

**SSE Energy Supply Ltd's completed
acquisition of Dynegy Hornsea Ltd's gas
storage facilities**

A consultation document

October 2002

Summary

This document sets out Ofgem's initial views on the competition and regulatory issues arising from Scottish and Southern Energy Limited's completed acquisition of Dynegy Hornsea Limited. Ofgem will make recommendations to the Director General of Fair Trading in relation to the acquisition. In order to allow comments to be considered, Ofgem needs to receive these not later than 5 pm on Tuesday 29 October 2002.

Ofgem's initial conclusion is that while the transaction, of itself, should not raise competition concerns, steps should be taken to ensure that the new owners of Hornsea agree to act in accordance with the terms of the statutory undertakings given by Dynegy to the Secretary of State in connection with its original purchase of the site (in lieu of reference to the Competition Commission). Ofgem therefore proposes to seek informal undertakings from Scottish and Southern Energy to this effect.

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1. Introduction

1.1. This document:

- ◆ gives details of Scottish and Southern Energy Group's (SSE) subsidiary SSE Energy Supply Limited's (SSE Energy) completed acquisition of Dynegy Hornsea Limited (Hornsea), a subsidiary of Dynegy Inc, which was announced on Monday 30 September 2002;
- ◆ gives details of the gas storage market and the framework within which the Hornsea facility is regulated;
- ◆ explains the merger control process for this transaction; and
- ◆ describes Ofgem's initial conclusions on the competition and regulatory issues raised by the acquisition, on which the views of interested parties are requested.

1.2. Ofgem will make recommendations to the Director General of Fair Trading (DGFT) in relation to the acquisition. In order to allow comments to be considered, Ofgem needs to receive these not later than 5 pm on Tuesday 29 October 2002.

2. Details of the completed acquisition

- 2.1. SSE Energy completed the acquisition of Hornsea on 30 September 2002. Under the terms of the purchase agreement, SSE Energy paid £129 million for all of the shares of Hornsea plus £1.4 million for working capital.
- 2.2. Under the transaction, SSE Energy will take over ownership and operation of the gas storage facility located at Hornsea on the east coast of Yorkshire, plus the development rights to the adjacent Aldborough site previously owned by Dynegy Finance Limited.
- 2.3. There are nine man-made salt cavities at the Hornsea storage facility located in East Yorkshire. The facility has a storage capacity of around 3,500 GWh, which represents 9% of physical storage space in GB, and deliverability of 195 GWh/day (13% of GB deliverability). Further details on gas storage are given below.

3. Merger control process

- 3.1. This transaction falls within the scope of UK merger control law since the value of the assets taken over exceeds the £70 million threshold under the Fair Trading Act 1973 (FTA), and the transaction does not have a European Community dimension. The transaction will therefore be assessed under the provisions of the FTA and the Secretary of State for Trade and Industry may refer the transaction to the Competition Commission if the transaction may, in the Secretary of State's opinion, give rise to significant competition concerns.
- 3.2. It is the responsibility of the Office of Fair Trading (OFT), headed by the 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 will consult Ofgem before advising the Secretary of State. Where the OFT recommends that the transaction should be referred to the 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.
- 3.3. If the transaction is referred to the Competition Commission, the Competition Commission has to consider whether the transaction operates, or is likely to operate, against the public interest.
- 3.4. If the Competition Commission finds that the transaction does not, or is not likely to, operate against the public interest, the Secretary of State must clear the transaction. However, if the Competition Commission makes an adverse finding, the Secretary of State may (but does not have to) take remedial action.

4. Details of the parties

SSE

4.1. Formed as a result of the merger of Scottish Hydro-Electric and Southern Electric, SSE is a large vertically integrated energy group. SSE has significant gas and electricity interests and is also involved in utility contracting, environmental control systems and electrical retailing. SSE's principal energy businesses include:

