity in that facility; and Dynegy shall not sell or offer for sale firm rights in respect of any proportion of the maximum physical capacity of the Hornsea Facility or of the Rough Facility other than in accordance with these undertakings except with the consent of the Director .

Secondary markets

12. Dynegy shall facilitate the development of a secondary market in each of the firm rights to capacity sold by it pursuant to these undertakings by:

- (a) ensuring that injectability, space and deliverability rights are defined in ways which allow them to be traded separately; and
- (b) establishing arrangements that allow for the transfer, on a basis which is not unreasonably restricted, of all or any part of the rights purchased under the auctions described above at the request of the holders of those rights.

Separation

- 13. Dynegy will maintain a robust internal financial, information and systems separation of the storage business from all other commercial activities carried on by Dynegy from the date on which the acquisition is completed.
- 14. Dynegy will maintain separate accounts for the storage business from the accounts for any of its other activities.

Transfer

- 15. If Dynegy transfers the Rough Facility or the Hornsea Facility to an affiliate it shall procure that that affiliate shall comply with the provisions of these undertakings as if that affiliate had given such undertakings to the Secretary of State.

Termination

- 16. These undertakings shall terminate at the end of the Storage Year beginning on 1 May 2003.

Director

and

.....

Director/Secretary

For and on behalf of []

Date:

Appendix 2 The form of undertakings that Dynegy proposes it should give to the Secretary of State

Introduction

1. (a) On 16 July 2001, Dynegy Europe Limited agreed to acquire the entire issued share capital of BG Storage Limited (which is to be renamed Dynegy Storage Limited) from BG Energy Holdings Limited (the "acquisition").
- (b) With effect from the completion of the acquisition, Dynegy Europe Limited, as the owner of Dynegy Storage Limited ("Dynegy") which in turn owns and operates the Rough and Hornsea gas storage facilities, gives undertakings to the Secretary of State for Competition ("Secretary of State") in the form set out below.

Interpretation

2. In these undertakings unless the context otherwise requires:

"affiliate" of any entity means any holding company or subsidiary company of that entity or any company which is a subsidiary company of any holding company of that entity and the expressions "holding company" and "subsidiary" shall have the meanings respectively given to them by section 736 Companies Act 1985.

"Authority" means the Authority established by section 1(1) of the Utilities Act 2000.

"firm rights" means rights to have gas injected into storage, to keep gas in storage or to have gas delivered from storage, each of which rights shall be exercisable in priority to any interruptible right.

"Hornsea Facility" means the gas storage facility at Hornsea in Yorkshire as at the date of these undertakings.

"maximum physical capacity" means the equivalent of the capacities set out in the table below less pre-sold capacity:

	Rough Facility	Hornsea Facility
Injectability	160 GWh/day for 162 days	21.6 GWh/day for 189 days
Storage Space	30,300 GWh	3,500 GWh
Deliverability	455 GWh/day for 67 days	195 GWh/day for 18 days

"pre-sold capacity" means, as at any point in time, any proportion of the maximum physical capacity which has been sold;

"Rough Facility" means the offshore gas storage facility in the Rough gas field as at the date of these undertakings.

"storage business" means the activities from time to time of Dynegy in the administration, maintenance, and operation of, and sale of physical storage injectability, space and deliverability in the Rough and Hornsea facilities.

"storage services contracts" means the terms referred to in paragraph 4 as modified or supplemented from time to time.

"Storage Year" means each of the 12-month periods starting on 1 May 2002 and 2003 and "2002 and 2003 Storage Years" shall mean both of such 12-month periods.

"term of rights" means the period of years in respect of which firm rights to capacity are to be offered for sale pursuant to these undertakings.

Capacity Release

3. In respect of each of the 2002 and 2003 Storage Years, Dynegy shall offer for sale firm rights to the maximum physical capacity on non-discriminatory terms.

4. The contract terms for the firm rights offered for sale pursuant to these undertakings will be published and made available to customers upon request.
5. Dynegy shall facilitate the continuation of a secondary market in each of the firm rights to capacity sold by it pursuant to these undertakings by:
 - (a) ensuring that injectability, space and deliverability rights are continued to be defined in ways which allow them to be traded separately; and
 - (b) continuing arrangements that allow for the transfer, on a basis which is not unreasonably restricted, of all or any part of such firm rights.
6. Dynegy shall ensure that the Authority, as the industry regulator, is able to audit Dynegy's offering for sale of firm rights to the maximum physical capacity by providing relevant information, as may be reasonably required, to the Authority in a timely manner.

