Decision

Making a positive difference for energy consumers

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

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Contact:	Mark Cassidy
Team:	Networks
Telephone:	020 3263 9800
Email:	mark.cassidy@ofgem.gov.uk

This document sets out our decision on the approach to mergers of energy network enterprises and Statement of Methods under the new special energy network merger regime introduced by the Energy Act 2023.

Any enquiries related to the text of this publication should be sent to Ofgem at:

10 South Colonnade, Canary Wharf, London, E14 4PU.

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Executive Summary

The Energy Act 2023 ("EA23") introduced into the Enterprise Act 2002 ("EA02") a special energy network merger regime applicable to relevant merger situations where two or more of the enterprises that cease to be distinct are energy network enterprises of the same type. In such circumstances, the Competition and Markets Authority ("CMA") may believe that it is, or may be, the case that the relevant merger situation has caused, or may be expected to cause substantial prejudice to Ofgem's ability to make comparisons.

Under the amended EA02, Ofgem is required to prepare and publish a Statement of Methods, which sets out the criteria we will apply when forming an opinion on the impact of a merger on our ability to make comparisons and the weight applied to each of those criteria.

During Phase 1 of the merger investigation the CMA must request, and Ofgem must provide, its opinion on the following:

a) whether and to what extent the merger situation has prejudiced, or may be expected to prejudice, Ofgem's ability to make comparisons between energy network enterprises of the type involved in the relevant merger situation; and if so,
b) whether the prejudice in question is outweighed by any Relevant Customer Benefits ("RCB"s) relating to the relevant merger situation.

Set out below are the criteria we will use when assessing the likely impact of a merger on our ability to make comparisons between energy network enterprises and whether the prejudice in question is outweighed by any RCBs relating to the relevant merger situation:

- **Criterion one:** Could the merger lead to a loss or deterioration in the quality of information on the relationship between costs and performance?
- **Criterion two:** Could the merger lead to a loss or deterioration in the quality of information on good performance/behaviours and efficient levels of costs?
- **Criterion three:** Could the merger lead to a reduction in the diversity of management approaches and practices that adversely affects the availability of information of good performance and efficient levels of costs?
- **Criterion four:** Could the merger lead to a reduction in rivalry between network enterprises that adversely affects the incentive of individual licensees to pursue performance improvements and cost efficiencies?

When assessing a merger against these criteria, we will consider whether there are RCBs attributable to the merger that could act to offset any prejudice that we find.

In forming our opinion, we will use the following criteria to evaluate RCBs and determine their relative certainty:

- **Criterion one:** Are there any potential RCBs associated with the merger?
- **Criterion two:** Are the potential RCBs directly and predominantly attributable to the merger?
- **Criterion three:** Is there compelling evidence on the likelihood, extent and duration of a reasonable period for potential RCBs?
- **Criterion four:** Are the merging parties able to make relevant assurances that would ensure that potential RCBs are passed on to customers?

1. Introduction

1.1 The Energy Act 2023 ("**EA23**")[1] introduced into the Enterprise Act 2002 ("**EA02**")[2] a special energy network merger regime applicable to relevant merger situations where two or more of the enterprises that cease to be distinct are energy network enterprises of the same type.

1.2 Great Britain's energy networks carry electricity and gas from where it is produced to homes and businesses around the country and are funded by consumers through their energy bills. The networks are privately owned natural monopolies and consumers cannot choose their network providers as there is only one in each area. This is why they need to be regulated and why Ofgem sets price controls. Energy networks are split into four distinct sectors: Electricity Transmission; Gas Transmission; Electricity Distribution and Gas Distribution.

1.3 Some of the activities undertaken by energy network enterprises present the features of a "natural monopoly", which means it is most efficient for a single entity to produce a number of outputs rather than two or more entities. The presence of a natural monopoly leads to a market failure whereby the monopoly entity might exploit its "market power" and charge consumers an excessively high price or produce poor quality outputs. Ofgem uses price controls to limit what energy network enterprises can charge to use their networks and to encourage them to produce outputs that consumers value.

1.4 As network enterprises are regional monopolies, Ofgem uses comparative information to regulate prices, and sets incentives for network licensees to promote choice and value for customers, improve their quality of service, foster innovation and maintain a reliable and secure network.

1.5 If one or more energy network enterprises of the same type cease, or have ceased, to be distinct because they are being brought under common ownership or common control,[3] there is a potential detriment to Ofgem's ability to benchmark in setting price controls, with regards to both our focus on prices and

[1] Energy Act 2023 available at: https://www.legislation.gov.uk/ukpga/2023/52/contents/enacted. Schedule 16 of the Energy Act 2023 refers to 'Mergers of Energy Network Enterprises'. In this document we refer to this regime as 'special energy network merger regime'.

[2] Enterprise Act 2002 available at: https://www.legislation.gov.uk/ukpga/2002/40/contents

[3] See Sections 68A and 26 EA02; Mergers: Guidance on the CMA's jurisdiction and procedures, CMA (chapter 4).

in setting conditions that incentivise network operators to improve non-price factors such as quality of service. This need for comparative information is recognised through the special merger regime of the EA23, which examines whether mergers of energy network enterprises of the same type may substantially prejudice Ofgem's ability to carry out its functions by impacting on our ability to make comparisons[4] and set price controls.

1.6 This is a test that differs from the approach followed in the general merger control which assesses whether there is a substantial lessening of competition. This type of "special merger" regime is something that has already been implemented in the water industry[5], another sector where comparisons and price controls are also part of the regulator's functions and, as such, there are similarities between the two regimes.

1.7 There are cases of network licensees whose network charges are not currently controlled by Ofgem. Given this, if there is a merger between two or more such licensees, we do not anticipate that there will 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. However, this will be considered on a case-by-case basis.

1.8 Although the special energy network merger regime is concerned with the potential impact that a merger could have on Ofgem's ability to regulate the regional energy network monopolies, competition issues might arise even in mergers involving energy network enterprises. There might be cases, for example, of mergers involving non-energy network enterprises as well as energy network enterprises (or energy network enterprises of a different type), which might give rise to competition concerns. The CMA has indicated that interested parties in such mergers should refer to its general merger guidance.[6] Such cases

[4] Section 68B(1)(b), 68C(1)(b) of the EA02.

[5] https://www.ofwat.gov.uk/publication/ofwats-approach-to-mergers-and-statement-of-methods-2/ https://www.ofwat.gov.uk/publication/ofwats-approach-to-mergers-and-statement-of-methods-2/

[6] For further information on competition issues please see the CMA's general merger guidance documents: https://www.gov.uk/government/collections/cma-mergers-guidance

are likely to be investigated together and, if the statutory requirements are met, be subject to a combined reference process.[7]

1.9 Under the amended EA02, Ofgem is required to prepare and consult on its Statement of Methods, which sets out the criteria we will use to assess the impact of a merger on our ability to make comparisons and the weighting applied to each of those criteria.[8]

1.10 In view of the above, this document sets out Ofgem's decision on the merger of energy network enterprises and sets out its Statement of Methods. This document should be read in conjunction with the EA23, the EA02 and any other relevant legislation, as well as the CMA's Energy Network Mergers Guidance ("**CMA's Special Energy Merger Guidance**").[9]

[7] Section 68E EA02 provides the CMA with the ability to make combined references under the energy network merger regime and the general merger regime, in which case the same group may consider the Phase 2 references jointly.

[8] Section 68D(3) and (5) of the EA02.

[9] For the CMA's Guidance on the energy network merger regime, please refer to CMA's publications website https://www.gov.uk/search/policy-papers-and-consultations?organisations[]=competition-and-markets-authority&parent=competition-and-markets-authority

2. Special energy network merger regime

The legal framework

2.1 The EA23 introduces amendments to Part 3 of the EA02 (*Mergers*). It establishes a "special merger regime" for completed or anticipated mergers that will take place between two or more energy network enterprises of the same type. An energy network enterprise is defined as an enterprise holding a licence under any of section 6(1)(b) or 6(1)(c) of the Electricity Act 1989 ("**EA89**") or section 7 of the Gas Act 1989 ("**GA86**"), excluding licences which were granted following a tender exercise.[10]

2.2 As with the rest of merger assessments, the special energy network merger regime follows the two-phase structure of merger control (Phase 1 and Phase 2 investigation). However, there are important differences from the general approach to mergers which are justified by the way energy network enterprises exist and operate, and our function to make effective comparisons when regulating energy network enterprises.

2.3 According to the EA02 as amended,[11] the CMA is under the duty to refer completed and anticipated energy network mergers for an in-depth Phase 2 investigation, where it believes that:

a) a relevant merger situation involving an energy network merger has been created, or there are arrangements in progress or in contemplation which have resulted or, if carried into effect, will result in the creation of a relevant merger situation involving an energy network merger; **and**

b) the creation of that situation has caused, or may be expected to cause, substantial prejudice to the ability of Ofgem to make comparisons between energy network enterprises of the type involved in the energy network merger.