- ◆ **electricity generation**—extensive GB generation interests from a range of sources, including hydro, combined cycle gas turbine and CHP plants. SSE's total generating capacity in England and Wales is 2,318MW (which represents 3.4% of total capacity in England and Wales) and its GB capacity is 5,423MW which accounts for 7% of total GB capacity. In 2001, SSE's generation output was 18.11TWh which represents 5.2% of total GB output.
- ◆ **electricity supply**—through wholly owned subsidiaries including SSE Energy Supply Limited and SSE Energy Limited. SSE's supply business includes the ex public electricity supplier businesses of Scottish Hydro, Southern Electric and SWALEC, and supplies around 3.5 million domestic customers and 300,000 I&C (industrial and commercial) customers;
- ◆ **electricity transmission**—ownership and operation of the electricity transmission system in the north of Scotland;
- ◆ **electricity distribution**—SSE delivers power to northern Scotland through its subsidiary Scottish Hydro-Electric Power Distribution Ltd and to southern England through its subsidiary Southern Electric Power Distribution plc.
- ◆ **gas and electricity trading**—involved in the sale and purchase of gas and electricity in the forward and wholesale markets;

- ◆ **gas supply**—through wholly owned subsidiaries including SSE Energy Supply Limited and Southern Electric Gas Limited. SSE supplies around 1 million domestic customers and 7,700 I&C customers.
- ◆ **gas shipping**—through its wholly owned subsidiaries SSE Energy Supply Limited and Southern Electric Gas Limited. In the financial year to March 2002, SSE shipped gas equivalent to less than 1.5% of the total volume shipped in Great Britain.

Dynegy

- 4.2. Dynegy Hornsea Limited (Hornsea) is a wholly owned subsidiary of Dynegy Finance Ltd, which is a subsidiary of Dynegy Europe Ltd (Dynegy Europe).
- 4.3. Following the acquisition, Dynegy will continue to own and operate the Rough storage facility and also has a 73% stake in the Easington onshore gas-processing terminal. Dynegy is an energy merchant, power generator, and energy trader in North America, UK and continental Europe, but has recently announced restructuring plans and a managed exit from its marketing and trading businesses. The company is based in Houston.
- 4.4. Dynegy UK Ltd holds two gas shipper licences, one of which is registered in the UK and the other in Switzerland. In the financial year to March 2002, Dynegy shipped gas equivalent to less than 1.5% of the total Great Britain volume.

5. Gas storage

- 5.1. Gas storage facilities have a number of key characteristics, chief amongst which are:
- ◆ the rate at which gas can be injected into a gas storage facility ('injectability');
 - ◆ the rate at which gas can be withdrawn from the facility ('deliverability');
 - and
 - ◆ space, ie the total amount of gas that the facility can hold when full.
- 5.2. The major gas storage sites in Great Britain are the Rough off-shore facility, Hornsea, and the five Liquefied Natural Gas (LNG) facilities. Originally, all the facilities were owned and operated by British Gas plc. The ownership of Rough and Hornsea was then transferred to BG Storage Ltd (a ring-fenced subsidiary within the BG Group). In November 2001, Dynegy purchased BG Storage Ltd.
- 5.3. Hornsea accounts for 3,495 GWh of storage space (approximately 9% of GB total) and 195 GWh/d of deliverability (approximately 13% of GB total). The six adjacent gas storage cavities at Aldborough, if developed, would add approximately 1,830 GWh. Planning consent for the development of the site is valid until 2005.
- 5.4. The corresponding figures for Rough are 75% of total GB storage space and nearly 30% of total GB deliverability. The withdrawal lead times at Hornsea and Rough vary from half an hour to twelve hours and injection lead times from two hours to twelve hours.¹
- 5.5. Transco's LNG sites account for around 10% (4,062 GWh) of storage space but 55% (812 GWh/d) of deliverability. The withdrawal lead times range from one to eight hours, and injection rates from twelve hours to ten days.
- 5.6. The remainder of the current physical storage market is comprised of new entrants. Scottish Power's storage site at Hatfield Moor has space capacity of

¹ For more details see 'Review of the supply of gas storage and related services. The Director General's SSE's completed acquisition of Dynegy Hornsea Ltd's gas storage facilities
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1,260 GWh and deliverability of 55 GWh/d. Aquila's site at Hole House has space capacity of 821 GWh and deliverability of 59 GWh/d.²

- 5.7. In addition to these sites, at least two other independent storage projects have been proposed: Intergen's, at Aldborough, with an expected capacity of 1,758–2,198 GWh and deliverability of 176–264 GWh/d, with storage available from 2005/06; and Star Energy's, at Humbly Grove, with an expected capacity of 1,080 GWh and deliverability of 36 GWh/d. A summary of the physical storage market, including existing and proposed new facilities, is set in Table 1 overleaf.