Information Separation

7. (a) Dynegy shall use all reasonable endeavours to keep separate from any of its affiliates engaged in the business of buying or selling gas in the United Kingdom, any confidential information that Dynegy receives from a customer of the storage business.
 - (b) Dynegy shall keep separate the accounts for the storage business from the accounts for any of its other activities.

Scope and Duration

8. These undertakings are only intended to relate to physical storage services from the Rough and Hornsea facilities for the period up to, and shall terminate at the end of the Storage Year beginning on 1 May 2003.

.....

For and on behalf of Dynegy Europe Limited

Date:

Attachment I

Were it felt necessary to require Dynegy to auction the capacity at the storage facilities, Dynegy would propose undertakings similar to those outlined below (to replace clauses 3 and 6 above):

Auction Process

1. Dynegy shall conduct auctions for the Rough and Hornsea storage facilities for the 2002 and 2003 Storage Years as set out below. At least one month prior to the commencement of the auction process for each of the 2002 and 2003 Storage Years, Dynegy shall publish details of the form and conduct of the relevant auction process.
2.
 - (a) In respect of each of the 2002 and 2003 Storage Years, Dynegy shall in accordance with these undertakings offer for sale by auction firm rights to the maximum physical capacity.
 - (b) In each of the auctions referred to in paragraph 2(a) above, Dynegy shall offer for sale by auction firm rights to capacity in respect of a term of rights of one or more years.
3. In the event that Dynegy offers for sale by auction in the 2002 Storage Year firm rights to capacity for a term of rights of two years starting on 1 May 2002, then, except as the Authority may otherwise consent:
 - (a) Dynegy shall offer for sale by auction such firm rights for the term of rights of two years before offering for sale by auction the firm rights for the term of rights of one year; and
 - (b) any such firm rights not sold in the auctions for a term of rights of two years shall subsequently be offered for sale by auction for a term of rights of one year.

Capacity not sold at auction

4. In respect of each of the 2002 and 2003 Storage Years, except with the consent of the Authority, Dynegy shall offer for sale any firm rights to any proportion of the maximum physical capacity in respect of that Storage Year which remains unsold at the start of that Storage Year, and to the extent not subsequently sold, at a price equal to the reserve price in respect of the most recent auction of the equivalent firm rights to capacity for that Storage Year.

Appendix 3 A background to the structure of present storage arrangements

Monopolies and Mergers Commission (MMC), 1993 report under the Gas Act 1986¹⁰

- 3.1 In 1993, the MMC examined the relationship between BG plc's transportation, storage activities, and trading activities in the non-tariff market, and recommended the separation of BG plc's monopoly transportation activities (which included storage) from its trading interests. It stated that the lack of effective neutrality of the transportation and storage system could be expected to inhibit the development of effective competition (in the non-tariff supply market).
- 3.2 During the process the MMC had taken evidence that the storage market was potentially competitive. At the time, however, BG plc was the only supplier of physical gas storage capacity and the MMC recommended that a separate price control formula be established for BG plc's storage business. This would ensure that the charges for transportation and storage services respectively were transparent. It would also limit the scope for cross subsidy of the potentially competitive storage business by the monopoly transportation business.

The Gas Act 1995

- 3.3 The Gas Act 1995 created the new licensable activity of Public Gas Transporter (PGT); this replaced the licensable activity of Public Gas Supplier. One aim of the new licensing regime was to separate the competitive activity of gas shipping and gas supply from the monopoly activity of transportation. Provisions relating to BG's storage business were included in BG plc's PGT licence. The Gas Act 1995 did not provide for the licensing of storage more generally, even though at the time it was clearly envisaged that new entrants might enter the market for physical gas storage services.

¹⁰ Volume 1 of reports under the Gas Act 1986 on the conveyance and storage of gas and the fixing of tariffs for the supply of gas by British Gas plc, MMC August 1993.