2.4 However, the CMA may decide not to make a reference where:[12]

[10] S68A(2) and (3) of the EA02.

[11] Section 68B and 68C of the EA02.

[12] See sections 68B and 68C EA02.

a) for anticipated mergers, the arrangements are not sufficiently far advanced or not sufficiently likely to proceed to justify a reference; or

b) the energy network merger has substantially prejudiced, or is likely to substantially prejudice, Ofgem's ability to make comparisons between energy network enterprises, but that this prejudice is outweighed by **RCBs** relating to the merger.

2.5 The CMA has also the power under EA02 to accept Undertakings in Lieu ("**UILs**") of a Phase 2 reference in relation to energy network mergers, as it can with general mergers.

2.6 If a reference for a Phase 2 investigation is made, the inquiry group of the CMA, which is an independent group of experts and final decision makers in Phase 2, must:

a) confirm that an energy network merger has taken place or that arrangements are in progress or in contemplation, which, if carried into effect, will result in an energy network merger; and

b) determine whether the energy network merger has substantially prejudiced, or may be expected to substantially prejudice, Ofgem's ability to make comparisons between different energy network enterprises of the type involved in the energy network merger.[13]

2.7 If the inquiry group decides that there is a prejudicial outcome, it must decide on the following additional questions:

a) whether the CMA should take action for the purpose of remedying, mitigating or preventing the prejudice or any adverse effects that has resulted, or may be expected to result, from this prejudice;

b) whether the CMA should recommend the taking of action by others for this purpose; and

in either case, what action should be taken and what is to be remedied, mitigated or prevented.[14]

[13] Sections 35(1) and 36(1) EA02 as amended by paragraphs 6 and 7 of Schedule 5A EA02.

[14] Sections 35(3) and 36(2) EA02 as amended by paragraph 8 of Schedule 5A EA02.

2.8 In deciding whether action should be taken and, if so, what action, the inquiry group shall, in particular, have regard to:

a) the need to achieve as comprehensive a solution as is reasonable and practicable to the substantial prejudice and any adverse effects resulting from it; and

b) the effect of any such action on any RCBs in relation to the creation of the relevant merger situation.[15]

2.9 For further information on the merger control process and CMA's jurisdiction, including the turnover merger fees, time limits for reference decisions, please refer to the CMA's Special Energy Merger Guidance.[16]

Ofgem's role in the special energy network merger regime

2.10 Ofgem has an important role under the newly introduced special energy merger regime. Within Phase 1 of the merger investigation, and before the CMA forms a view about the potential impact of the merger on Ofgem's ability to make comparisons, the CMA must request, and Ofgem must provide, its opinion on the following:

whether and to what extent the merger situation has prejudiced, or may be expected to prejudice, Ofgem's ability, in carrying out its functions under Part 1 of the GA86 or Part 1 of the EA89, to make comparisons between energy network enterprises of the type involved in the relevant merger situation; and if so,

whether the prejudice in question is outweighed by any RCBs relating to the relevant merger situation.[17]

2.11 The CMA is required to seek and consider Ofgem's opinion about both the likely prejudice and whether such prejudice is outweighed by RCBs.[18] The CMA will refer a merger to a Phase 2 investigation only if it believes that there is a prejudice or

[15] Sections 35(4), 35(5), 36(3) and 36(4) EA02 as amended by paragraphs 6 and 7 of Schedule 5A EA02.

[16] For the CMA's Guidance on the energy network merger regime, please refer to CMA's publications website https://www.gov.uk/search/policy-papers-and-consultations?organisations[]=competition-and-markets-authority&parent=competition-and-markets-authority

[17] Section 68D(2) EA02.

[18] Section 68D(2) EA02.

a likelihood of prejudice to Ofgem's ability to make comparisons between energy enterprises resulting from the energy network merger that is not outweighed by RCBs.

2.12 In forming its opinion, Ofgem will apply the Statement of Methods included in this document.

2.13 Where the CMA, after having received and considered Ofgem's opinion, considers that it is under a duty to refer an energy network merger for a Phase 2 investigation (due to the reasons referred in paragraph 2.3. above), it may instead accept appropriate UILs for the purpose of remedying, mitigating or preventing the merger's prejudice to Ofgem's ability to make comparisons between energy network enterprises.[19] When forming a view on UILs, the CMA must consider the need to achieve as comprehensive a solution as is reasonable and practicable to the prejudice.[20] At this stage, Ofgem will provide the CMA with its opinion on any proposed UILs. The CMA is under a duty to request and consider Ofgem's opinion on the effect of the UILs.[21]

2.14 As stated in the CMA's Special Energy Merger Guidance,[22] in reaching its decision at Phase 1, the CMA will place significant weight on Ofgem's opinion on whether the merger is likely to prejudice its ability to make comparisons between energy network enterprises as well as whether the prejudice identified is outweighed by any RCBs related to the merger concerned. The prospect of the CMA determining at Phase 1 that it does not believe the merger results in a realistic prospect of a substantial lessening of competition, on the basis of a lack of substantial prejudice, countervailing RCBs or acceptance of UILs is likely to be higher when the views of the parties and Ofgem on the impact of the merger are relatively aligned. In particular, 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 2 investigation. We note that Ofgem's views on any proposed UILs will play an important role in CMA's final decision.

[19] Section 73(3B) EA02 as amended by Schedule 5A Part 2 EA02.

[20] Section 73(3C) EA02 as amended by Schedule 5A Part 2 EA02.

[21] Section 73(3D) EA02 as amended by Schedule 5A Part 2 EA02.

[22] Paragraph 4.25 of the CMA's Special Energy Merger Guidance.

2.15 As part of Ofgem's role under the special energy network merger regime, Ofgem must prepare and keep under review a Statement of Methods.[23] The Statement of Methods must in particular set out: (a) the criteria to be used for assessing the impact of a merger on Ofgem's ability to make comparisons; and (b) the relative weight to be given to the criteria. Ofgem must use this Statement of Methods when providing an opinion to the CMA as described in paragraphs 2.10-2.12 above.

2.16 For an overview of Ofgem's role and responsibilities in every stage of Phase 1 investigation see also Table in Appendix 2 below. In addition, the details of Ofgem's working relationship with the CMA in relation a special energy network merger will be set out in the memorandum of understanding Ofgem and the CMA will put into place and publish on their websites.

[23] Section 68D(3), 68D(4) and 68D(7) EA02.

3. Our approach to assessing the merger's prejudicial impact to Ofgem's ability to make comparisons and the extent of it

3.1 Our principal objective is to protect the interests of existing and future consumers of gas and electricity in Great Britain,[24] and we are required to carry out our functions in a manner that is best calculated to further that principal objective. As part of our functions, we periodically review the outputs and targets that network licensees are held accountable for delivering, and the amount of expenditure that network licensees are permitted to recover through charges to users of their networks.

3.2 When doing so, we protect the interests of consumers by seeking to ensure that network licensees operate their networks efficiently, deliver a high-quality service and outputs that benefit consumers and the environment. We also seek to ensure that existing and future consumers pay no more than the efficient cost of delivering those outputs and services. The ability to compare and benchmark costs and performance of network licensees is important to our efforts to set challenging performance targets and efficient cost allowances. Further details on the value of comparisons and how we use them are set out in Section 4.

3.3 Upon receipt of a request for an opinion from the CMA as part of its Phase 1 investigation, Ofgem must make an assessment of whether, and to what extent, the merger has prejudiced, or may be expected to prejudice, our ability to carry out our functions under Part 1 of the GA86 or Part 1 of the EA89, to make comparisons between energy network enterprises of the type involved in the relevant merger situation.[25] When making this assessment, we will consider the question in two parts:

a) whether the merger has prejudiced, or may be expected to prejudice, our ability to make comparisons; and
b) if so, what is the extent of that prejudice.

3.4 The first part of the question is concerned with whether the merger has, or could have, a prejudicial impact on our ability to make comparisons in carrying out our

[24] Sections 3A EA89 and 4AA GA86.

[25] Sections 68A-68D EA02.

statutory functions. The value of any comparisons that we make depends on the extent to which those comparisons support our statutory functions. As such, we would consider any detrimental impact of the merger on the value of comparisons that we are able to make to be relevant to our assessment. 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. We consider that both of these attributes are relevant to our ability to make effective comparisons in carrying out our statutory functions.

b) The impact, or potential impact, of the merger on the structure of the energy network enterprises and their behaviour, 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.

