Ofgem’s approach to energy network mergers and statement of methods

Linklaters’ Response dated 24 January 2024

1 Introduction

(1) We welcome the opportunity to engage with Ofgem on the proposed approach to mergers of energy network enterprises and, in particular, on its draft statement of methods (“**Statement of Methods**”) under the new special energy network merger regime introduced by the Energy Act 2023 (“**EA23**”).

(2) The Statement of Methods provides a helpful tool for practitioners and stakeholders to understand the criteria that Ofgem will use to assess the impact of a merger on its ability to make comparisons, as well as the weighting applied to each of those criteria.

(3) Throughout this response, we comment on specific elements of the Statement of Methods which could benefit from further clarifications or guidance, or where an alternative approach could foster increased legal certainty and ensure that the regime effectively targets those transactions which may substantially prejudice Ofgem’s ability to make comparisons between energy network enterprises, without creating an undue burden for merging parties or undermining the attractiveness of continued investment in the sector.

(4) Paragraph numbers cited in this response refer to paragraphs in the Statement of Methods, unless indicated otherwise.

2 Applicability to RIIO-3

(5) As a general note, the Statement of Methods contains references to a number of concepts and mechanisms that are specific to RIIO-2 or RIIO-1. Although RIIO-3 plans to retain many of these features, there are likely to be changes to the way that these operate and are assessed in practice. This could create uncertainties for merging parties during the RIIO-3 price setting process, given that a number of the areas referenced in the Statement of Methods are being consulted on as part of the RIIO-3 methodology consultation. For example, the Statement of Methods references the business plan incentive (“**BPI**”) tool, which is being consulted on as part of RIIO-3. Likewise, the Statement of Methods mentions the National Infrastructure Commission (“**NIC**”), which has been replaced by the Strategic Innovation Fund (“**SIF**”).

(6) Whilst the Statement of Methods could be changed in the future to address reforms made following RIIO-3, in our view, it would be more effective to take a more general approach to the guidance. This would provide greater certainty to companies, as it removes doubt as to how the principles of the Statement of Methods would be applied following RIIO-3. A more general approach would also help future-proof the guidance, minimising the need to update the Statement of Methods as regulation changes.

3 Engagement at Phase I

(7) We stress the importance of engagement with the merging parties in Phase I. In our experience, alignment between Ofgem and the merging parties regarding key areas of concern, approach and the application of the Statement of Methods are crucial to maximising the benefits of Phase I and reducing regulatory risk and burden. Whilst the Statement of Methods does contain references to engagement between Ofgem and the merging parties at the pre-notification stage and throughout the life of the investigation, specific mention of engagement during Phase I would help reinforce this further.

4 Specific amendments or clarifications proposed

4.1 Paragraph 1.7 – Treatment of network licensees whose network charges are not currently controlled by Ofgem

(8) The Statement of Methods notes that "*There are cases of network licensees whose network charges are not currently controlled by Ofgem. In the case of a merger between two or more of such licensees arises, we would not expect there to be any prejudice to Ofgem's ability to make comparisons between energy network enterprises for the purpose of setting network price controls in respect of such a transaction or the relevant part of a broader transaction*".

(9) Under the EA23, we note that acquisitions involving Independent Distribution Network Operators ("**IDNOs**") and Independent Gas Transporters ("**IGTs**") are technically captured by the new energy network merger regime. However, these licensees are not subject to price controls and there should be minimal (or no) impact on Ofgem's ability to make comparisons between energy network enterprises arising from a merger of such licensees.

(10) We note that Paragraphs 3.2 and 3.3 also refer to "*energy network enterprises of the type involved in the relevant merger situation"*. We would welcome further clarity as to the meaning of enterprises "*of the type involved*", including whether this intends to designate a sub-set of energy network enterprises as subject to the regime. For example, this could be an opportunity to clarify that mergers involving IDNOs and IGTs will not be subject to the regime, or that mergers between such enterprises would not be prioritised for review (even if technically captured by the new regime).

4.2 Paragraph 2.14 – Weight of Ofgem's opinion

(11) The Statement of Methods notes that "*where Ofgem considers that a merger is likely to lead to a prejudice to its ability to make comparisons, but the parties disagree with its analysis, and a detailed analysis is required for the CMA to take a decision, the CMA would typically expect the case to progress to a phase II investigation. We note that Ofgem's views on any proposed UILs will play an important role in CMA's final decision*".