BG transportation and storage price control 1997 – 2002

- 3.4 Ofgas published its final proposals for BG's transportation and storage price control covering the period 1997-2002 in August 1996; these included a separate price control formula for BG plc's storage business.¹¹ The proposals were rejected by BG plc and the matter was referred to the MMC by the Director General of Gas Supply.
- 3.5 BG plc maintained that once removed from the main transportation price control, its storage business should not be subject to further regulation. BG plc submitted to the MMC that its storage business already faced competition from a range of alternatives including beach swing, interruptible load and the purchase of spot gas.¹² The Director General submitted that continued regulation under the Gas Act was necessary for a period since BG plc's storage business remained dominant in the gas storage market.
- 3.6 The MMC rejected BG plc's arguments that its storage business faced sufficient competition from alternatives such that further regulation was unnecessary. However, the MMC agreed that the price control formula could be disapplied after three years and a transition to competitive storage markets was clearly envisaged. When the MMC report was published, Ofgas stated that:

"Ofgas will be monitoring the development of competition within the storage market and will be working with Transco towards the removal of the price control at the earliest appropriate opportunity".¹³

Ofgas review of the supply of storage and related services

- 3.7 Ofgas and BG plc had been discussing proposals for selling services provided by BG plc's storage facilities; services from the Hornsea facility were auctioned and the discussions focussed on whether services from the Rough field should continue to be sold at fixed pre-determined prices or by way of an auction. Ofgas and the majority of shippers favoured an auction. BG plc argued that

¹¹ 1997 Price control review British Gas' Transportation and Storage, The Director General's Final proposals, August 1996.

¹² MMC report, para. 5.10(a).

¹³ BG Transportation and storage: The Director General's position following the 1997 Monopolies and Mergers Commission Report. Ofgas, June 1997.

under the terms of its PGT licence it could not be required to auction capacity at Rough. BG plc put forward pricing proposals for the storage year 1998/99.

Storage investigation

- 3.8 Ofgas did not veto the new proposals but immediately launched an investigation “to collect and assess evidence on the existence and use of market power in the provision of storage services”.¹⁴ The investigation covered a number of issues including the availability of effective substitutes, including linepack,¹⁵ and the potential for new entry into the physical storage market. At the time all of BG plc’s storage facilities, including the LNG facilities, were under the control of BG Transco and were included in the review.
- 3.9 The preliminary conclusion of the investigation was that “BG Storage possessed significant short-term market power”. At the time several new storage projects were being developed by independent operators; Scottish Power at Hatfield Moors was one such facility that is now fully operational. Even if all these projects were completed, it was estimated that BG Storage would continue to control approximately 80% of space capacity and 90% of deliverability.¹⁶
- 3.10 Additionally, competitive pressures were building up from a number of other close substitutes. The UK-Belgium Interconnector became operational in October 1998 and with it came substantial potential import capacity. The investigation also noted evidence to suggest that BG Storage’s large customers were becoming more sensitive to price.
- 3.11 Although competitive pressures were building within the physical gas storage market and from close substitutes, the investigation also found a number of structural issues that mitigated against that process. For instance, the common ownership of BG Storage and Transco (which at the time were both businesses with BG plc) was viewed as a possible obstacle to the development of competition.

¹⁴ Open letter to Industry 23 April 1998.

¹⁵ Linepack is the ability of BG Transco to ‘store’ gas in its pipeline system by varying the pressure within certain limits.

¹⁶ With the return of the LNG facilities to the control of BG Transco, BG Storage’s control over deliverability capacity will have reduced relative to their control over space. LNG sites were designed as peak shaving facilities and hence have high deliverability in relation to space.

Ofgas' Initial proposals

- 3.12 The core Ofgas' proposals was that BG Storage should be required to conduct auctions of up to 5 years for storage rights at Rough and Hornsea.¹⁷ Such rights were to be transferable and BG Storage would also be required to promote and facilitate a competitive and liquid secondary market in such rights. At the time Ofgas stated, that were BG plc not to agree to the Ofgas proposals or put forward acceptable alternatives, then the full range of legal courses of action would be considered. This included a reference to the MMC under the Fair Trading Act 1973; the outcome of such a reference could have been a recommendation to the Secretary of State for some form of divestment.