3.5 Further details about how a merger could potentially affect our ability to carry out effective comparisons are set out in Section 5.

3.6 The second part of the question is concerned with the *extent* of any prejudice to our ability to make effective comparisons. This is in a context where the relevant statutory test for the CMA is whether the prejudice is *substantial*.

3.7 In line with our principal objective, the focus of our assessment would be on the impact on existing and future consumers of gas and/or electricity. Noting the limited number of participants across the gas and electricity sectors at both distribution and transmission level, we are mindful that any merger involving two or more energy network enterprises of the same type has the potential to have a prejudicial impact on our ability to perform meaningful benchmarking, therefore limiting our ability to fulfil our statutory duties to protect current and future consumers. We would therefore undertake a thorough assessment of the prejudice, and any countervailing RCBs, from the merger before providing our opinion.

3.8 We expect that our assessment of the extent of the prejudice arising from the merger would involve both quantitative and qualitative elements. To the extent that it is analytically feasible and robust, we will aim to quantify the impact of the

merger on existing and future consumers in monetary terms. When aggregating multiple estimates of the monetary impact, we will give equal weight to impacts arising from different sources, where appropriate to do so. 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. Our qualitative assessment will focus on the risk that the merger has prejudiced, or is expected to prejudice, our ability to make effective comparisons. The exercise of assessing the 'extent' of the prejudice is a highly fact sensitive one and will depend on the circumstances of each merger.

3.9 We will combine the results of our qualitative and quantitative assessments to arrive at a holistic assessment and view of the extent of any prejudicial impact.

4. The value of comparisons to Ofgem's regulation of energy networks

4.1 Comparing energy network enterprises is one of the key tools that Ofgem has at its disposal to carry out its functions effectively and in line with its principal objective and statutory duties.

4.2 Our regulatory framework for energy network enterprises uses the concept of a 'notional efficient' network licensee, which is well-established in UK economic regulation. A notional efficient network licensee is a hypothetical construct that delivers industry-leading levels of performance in an efficient and cost-effective manner. We use the notional efficient licensee as a 'yardstick' for actual network licensees when setting expenditure allowances and performance targets, along with a package of regulatory incentives that rewards licensees that move closer to (or beat) the yardstick and penalises licensees that fall behind.

4.3 The performance levels and expenditure of a notional efficient licensee cannot be directly observed as the notional efficient licensee is a hypothetical construct. Instead, we estimate the performance levels and expenditure of this notional licensee by making comparisons of the performance and expenditure of actual licensees.

4.4 Throughout this chapter and elsewhere in this document, we include references to specific RIIO-1 and RIIO-2 price control mechanisms to illustrate Ofgem's use of comparisons in regulating electricity and gas network licensees. These examples help demonstrate the value that effective comparisons can bring in supporting Ofgem to undertake its statutory functions. We expect that comparisons would continue to play an important role in future regulatory frameworks even if the specific price control mechanisms used are different.

The role of comparisons in setting outputs

4.5 We set outputs and performance targets so that we can hold network licensees to account for delivering the quality of service and outcomes that matter to consumers. These include licence obligations which represent the minimum standards of performance that network licensees must achieve (e.g., compliance with relevant industry codes such as the Distribution Code, Grid Code etc), price control deliverables that specify the deliverables that the licensees must provide

in return for price control funding, and output delivery incentive ("**ODI**") targets to drive ongoing service and environmental quality improvements.

4.6 Comparisons between network licensees play a significant role in helping us to identify the levels of performance that can be expected from a well-run and notionally efficient network operator. These include, for example:

- Comparisons of performance and setting of ODI targets in relation to customer service (e.g., the RIIO-2[26] quality of connections survey ODI for electricity transmission,[27] and the RIIO-2 customer satisfaction survey ODI in our gas distribution ("**GD**") price controls[28]).
- Comparisons of performance and setting of ODI targets in relation to environmental impacts (e.g., the RIIO-2 insulation and interruption gases ODI for ET).
- Comparisons relating to network reliability and responding to exceptional events (e.g. the RIIO-2 interruptions incentive scheme).

The role of comparisons in setting revenue allowances

4.7 We regulate the amount of revenue that network enterprises can raise through charges that are ultimately paid by consumers. These allowed revenues are based on our assessment of the costs that would be incurred by a notional efficient licensee to meet their obligations and to deliver the outputs that we have set for them.

4.8 We use benchmarking and comparisons of network enterprises' costs to produce estimates of the costs of a notional efficient company and use these to help us to set revenue allowances. Examples of this approach include:

a) Using econometric modelling of individual network licensees' historical and/or forecast costs to estimate the costs of the notional efficient company. This

[26] This refers to our network price control framework and it stands for Revenue = Incentives + Innovation + Outputs.

[27] Electricity transmission consists of carrying electricity at high voltage, usually over long distances, from where it is generated to where it can be distributed, at lower voltages, into homes and businesses.

[28] Gas distribution is where network companies take gas from the (higher pressure, longer distance) transmission network and deliver it at safe, lower pressures to homes and businesses.

approach is used to set approx. 90% of totex[29] allowances in RIIO ED2/GD2[30] and approx. 20% in RIIO ET2/GT2.[31]

b) Benchmarking of the unit costs of specific activities (e.g., GD2 repex[32], ET2 capex) to establish the efficient costs.

c) Benchmarking of indirect costs and overheads across network licensees.

d) Comparisons of the forecast scenarios/proposed volumes of activity to address common challenges (e.g., electrification of transport).

e) Comparisons of the types of solutions that network licensees have used, or are proposing, to address common challenges and/or achieve good outcomes (e.g., extent of reliance on flexibility vs network reinforcement).

f) Comparing forecasts of other price control parameters such as future real price effects and ongoing efficiency improvements that a notional efficient licensee would deliver.

The role of comparisons in calibrating uncertainty and risk-sharing mechanisms

4.9 We use uncertainty mechanisms to manage risks arising from uncertainty about the scale and nature of demand for network services and the efficient cost of delivering outputs that consumers need.

4.10 A volume driver is one type of uncertainty mechanism that automatically adjusts allowances in line with out-turn demand.[33] Where possible, we use econometric benchmarking and comparisons of unit costs across network licensees to determine the efficient unit rate for these volume drivers, i.e., the amount by which allowances would automatically go up for each unit of additional demand.

[29] See Glossary for definition of totex or total expenditure: https://assets.publishing.service.gov.uk/media/6509747d4cd3c3001468cc78/21_September_2023_Glossary_-_RIIO-2_ED2_Appeal_-_version_for_publication_.pdf

[30] The RIIO-ED2 price control period concerns electricity distribution networks and runs from 2023 to 2028. The RIIO-GD2 price control period concerns gas distribution and runs from 2021 to 2026.

[31] The RIIO-ET2 price control concerns electricity transmission and the RIIO-GT2 period concerns gas transmission networks. The price control periods for both RIIO-ET2 and RIIO-GT2 run from 2021 to 2026.

[32] In gas distribution, the replacement of gas lines by modern ones, is known as repex for replacement expenditure. This is a separate item from normal capex.

[33] See, for example Ch 4. Adjusting baseline allowances for uncertainty, https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_annex_revised.pdf

The role of comparisons in driving ongoing improvements in cost efficiency

4.11 We use comparisons between network licensees alongside regulatory mechanisms to help drive ongoing improvements in cost efficiency.

4.12 As set out earlier, our price controls for energy networks involve the setting of revenue allowances, which in turn are based on our estimates of the efficient levels of expenditure that each network licensee would need to incur to deliver the outputs and obligations placed upon them.

4.13 Once expenditure allowances are set at the start of the price control period, we use a cost-sharing incentive mechanism (e.g., the RIIO-2 totex incentive mechanism ("**TIM**")) to encourage licensees to incur expenditure efficiently. Under the TIM, any underspends or overspends against allowances must be shared between consumers and the licensee using pre-defined sharing rates. For licensees, this mechanism provides a strong financial reward for managing their expenditure efficiently and delivering efficiency savings.

4.14 While consumers benefit from a share of any underspends achieved within the price control period, the TIM also reveals valuable information about the efficient levels of cost and the ongoing improvements in efficiency that network licensees are capable of delivering.

4.15 We use the information revealed to make comparisons between network licensees at future price control reviews to set appropriately challenging cost allowances and targets for ongoing efficiency improvements.

The role of comparisons in driving ongoing performance improvements

4.16 We use comparisons between network licensees alongside regulatory mechanisms to drive ongoing improvements in the performance of network licensees in relation to their licensed activities.

4.17 Our price controls include several financial ODIs that offer financial rewards for network licensees that meet (and exceed) performance targets, and financial penalties for those that fall short of those targets. We use comparisons of historical performance between network licensees to help us set targets for these ODIs at levels that we consider that a notional efficient licensee should be able to deliver.

