Response to Ofgem's Consultation: *Ofgem's approach to energy network mergers and statement of methods*

NORTHERN POWERGRID'S KEY POINTS

- Efficient ownership structures are beneficial for consumers. When the right companies own and operate the right businesses, they deliver better performance at a lower cost.
  - Regulators should only interfere in the market determining this when it is clear that otherwise the outcome would be detrimental for consumers.
  - The new regime for assessing energy network mergers recognises this high hurdle. Before intervening, the CMA must be satisfied both that:
    - the merger would *substantially* prejudice Ofgem's ability to make comparisons between networks; and
    - that this is not outweighed by other benefits.
- Ofgem is wrong to start from the presumption that a merger will have a negative impact on its ability to perform meaningful benchmarking.
  - Changes in ownership will not alter the number of ring-fenced licensees.
    - There will be no change in the amount of information Ofgem receives and no material reduction in the quality of the information for the majority of cost and output categories.
  - For those areas where a merger would result in Ofgem receiving less varied information, it is not necessarily the case that this would substantially prejudice Ofgem's ability to compare networks.
    - For example, the move from seven to six owners in electricity distribution did not cause any substantial prejudice. It is not clear a change from six to five would do so either.
    - Ofgem has a wide array of tools available to it when comparing network companies.
- Ofgem's statement of methods should set out how it will seek to seek to "quantify the impact of the merger on existing and future consumers in monetary terms".
  - The consultation is essentially silent on this.
  - A stylised example, from a simple yardstick regime, illustrates that there would be less than a 3.5p.p loss of incentive power when moving from six to five comparators.
- Instead, Ofgem has set out four high level criteria for assessing the impact of a merger on its ability to compare networks, which it states are all equally relevant.
  - The criteria are duplicative and/or not strictly relevant to assessment, and will therefore overstate any negative impact.
- Yet, when it comes to assessing the upside to consumers of any merger, Ofgem's approach is unduly restrictive and is likely to understate any benefits.
- Overall, Ofgem's approach is skewed inappropriately against mergers and, if implemented as set out here, we do not believe it is likely to assist the CMA in striking the right balance.

Efficient ownership structures are beneficial for consumers. When the right companies own and operate the right businesses they deliver better performance at a lower cost.

1. Regulators should only interfere in the market determining this when it is clear that otherwise the outcome would be detrimental for consumers. The new regime for assessing energy network mergers recognises this high hurdle. Before intervening the CMA must be satisfied both that (i) the merger would substantially prejudice Ofgem's ability to make comparisons between networks and (ii) that this is not outweighed by other benefits.

Ofgem is wrong to start from the presumption that a merger will have a negative impact on its ability to perform meaningful benchmarking.

2. Changes in ownership will not alter the number of ring-fenced licensees. There will be no change in the amount of information Ofgem receives and no material reduction in the quality of the information for the majority of cost and output categories. Companies are required to report costs at a licensee level, the number of licensees under any comparative benchmarking would not change. Companies are obliged to allocate consolidated company costs appropriately between licensees under single ownership.
3. For those areas where a merger would result in Ofgem receiving less varied information, it is not necessarily the case that this would substantially prejudice Ofgem's ability to compare networks. For example, the move from seven to six owners in electricity distribution did not cause any substantial prejudice. It is not clear a change from six to five would do so either. Ofgem has previously recognised this when awarding price control settlements, and in taking no other steps than recalculating cost sharing splits as a form of "merger tax". Following WPD moving from two to four licensees in April 2011, Ofgem amended the IQI mid-period with "no other steps … taken to reduce allowed revenues in the form of a merger tax". Additionally, Ofgem recalculated the IQI with a low impact from the merger. WPD was 51% for DCPR5, with Central Networks 47%, and it ended up being 49% when taking the four into account.
4. Ofgem has a wide array of tools available to it when comparing network companies. Ofgem currently effectively regulate the GDN sector despite fewer licences and ownership groups with ostensibly similar models and sound outcomes. All the evidence suggests that the DNO sector could see further consolidation without there being any substantial harm to Ofgem's ability to undertake comparative benchmarking, and a policy that is unduly cautious around such mergers will simply deny customers the potentially material and enduring benefit of economies of scale and scope.

Overall, Ofgem's approach is skewed inappropriately against mergers and, if implemented as set out here, we do not believe it is likely to assist the CMA in striking the right balance.

5. Ofgem's statement of methods should set out how it will seek to seek to "quantify the impact of the merger on existing and future consumers in monetary terms". The consultation is essentially silent on this. A stylised example, from a simple yardstick regime, suggests less than 3.5p.p loss of incentive power would arise from a six to five merger.

	Company share of yardstick	Implied incentive strength
Six companies	16.7%	83.3%
Five companies	20.0%	80.0%
Assumed lost incentive power		3.3p.p

Figure 1: Stylised example of a yardstick regime

6. Under a yardstick regime, companies are incentivised to find cost efficiencies that in turn lower their share in the yardstick. The company benefits from the difference between their efficient cost and the new yardstick value. In this framework we can characterise the strength of the incentives as the benefits retained from each saving. The company share of the yardstick (i.e., amount of the whole) sets the power of the incentive. We set out calculations for a notional yardstick with the number of companies reducing from six to five, showing the lost incentive power being only 3.3p.p.

7. Instead, Ofgem has set out four high level criteria for assessing the impact of a merger on its ability to compare networks, which it states are all equally relevant. The criteria are duplicative and/or not strictly relevant to assessment, and will therefore overstate any negative impact.

8. Criteria one and two are very similar in that they relate to Ofgem's ability to assess "what does good look like?". It is difficult to envisage how an assessment that a merger caused harm in one category would not automatically be reflected in both. Criterion two is the only real test here, with criterion one simply duplicating rather than adding.

9. Further, and, for the sake of argument, accepting Ofgem's basis of concern, criteria three and four would impact future network performance, rather than impact Ofgem's ability to make comparisons. It is Ofgem's ability to compare that is the only relevant test.

10. The detrimental impact to benchmarking test is that the merger must "substantially prejudice" Ofgem's ability to compare networks, yet Ofgem has presumed all mergers will reduce its ability to do so, included criteria that do not go to its ability to do so and omitted from its four criteria any reference to how it will quantify the extent of any prejudice.

11. Yet, when it comes to assessing the upside to consumers of any merger, Ofgem's approach is unduly restrictive and is likely to understate any benefits. Any benefit of a merger requires "compelling evidence", measured over a "reasonable period", that is "directly and predominantly attributable" to the merger, arbitrarily requires that the benefits persist for the same amount of time as the reduction in Ofgem's ability to benchmark, and completely ignores the factors which would justify a presumption that there will be benefits (e.g. economies of scales).

12. Overall, Ofgem's approach is skewed inappropriately against mergers and, if implemented as set out here, we do not believe it is likely to assist the CMA in striking the right balance.