Final proposals

- 3.13 Ofgas did not consider divestment to be essential to reform providing that the core proposals were implemented in full and that adequate separation was established between BG Storage and Transco. BG plc proposed instead that references to Rough and Hornsea should be removed from its PGT licence and replaced with a set of 'undertakings' (copy attached below).
- 3.14 Ofgas agreed to remove the Rough and Hornsea facilities from the PGT licence provided adequate undertakings were in place.
- 3.15 The final proposals document reiterated the findings of the investigation:

"although the competitive pressures on BG Storage were increasing over time, BG Storage nevertheless enjoyed significant market power in the short term".

Development and implementation

- 3.16 When details of the development and implementation of the agreement with BG plc were published in December 1998, there was an expectation of a future

¹⁷ Review of the supply gas storage and related services, 'The Director General's initial proposals', Ofgas, July 1998.

competitive storage market.¹⁸ The agreement between BG plc and Ofgas was described:

“as marking a critical stage in the transition from administered prices and services, determined under regulatory supervision, to a market-based approach in which the services on offer, prices, investment etc. are freely determined in a competitive environment”.

- 3.17 With the removal of references to storage from BG plc’s PGT licence and the lack of a separate storage licence under the Gas Act for independent operators, it was clear that the ‘competitive environment’ envisaged would be unregulated except by the provisions of general competition law. When BG plc gave the Undertakings to Ofgas, the Competition Act 1998 had already gained Royal Assent. Given that the Undertakings were for five years, BG plc (and Ofgas) clearly understood that the Undertakings would remain for a period after the Competition Act 1998 came into force. As noted above, the absence of a separate storage licence meant that independent operators would not be subject to utility specific regulation.
- 3.18 BG plc’s LNG facilities remained regulated via its PGT licence and under the Gas Act 1986. This was pending a formal and separate review of LNG services, although Ofgas agreed that in the interim period, BG Storage should be able to operate these facilities. BG plc’s PGT licence, however, required that its transportation business (which, given the support they provide for relieving transportation constraints, continued to include all LNG facilities) is separated from all of BG plc’s other businesses. Therefore, without derogation or change to this licence requirement, BG Storage (a business unit that was by now separate from BG plc’s transportation business unit) would be unable to manage and operate the LNG facilities.
- 3.19 Ofgas granted BG plc such derogation allowing it, for one year only, (ie. until Ofgas had completed its review of LNG services) to operate in a way that would otherwise have constituted a breach of BG plc’s PGT licence.

¹⁸ Review of the supply of gas storage and related services. Development and implementation of the agreement between Ofgas and BG plc. Vol. 1: Consultation document. Ofgas, December 1998.

Decision

- 3.20 In February 1999, Ofgas published its decision document on the storage deregulation process. The document set out the underlying objective of the storage review, which were to ensure that:

“all capacity is made available in a way that ensures efficient utilisation and on terms that are non discriminatory and that do not distort competition.”

- 3.21 The document also stated the criteria for evaluating BG Storage’s conduct against this objective. The decision document formalised the ‘competitive benchmark’ approach. The investigation determined that “all of the facilities were capital intensive...with a large fraction of the operating costs not closely related to output”. Given these cost characteristics it would be expected, therefore, that capacity utilisation (especially space) would be high were there a genuinely competitive market in storage services. It was on this basis that the competitive benchmark was established.

- 3.22 Having negotiated the Undertakings as a means of making all capacity available on non-discriminatory terms, the revenue cap and references to Rough and Hornsea were duly removed from BG plc’s PGT licence. The Undertakings would remain in place up to the end of the 2003 storage year, that is 30 April 2004. The Decision document noted that:

“the future level of regulation of the storage business will depend upon the extent to which BG Storage will continue to possess market power”.

- 3.23 In June 1999, Ofgem published a consultation document seeking views on how BG plc’s other storage facilities, the Liquefied Natural Gas (LNG) sites, should be regulated from 2000.¹⁹ Ofgem subsequently developed proposals for deregulating the LNG facilities from 1 May 2000, through the auctioning of capacity. After consultation, the proposals were implemented in April 2000.

¹⁹ Ofgas review of BG plc’s Liquefied Natural Gas facilities, a consultation document’ June 1999.

