



Promoting choice and value for all gas and electricity customers

To energy network companies, investors,
customer groups and other interested
parties

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Dear colleagues

Consultation on the suspension, pending review, of our existing merger policy for mergers between energy network companies

It is more than seven years since we last undertook a thorough review of our approach to mergers between the energy network companies that are subject to five-yearly price controls. Given the changes in ownership structure over that time and the questions raised by potential future mergers, we intend to review our merger policy. Before we conclude this review, we are minded to suspend our existing merger policy and review any mergers occurring during the review on a case by case basis.

We invite views on this minded to position.

Context

There are currently three electricity transmission companies, one gas transporter, fourteen electricity distribution companies (owned by seven independent groups), and eight gas distribution companies (owned by four independent groups). There is also considerable cross ownership between the four sectors. In addition, there are a number of independent gas and electricity network operators, which own and run smaller networks embedded in the distribution networks.

In the event of merger activity in the energy market, Ofgem's role is to advise the relevant merger authority, the Office of Fair Trading (OFT), which can decide to approve a merger or refer it to the Competition Commission (CC). Ofgem may also be required to advise the European Commission if a merger would have an impact on the European energy market.

The merger authorities assess mergers on the grounds that they may result in a significant lessening in competition. Given that all the network companies are regulated monopolies, it is unlikely that mergers between networks are likely to cause concern for the merger authorities.

Even where a proposed merger does not raise concerns for the relevant merger authority, we can also propose and (with the affected company's consent) implement licence modifications to network licences that impose conditions on merged entities. As for all licence modifications, we must consult on the specific proposed modification ahead of time. Where a network company refuses its consent to a modification, the Authority can refer the modification to the Competition Commission. The Competition Commission will then review the proposal on its merits and either confirm the proposal or reject it, imposing its own solution if it wishes.

We have stated merger policies for mergers between electricity distribution networks and for those between gas distribution networks. These have been in place since 2002¹ and 2007², respectively. For the mergers that have taken place between energy networks since, the policy has served consumers well.

However, the changes in ownership structure of the energy networks seen over the last few years, in particular the smaller number of independent groupings in the electricity distribution sector, as well as potential future mergers raise a number of questions with regards to the treatment of mergers in the sector.

Reviewing our merger policy

We therefore intend to review our merger policy to ensure it remains fit for purpose. This review will cover the way we treat mergers between electricity distribution companies, between gas distribution companies, between transmission operators, and between these network sectors. The review will both update the 2002 and 2007 analysis and consider a number of additional issues, including:

- Our existing merger policies are not intended to cover the independent network operators. Is there merit in incorporating them within our future policy?
- Given the value to consumers of conducting comparative efficiency analysis between network companies as part of our price control process, how does the value of a loss in comparators change as the number of independent groupings changes?
- Is there a minimum number of independent groupings that we are prepared to accept?
- Are there any issues that we should consider with mergers between transmission and distribution network companies or between gas and electricity network companies?

The answers to these questions will then inform our view of the appropriate policy going forward. Options include:

- Determining our approach on a case by case basis informed by a set of principles set out in published guidance; and
- Retaining our approach of reducing future regulated revenues by a set amount that reflects the value of the loss of comparator, with the potential addition of a sliding scale depending on the number of comparators remaining.

We plan to consult on our proposals for updating the merger policy early in 2010. We then intend to conclude on the revised policy midyear.

Minded to decision on suspending our existing policy

Ahead of this review, we are minded to suspend our 2002 and 2007 merger policies. This would mean that for any mergers between energy network companies occurring after the suspension but before the revised policy is in place, we would scrutinise the merger on a case by case basis.

¹ The policy document is available at <http://www.ofgem.gov.uk/About%20Us/enforcement/mergers/oft/Documents1/mergersandaquisitions%2048.pdf>

² The policy document is available at http://www.ofgem.gov.uk/NETWORKS/GASDISTR/OTHERWORK/Documents1/7561-Ofgem_position_paper_DISG_13.pdf

Your views

We would welcome views on any of the issues raised in this letter and, in particular, on our minded to decision to suspend the existing merger policy prior to the conclusion of the review.

Responses should be received by **midday on Monday 25th January 2010** and should be sent to:

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Unless marked confidential, all responses will be published by placing them in Ofgem's library and on our website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

If you have any questions on this letter then please contact me on 020 7901 7165.

Yours sincerely,

Hannah Nixon
Partner, Regulatory Review