(12) This statement cuts across the standard for reference to a Phase II investigation and alters the statutory role afforded to Ofgem, empowering the sectoral regulator to be the de facto decision-maker. The EA23 makes clear that the CMA "*must ask*" and "*must consider*" Ofgem's opinion.[1] An approach whereby the CMA adopts a "decision rule"-type approach, "*typically*" referring to a Phase II investigation transactions where Ofgem issues an opinion of likely prejudice, risks becoming an unlawful delegation of authority for the CMA and an ultra vires action for Ofgem.

(13) Whilst the CMA is required to consider Ofgem's opinion, it should also take into account the parties' submissions and its decision to refer to Phase II should be based on the particular facts of the case and evidence in front of it. We suggest removing this reference to the CMA's typical expectation and including an explicit clarification on the weight accorded to Ofgem's opinion, which, in turn, ought to be compatible with the statutory instrument underpinning it.

4.3 Paragraph 3.4 – Ofgem's approach to assessing the merger's prejudicial impact to its ability to make comparisons and the extent of it

(14) The Statement of Methods notes that "*Specifically, we will consider: (a) the impact, or potential impact, of the merger on the availability of information and the quality of available information to make comparisons between network licensees […]; (b) the impact, or potential impact, of the merger on the structure of the energy network enterprises and their behaviour,*

[1] EA23, Schedule 16, Part 1, Paragraph 2 (Section 68D(1)).

insofar as they affect our ability to use comparisons effectively as part of regulatory mechanisms that drive ongoing efficiency and performance improvements in the sectors that we regulate".

(15) We would welcome clarification on the application of the above considerations to particular types of companies. Ofgem could, for example, clarify whether the acquisition of a "frontier" company would lead to a higher prejudice than the acquisition of an "underperforming" company. Outlier performers are likely to have a different impact on Ofgem's ability to make comparisons between energy networks. We would welcome any guidance as to whether Ofgem might be more concerned about under- or overperformers, why this may be the case and whether this depends on specific areas and/or performance parameters. This would in turn assist merging parties in relation to not only the evidence that they need to gather and prepare to show any merger specific impacts, but also their ability to engage in as meaningful a dialogue with Ofgem as possible in the context of it issuing its opinion for the CMA.

4.4 Paras 3.8–3.9 – Approach to assessing prejudicial impact

(16) Ofgem notes that the assessment would involve both quantitative and qualitative elements. To the extent "*analytically feasible and robust*", Ofgem will aim to quantify the impact of the merger in monetary terms. When aggregating multiple estimates of the monetary impact, Ofgem will give equal weight to impacts arising from different sources, where appropriate. The Statement of Methods notes that "*We do not expect this to be a straightforward comparison between two sets of monetary values. It is unlikely that we would be in a position to quantify the full extent of either the prejudice or the RCBs, and there are likely to be qualitative considerations on both sides […] The exercise of assessing the "extent" of the prejudice is a highly fact sensitive one and will depend on the circumstances of each merger. We will combine the results of our qualitative and quantitative assessments to arrive at a holistic assessment and view of the extent of the prejudicial impact*".

(17) We understand that it is not always possible to quantify considerations that are inherently qualitative. We recognise that this can generate uncertainty and hinder "straightforward" comparison. In light of this, we would welcome an explicit statement that qualitative approaches would not be prioritised above quantitative approaches without clear justification. We would further welcome clarifications as to whether Ofgem is likely to prioritise certain analytical tools over others (e.g. static versus dynamic, forward-looking versus historical approaches) and whether this is expected to vary between specific building blocks/parameters of its comparative regulation.

(18) Later in this section, Ofgem also notes that there are "*limited participants across the gas and electricity sectors*" and "*anticipate[s] that <u>any merger</u> will likely have a negative impact on our ability to perform meaningful benchmarking, therefore limiting our ability to fulfil our statutory duties to protect current and future consumers*" (emphasis added).

(19) This statement risks prejudicing the outcome of Ofgem's assessment in all cases and may act to deter beneficial combinations in the energy sector and ultimately could lead to a chilling effect on investment in the sector. This is especially relevant for Ofgem given that it already models at a network level. It is also particularly detrimental when such assertions are combined with Ofgem's indication at Paragraph 6.15 that it will apply a "*high evidential bar*" to any conclusion that RCBs outweigh any prejudice. Given that the purpose of this assessment is to inform the CMA's decision on whether to refer a merger to Phase II, the standard appears to be disproportionately high. This, in practice, risks leading to many (if not all) mergers being unnecessarily subject to Phase II assessment.

4.5 Paragraph 4.7 – Econometric modelling of individual network licensees' historical and/or forecast costs to estimate costs of the notional efficient company

(20) The Statement of Methods indicates that "*This approach is used to set approx. 90% of totex allowances in RIIO ED2/GD2 and approx. 20% in RIIO ET2/GT2*".

(21) We note the importance of benchmarking and comparisons of network enterprises' costs to produce estimates of the costs of a notional efficient company and to use these to help Ofgem to set revenue allowances. However, this paragraph demonstrates that there is a significant disparity between the approach used to setting totex allowances for transmission versus distribution networks. We encourage Ofgem to provide further comfort and clarity regarding the exact extent and scope of benchmarking and costs comparisons when setting allowances for transmission and distribution networks, and to explain the underlying reason and rationale behind such disparity of use between these.

4.6 Paragraph 4.20 – The role of comparisons in supporting enforcement functions

(22) The Statement of Methods indicates that "*Comparisons are also helpful in determining the appropriate remedies where our investigation has revealed a breach. For instance, such comparisons could help quantify the extent of harm to consumers caused by the breach (eg, by establishing a standard, informed by the performance of other licensees, to which the licensee's performance can be compared and aligned) and therefore the nature and extent of any remedy (eg, financial penalties or compensation)*".

(23) Whilst we understand the role of comparisons supporting enforcement functions at a high-level, we would caution Ofgem to focus its exercise under the Statement of Methods to the merger environment. Future investigations/enforcement action will be uncertain and efficiencies arising from a merger should not be discarded due to a potential risk or desire of taking a comparative approach to remedies for enforcement action in the future.

4.7 Paragraph 4.23 – Example*:* RIIO-2 BPI

(24) The Statement of Methods indicates that "*While the stage 1 test is an absolute one (ie, whether the minimum requirements were met), comparisons between plans submitted by other network licensees help us to understand whether minimum requirements are achievable (eg, because other companies were able to meet them). Such comparisons also enable us to set more challenging minimum requirements for business plan submissions in future price control reviews where these are in the interests of consumers*".

(25) Whilst we agree with Ofgem's assessment that comparisons between energy network enterprises can be used to encourage engagement with regulatory processes, we consider that BPI may not be the most effective example of this. Our view is that comparisons between network licensees' business plans are not required for the BPI tool to function – for example, the fact that other network licensees are unable to meet a given set of minimum requirements does not mean that those requirements are not achievable. In fact, setting minimum standards by way of comparison between energy network enterprises could have a negative effect on the quality of plans, as it could discourage licensees from pursuing more ambitious plans insofar as doing so might drive up the minimum requirements.

4.8 Paragraphs 5.5–5.6 – Reduction in the quality of reported information on costs and performance

(26) Ofgem notes its view that even if a merger does not automatically result in a reduction in the number of network licensees with separate reporting obligations, there will be significant risk of a reduction in the quality of information reported to Ofgem and therefore available for comparisons. Paragraph 5.5 stresses that "*For instance, the merged entity might decide to*

combine the non-operational functions (e.g., finance, regulation, commercial etc.) associated with the individual licensees, which means that the costs associated with these functions would be incurred centrally". Further, in Paragraph 5.6, Ofgem highlights that: "*A loss of quality in the available information risks adversely impacting upon our ability to make reliable estimates of those relationships, and this in turn would have an adverse impact on our ability to make effective comparisons of the costs and performance of each network licensee*".

(27) We consider this paragraph to be overly pessimistic with regard to the impact of a merger and fails to fully recognise the potential of such transactions to bring material benefits to consumers, not least because energy mergers could exhibit clear and material economies of scale.

(28) We would advise that the general advantages of mergers should also be outlined here – for example, it should be recognised that combining non-operational functions can lead to significant cost savings which, in turn, translate into lower bills for consumers. The same principle applies at Paragraphs 6.3 and 6.5 relating to assessing mergers against the criteria, which unduly focuses on the fact that "*a merger between a highly efficient licensee and a less efficient one could lead to costs being reported jointly (or allocated in some way), which in turn could mean the loss of information on efficient costs*".

4.9 Paragraphs 5.7–5.8 – Reduction in the diversity of management approaches and practices

(29) The Statement of Methods notes that "*A merger between two or more relevant energy network enterprises of the same type could lead to a reduction in the diversity of management approaches and practices (eg, procurement practices) in the sector, particularly if the merger leads to consolidation of management control. This diversity can be an important driver of efficiency, performance improvements and innovation in the sector. The more variety that exists, the more likely that examples of good practice and innovation emerge organically from within the sector. A reduction in the diversity of approaches, could, over time, act as a drag on observed efficiency and performance improvements, and have an adverse impact on the availability of information on efficient levels of costs and good performance. This in turn would adversely affect our ability to use comparisons between network licensees to set efficient cost allowances and challenging performance targets*".

(30) It is not automatically the case that mergers impact diversity of management approaches and practices, or that diversity of management approaches necessarily have a positive impact on efficiency and performance. It is equally conceivable that the consolidation of management control may in fact increase efficiency and performance, such as where the practices of a well-performing and highly efficient licensee are adopted to improve those of an underperforming and less efficient licensee. We would recommend that Ofgem clarify its assertions in this paragraph, noting examples of networks owned by the same shareholders which have clearly different efficiency and performance levels. In particular, where there are limited "common" shareholders, such assumptions should not be made solely because one shareholder has control over two separate networks of the same type.

4.10 Paragraph 5.11 – Reduction in the rivalry between network licensees, totex incentive mechanism ("TIM")

(31) The Statement of Methods notes that "*The TIM works by providing a sharing factor on over/underspends incurred by electricity transmission operators, sharing the overspend between the network licensee and consumers*".

(32) As TIM is not limited to electricity transmission operators only, we recommend amending this paragraph to also reference gas transmissions, gas distribution and electricity distribution.

4.11 Paragraph 5.12 – Reduction in the rivalry between network licensees, common control

(33) The Statement of Methods indicates that "*The management of network licensees that are under common control might take a more holistic view of their financial incentives across all licensees under their ownership, taking account of the financial rewards for cost savings as well as the potential impact on expenditure allowances across all their licensees. This in turn is likely to adversely affect the incentive of individual licensees to pursue efficiencies, and consequently the quality of information available to us on efficient levels of costs*".

(34) We are not aware of any evidence that this has been the case in relation to networks which are already owned by the same shareholders. We would welcome any indication as to the underlying empirical evidence or economic theory behind the assertions in this paragraph. Otherwise, we would encourage Ofgem to conduct case-specific analysis, without adopting a rebuttable presumption-type approach.

4.12 Paragraph 5.13 – Reduction in the rivalry between network licensees, NIC mechanism

(35) The Statement of Methods indicates that "*We have made use of formal competitions between network licensees as part of our price control frameworks. The RIIO-1 network innovation competition ("NIC") mechanism is an example of such a competition. Under the NIC mechanism, network licensees were invited to submit applications for consumer funding to support innovation projects*".

(36) Paragraph 5.13 discusses the NIC mechanism as an example of rivalry between network licensees being used to drive innovation, explaining that "*[a] reduction in the number of energy network enterprises under distinct management control could have had a detrimental impact on the quality of information in [NIC] applications and therefore our ability to make effective comparisons between them*".

(37) Whilst we welcome the use of the NIC tool, we note that previous NICs have involved multiple applications from multiple energy network companies under the same corporate structure and, in some cases, multiple applications from the same energy network company. For example, in the 2020 NIC, National Grid Electricity Transmission submitted two proposals to the electricity NIC, one of which was granted funding.[2] On this basis, it does not appear to be the case that energy network mergers make it more difficult to judge NIC applications.

(38) We also note that the NIC tool has been replaced by the SIF as part of RIIO-2. We would suggest amending Paragraph 5.13 to reflect this change and to explain how the SIF would be affected by a loss of rivalry between network licensees.

4.13 Paragraph 5.13 – Reduction in the rivalry between network licensees, reputational benefit

(39) The Statement of Methods notes that "*There is also rivalry between network licensees for reputational benefits and credibility with stakeholders including Ofgem, government, the investor community and users of the networks. Better performing companies are more likely to attract favourable opinion amongst these stakeholders, and therefore more likely to achieve favourable outcomes for their customers and shareholders. This rivalry and our observation of the resulting performance assists us in highlighting best practice and to use*

[2] Ofgem, *Decision on the 2020 Gas and Electricity Network Innovation Competition*, 30 November 2020.

comparisons between network licensees to drive performance improvements across a range of operational activities".

(40) Such focus on reduction of rivalry fails to take account of the wider benefits of mergers that result in an underperforming company being managed or owned by a group that also controls a well-performing company. In this scenario, the performance of both may be improved and we would suggest explicit acknowledgement of this benefit.

4.14 Paragraph 6.1–6.7 – Assessment of the impact of a merger

(41) The Statement of Methods provides a set of criteria for the assessment of the impact of a merger and notes that "*Each of these criteria is equally relevant to our assessment of the merger, and we will not assign differential weights to any of them*" (Paragraph 6.2).

(42) Whilst we welcome the inclusion of specific criteria, we consider that there is significant commonality between the criteria identified (which all stem from the loss of intensity of competition between networks, which is already limited). As such, we invite Ofgem to consider the additive value of each of these.

(43) We also encourage Ofgem to consider historical evidence, including from prior mergers, when devising its merger assessment criteria. We note, for example, that in the past, consolidation of licensees into a smaller number of ownership groups has not arisen or led to a complete merger of licences (i.e. combining two licences into one) and that there is no reason to consider that future mergers would necessarily lead to that outcome (thus preserving separate reporting at a licensee level). Since Ofgem would continue to have access to the same level of information on operating conditions, an a priori expectation of harm (as currently suggested by criterion one under Paragraph 6.1), would not always be justified.

(44) We also invite Ofgem to consider the wider regulatory tools at its disposal when undertaking its harm-benefit analysis. We note, for example, that if a merger were to lead to some weakening of the intensity of competition in certain areas (e.g. in innovation projects or performance terms), Ofgem is also able to make countervailing adaptations to its regime that may offset this. For example, incentive rates could be tailored appropriately, as could the benefits of lean business planning and volunteering information.

4.15 Paragraphs 6.8–6.16 – Assessment of RCBs

(45) Whilst we welcome the discussion of RCBs, we consider that the guidance given in this section could be more detailed and, in particular, could include examples of RCBs that would outweigh the prejudice relating to the merger.

(46) For example, Ofwat's approach to mergers and statement of methods (the "**Ofwat Statement of Methods**") gives examples of relevant customer benefits, such as "*improving security of supply*", and lists specific customer benefits that are more likely to be relevant, such as licence modifications.[3] Similar guidance in respect of energy network mergers would be helpful.

(47) We would also welcome further detail on the following particular aspects:

(i) **Paragraph 6.9 – RCBs, inclusion of future customers**: "*In this context, relevant customers are customers of the merging enterprises at any point in the chain of production and distribution and are therefore not limited to final consumers and include future customers*." We would suggest incorporating more specific examples

[3] Ofwat, *Ofwat's approach to mergers and statement of methods*, October 2015.

of benefits to future customers, such as avoiding insolvency or special administration.

(ii) **Paragraph 6.12 – RCBs, Criterion one**: "*Is there compelling evidence that the merger would, or is likely to, lead to RCBs within a reasonable period?*" We welcome Ofgem's explanation of the three criteria it will use to evaluate RCBs. However, it would be useful to include guidance as to what might constitute a reasonable period and to outline the factors that may affect this assessment. Merging parties will be able to provide more helpful explanations of likely RCBs if given clearer guidance on this point. This will, in turn, make it easier for Ofgem to provide its opinion on the likelihood of RCBs arising.

4.16 Paragraph 6.15 – Assessing RCBs against the criteria

(48) The Statement of Methods indicates that "*Given that a) the purpose of our assessment is to inform the CMA's decision on whether to refer the merger to a more detailed phase II investigation; and b) our principal objective is to protect the interests of consumers, we would apply a relatively high evidential bar to any conclusion that the RCBs outweigh any prejudice arising from the merger*".

(49) We would welcome any guidance as to the types of evidence (and/or worked examples of likely RCBs) which would meet such a "*high evidential bar*". We note that the Ofwat Statement of Methods does not refer to a "*high evidential bar*", but states that Ofwat will need "*compelling evidence*" to recommend that RCBs outweigh any prejudice resulting from the merger. Based on our experience advising parties in relation to the special water merger regime under the Water Industry Act 1991, absent such guidance, it would be difficult for practitioners and merging parties to evaluate RCBs.

4.17 Paragraph 7.2 – Undertakings in lieu of a Phase II reference

(50) The Statement of Methods indicates that "*According to section 73(3D) of the EA02, the CMA should ask and consider Ofgem's opinion on the effects of any UILs offered by the merging enterprises. Ofgem will generally expect UILs to restore our ability to make comparisons between energy network enterprises to a level similar to that which existed pre-merger*".

(51) To ensure merging parties are able to offer the most appropriate UILs, we consider it would be useful to include further guidance as to what would constitute "*a level similar to that which existed pre-merger*". We would also welcome further clarity as to whether Ofgem would accept a UIL that achieves some remedy, but does not look to exactly replicate Ofgem's ability to run comparators prior to the merger. For example, in the *Pennon / Bristol Water* merger, Ofwat accepted UILs to provide separate reporting information for the two entities and to accept separate price controls for the entities' wholesale activities.[4] Guidance as to whether similar UILs would be acceptable in an energy network merger would be welcome.

4.18 Paragraph 8.15 – Information requests and exchange of information between Ofgem and the CMA

(52) The Statement of Methods indicates that "*Given the short timeframe of a phase I investigation, Ofgem might require the submission of such additional information at short notice*".

(53) Whilst we understand additional information may be required by Ofgem at short notice, we would urge Ofgem to exercise caution with any such request. Merging parties will already be required to provide large amounts of information to the CMA and this burden should not

[4] CMA, *ME/6946/21 – Pennon / Bristol Water, Decision on Acceptance of Undertakings in Lieu of Reference,* 7 March 2022.

be unnecessarily increased by additional short-notice requests from Ofgem. It would be helpful for Ofgem to note that this power will only be exercised in limited circumstances in light of the fact that extensive information will be provided to the CMA.

(54) A coordinated approach to information gathering is paramount to ensure that the new regime does not create duplicative requests, with the consequent undue burden on merging parties.

4.19 Paragraph 8.15 – Information requests and exchange of information between Ofgem and the CMA

(55) The Statement of Methods indicates that "*To assist the functions of both the CMA and Ofgem in this tight timeframe of the phase I investigation, parties are expected to send all information to Ofgem and the CMA at the same time*".

(56) We urge Ofgem to reconsider whether this default position is appropriate. The CMA process is independent from Ofgem's and it is not always appropriate to automatically send all information required by the CMA to Ofgem in parallel. For example, merging parties may have concerns in relation to sharing confidential information (which is not directly relevant to Ofgem's assessment) with Ofgem where a price control process is underway.

(57) We would therefore suggest that this statement is qualified, in line with the approach taken in the Ofwat Statement of Methods, to note that "*all parties are encouraged to send all information to Ofwat and the CMA at the same time*".

4.20 Paragraph 8.22 – Decision-making process

(58) The Statement of Methods indicates that "*We will publish a non-confidential version of our opinion after the CMA makes and publishes its decision on whether the merger should be referred to phase II*".

(59) We note that Appendix 2, Annex 2 of the Statement of Methods outlines that merging parties will receive Ofgem's opinion together with the issues letter. We welcome the fact that this is expressly set out in the Statement of Methods but to ensure maximum clarity, we suggest referencing this in the main text of the document rather than in the Appendix only.

5 Conclusion

(60) As noted above, we welcome the opportunity to comment on Ofgem's proposed approach to mergers of energy network enterprises and, in particular, on the Statement of Methods that Ofgem will use to assess the impact of a merger on its ability to make comparisons and the weighting applied to each of those criteria. However, we consider that there is scope for the Statement of Methods to be further refined in the areas outlined above and that addressing these would bring greater clarity to certain aspects of the energy network merger regime.

Linklaters LLP – 24 January 2024