Appendix 4 The undertakings given by BG plc to the Director General of Gas Supply

The undertakings

Introduction

1. (a) BG plc ("BG") is the holder of a public gas transporter's licence (the "Licence") treated as granted to it under Section 7 of the Gas Act 1986 (the "Act").
- (b) On 24 December 1998 the Director General of Gas Supply (the "Director") gave notice (the "section 23 notice") pursuant to Section 23 of the Act that he proposes to modify the standard and special conditions of the Licence. These proposals were made in contemplation of BG giving to the Director undertakings in the form set out below and will have the effect of removing storage arrangements which relate to the utilisation of an offshore gas storage installation or storage cavities in natural strata from the ambit of the Licence.
- (c) BG is subject to a duty pursuant to Regulation 3 of the Gas Safety (Management) Regulations 1996 (the "Regulations") to prepare a safety case. Changes are needed to that safety case (the "Top-Up Changes") so that the provisions of BG's network code can be amended so as to remove from that network code BG's obligations as Top-Up Manager as therein defined without placing BG in breach of Regulation 5 of the Regulations.
- (d) BG hereby:
 - (i) irrevocably consents to the making of the modifications described in the section 23 notice; and

- (ii) on condition that the Director modifies the Licence substantially in the manner described in the section 23 notice, gives to the Director the undertakings set out in paragraphs 2 to 21 below with effect from the date of such modifications.

Interpretation

- 2. In these undertakings unless the context otherwise requires:

“1999 Storage Year” means the Storage Year starting on 1 May 1999

“auction procedures” means the document to be drawn up by BG pursuant to paragraph 5 as modified from time to time

“competition law” means any law relating to the existence or exercise of market power or to agreements which may prevent, restrict or distort competition and includes, without limitation, the provision of Articles 85 to 93 inclusive of the Treaty of Rome (as numbered at the date of these undertakings), the Fair Trading Act 1973, the Restrictive Trade Practices Act 1976, the Competition Act 1980 and to the extent that it is at any time in force the Competition Act 1998

“firm rights” means rights to have gas injected into a storage facility, to keep gas in a storage facility or to have gas delivered from a storage facility which shall be exercisable in priority to any interruptible right

“future operations statement” means the statement to be prepared by BG pursuant to paragraph 6

“HSE” means the Health and Safety Executive

“Hornsea Facility” means the gas storage facility at Hornsea in Yorkshire operated by BG at the date these undertakings were entered into

“maximum physical capacity” means in respect of each of the Rough Facility and the Hornsea Facility the maximum physical capacity for the injection of gas, the storage of gas and the delivery of gas which can be safely and economically

provided at each facility at the date of these undertakings and which is understood to be not less than the capacities set out in the following table:

	the Rough Facility	the Hornsea Facility
Injectability	160 GWh/Day	21.6 GWh/Day
Storage Space	30,300 GWh	3,500 GWh
Deliverability	455 GWh/Day	195 GWh/Day

“Rough Facility” means the offshore gas storage facility in the Rough gas field operated by BG at the date these undertakings were entered into

“storage business” means the activities from time to time of BG connected with the development, administration, maintenance, operation and sale of services in connection with any facility used by BG for the storage of gas other than facilities

- (a) used solely for diurnal storage
- (b) afforded by, or connected to, an independent system or facilities for the conveyance of gas which BG uses exclusively for the conveyance of gas to such a system or
- (c) in the event that the derogations given by the Director in respect of the LNG Storage Business (as defined in amended standard condition 2 of BG’s licence) dated 18 February 1999 from certain provisions of Special Condition 8A and Standard Condition 11 of the Licence (or any extension thereof) have ceased to have effect, in which gas is stored as liquefied natural gas

“storage services contracts” means the documents to be drawn up by BG pursuant to paragraph 8 as modified from time to time

“Storage Year” means a 12 month period starting on 1 May in any year

“term of rights” means the period of years in respect of which firm rights to capacity are to be offered for sale by auction pursuant to these undertakings.

1999 Auction

3. BG shall:
 - (a) no later than 1 May 1999 offer for sale by way of auction firm rights to 100% of the maximum physical capacity for each of the Hornsea Facility and the Rough Facility (the “1999 auctions”);
 - (b) offer for sale in the 1999 auctions firm rights to at least 50% of the maximum physical capacity for each of the Hornsea Facility and the Rough Facility for a term of rights of not less than five years commencing on 1 May 1999; and
 - (c) offer for sale in the 1999 auctions firm rights to the balance of the maximum physical capacity for each of the Hornsea Facility and the Rough Facility remaining after completion of the auctions referred to in paragraph 3(b) including any rights offered for a term of rights of at least five years but not sold on that basis for a term of rights of not less than one year commencing on 1 May 1999.
4. (a) BG shall offer for sale in separate auctions:
 - (i) firm rights in respect of each of the Rough Facility and the Hornsea Facility; and
 - (ii) firm rights for different terms of rights.
- (b) Unless the Director otherwise consents BG shall conduct the 1999 auctions in the following order:
 - (i) first in respect of firm rights for a term of rights of at least five years in respect of the Hornsea Facility;
 - (ii) second in respect of firm rights for a term of rights of at least five years in respect of the Rough Facility;