Initial Proposals', Ofgas, June 1998.

² At the time of publication, it has been announced that Aquila has sold the Hole House facility, although the identity of the purchaser has not been disclosed (the transaction was too small to require examination under merger control).

Table 1: summary of existing and planned physical storage facilities

Existing Storage facilities	Owner	Space (GWh)	Deliverability (GWh/d)
Rough	Dynegy	30,344	455
Hornsea	SSE Energy	3,495	195
Sub-total		33,839	650
Avonmouth LNG	Transco	827	165
Dynevor Arms LNG	Transco	276	55
Glenmavis LNG	Transco	551	110
Isle of Grain LNG	Transco	1,213	243
Partington LNG	Transco	1,195	239
Sub-Total		4,062	812
Hatfield Moor	Scottish Power	1,260	55
Hole House	Aquila ³	821	29
Sub-Total		2,081	84
TOTAL		39,982	1,546
Possible additions			
Aldbrough	Intergen	(max) 2,198	(max) 264
Humbly Grove	Star Energy	1,080	36
Sub-total		2,361	300
OVERALL PROJECTED TOTAL		42,343	1846

The regulatory framework

- 5.8. Neither the operation nor the ownership of gas storage facilities are licensed activities under the Gas Act 1986. The LNG facilities, owned and operated by Transco LNG (a ring-fenced business unit within Transco), are, however, included within Transco's Gas Transporter licence.

³ At the time of publication, it has been announced that Aquila has sold the Hole House facility, although the identity of the purchaser has not been disclosed (the transaction was too small to require examination under merger control).

- 5.9. All storage facilities (including LNG) are subject to European regulatory requirements regarding third party access. Sections 19B and 19C of the Gas Act and section 17 of the Petroleum Act 1998 give Ofgem powers to consider applications made by storage owners for exemption from certain provisions in the legislation regarding Third Party Access (TPA) requirements introduced by European Community legislation.
- 5.10. None of the previous owners has applied for an exemption in respect of Hornsea and the relevant provisions of the legislation relating to TPA therefore apply. Transco LNG applied for (and was granted) an exemption in respect of each of its five LNG facilities. Similarly, Scottish Power and Aquila applied for and were granted exemptions for their sites.
- 5.11. General competition law applies to gas storage businesses. The Competition Act 1998 prohibits anti-competitive agreements and abuse of a dominant position. Chapter I prohibits agreements between undertakings, decisions by associations of undertakings or concerted parties which have the object or effect of preventing, restricting or distorting competition in the United Kingdom and which may affect trade in the United Kingdom. Chapter II prohibits conduct by one or more undertakings, which amounts to the abuse of a dominant position in a market in the United Kingdom, which may affect trade in the United Kingdom. Ofgem has concurrent powers with the DGFT under the Competition Act, and has the power to impose financial penalties of up to 10 per cent of UK turnover on companies found to be infringing the prohibitions of the Competition Act. In relation to these concurrent powers, Ofgem works in conjunction with the OFT as set out in the OFT Guideline *Concurrent Application to Regulated Industries*.

Dynegy's undertakings

- 5.12. An additional form of regulation covering the ownership and operation of the Hornsea facility has been the set of undertakings given by Dynegy to the Secretary of State in lieu of a reference to the Competition Commission. As part of Dynegy's acquisition of Hornsea (and also the Rough facility) in November 2001, the Secretary of State required Dynegy to give a set of undertakings in lieu

of a reference to the Competition Commission.⁴ These are binding undertakings (on which, for example, third parties can rely in taking court action under the Fair Trading Act 1973 in the event of the undertakings being breached). Dynegy's undertakings replaced assurances given by BG to Ofgem to cover its operation of Rough and Hornsea over the period 1999–2004. Dynegy's undertakings to the Secretary of State covered the part of this period remaining when Dynegy purchased Rough and Hornsea from BG. It is important to note that while the assurances given by BG have usually been referred to as informal 'undertakings', they did not have the statutory force of the undertakings given by Dynegy to the Secretary of State in lieu of a reference to the Competition Commission.