4.18 In addition to the immediate benefits that consumers may enjoy as a result of these performance improvements, the ODIs offer longer term benefits to consumers through the information that is revealed about the performance that network licensees are capable of delivering, both in terms of the levels of performance as well as in terms of the potential for improvements to that performance.

4.19 We use the information revealed as a result of these financial incentives as part of comparisons used to set more challenging performance targets in future price control reviews.

The role of comparisons in supporting our enforcement functions

4.20 As part of our role as the economic regulator for energy networks in Great Britain, we have powers to ensure that network licensees comply with their statutory and licence obligations. When appropriate and in order to protect the interests of consumers, we will investigate potential breaches of these obligations and, if necessary, take enforcement action.

4.21 Comparisons between network licensees are useful when investigating potential breaches. For example:

a) Comparisons between network licensees could help by highlighting instances of exceptionally poor performance or non-compliance with obligations.

b) Comparisons between network licensees could help in the assessment of what actions might be considered to be "reasonable" for a network licensee to take and therefore could help set minimum acceptable standards of behaviour.

4.22 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 (e.g., 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 (e.g., financial penalties or compensation).

The role of comparisons in encouraging high quality regulatory submissions and engagement with regulatory processes

4.23 We use comparisons between energy network enterprises as part of regulatory mechanisms to encourage high quality regulatory submissions and engagement with regulatory processes.

4.24 An example of this is the RIIO-2 business plan incentive ("**BPI**"), through which Ofgem rewarded network licensees for putting forward high-quality plans that demonstrated clear customer value, and penalised others for putting forward poorly evidenced or poorly justified plans. The BPI had four stages, with the stage 1 assessment focused on whether the plan met minimum requirements set out in our business plan guidance.[34] While the stage 1 test is an absolute one (i.e., whether the minimum requirements were met), comparisons between plans submitted by other network licensees help us to understand whether minimum requirements are achievable (e.g., 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.

How the role of comparisons could evolve in the future

4.25 Our approach to regulating energy networks has evolved over time to respond to the changing needs of consumers and the environment, technological developments, and government policy. The current RIIO regulatory framework was introduced in 2012 (as RIIO-1), and then refined further in 2021 (as RIIO-2). The next iteration of the price control review process (RIIO-3) will be designed to reflect the challenges that the networks are expected to face, while continuing to ensure that energy network enterprises are set efficient, fair allowed returns to deliver the outputs that consumers value.

4.26 Our ability to compare network licensees has played an important role in the effective regulation of network licensees, and we expect that it will continue to play an important role in future iterations of our regulatory framework. The precise manner in which comparisons are made in the future may be different to what it is now. We will keep this Statement of Methods under review and amend it when necessary and in accordance with section 68(D)(6) of the EA02.

[34] https://www.ofgem.gov.uk/publications/riio-ed2-business-plan-guidance

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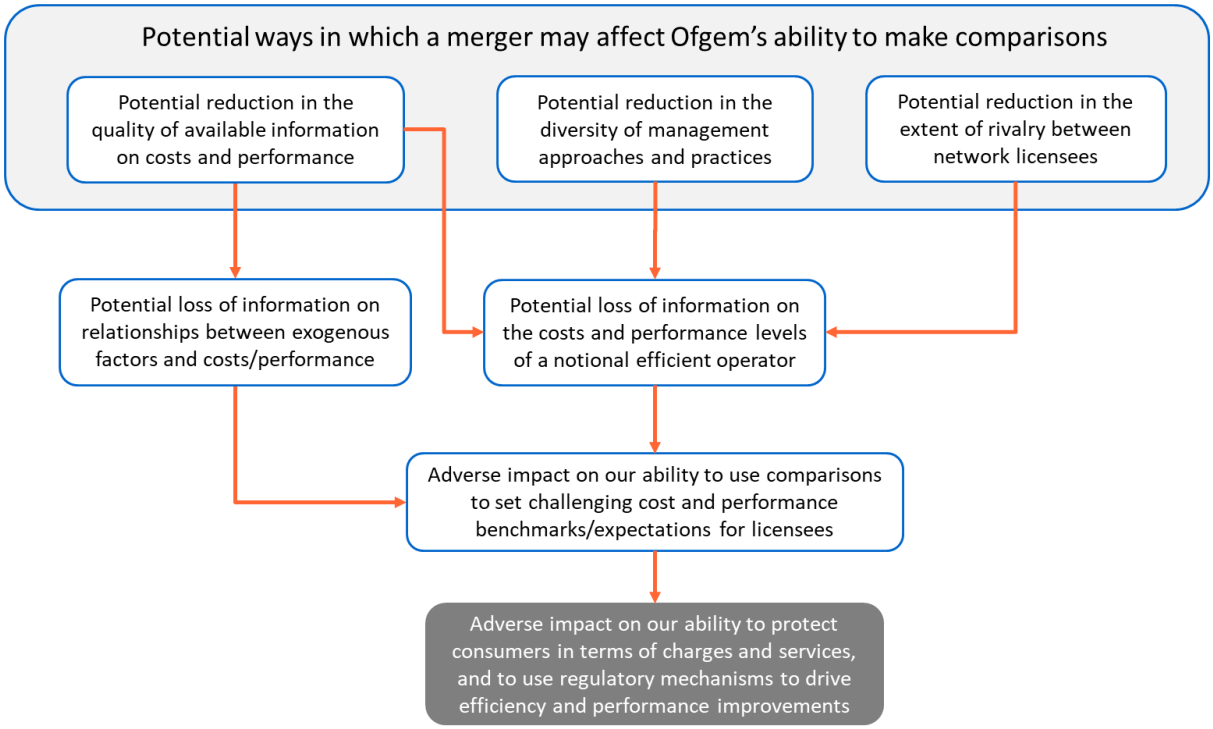
5. The potential impact of a merger on Ofgem's ability to make comparisons

5.1 As previously discussed, comparing energy network enterprises is one of the key tools that Ofgem has at its disposal to carry out its functions effectively and in line with its principal objective and statutory duties. Comparisons between energy network enterprises play a significant role in helping us to identify the levels of performance that can be expected from a well-run and notionally efficient network operator. We use benchmarking and comparisons of network enterprises' costs to produce estimates of the costs of a notional efficient company and use these to help us to set revenue allowances. This can involve utilising econometric modelling of individual network licensees' historical and/or forecast costs; unit cost benchmarking of specific activities; benchmarking of indirect costs and overheads; benchmarking performance levels/trends; and comparisons of the forecast scenarios/proposed volumes of activity to address common challenges amongst others.

5.2 A merger between energy network enterprises of the same type could lead to changes in the way in which network licensees operate and manage their businesses and could potentially have a detrimental impact on our ability to make the types of comparisons listed above. Figure 1, below, is a high-level overview of different ways in which an energy network merger could have detrimental impacts on Ofgem's ability to make comparisons between energy network enterprises.

Overview of potential detrimental impacts of a merger of energy network enterprises

Figure 1: Overview of potential detrimental impacts of a merger.



Reduction in the quality of reported information on costs and performance

5.3 A merger between relevant energy network enterprises could lead to a reduction in the quality of information that is available to us on costs and performance. This could adversely affect our ability to compare network enterprises.

5.4 A merger would not automatically result in the consolidation of two or more licensed entities into one licensed entity, as this consolidation would require modifications to the licences of the merging network licensees which can only take place following the relevant statutory process. This means that, unless their licences are modified or revoked, any licensee that is a merging network enterprise itself, or is owned by a merging network enterprise, would continue after the merger to have the same information reporting obligations that it had before the merger.

5.5 Even if a merger does not automatically result in a reduction in the number of network licensees with separate reporting obligations, there could potentially be a significant risk of a reduction in the quality of information reported to us, and therefore available for comparisons. For instance, the merged entity could 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. While each licensed entity might still report those costs separately in their regulatory submissions, they would be jointly incurred with the other merged licensed entity or entities. Such allocations are typically approximations that are made based on drivers (e.g., customer numbers or allowed revenues) that: a) do not necessarily capture the true impact of external cost drivers on costs; and b) may not capture differences in efficiencies or performance between the merged licensed entities.

5.6 A reduction in the quality of available information on costs and performance is likely to adversely affect our ability to make meaningful comparisons in undertaking our statutory functions. Specifically:

a) 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. The network enterprises that we regulate operate under different circumstances and in different environments. It is essential that we have a good understanding of the relationships between costs, performance and exogenous cost drivers. This helps us compare the costs and performance of network licensees after placing them on an even footing by controlling for external factors that are typically outside management control. We use the results of our comparisons to set efficient cost allowances and outputs or performance targets for all network licensees.

b) A reduction in the quality of information about costs and performance risks impeding our ability to identify and observe areas of good performance and cost efficiency through the use of comparators. For example, if a relatively efficient enterprise were to merge with another that is relatively inefficient, the combined entity could potentially become less efficient than the more efficient enterprise or might report costs (jointly or separately) in a way that makes it difficult to observe the costs actually incurred by the more efficient entity. This could adversely affect our ability to estimate the costs and performance levels of a

notional efficient network operator, in turn making it difficult for us to set efficient cost allowances and performance targets.

Reduction in the diversity of management approaches and practices

5.7 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 (e.g. asset management or procurement practices) in the sector, particularly if the merger leads to consolidation of management control.

5.8 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.

Reduction in the rivalry between network licensees

5.9 Although network licensees do not face the same competitive pressures as companies in the wider economy, our regulatory frameworks use mechanisms that mimic certain features of competitive markets to drive cost efficiencies and performance improvements that ultimately benefit consumers.

5.10 These mechanisms are typically designed in a way that allows individual licensees to receive financial rewards by acting efficiently, and in that process reveal information to us about efficient levels of costs or performance that we can then use as a comparative benchmark to set efficient cost allowances and performance targets for other network licensees. The effectiveness of these mechanisms relies on the existence of a degree of rivalry between the licensees.

5.11 One example of this is the approach we have used to set expenditure allowances for network licensees in recent price control reviews (RIIO-1 and RIIO-2) for all four sectors. Each licensee has strong financial incentives under the TIM to deliver cost savings, thereby revealing to us information about efficient levels of costs. The TIM works by providing a sharing factor on over/underspends incurred

by the network licensees, sharing the overspend between the network licensee and consumers. It is predicated on the quality of information provided in business plans and our assessment of how close to efficient benchmarks these are.[35] We then use this information through comparative benchmarking to set efficient expenditure allowances for each network licensee, which in turn delivers benefits to consumers that exceed the cost of the financial reward under the TIM.

5.12 The effectiveness of this mechanism depends on the willingness of individual network licensees to pursue cost savings and associated financial rewards, at the potential cost of more challenging cost efficiency targets for all network licensees. 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 could adversely affect the extent of rivalry in the sector and the incentive of individual licensees to pursue efficiencies, and consequently the quality of information available to us on efficient levels of costs. This could have a detrimental impact on our ability to make and use comparisons for the purpose of setting efficient allowances.

5.13 We have also 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] These applications were assessed by an assessment panel set up by Ofgem, and the best projects were selected for funding. The competitive aspect of this mechanism encouraged network enterprises to submit high quality applications and rewarded those that stood out from the rest through the grant of funding.

[35] RIIO-ED2 Business Plan Guidance, Chapters 4 and 5:

https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/ed2_business_plan_guidance_-_published_1_february_2021.pdf

[36] Documents relating to this can be found on Ofgem's website: https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/network-price-controls-2013-2023-riio-1/network-price-controls-2013-2023-riio-1-riio-1-network-innovation-funding/electricity-network-innovation-competition-riio-1?sort=publication_date

5.14 This mechanism acted as a significant driver of innovation in energy networks, and the ability to compare applications along various dimensions of quality was an integral part of ensuring its success. 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 those applications and therefore our ability to make effective comparisons between them.

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

6. The potential benefits of a merger

6.1 In the previous section, we discussed different ways a merger could have a detrimental impact on our ability to make effective comparisons. However, we also recognise that mergers and the resulting changes to ownership and control could deliver benefits.

6.2 If we consider that a merger has prejudiced, or is expected to prejudice, our ability to make comparisons between energy network enterprises, we will be required to provide an opinion on whether the prejudice is outweighed by RCBs demonstrated and evidenced by the merging parties relating to the merger. In doing so, we need to be satisfied that the benefits that arise from the merger fall within the definition provided in the EA02.

6.3 As per section 30(1)(a) of the EA02, RCBs are benefits in the form of:

a) lower prices, higher quality or greater choice of goods or services in any market in Great Britain; or

b) greater innovation in relation to such goods and services.

6.4 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.[37]

How might RCBs arise?

6.5 Mergers between energy network companies of the same type could lead to improvements in the efficiency and performance of one or more merging parties. This could be through, for example: the sharing of expertise, good practice and innovation between the merging parties; economies of scale and/or scope that improve the efficiency of the merging parties; and access to more reliable and cheaper sources of finance.

6.6 In recent years, there have been examples of energy network licensees being acquired (through their parent companies) by enterprises that also control other energy network licensees. In such cases the acquiring enterprises expect material benefits to arise and cite these factors as contributory factors to the acquisition. These examples pre-date the introduction of the special merger regime and, if

[37] For the full definition of 'relevant customers' please refer to Section 30(4) EA02.

considered under the special merger regime, would need to be justified and evidenced in line with the requirements set out in Chapter 7.

6.7 Any benefits that are not passed on to the relevant customers through lower prices, higher quality, greater choice of goods or services or increased innovation in relation to such goods or services will not be considered as RCBs. Our regulatory approach incentivises network licensees to make cost savings by letting them retain a share (for example, between 30% and 50% in RIIO-2) of any cost savings achieved relative to upfront allowances, with the remainder passed on to consumers through lower prices. In the short term, this means that only a proportion of any cost savings will be passed on to consumers. In future price control reviews, the lower expenditure resulting from these cost savings is likely to contribute to lower allowances for all licensees, thus passing on further savings to consumers. When assessing the extent of RCBs, we will consider what proportion of any cost savings attributable to the merger are likely to be passed on to energy consumers in Great Britain via the cost sharing arrangements and the setting of expenditure allowances in accordance with price control mechanisms.

6.8 In relation to higher quality, or greater choice of goods or services, we will consider (amongst other potential RCBs) whether the merger can be expected to lead to improvements in performance (e.g. reduced service interruptions). Under our current regulatory approach, consumers fund the payment of incentive rewards if licensees are able to perform better than their targets. When assessing the extent of RCBs attributable to performance improvements, we will take account of the value of performance improvements to customers, net of any incentive payments to the licensee.

7. Statement of Methods

Criteria for the assessment of the impact of a merger

In line with section 68D(4) of the EA02, we set out below the criteria we will use when assessing the likely impact of a merger on our ability to make comparisons between energy network enterprises in carrying out our functions under Part 1 of the GA86 or Part 1 of the EA89. These criteria reflect our views on the different ways in which a merger could prejudice that ability as set out in this section.

> **Criterion one**: Could the merger lead (or has the merger led) to a loss, or a deterioration in the quality, of information available to us on a) the relationship between costs and performance; and b) exogenous drivers of costs and performance such as regional factors (e.g., urbanity, sparsity)?
>
> **Criterion two**: Could the merger lead (or has the merger led) to a loss, or a deterioration in the quality, of information collected and reported to us on good performance/behaviours and efficient levels of costs?
>
> **Criterion three**: Could the merger lead (or has the merger led) to a reduction in the diversity of management approaches and practices in a way that ultimately adversely affects the availability of information of good performance and efficient levels of costs?
>
> **Criterion four**: Could the merger lead (or has the merger led) to a reduction in rivalry between network enterprises in a way that adversely affects the incentive of individual licensees to pursue performance improvements and cost efficiencies?

Each criterion is *equally relevant* to our assessment of the merger, and we will not assign differential weights to any of them.

How we will assess mergers against these criteria

7.1 We do not expect the questions in our criteria to have simple "yes" or "no" type answers in all circumstances. Our assessment of the merger against each of these criteria will involve an assessment of the risks to our ability to make effective comparisons in view of our statutory duties. This is likely to involve careful analysis taking account of the circumstances of the merging energy network enterprises, the features of the sector in which those enterprises operate, and the regulatory frameworks that those enterprises operate under.

7.2 Our assessment will be based on a comparison between the merger and one or more counterfactual scenarios. The appropriate counterfactual scenarios in each case would depend on the circumstances of the merger. In developing appropriate counterfactual scenarios we will consider reasonable alternative scenarios (e.g. how the ownership structure of the merging parties might evolve over time in the absence of the merger). For example, one possible counterfactual scenario would be where the merging parties continue to operate under separate ownership and management.

7.3 Criterion one relates to information about the relationship between costs and performance, the relationship between costs and exogenous cost drivers, and the relationship between performance and exogenous cost drivers. When assessing a merger against criterion one, we will consider the risks that the merger could result in changes to the way in which information on costs and performance is collected and reported by the merging enterprises and consider the impact of those changes on both the availability, and quality, of information on the relationships between costs, performance and external factors. We would look at evidence from the merging parties on what proportion of costs of the merged entity would be directly attributable to individual licensees rather than being jointly incurred across multiple licensees and reported at the licensee level using an allocation approach. We will assess if these changes could have adverse effects on the comparability, reliability and accuracy of our estimates of efficient costs and performance.

7.4 Criterion two relates to information about good performance and efficient levels of costs. This information is a valuable source of evidence on the levels of performance and cost efficiency that we can reasonably expect from network licensees. When assessing a merger against criterion two, we will consider the risks that the merger could result in a reduction in the efficiency/performance of the more efficient licensee, either because performance is averaged out after the merger or because there are transaction/implementation costs which are not offset by planned merger benefits. We will look at evidence on the past performance of the merging parties (in terms of, for example, cost efficiency and service levels) and consider different scenarios for how that performance could evolve following the merger.

7.5 Criterion three relates to the loss of diversity of management approaches and practices. The more consolidated the sector to begin with, the higher the risk that a merger could lead to a material loss of diversity. In assessing the merger

against criterion three, we will consider evidence on the extent of diversity of approaches in the relevant sector, and the potential impact of the merger on that diversity (e.g. procurement strategy; corporate finance structuring and strategy; attitudes to risk; asset management practices.) and undertake the appropriate assessment on how, or if, these adversely impact our cost assessment approach or benchmarking evidence. We would expect merging parties to provide their own evidenced views on how diversity matters for industry performance and the potential consequences of the merger in this respect.

7.6 Criterion four relates to the reduction in rivalry between network enterprises. In assessing the merger against criterion four, we will consider the risk that the merger could lead to a consolidation of management control in a way that adversely affects the efforts made by individual licensees to pursue performance improvements and cost efficiencies. This in turn could adversely affect the availability for comparisons of information on efficient levels and cost and performance. As with the risk of material loss of diversity, the more consolidated the sector to begin with, the higher the risk that a reduction in this incentive adversely affects our ability to use comparative benchmarking to drive ongoing efficiency and performance improvements across the sector. We will consider the different aspects of activity within the relevant sector where there is rivalry between licensees, and how the scope and extent of that rivalry might change in the future in a way that adversely affects efficiency and performance.

7.7 We will also consider whether any prejudice to our ability to make effective comparisons arising from the merger could be mitigated by use of regulatory information gathering tools or, where appropriate and in line with statutory duties, by making changes to aspects of our regulatory framework. For instance, concerns about the quality of information available from the merging licensees could potentially be overcome by making greater use of independent or external benchmarking information. We would need to consider this on a case-by-case basis, including in relation to any wider implications, for example relating to reliability of independent or external benchmarking information.

Criteria for the assessment of relevant customer benefits of a merger

7.8 In forming our opinion that we will submit to the CMA, we will use the following criteria to evaluate RCBs and determine their relative certainty:

Criterion one: Are there any potential RCBs associated with the merger?

Criterion two: Are the potential RCBs directly and predominantly attributable to the merger?

Criterion three: Is there compelling evidence on the likelihood, extent and duration of delivering potential RCBs within a reasonable period?

Criterion four: Are the merging parties willing and able to give assurances (and provide evidence) that potential RCBs will be delivered and passed on to customers?

Each criterions is *equally relevant* to our assessment of the RCBs, and we will not assign differential weights to any of them.

How we will assess any RCBs against these criteria

7.9 As part of our assessment of RCBs, we are required to consider whether any prejudice that we have identified is outweighed by RCBs. We do not expect this to be a straightforward comparison between two sets of monetary values. Given the timeframes available for our assessment, 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 quantitative as well as qualitative considerations on both sides. Given this, our assessment of whether any prejudice is outweighed by RCBs is likely to involve some exercise of regulatory judgement.

7.10 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 2 investigation; and b) our principal objective is to protect the interests of consumers, we would require compelling and detailed evidence that the RCBs proposed outweigh any prejudice arising from the merger.

7.11 In light of our principal objective and statutory duties, our assessment will focus on RCBs that are likely to accrue in present and future energy consumers in Great Britain.

7.12 Our assessment of RCBs will be based on a comparison between the merger and one or more counterfactual scenarios that are internally consistent with the scenarios that we look at for the purposes of assessing the impact of the merger on our ability to make effective comparisons.

7.13 Criterion one considers whether the merger is expected to lead to benefits that meet the statutory tests to qualify as RCBs. This includes an assessment of

whether the benefits are in the form of lower prices, higher quality or greater choice of goods or services in any market in Great Britain; or greater innovation in relation to such goods and services. 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.

7.14 Criterion two relates to the establishment of a direct causal relationship between any RCBs and the merger. We will consider the quality of evidence to support the view that the RCBs arise as a direct consequence of the merger and would not accrue to customers in the absence of the merger.

7.15 Criterion three relates to the quality of evidence available to us on RCBs that might arise from the merger. We would expect the merging parties to provide, as part of their merger impact assessment submission, clear evidence to support our assessment of the RCBs arising from the merger. The submissions should set out the assumptions made and analysis undertaken in a clear and transparent manner, allowing us to review and reproduce the results where appropriate. We do not expect to treat forecasts or projections of cost savings or performance improvements as evidence by themselves and would look for the merging parties to explain the reliability of those forecasts/projections.

7.16 Criterion four relates to specific measures aimed at ensuring that RCBs are passed on to customers. We would place significant value on those RCBs that are backed up by evidence and assurances from the merger parties.

7.17 In assessing the RCBs, we will consider the likelihood that RCBs are passed on to customers now and in the future, taking account of any evidence and assurances presented by the merging parties. The greater the scope and extent of RCBs covered by those commitments, the greater the likelihood in our view that the RCBs will be passed on to customers. We are likely to have lower confidence in claimed benefits where merging parties do not provide compelling evidence and assurances.

8. Undertakings in lieu of a Phase 2 reference

UILs must remedy, mitigate or prevent the prejudicial effect of a merger on our ability to make comparisons. When considering UILs, the CMA will have regard to the need to achieve as comprehensive a solution as reasonable and practicable to address the prejudicial effect on our ability to make comparisons.[38]

8.1 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.

8.2 As part of our assessment of the impact of any UILs, we will expect the merging enterprises to provide clear evidence that the proposed actions are likely to mitigate, remedy or prevent the adverse impacts of the merger on our ability to make comparisons between energy network enterprises. We would also look for such UILs to include arrangements to support our ability to monitor compliance with the undertakings, as well as providing effective and proportionate redressal mechanisms in the event of non-compliance.

8.3 When providing an opinion on UILs, Ofgem will take account of the following:

a) The expected impact of the proposed actions on any adverse effects of the merger on our ability to make comparisons.

b) The extent to which their evidence provides us with confidence that the impacts of those actions will materialise.

c) The duration over which the impacts of any undertakings can be expected to persist.

d) The extent to which we are able to effectively monitor compliance with the undertakings and the level of any additional costs to us of doing so.

e) The appropriateness of any redressal mechanism proposed by the merging enterprises in the event of non-compliance.

[38] Section 73(3B) and 73(3C) of the EA02.

9. Phase 1 energy network merger investigation process and Ofgem's expectations of merging parties

Overview

9.1 There are three main stages to the Phase 1 investigation process:

a) Pre-notification: In the pre-notification Phase, merging parties are encouraged to discuss the merger with both Ofgem and the CMA. The parties are encouraged to reach out to both the CMA and Ofgem at the same time. There is no formal time limit on these discussions, so merging parties are encouraged to open dialogue with Ofgem and the CMA at the earliest opportunity in respect of merger impacts and UILs to enable all parties to consider their positions ahead of any formal notification to the CMA and any Phase 1 investigation. At this stage, the CMA and Ofgem will discuss the transaction with the parties, including the relevant information required from the parties necessary to start the investigation.

   If requested, we may provide informal advice on a potential transaction, but this will not endorse any particular view put forward by the merging parties, nor be binding on Ofgem.

b) Phase 1 investigation: In the Phase 1 investigation, the CMA will consider whether the merger will prejudice Ofgem's ability to make comparisons and whether RCBs arising from the merger would outweigh this prejudice. The CMA must request and consider Ofgem's opinion on these issues. Ofgem must provide its opinion in accordance with its Statement of Methods. If the merging parties have raised UILs by this stage of the process, the CMA must also consider Ofgem's opinion on the effect of those UILs.

c) Consideration of UILs of a Phase 2 reference: If the CMA concludes that a merger prejudices Ofgem's ability to make comparisons between energy network enterprises, and that this prejudice is not outweighed by RCBs, the merging parties will have the opportunity to propose UILs to offset that prejudice. If UILs are proposed, the CMA must request and consider Ofgem's opinion on these undertakings before determining whether the UILs offered are sufficient to offset the prejudice.

9.2 For the avoidance of doubt, the ultimate decision on whether there is a requirement to undertake a Phase 2 investigation, and which (if any) UILs to accept, rests with the CMA after considering Ofgem's opinion.

9.3 Given the short timescales for the Phase 1 investigation and the need for robust analysis, it is important that merging parties meaningfully engage with the CMA and Ofgem throughout the entire merger investigation. The Phase 1 investigation process and timetable are provided in Annex Two of the present document.

We would expect the merging parties to submit a merger impact assessment document and any other relevant information in the pre-notification discussions, as is further explained in the table of Annex One to the present document.

Pre-notification discussions

9.4 Pre-notification discussions take place when the parties to a merger have decided to notify a merger and wish to engage with Ofgem and the CMA in advance of its formal notification. During this period, the merging parties are expected to develop and share with us a draft merger impact assessment, which will set out the expected impact of the merger and will have regard to the present document and Statement of Methods.

9.5 Due to the complexity of the energy network regulation, the pre-notification process can help Ofgem as well as the CMA case team to better understand the issues that might arise under the relevant merger situation. Discussions in advance can be used to clarify the information that the CMA and Ofgem require from the merging parties in order to start the investigation. This can help reduce the amount of information that is provided at notification and streamline subsequent information requests to the merging parties during the investigation.

9.6 More detailed discussions will benefit both regulators' performance of their functions under the special energy network merger regime. Ofgem will expect parties to engage openly and meaningfully and maximise the regulator's opportunity to consider at this early stage any likely impact that the merger could have on Ofgem's ability to use comparators when setting price controls. Given the short timescale for the Phase 1 investigation, pre-notification discussions are also important to the parties to the merger as they can assist them with submitting a

well-formed merger notice and final merger impact assessment submission to us.[39]

9.7 In certain cases, it may be appropriate to discuss potential UILs during pre-notification, particularly where the merging parties acknowledge that the merger may prejudice Ofgem's ability to use comparative regulation.

Ofgem will not make any pre-notification discussions public. However, during this period and throughout the investigation, information may be shared between Ofgem and the CMA. This will be further detailed in the Memorandum of Understanding between the CMA and Ofgem. We expect to publish it alongside, or shortly afterwards, our final version of the Statement of Methods. Please also refer to the relevant paragraphs of the CMA's Special Energy Merger Guidance.

9.8 The pre-notification process can assist both us and merging parties in a number of ways:

a) It provides us with details on the merger, including its rationale and potential benefits.

b) It allows the merging parties to seek clarification on our process and to take account of the information we require to assess the merger's impact on our ability to make comparisons and RCBs as part of the formal merger impact assessment submission by the merging parties.

It allows the merging parties to provide the preliminary evidence they intend to submit and allow us to provide informal advice on these submissions, where appropriate, as well as to allow the formal submission to be well informed. Any informal advice will:

a) be made on an informal 'without prejudice basis' and will not fetter our discretion to submit our formal opinion to the CMA,
b) be made on a strictly confidential basis,
c) will not provide agreement in principle on a merger, nor endorse a particular view put forward by advisers, nor will it be binding, and
d) be restricted to a limited number of occasions so that informal advice is not iterative, although other informal pre-notification discussions are not limited.

[39] For further information on the benefits of pre-notification, please see Chapter 6 (para 6.18-6.19) of the Mergers Guidance of the CMA's Jurisdiction and Mergers: https://www.gov.uk/government/publications/mergers-guidance-on-the-cmas-jurisdiction-and-procedure

It allows the merging parties to discuss with us any potential UILs that could prevent, remedy or mitigate any prejudice to our ability to make comparisons. We are particularly ready to engage with parties who acknowledge that the merger might create potential issues and wish to seek advice on how to resolve these.

Phase 1 investigation

9.9 Phase 1 starts on the first working day after the CMA confirms to the merging parties that it has received sufficient information to enable it to begin its investigation.[40] Ofgem expects that, on day one of a Phase 1 investigation, it will have received all information that the merging network enterprises wish to be considered including their final merger impact assessment submission.

9.10 At this stage, we will review the formal **merger impact assessment submissions** of the merging parties. The merging parties' submissions that comply with our Statement of Methods are likely to have the most weight. To this end, energy network enterprises, when developing their submissions, should consider whether the merger could prejudice our ability to make comparisons under the criteria set out in this document and after having considered Table One (Annex One): Our expectations of the contents of the merger impact assessment submission.

9.11 The onus is on the merging parties to provide enough evidence and a robust and thorough analysis to justify why the merger investigation should not proceed to Phase 2.

Information requests and exchange of information between Ofgem and the CMA

9.12 To minimise the burden on merging parties, where appropriate, Ofgem and the CMA will coordinate information requests. In addition to relying on the 'gateways' for information exchange in Part 9 of the EA02 and Section 105 of the Utilities Act 2000 ("**UA00**"), the CMA has indicated in their Special Energy Merger Guidance, that it may request a waiver from the merging parties to allow disclosure of information to Ofgem.

[40] Section 34ZA EA02

9.13 In order to assist our assessment of the merger submissions, we may request additional or more comprehensive information than it is provided in the initial merger impact assessment submission (despite the fact that the initial information might have been sufficient for the CMA to initiate the Phase 1 investigation). In this case, Ofgem will ask for any such additional information or documents as soon as it is clear they will be necessary. Given the short timeframe of a Phase 1 investigation, Ofgem might require the submission of such additional information at short notice.

Network licensees are encouraged to provide Ofgem with information that we reasonably require for the purposes of carrying out our regulatory functions under relevant statutes (including the UA00, EA89, GA86), including our functions of advising the CMA.[41]

9.14 We would expect to share relevant information provided to Ofgem with the CMA. The CMA and Ofgem may, where appropriate, discuss with each other energy network merger issues that the merging parties bring to their attention; informal advice they will be providing or have provided; pre-notification drafts; and information obtained throughout the Phase 1 investigation.

9.15 To assist the functions of both the CMA and Ofgem in this tight timeframe of the Phase 1 investigation, parties are encouraged to send all information to Ofgem and the CMA at the same time. Any disclosure of information between Ofgem and the CMA, and any use by the recipient of such information, shall only be to the extent permitted by law, including by reference to the provisions of Part 9 of the EA02 and section 105 of the UA00.

9.16 We will continue to engage with and request information from the merging parties as appropriate until we submit our final opinion to the CMA. We will also continue to engage with the merging parties throughout the Phase 1 process on potential UILs that may allow a reference to Phase 2 to be avoided.

[41] See, for example, Standard Licence Condition B4 of the Electricity Transmission Standard Licence Conditions: https://www.ofgem.gov.uk/sites/default/files/2023-03/Electricity%20Transmission%20Consolidated%20Standard%20Licence%20Conditions%20-%20Current.pdf

9.17 The level of engagement with the merging parties and their advisers will depend on the individual circumstances of the merger in question. A series of communication routes, including emails, conference calls and meetings might be used. We encourage merging parties and their advisers to liaise closely with our merger team during the lifetime of the case. Ideally, this process should start with pre-notification discussions.

Decision-making process

9.18 We will assess the merging parties' submissions based on our Statement of Methods, taking into account the evidence they have provided. We will provide our opinion to the CMA. The decision on whether to refer a merger to Phase 2 investigation rests with the CMA.

9.19 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 2. Merging parties will receive a non-confidential version of Ofgem's opinion together with the issues letter.

Undertakings in lieu

9.20 Notifying parties can provide draft UILs as part of the merger impact assessment submission or during the Phase 1 investigation. We strongly recommend that, where notifying parties consider that there may be concerns with the impact of the merger on our ability to make comparisons, they should consider possible UILs during the pre-notification Phase and include proposals as part of the merger impact assessment submission. It should be emphasised that although we will provide our opinion to the CMA on any UILs offered by the parties, the final decision on whether the UILs are acceptable rests with the CMA and not with Ofgem. Ofgem will also publish a non-confidential version of its opinion on UILs on its website. As noted in Appendix 2, annex 2, Ofgem will provide the CMA with a confidential and non-confidential version of its opinion; the parties will receive the non-confidential version when they receive the issues letter.

Phase 2 investigation

9.21 If the CMA decides to refer the merger to a Phase 2 investigation, the process for the energy merger investigation will follow the same procedure as general merger

investigations. For more information about the Phase 2 process please refer to the CMA Guidance.[42]

9.22 In contrast to a Phase 1 investigation, Ofgem does not have a statutory role in a Phase 2 merger investigation. However, it is very likely that Ofgem will be asked by the CMA to continue working closely with them and provide its independent, expert views throughout a Phase 2 investigation. However, the final decision on the Phase 2 investigation rests entirely with the CMA.

[42] https://www.gov.uk/government/publications/mergers-guidance-on-the-cmas-jurisdiction-and-procedure

Appendix 1 Merger Impact Assessment Submission

Table 1: Our expectations of the contents of the merger impact assessment submission

Topic area	Expected contents
Background information	Relevant context and background information on the merger. This must include: • Names and a brief description of the merging enterprises including whether they hold a licence issued under section 7 of the GA86, 6(1)(b) and 6(1)(c) of the EA89. • If one or more of the merging enterprises does not hold a licence issued under section 7 of the GA86, 6(1)(b) and 6(1)c of the EA89, the names of any entities holding a licence issued under section 7 of the GA86, 6(1)(b) and 6(1)c of the EA89 that are owned or controlled by either of the merging enterprises.
Assessment of whether the merger could prejudice our ability to make comparisons	Views of the merging enterprises, along with supporting evidence, analysis and assumptions, on the potential impact of the merger on our ability to make comparisons between network enterprises in carrying out our functions. This must include, but not be limited to, views relating to our criteria for the assessment of the merger. Specifically, this should include: **Criterion 1**: whether the merger could lead (or has led) to a loss, or a deterioration in the quality, of information available to us on a) the relationship between costs and performance; and b) exogenous drivers of costs and performance such as regional factors (e.g., urbanity, sparsity). **Criterion 2**: whether the merger could lead (or has led) to a loss, or a deterioration in the quality, of information collected and reported to us on good performance and efficient levels of costs. **Criterion 3**: whether the merger could lead (or has led) to a reduction in the diversity of management approaches and practices in a way that adversely affects the availability of information of good performance and efficient levels of costs. **Criterion 4**: whether the merger could lead (or has led) to a reduction in rivalry between network enterprises in a way that adversely affects the incentive of individual licensees to pursue performance improvements and costs efficiency. To the extent feasible, quantitative estimates (in monetary terms) of the impact of the merger on consumers, along with an explanation of the analysis and assumptions used. Please include any spreadsheets used to produce the estimates.

Topic area	Expected contents
Assessment of the extent of RCBs arising from the merger	A detailed explanation of any RCBs, including but not limited to lower prices, higher quality or greater choice of goods or services or greater innovation, expected from the merger along with supporting evidence, analysis and assumptions, on any RCBs expected to arise from the merger on our ability to make comparisons between network enterprises in carrying out our functions. The following is of particular relevance to our assessment criteria: **Criterion one**: Are there any potential RCBs associated with the merger? **Criterion two**: Are the potential RCBs directly and predominantly attributable to the merger? **Criterion three**: Is there good evidence on the likelihood, extent and duration of potential RCBs? **Criterion four**: Are the merging parties prepared to make binding commitments that would ensure that potential RCBs are passed on to customers? In assessing the RCBs, we will consider the likelihood that RCBs are passed on to customers now and in the future, taking account of any evidence and assurances presented by the merging parties. The greater the scope and extent of RCBs covered by those commitments, the greater the likelihood in our view that the RCBs will be passed on to customers. We are likely to have lower confidence in claimed benefits where merging parties are not prepared to provide compelling evidence and give relevant assurances. To the extent feasible, quantitative estimates (in monetary terms) of the RCBs arising from the merger, along with an explanation of the analysis and assumptions used. Please include any spreadsheets used to produce the estimates.
Assessment of whether RCBs outweigh any prejudice	The views of the merging enterprises on whether the RCBs arising from the merger outweigh the prejudice to our ability, in carrying out our functions, to make comparisons between energy network enterprises. Any supporting evidence, analysis and assumptions used to arrive at those views.

Topic area	Expected contents
Undertakings in lieu	Details of any undertakings in lieu that the merging enterprises are prepared to offer, along with an explanation of how, and the extent to which, the undertakings offset or outweigh any remaining prejudice to our ability to make comparisons in carrying out our activities after taking account of the RCBs arising from the merger. Any supporting evidence, analysis and assumptions that the merging enterprises have relied upon to arrive at their views. What arrangements will be put in place to ensure compliance with the undertakings over the relevant duration including any redressal mechanisms for non-compliance. Explain how the merging enterprises will support our ability to monitor and enforce compliance.

Appendix 2 Annex 2 – Phase 1 Investigation process and timetable

A2.1 The table below sets out the expected timetable for principal stages and Phase 1 investigation process. This is also based on the application of section 34ZA of the EA02 on the energy network mergers. This is in line with the table included in the **CMA's Special Energy Merger Guidance**.

Table 2: Principal stages and interaction between the CMA and Ofgem during a Phase 1 investigation

Day[43]	Stage	CMA	Ofgem
Typically at least two weeks before notification	Pre-notification	Merging parties to contact Ofgem to identify potential merger and discuss merger process. Merging parties are encouraged to contact the CMA at the same time. Merging parties submit their draft merger impact assessment. The CMA and Ofgem discuss the transaction with the parties, including the relevant information required from the parties necessary to start the investigation.	
1	Commencement of Phase 1	The CMA publishes on its webpage the notice of commencement of the Phase 1 investigation.	Ofgem will receive the complete and final merger impact assessment from the merging parties. Merging parties should provide confidential and non-confidential versions of the merger impact assessment.
1	Information gathering	The CMA and Ofgem will continue to liaise with the parties throughout the 40 working day period and request further information as appropriate.	
1-10	Invitation to comment	The CMA will publish a notice on its webpages inviting views from third parties. The CMA will provide Ofgem with any responses received by third parties that are relevant for its assessment.	
15–20	State of play meeting	The CMA will hold a 'state of play' discussion with the merging parties.	Ofgem will attend the state of play meeting. Ofgem will provide the CMA with a draft opinion on the transaction no later than day 15.
Phase 1 decision (for cases raising no serious concerns)			

[43] Working days.

By day 40	Phase 1 decision (for cases raising no serious concerns)	CMA clears the transaction and issues a clearance decision.	
Phase 1 decision process (for cases raising more complex or serious concerns)			
By day 40 but typically no earlier than day 25	Issues letter	CMA will share and discuss the issues letter with Ofgem before sending it to the merging parties. CMA sends an issues letter to the parties. CMA organises an issues meeting.	Ofgem provides the CMA with its final opinion on the issues raised by the merger no later than two working days before the issues letter is sent to the parties. Ofgem provides the CMA with a confidential and non-confidential version of its opinion; the parties will receive the non-confidential version when they receive the issues letter.
	Issues meeting	The CMA will consider any response Ofgem subsequently makes to the parties' response to the issues letter. The CMA may ask Ofgem to provide supplementary information in relation to its opinion or additional evidence submitted by the parties.	Ofgem will attend the issues meeting. Ofgem will be available to meet the CMA case team and explain the reasoning and analysis in its advice. Where appropriate, Ofgem will provide the CMA with its reply to the parties' response to the issues letter and issues meeting.
By day 40	Phase 1 decision (for cases raising more complex or serious concerns)	CMA holds an internal case review meeting.	
		CMA publishes notice of its decision (whether the test for reference has been met).	

After day 40	Publication of the decision	At a later date the CMA will publish a full non-confidential decision.	Ofgem will issue a non-confidential version of its opinion to the CMA following the publication of the CMA's full decision.
Undertakings in lieu of a reference			
Before day 40	Preliminary discussion on UILs	The CMA will inform Ofgem as soon as practical of any material discussions on UILs. The CMA will share with Ofgem any relevant information provided by the parties on potential UILs.	(Where appropriate) Ofgem may attend meetings and/or calls between the CMA and the merging parties when discussing UILs. Ofgem will provide the CMA with a written or oral provisional opinion[44] on any potential UILs that have been raised by the parties.
0–5 days after reference decision	Parties offer UILs	If no UILs are offered within 5 days of the decision the CMA will refer the merger for a Phase 2 investigation. CMA will share with Ofgem UILs offered.	
0–10 days after reference decision	Consideration of the UILs	The CMA considers the UILs and Ofgem's provisional opinion and makes a decision whether to provisionally accept or reject the UILs offered.[45]	Ofgem provides the CMA with a provisional opinion on the UILs offered by the parties no later than 9 days after the reference decision.

[44] This provisional review may not reflect Ofgem's final formal view.

[45] Where there is a disagreement between the CMA and Ofgem on the UILs offered, the CMA will inform Ofgem before it takes its final decision. Where UILs proposed by the merger parties are rejected by the CMA the merger will proceed for a Phase 2 investigation.

Within 50 days of the reference decision	Agreement and acceptance	The CMA gives detailed consideration to the UILs offered and publishes draft UILs for comment. If UILs are agreed the CMA publishes notice of acceptance; if not the transaction is referred to Phase 2.	Ofgem submits its final opinion to the CMA on the UILs offered by the parties no later than two days before the consultation period begins.