- (iii) third in respect of firm rights for at least one year in respect of the Hornsea Facility; and
- (iv) fourth in respect of Firm Rights for at least one year in respect of the Rough Facility.

Auction Process

5. BG shall conduct the 1999 auctions in accordance with the arrangements set out in the document prepared by BG dated 17 February 1999 entitled the "auction procedures" which has been approved by the Director.
6. Prior to the 1999 auctions BG will make available documentation setting out its intention with regard to the operation of the storage business ("the future operations statement") until the end of the Storage Year beginning on 1 May 2003.
7. BG shall publish the auction procedures, the future operations statement and the storage services contracts and send a copy of the auction procedures, the future operations statement and the storage services contracts free of charge to any person who asks for such copies.

Storage Services Contracts

8. BG will offer to enter into a contract with each successful bidder in each auction on the terms and conditions set out in the documents which have been approved by the Director for that purpose.
9. BG will sell to each successful bidder firm rights to have gas injected into storage, to keep gas in storage and to withdraw gas from storage in each of the Rough Facility and the Hornsea Facility in the following proportions (as set out in the auction procedures):

	Deliverability (kWh/Day)	Storage Space (kWh)	Injectability (kWh/day)
Hornsea Facility	1	17.948718	0.110769
Rough Facility	1	66.593407	0.351648

Subsequent Storage Years

10. (a) In respect of each Storage Year subsequent to the 1999 Storage Year up to and including the Storage Year starting on 1 May 2003 (the “subsequent storage years”), BG shall offer for sale by auction firm rights to any proportion which remains unsold of the maximum physical capacity of the Hornsea Facility and of the maximum physical capacity of the Rough Facility.
- (b) In each of the auctions referred to in paragraph 10(a) above, BG shall offer for sale by auction firm rights to capacity in respect of a term of rights of one or more years.
11. (a) This paragraph will apply only if in either of the auctions referred to in paragraph 3(b) above BG sells firm rights to less than 50% of the maximum physical capacity of the Hornsea Facility or to less than 50% of the maximum physical capacity of the Rough Facility.
- (b) BG will offer for sale by auction before 1 May 2000 firm rights to a proportion of the maximum physical capacity of each of the Hornsea Facility or the Rough Facility equal to the difference between the proportion of the maximum physical capacity of each facility sold in the auctions referred to in paragraph 3(b) above and 50% of the maximum physical capacity in each facility (the “1999 capacity shortfall”) for a term of rights of at least four years starting on 1 May 2000.

- (c) If not all of the 1999 capacity shortfall is sold in the auction referred to in paragraph 11(b) BG will offer for sale by auction before 1 May 2000 firm rights to a proportion of the maximum physical capacity of the Rough Facility and to the maximum physical capacity of the Hornsea Facility equal to the unsold proportion of the 1999 capacity shortfall (the "2000 capacity shortfall") for a term of rights of at least three years starting on 1 May 2001.
 - (d) If not all of the 2000 capacity shortfall is sold in the auction referred to in paragraph 11(c) above BG will offer for sale by auction before 1 May 2002 firm rights to a proportion of the maximum physical capacity of the Rough Facility and to the maximum physical capacity of the Hornsea Facility equal to the unsold proportion of the 2000 capacity shortfall for a term of rights of at least two years starting on 1 May 2002.
12. (a) In the event that BG offers for sale by auction in any year firm rights to capacity in the Hornsea Facility or in the Rough Facility pursuant to these undertakings in respect of any one or more of the subsequent storage years for more than one term of rights except as the Director may otherwise consent it shall offer for sale by auction first those firm rights offered for the longest term of rights and in each subsequent auction by decreasing term of rights. Any firm rights not sold for a term of rights of more than one year shall subsequently be offered for sale by auction again for a term of rights of one year.
- (b) In respect of each term of rights BG shall offer for sale by auction firm rights to capacity in the Hornsea Facility before offering for sale by auction firm rights in the Rough Facility.
 - (c) Prior to conducting any auction in respect of firm rights to capacity in any subsequent storage year BG will make available the future operations statement, suitably updated.