5.13. The Secretary of State's decision had been informed by advice from Ofgem, including the results of an Ofgem consultation process regarding Dynegy's purchase of the storage facilities.⁵ This exercise indicated a number of areas where respondents agreed with Ofgem's initial conclusion that undertakings similar to BG's were still required. In particular, the maximum physical capacity should continue to be made available on non-discriminatory terms; and there should be a robust separation between Dynegy's storage and trading activities. In Dynegy's undertakings to the Secretary of State, therefore:

- ◆ the definition of the maximum physical capacity at each facility remained unchanged from that agreed to by BG;
- ◆ the obligation to offer the maximum physical capacity on non-discriminatory terms remained unchanged from BG's undertakings;
- ◆ there is an obligation to produce an auctions procedure document, a standard storage services contract and a future operations statement, as required by BG's non-statutory undertakings;
- ◆ Dynegy can only change the terms of either the auctions procedure or the standard storage services contract with the consent of the Secretary of State (similarly, BG was only able to change the terms with Ofgas consent);

⁴ A full set of Dynegy's undertakings are contained in annex 1.

⁵ 'Dynegy's proposed acquisition of BG Storage—A consultation paper', Ofgem October 2001. SSE's completed acquisition of Dynegy Hornsea Ltd's gas storage facilities

- ◆ as Dynegy's storage business would be in possession of market sensitive information regarding storage customers' injection and withdrawal patterns, the storage business, like BG Storage before it, can trade gas for operational purposes only; and
 - ◆ as with BG, there is an obligation on Dynegy to maintain a robust financial and informational separation between its storage business and the rest of Dynegy's trading activities. This is to prevent Dynegy's trading activities benefiting from privileged access to market sensitive information.
- 5.14. An additional requirement that respondents felt was required was in the provision of one-year storage rights to help to safeguard the ability of new entrants to the gas market to secure storage capacity rights. Paragraph 5 of Dynegy's undertakings places an additional obligation to offer 20% of the capacity at each facility on a one-year basis (either through bilateral sales or any subsequent auctions).

Competition in and substitutes for storage

- 5.15. Competition in the physical storage market is developing with the prospect of increased new entry. There are also relatively close substitutes for physical gas storage. These alternative sources of flexibility include beach swing, interconnector flows and interruptible demand contracts. These are summarised below (in principle, linepack—ie, gas stored in the pipeline network itself—could also be a substitute although it is not discussed here).

Beach Swing

- 5.16. The potential to increase supplies of gas from beach terminals at times of high demand/price, provides a potential substitute for the flexibility services provided by storage sites. An indication of the potential flexibility provided by beach swing can be gained from examining variations in observed beach flows. For example, the difference between peak and annual average aggregate flows at the six largest terminals (excluding Bacton interconnector and Rough storage flows) over the past two years has been approximately 1,000 GWh/d. Alternatively, while there have been some significant recorded daily flow increases at specific

terminals, it is notable that the largest daily change in aggregate beach flows from these terminals in each of the last 2 years has been between 350 and 400 GWh/d.

Bacton Interconnector

- 5.17. The Bacton interconnector provides a particularly significant source of potential flexibility for the NTS, and the extremes of its operational capabilities imply a swing potential of 899 GWh. Furthermore, the lead-time required for the renomination of flows on the interconnector is comparable with those at storage sites. However, operational and contractual difficulties suggest that the flexibility that the interconnector can offer on both an inter- and intra-day basis is significantly lower than the difference between its import and export capabilities.
- 5.18. In addition to these physical and contractual factors, it is clear that the level of inter- and intra-day physical flexibility that can be provided at any point in time will be dependent on the 'opening' level of flows. An indication of the importance of these factors can be gained from examining interconnector usage data. In particular, it is notable that the highest observed daily increase in flows onto the NTS from the interconnector since it became operational is 191 GWh/d.

Interruptible contracts

- 5.19. The primary mechanism by which demand-side responsiveness contributes to supply–demand balancing is through the use of interruptible contracts. Currently, users on interruptible transportation terms account for 1,123 GWh/d of capacity (excluding the interconnector). Under the contract terms, Transco has the right to interrupt users with a 5 hour notice period for up to 45 days per year (and in some cases in excess of 45 days) subject to criteria defined in its network code.
- 5.20. When considering the potential for interruption to substitute for storage services, it is also useful to recognise that the specific effect of interruption at any particular time will depend on the actual off-take levels at that time, and expectations concerning subsequent usage levels. Given this, the maximum

interruptible off-take capacity figure given above may significantly overstate the potential for interruption to offer an effective supply-side substitute to storage usage under many circumstances.

- 5.21. Customers with firm transportation contracts may also enter into interruptible gas supply contracts, and/or contracts that are indexed to spot prices such that the benefits to them of demand-side management may be closely related to market conditions. The potential demand reduction that might be associated with such contracts is likely to be significant, although recent estimates have varied considerably.

Table 2 – Summary of Flexibility Levels (2001/02)

Flexibility Source	GWh/d	
beach swing	350–1,000	Theoretical maximum figures observed on a daily and seasonal basis
interconnector	194–899	Theoretical maximum figures observed on a daily and seasonal basis
Demand Side NTS interruptibles LDZ interruptibles	602 521	total 1,123 (quoted above)
<i>sub total</i>	<i>1,811– 3,867</i>	
Hornsea	195	
other storage sites	1,351	
<i>storage sub-total</i>	<i>1,546</i>	
<i>overall total</i>	<i>3,357–5,313</i>	

6. Issues arising from the transaction

- 6.1. In preparing its advice to the DGFT, Ofgem needs to consider the possible impacts of the transaction on competition. Ofgem also needs to consider whether the transaction has implications for the way in which it regulates gas and electricity markets.

Horizontal issues

- 6.2. SSE's acquisition of Hornsea has resulted in an increase in the number of different storage providers.
- 6.3. Chapter four of this document described possible substitutes for the services provided by the Hornsea facility. Hornsea is a relatively minor part of the physical storage market (9% by storage capacity and 13% by deliverability) and even smaller part of the overall market when other forms of flexibility are included in the analysis (less than 6% of deliverability).
- 6.4. This analysis does not take into account the contractual rights that parties may have with respect either to physical storage or alternative forms of flexibility. SSE's contractual position with respect to physical storage rights and other forms of flexibility is also relevant to the analysis of whether the purchase of Hornsea could raise any competition or market power concerns.

SSE and physical storage

- 6.5. At the time of SSE's acquisition, 100% of the total storage deliverability at the Hornsea facility for the 2002/03 storage year has already been sold. At the time of Dynegy's purchase of the facility, 65% of the facility's capacity had been sold up to the end of storage year 2003/04 had been sold in BG Storage's auctions; it would be reasonable to assume that this figure has increased in the year that Dynegy has operated the facility. While information concerning SSE's actual holdings of storage capacity is commercially confidential, Ofgem is satisfied that the figures do not to raise any market power or competition concerns.

SSE and other forms of flexibility

- 6.6. At the time of publication, SSE accounted for less than 1.5% of overall NTS throughput. It is reasonable to assume from this figure that SSE has a similarly low percentage of beach swing. SSE's share of the interruption market is also small. According to John Hall Associates, as of January 2002, SSE did not have a significant share of the interruption market.⁶ SSE has also confirmed that it is neither a primary nor a secondary capacity rights holder on the interconnector. Overall, SSE's ownership of the contractual rights to use physical storage and other forms of flexibility is at a low level.

Vertical issues

- 6.7. SSE supplies gas and electricity to both domestic and I&C customers, and owns electricity generating plant, some of which is gas-fired. SSE's share of these markets is relatively low, and, in particular, it accounts for less than 1.5% of the total volume of gas shipped in Great Britain.
- 6.8. Gas shippers are the customers of gas storage service providers, and provide injection and withdrawal nominations to the storage provider. The information contained in these nominations could have commercial significance in relation to gas trading. SSE is actively involved in gas trading.

Ofgem's initial conclusions

- 6.9. Access to flexibility (including storage) plays an important role in the ability of shippers to balance their portfolio requirements both on a within-day and seasonal basis. The purchase of Hornsea by SSE has resulted in an increase in the number of independently-owned gas storage service providers, which, of itself, could be beneficial to competition. Although Rough and Hornsea have different physical characteristics, they are able to compete with one another at least to a certain extent. Beach swing, the interconnector and demand-side flexibility are alternatives to the flexibility provided by storage. While not perfect substitutes for physical storage, these alternative flexibility sources do provide

⁶ Page 10, Gas Price and Supply Report, Volume 18—Report 1, January 2002, John Hall Associates
www.jha.co.uk
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some element of substitutability for physical storage. SSE's ownership of the contractual rights to use physical storage and other forms of flexibility is at a low level.

- 6.10. Ofgem's initial conclusion is that, following the transaction, SSE will face substantial competition from other gas storage service providers, as well as some competition from other flexibility sources.
- 6.11. SSE's position in vertically related markets is relatively small. However, storage customers provide injection and withdrawal nominations to the storage provider that contain information potentially of commercial significance in terms of gas trading, in which SSE is active.
- 6.12. Under both BG and Dynegy ownership, there was concern that market sensitive information could pass to other parts of their respective businesses. To guard against this concern, Ofgas (with respect to BG) and OFT (with respect to Dynegy) required a robust separation between the storage and trading activities. In the case of BG non-statutory undertakings were given to Ofgas, and, in the case of Dynegy, statutory undertakings in lieu of a Competition Commission reference were given to the Secretary of State.
- 6.13. Ofgem's initial view is that the existing separation between the storage and trading activities should remain, and that this should be backed by informal undertakings from SSE to Ofgem that it will abide by the terms of the undertakings given by Dynegy to the Secretary of State. Ofgem's view is reinforced by the fact that customers currently holding storage rights at Hornsea purchased these rights with the expectation that their interests would be protected by the Dynegy undertakings until the end of the 2003/04 gas storage year (when the undertakings were due to expire).
- 6.14. SSE have indicated that it does not consider that undertakings should be required with respect to its purchase of Hornsea, since its view is that it would be in SSE's interests to make all capacity available anyway, and that the commercial pressures of a competitive market would require SSE to observe the confidentiality of storage customers' injection/withdrawal nominations. However, SSE have also indicated that it would, if considered appropriate, agree to equivalent undertakings.

6.15. The need for undertakings is discussed in more detail below.

Undertakings

6.16. Dynegy's undertakings were designed to apply up to and including the 2003/04 storage year. The undertakings were in addition to protection afforded to storage customers by the provisions of competition law. A copy of Dynegy's undertakings is annexed to this paper.

6.17. The main aims of the undertakings are to ensure that the maximum physical capacity of each site is made available on non-discriminatory terms and that there is a full separation (including in respect of information) of the storage business from all other commercial activities of Dynegy.

6.18. Dynegy's undertakings are in part a continuation of a high level agreement that storage customers could reasonably have expected would remain in force for the full five-year period and which formed the basis on which they purchased Hornsea storage services.

6.19. Respondents to Ofgem's 2001 consultation document⁷ on Dynegy's purchase of Rough and Hornsea indicated a continuing need for undertakings in a number of areas, including: making available the storage facility's maximum physical capacity on non-discriminatory terms; the provision of one year storage rights; and a 'robust internal physical, financial, informational and systems' separation of the storage business from all other commercial activities of Dynegy.

6.20. There have not been any material changes in the storage market since Dynegy purchased Rough and Hornsea, in respect of which it was required to give undertakings to the Secretary of State. Ofgem's view at the time was that the non-statutory undertakings given by BG Storage (and which were due to run to the end of the 2003/04 storage year) were still required; Ofgem's view is that similar non-statutory undertakings should now be sought from SSE.

6.21. It is therefore Ofgem's initial conclusion that informal undertakings should be sought from SSE (by Ofgem) in terms similar to those of the Dynegy

⁷ 'Dynegy's proposed acquisition of BG Storage—A consultation paper', Ofgem October 2001.
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undertakings (though on a non-statutory basis). Ofgem's initial view would then be that the transaction should not raise significant concerns.

6.22. Ofgem notes that the undertakings given by Dynegy will in any case expire at the end of the 2003/04 storage year (including the ongoing undertakings in respect of Rough). Ofgem is currently considering whether the competitiveness of the gas storage market, and its ongoing regulation, should be reviewed more generally.

Views invited

6.23. Ofgem invites respondents' views on SSE's purchase of Hornsea and Ofgem's initial conclusions described above. In particular, Ofgem would welcome views on:

- ◆ the degree to which services provided by Hornsea are substitutes for services provided by other gas storage sites of different types or in different locations, or by other forms of flexibility;
- ◆ SSE's access to storage and other forms of flexibility;
- ◆ issues raised by SSE's vertical integration in both gas and electricity; and
- ◆ whether Ofgem should seek undertakings from SSE in similar terms to those of the Dynegy undertakings (though on a non-statutory basis).

7. Conclusions

- 7.1. Ofgem is seeking the views of interested parties on the acquisition of Hornsea by SSE, so that Ofgem may advise the DGFT.
- 7.2. Whilst we invite views on the specific issues raised in this document, we would also welcome views on other issues raised by the merger, to the extent that they have not been highlighted in this document.
- 7.3. Responses will normally be available in the Ofgem library unless there are good reasons why they must remain confidential. Respondents should mark the part of their response (or whole response) which is to remain confidential, if this is the case, and where possible should consign any confidential material to appendices.
- 7.4. Comments on the proposed acquisition should be sent, by 5pm on Tuesday October 29 2002, to:

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Annex 1

PROPOSED ACQUISITION BY DYNEGY EUROPE LIMITED OF BG STORAGE LIMITED

UNDERTAKINGS GIVEN BY DYNEGY EUROPE LIMITED 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 (“BG”) (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, in the absence of appropriate undertakings, 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) 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 she 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 7 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 8.

“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 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 documents to be drawn up by Dynegy pursuant to paragraph 10 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 time in respect of which firm rights to capacity are to be offered for sale pursuant to these undertakings.

Making Storage Capacity Available

3. Dynegy shall ensure that the maximum physical capacity of the facilities is made available to the market on non-discriminatory terms.
4. In respect of each Storage Year, Dynegy may, subject to paragraph 3 above, sell by any means (including without limitation auctions, tenders, or bilateral negotiations) 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 provided that it does so in the following proportions or any other proportions agreed between the Director and Dynegy:

	Deliverability kWh/Day)	Storage Space (kWh)	Injectability (kWh/day)
Hornsea Facility		7.948718	0.110769
Rough Facility		56.593407	0.351648

5. Dynegy shall ensure that in each Storage Year a minimum of 20% of the maximum physical capacity of the Rough facility and 20% of the maximum physical capacity of the Hornsea facility are made available for a term of rights of one year, to the extent not sold for that Storage Year for such a term of rights.
6. In respect of each Storage Year, Dynegy shall in accordance with the process set out below offer for sale by auction at least 30 days before the start of each Storage Year firm rights to any proportion which then remains unsold of the maximum physical capacity of the Hornsea Facility and of the maximum physical capacity of the Rough Facility.

Auction Process

7. Dynegy shall conduct any auctions, as referred to in paragraph 6, in accordance with the arrangements set out in the document prepared by BG plc (as constituted at that time) dated 17 February 1999 entitled the “auction procedures”, the latest application of which was for the auctions carried out by BG Storage for the storage year beginning 1 May 2001.
8. Prior to the 2002 Storage Year 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.
9. Dynegy shall publish the auction procedures, the future operations statement and the storage services contracts at least 30 days before the start of each Storage Year, 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 during that Storage Year within a reasonable period of time from having received that request.

10. 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.
11. 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		7.948718	0.110769
Rough Facility		56.593407	0.351648

12. (a) Any auctions shall be conducted according to the auction procedures modified only (other than in accordance with paragraph 12(b) below) to take account of the change of Storage 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 11 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 remaining unsold following auctions

13. In respect of any Storage Year up to and including the Storage Year starting on 1 May 2003 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 following any auctions as referred to in paragraph 6, 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 for any

Storage Year 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

14. 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

15. Dynegy will maintain a robust 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.
16. Dynegy will maintain separate accounts for the storage business from the accounts for any of its other activities.

Provision of information

17. Dynegy shall promptly provide to the Director such information as he may reasonably require from time to time for the purpose of ascertaining that these undertakings are being or will be complied with.

Transfer

18. 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

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

Signed for and on behalf of Dynegy Europe Limited by:

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Director

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Director

Date: 8 November 2001