Regulatory implications of acquiring a gas storage facility – some lessons from Australia

Centrica's recent purchase of the gas storage and gas processing facilities at Rough from Dynegy raises a number of interesting regulatory issues. Ofgem has recently published a consultation paper[1], which lists the main issues and areas of potential regulatory concern. Their initial view is that the deal leads to a substantial lessening of competition[2]', but that undertakings 'deeper and wider than those agreed with Dynegy[3]' may be sufficient to avoid referral to the Competition Commission.

But other major energy companies in other markets have done similar deals in the past: For example, TXU Australia, a gas and electricity company based in Victoria, recently acquired the rights to build, operate and own a 100bcf gas storage facility. This paper outlines the context of the deal and the key terms of the sale and other agreements between TXU and the State.

Context

Approximately 98% of all natural gas supplied in Victoria is produced at the Esso/BHP plant at Longford from the offshore Bass Strait gas fields to the east of the State. In September 1998, a fatal accident at the plant damaged production facilities and cut off all production for 12 days. Millions of households in Victoria were without gas for heating and cooking, so the political pressures to restore supply and prevent such an event ever happening were huge.

The State Government increased its efforts to negotiate transmission interconnectors with NSW and South Australia , and brought forward existing plans to develop a gas storage facility in the western part of the state using depleted reservoirs in the Port Campbell area. This had been discussed for many years as a way of increasing diversity of supply and reducing dependence on the main east-west pipeline from Longford to Melbourne, but it had languished in the doldrums until the Longford explosion suddenly brought it to the fore.

At this time, the Victorian Government was privatising its gas and electricity businesses, partly because it believed that such activities were better managed in the private sector, and partly because they needed the sale proceeds to reduce State debt. Development of the gas storage facility ('WUGS') was progressing slowly under control of state owned GASCOR, but given their track record, the Government were not convinced that GASCOR could develop this facility on time and to budget.

TXU Australia ('TXU') owned one of the five electricity supply/distribution companies, and was bidding to acquire one of the three gas supply companies being formed out of GASCOR (It acquired Westar/Kinetik in January 1999). It is a wholly owned subsidiary of Texas Utilities Company ('TXU Inc.) which operates 10 natural gas storage facilities and is one of the largest natural gas distribution and pipeline companies in the United States. TXU Inc.

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[1] Ofgem consultation paper 'Centrica's completed acquisition of Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd' published 2 December 2002

[2] Ofgem consultation paper

[3] Ofgem consultation paper

was in acquisitive mode at the time: it had recently bought Eastern Electricity in the UK, and was looking for ways of further integrating its capabilities in energy supply, transport, production and trading.

The initial proposal

Following the Longford explosion, we suggested to TXU that they approach the State Government and offer to build, own and operate WUGS as merchant plant, buying low price gas in the summer, storing it, and releasing it when prices are higher in the winter. Unfortunately, unlike some other forms of storage such as salt domes, the facility could not commercially provide intra-day storage.

There were three stages in the original plan for WUGS. Stage one was that the gas processing facility would be operational in time for the 1999 winter, and that a specified amount of gas would be made available to the State from the partially depleted Iona gas field. Stage two requires the construction of the entire underground storage facility by the year 2001, while stage three mainly involves ensuring that the capacity of the facility satisfies certain enhanced performance criteria. The associated capital cost of these developments was estimated at that time to be approximately $85 million.

The benefits to the State of allowing TXU to buy and develop WUGS include:

- The facility would definitely be operational on time – TXU had a long track record of developing such facilities
- The deal would result in an immediate financial contribution to State coffers (including reimbursement of development costs already paid by the State)
- There would be increased diversity through the efficient operation of gas storage facilities, leading to increased security of supply
- The deal is in line with Government efforts to transfer assets to private sector

The regulatory concerns

The State regulator (Office of the Regulator – General 'ORG') and the State Treasury (included the State competition authority, 'Treasury') were pleased to receive our proposal, but were a little concerned that TXU might use the facility anti-competitively. In particular, they were concerned that:

- TXU might not deliver the facility any earlier than the existing team, if at all. What happens if TXU goes bust, or the project is put on hold?
- By controlling all gas storage in the State, TXU would have undue advantage over other suppliers at times of peak system demand
- Once it owned the facility and the land around it, TXU could conceivably delay the development of the gas pipeline to South Australia (the South West Pipeline)
- If it allowed third party access, it would have unfair knowledge of other supplier's operational plans

We discussed these issues extensively with the ORG and Treasury, and developed with them a number of agreements and undertakings that made them feel more comfortable in allowing TXU to take on operational control of WUGS.

The final result

In late November 1998, TXU and the State entered into a number of agreements for the sale and development of the underground gas storage facility, for a total price of $58.5 million. The price paid by TXU comprised an amount of $31.6 million paid for the acquisition of WUGS Pty Ltd and $26.9 million for the acquisition of the rights to the Iona reservoir gas reserves.

- TXU would develop the gas storage and processing facility at its own cost, and guarantee delivery of gas from the field by Winter 1999. Penalties would apply for late or non-delivery
- Rather than operate the whole facility as merchant plant, TXU would make 50% of the capacity available to GASCOR (and its successors) for the first five years. We calculated the fee for this service by taking the projected opportunity cost of that lost capacity over the five years. This figure was agreed by the State, and rolled into the sale agreements for the new gas suppliers

Key terms of the Agreements

As part of the deal, TXU took on five separate agreements. The key terms of these agreements are outlined below:

The *Underground Gas Storage Share Sale Agreement* includes the following key terms:

- TXU is required to remain the ultimate owner of at least 50 per cent of the share capital of WUGS Pty Ltd until the completion of the project
- TXU has undertaken to develop the Iona gas reservoir as an underground storage facility at its own cost, in 3 stages of development. Furthermore, under the terms of the agreement TXU is required to provide fully operational facilities which will allow an increasing amount of gas deliverability from the Iona reservoir, a steadily increasing processing and storage capacity and the ability to deliver gas to various delivery points along various pipelines
- TXU will receive an incentive payment if stage one of the project is completed prior to Winter 1999
- In the event that TXU is unlikely to meet the performance criteria under the agreement, the State must provide written notice to TXU to cure or remedy the default. However, if the default has not been remedied by TXU within a given timeframe, the State may exercise the right to step-in and remedy the default, with the costs incurred by the State to be reimbursed by TXU
- In the event of any non-performance of TXU's obligations due to a force majeure event, such non-performance will not give rise to any liability, losses or damages on TXU
- The maximum aggregate amount which TXU may recover from the State under the warranties and indemnities provided within this agreement is a nominal amount of $1
- As from October 2000, TXU is required to offer to all gas market participants the right to access, under reasonably commercial terms, a minimum level of gas which has not been contracted to third parties

- TXU is required to grant an easement over certain land in favour of the State for the purposes of providing the South-West Pipeline access to the storage facilities

In March 1999, following extensive negotiations with TXU, the Treasurer agreed to various amendments to this agreement to provide additional incentives to TXU to complete the project as early as possible and to therefore assist the Government in achieving its Winter 1999 objective of ensuring the security of Victoria's gas supply over this critical period in the event that the restoration of the Longford gas plant was not completed by this time.

In addition to the *Underground Gas Storage Share Sale Agreement*, various other agreements were also executed between the State and TXU, viz:

- *Underground Gas Storage Services Agreement*, whereby TXU agreed to supply gas from the storage facility to the State, representing around 50 per cent of the facility's capacity, at agreed tariffs over the 5 year period commencing from the expected completion date of the facility in 2001 to 2005
- *Gas Sales Agreement*, under which for the period from June 1999 to December 1999 the State acquired the right to a specified amount of gas located in the Iona Reservoir for an agreed sum, to ensure that peak demand was met during that period
- The *Natural Gas Toll Processing Agreement*, under which TXU agreed to process raw gas delivered by the state Transmission Company to enable it to meet its requirements to supply gas to its customers in the Victorian gas market for a period of one year to December 1999
- *Interconnection Agreement*, which provides for the interconnection of the gas processing and storage facility being developed by TXU, and the South-West Pipeline being developed by Transmission Pipelines Australia

Lessons for the UK

Clearly, several of the drivers behind the ORG and Treasury's decision to allow TXU to acquire WUGS do not apply here in the UK. Certainly, moving Rough from Dynegy to Centrica does not transfer risk from public to private sector, and the financial incentive to raise revenue for state coffers does not apply. However, some arguments that we developed can be used here:

- Centrica is a credible operator of gas storage facilities – they are competent and have a financial incentive to keep the facility operational, which is more than can be said of a new entrant company specially created to buy the asset. So the market does benefit from increased diversity
- Centrica seems willing to ring-fence its gas storage facility from its supply business. This should reduce some of the concerns about leakage of competitor information. In Victoria, we used a different approach: the third-party capacity was pre-sold to the State, who then rolled it into the new gas businesses as an asset/obligation. Once the deal was done, TXU did not need to know anything about how the new gas supply companies planned to use their part of the facility. Maybe something similar could be done in the UK, perhaps using an intermediary

- How much of the capacity needs to be made available to third parties? In Victoria, the regulator treated the facility as two separate entities: a merchant plant of 50bcf capacity owned by TXU, and a 50bcf capacity option shared by the three new companies that they could use at no cost. What then is the marginal cost storage capacity?

About the Author

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