13. (a) Each of the auctions provided for in paragraphs 10 and 11 shall be conducted according to the auction procedures modified only (other than in accordance with paragraph 13(c) below) to take account of the change of year. Except with the consent of the Director, which will not be unreasonably withheld so far as concerns modifications which facilitate the separate auctioning of the rights referred to in paragraph 9 above, the firm rights offered for sale in those auctions shall be the rights defined in the auction procedures and the storage services contracts.
- (b) Upon completion of the 1999 auctions and in June of each of 2000, 2001 and 2002 BG and the Director shall jointly review the auction procedures (the "annual review"). The annual review shall consider the mechanics of the auction with the aim of agreeing any modifications to the auction procedures, including reserve prices (which, if 100% of the firm rights to capacity are not sold in any Storage Year, may be reduced), warranted by the conclusions of that review.
- (c) The auction procedures and the storage services contracts shall not be modified, other than by agreement between the Director and BG.

Capacity not sold at auction

14. In any Storage Year up to and including the Storage Year starting on 1 May 2003:
 - (a) except with the consent of the Director, BG shall offer for sale any firm rights to any proportion of the maximum physical capacity of the Rough Facility or of the Hornsea Facility in respect of that Storage Year which remain unsold at the start of that Storage Year at a price equal to the reserve price in respect of the most recent auction of firm rights to capacity in that facility; and
 - (b) subject to paragraph 14 (a) BG shall not sell or offer for sale firm rights in respect of any proportion of the maximum physical capacity of the Hornsea Facility or of the Rough Facility other than in accordance with these undertakings except with the consent of the Director.

Secondary markets

15. BG shall facilitate the development of a secondary market in each of the firm rights to capacity sold by it pursuant to these undertakings by
 - (a) ensuring that injectability, space and deliverability rights are defined in ways which allow them to be traded separately; and
 - (b) establishing arrangements that allow for the transfer, on a basis which is not unreasonably restricted, of all or any part of the rights purchased under the auctions described above at the request of the holders of those rights.

Competition law

16.
 - (a) BG will conduct the storage business (whether using existing, enhanced or new facilities) and such other storage operations as it may from time to time develop in such manner as to comply with the requirements from time to time of competition law.
 - (b) Pending the coming into force of the provisions of the Competition Act 1998 relating to the abuse of a dominant position (the Chapter II prohibition) BG as operator of the Rough Facility and the Hornsea Facility will not act in such a way that the storage business obtains any unfair commercial advantage compared to any other person offering storage services using those facilities.

Separation

17. BG will use all reasonable endeavours to complete a robust internal physical, financial, information and systems separation of the storage business from all other commercial activities (except the Common Service Business as defined in Standard Condition 2) carried on by BG by 30 April 1999.

Top-Up

18. To the extent that the Top-Up Changes are material for the purposes of Regulation 4 of the Regulations BG will expedite discussions with the HSE with

a view to obtaining the HSE's acceptance of the Top-Up Changes as soon as possible.

Disposal of storage facilities

19. BG shall not dispose of:
- (a) the Rough Facility or of the Hornsea Facility or any part thereof; or
 - (b) any interest in any wholly owned subsidiary to which any interest in the Rough Facility or the Hornsea Facility or any part thereof has been transferred;

Other than to a wholly owned subsidiary without the consent of the Director which will not be withheld so long as the person to whom the facility is transferred:

- (i) provides to the Director undertakings in the form of these undertakings excluding paragraph 18; and
 - (ii) is a person in respect of whom the Director is satisfied as to its ability to comply with and perform such an undertaking, and will not otherwise be unreasonably withheld.
20. If BG transfers the Rough Facility or the Hornsea Facility to a wholly owned subsidiary it shall procure that that subsidiary shall comply with the provisions of these undertakings as if that subsidiary had given such undertakings to the Director.

Termination

21. These undertakings shall terminate at the end of the Storage Year beginning on 1 May 2003.

.....
For and on behalf of BG plc
Date: