

August 2001

**Northern Electric plc's proposed
acquisition of Innogy Holdings plc's
Yorkshire electricity distribution
business**

A consultation paper

1. Introduction

Purpose of this document

1.1 This document:

- ◆ gives details of the proposed acquisition by Northern Electric plc of Innogy Holdings plc's Yorkshire Electricity Group plc's electricity distribution business;
- ◆ explains the merger control process for this transaction; and
- ◆ invites comments on the regulatory issues arising from the proposed transaction.

1.2 Ofgem will make recommendations to the Director General of Fair Trading in relation to the merger. In order to allow comments to be considered Ofgem needs to receive these not later than 5pm on Thursday 23 August 2001.

2. Details of the proposed acquisition

- 2.1 At present, Innogy Holdings plc (Innogy) owns, amongst other activities, Yorkshire Electricity Group plc (YEG), which holds a public electricity supply (PES) licence. Innogy holds 94.75% of YEG, whilst Xcel Energy Inc holds the remaining 5.25%. CE Electric UK plc (CEE), the holding company of Northern Electric plc (NE) is proposing to acquire Innogy's 94.75% share in the distribution business of YEG.
- 2.2 This consultation paper seeks views on the regulatory issues raised by the proposed acquisition of YEG with its distribution business by the NE group. A separate consultation paper being issued in parallel deals with the proposed acquisition of NE's supply business by Innogy, titled "Innogy Holdings plc's proposed acquisition of the electricity supply business of Northern Electric plc".
- 2.3 On 16 August 2001 the parties notified the proposed distribution business transaction to the Merger Task Force at the European Commission for a decision to clear the transaction or to refer it to Phase II of the European Community Merger Regulation.

3. Merger control process

- 3.1 Under the European Community Merger Regulation (Council Regulation 4064/89 as amended by Council Regulation 1310/97) ("the Regulation"), a merger having a Community dimension should be appraised by the Commission of the European Union ("the Commission") with a view to establishing whether or not it is compatible with the common market. Because of the parties' combined world-wide and EC turnover, NE's proposed acquisition of YEG's distribution business from Innogy appears to meet the relevant criteria for a merger having a Community dimension. The Commission has one month from the date of receipt of a complete notification to decide whether the merger raises serious doubts as to the acquisition's compatibility with the common market and, if so, whether to initiate an in-depth investigation under Phase II of the Regulation. Before the Merger Task Force reaches a decision, it will transmit copies of the notification to the competent authorities of the relevant Member States. In this case it will be the OFT, which liaises with Ofgem under the OFT / Ofgem Concordat in relation to mergers in the energy markets. The responses to this consultation will therefore be taken into account in preparing the UK's representations to the Merger Task Force.
- 3.2 Article 9 of the Regulation provides for the Commission to refer a merger to the competent authorities of a Member State on application of that Member State where:
- ◆ a concentration threatens to create or to strengthen a dominant position as a result of which effective competition would be significantly impeded in a market within that Member State which presents all the characteristics of a distinct market; or
 - ◆ a concentration affects competition in a market within that Member State which presents all the characteristics of a distinct market and which does not constitute a substantial part of the common market.
- 3.3 If a merger is referred back to the Member State under Article 9, the Member State may take only measures strictly necessary to safeguard or restore effective competition in the market concerned. Unless the Commission decides to refer the merger back to the UK, the UK will be precluded from applying its national

legislation on competition to the merger. The Commission then has exclusive jurisdiction to determine whether the proposed acquisition, with or without conditions, does or does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or a substantial part of it and accordingly whether it is, or is not, compatible with the common market.

- 3.4 Article 21 of the Regulation provides for a Member State to take appropriate measures to protect legitimate interests other than those taken into consideration by the Regulation.

4. Details of the parties

Innogy Holdings plc

4.1 Innogy was originally established to hold the UK assets of the former National Power plc. Its principal businesses are:

- ◆ **electricity generation** – the operation of seven wholly owned major power stations (and 3 minor ones) in the UK with total capacity of 8,500 MW;
- ◆ **electricity supply** – a national electricity supply business currently including the former supply businesses of YEG, Midlands Electricity and Independent Energy, supplying approximately 4.3 million domestic electricity customers;
- ◆ **electricity distribution** – pending the sale of YEG’s distribution business, Innogy owns and operates, through YEG, the distribution business serving the YEG authorised area, with approximately 2.1 million sites connected to the network;
- ◆ **metering services** – Innogy is involved, through YEG, in providing metering services. These are data aggregation, data processing, data collection meter provision and meter operation;
- ◆ **electricity and gas trading** – Innogy is involved in the sale and purchase of electricity and gas in the wholesale and forward markets;
- ◆ **gas supply** – Innogy has a national gas supply business including the former gas supply businesses of Calortex Limited, Independent Energy (principally York Gas) and YEG, supplying 1.3 million domestic gas customers;
- ◆ **gas shipper** – Innogy has four gas shipper licences; Innogy plc, npower commercial gas limited, npower direct limited and npower gas limited plus two owned by YEG; Yorkshire Energy Ltd and YE Gas Ltd; and
- ◆ **other gas activities** – YEG own a 6.97% equity stake in the Armada offshore gas field.

Northern Electric plc

4.3 NE is a subsidiary of CEE, the UK subsidiary of Mid American Energy Holdings Company, a US-based group. NE's principal activities are:

- ◆ **electricity distribution** - operation of an electricity distribution business in the NE authorised area, with approximately 1.5 million customers sites connected to the network;
- ◆ **electricity supply** - operation of an electricity supply business supplying customers in NE's authorised area as well as customers in other parts of England, Wales and Scotland, totalling some 1 million domestic electricity customers, (although in a parallel transaction NE has agreed to sell this business to Innogy);
- ◆ **electricity trading** – NE's supply business is involved in the purchase of electricity under NETA;
- ◆ **gas supply** - operation of a gas supply business both in NE's authorised area for electricity supply and in other parts of England, Wales and Scotland, supplying 0.46 million domestic gas customers, (although in a parallel transaction NE has agreed to sell this business to Innogy);
- ◆ **gas shipper** – NE holds a gas shipper licence;
- ◆ **metering services** - NE's supply business is active in operating metering services. These are in electricity data aggregation, data processing, data collection, meter provision and meter operation and a gas and water metering service; and
- ◆ **retailing of electrical and gas appliances** – through Northern Electric Retail Ltd.

5. Issues arising from the proposed acquisition

5.1 Ofgem believes that this acquisition raises 4 issues for consideration:

- ◆ regulation of distribution businesses;
- ◆ efficiency savings;
- ◆ metering competition; and
- ◆ separation of the supply and distribution activities.

The potential effect of this acquisition on each of these issues is discussed below.

Regulation of distribution businesses

5.2 As a result of the proposed transaction, the NE group will own distribution businesses in Yorkshire's and Northern's authorised areas. These distribution businesses are expected to retain their monopoly position for the foreseeable future and Ofgem has responsibilities to set and enforce performance standards and price controls for the distribution activities. In setting these standards and price controls, comparative information about the performance of different companies is important. Of the original 14 PESs responsible for distribution, 3 companies now own 2 distribution businesses each. A further 2 distribution businesses are jointly operated by one company. Whereas previously there were 14 separate owners operating distribution activities within Great Britain, should this transaction proceed there will only be 9 separate operators.

5.3 Ofgem recognises that efficiency savings can arise from mergers, but at the same time mergers reduce the quality and comparability of information available to the regulator. Moreover, mergers between distribution businesses reduce the comparators available for analysis when carrying out a review of the distribution price controls. This is because the number of different management approaches is reduced, the real number of observable data-points for an efficiency measure is reduced, and the scope for inappropriate cost allocation is increased. Ofgem invites views on whether sufficient comparators will be maintained and what compensatory action may be necessary in terms of regulation.

- 5.4 As a result of the proposed transaction NE will own two distribution businesses sharing a geographic border. Ofgem has previously discussed the issue of adjacency in considering the joint venture between TXU Europe and London Electricity. It was decided in that case that while the savings to be achieved from merging adjacent PESs might be higher or quicker to deliver it would be wrong to penalise a merger for being more efficient in this way.
- 5.5 Ofgem expects there to be some regulatory effects as a result of the merger. We will need to consider whether the proposed transaction will affect the ability of Yorkshire and NE to fulfil their duties and obligations under the Electricity Act 1989, the Gas Act 1986, the Utilities Act 2000, and its licence. We will also need to consider whether measures will be needed to ensure that Ofgem's ability to fulfil its duties under the relevant Acts are not compromised by the transaction. We would welcome any comments on this issue.

Efficiency savings

- 5.6 When looking at previous similar transactions, Ofgem has indicated that it will expect an sustained annual saving of £12.5 million (reckoned to be half of the estimated fixed costs of a single distribution business) to be rebated to customers five years after the venture or merger to reflect efficiency savings. However, Ofgem expects that in practice the efficiency savings should be greater than this, since the incentives to maximise efficiencies will have been allowed to operate freely. The £12.5 million might therefore constitute a minimum cost benefit for customers. These matters will be considered as part of the next price control. In addition, we expect that merged distribution businesses will be at the efficiency frontier.

Metering competition

- 5.7 The acquisition by NE of the Yorkshire distribution business includes the electricity metering assets but does not include its operational metering business. NE's operational metering business will be sold as part of the parallel transaction to sell its supply business to Innogy (dealt with in a separate consultation paper titled "Innogy Holdings plc's proposed acquisition of the electricity supply business of Northern Electric plc"). This leaves NE without an operational metering business. Ofgem will need to be assured that the distribution

businesses owned by NE will still be able to meet their licence obligations to provide electricity metering services to suppliers in the authorised areas of NE and YEG.

Separation of distribution and supply activities

- 5.8 Under schedule 7 of the Utilities Act 2000, PESs are preparing transfer schemes so that their new distribution and supply licences are held by legally separate companies. The existing PES licences will be modified by licensing schemes to become new standard supply and distribution licences held respectively by the PES supply and distribution successor companies. When this occurs, NE will hold 2 distribution licences, one for YEG's distribution area and one for NE's distribution area. However, if the acquisition takes place prior to this date an agency agreement between Northern Electric, as owners of the Yorkshire PES licence, and Innogy, who will be operating the supply business of YEG on behalf of NE, will be required. As in previous similar acquisitions, Ofgem will need to consider what assurances and/or amendments to the relevant licences will be required.
- 5.9 Ofgem will also need to re-consider the separation plan for the distribution business of YEG to ensure that this reflect changes in the company structures.

6. Conclusion

- 6.1 In this document Ofgem is seeking the views of interested parties on the proposed acquisition of Innogy's Yorkshire electricity distribution business by NE, so that it may make recommendations to the Office of Fair Trading, for them to include in their advice to the Mergers Task Force.
- 6.2 Responses will normally be made available in the Ofgem library unless there are good reasons why they must remain confidential. Respondents should mark any part of their response (or the whole response) which is to remain confidential, if this is the case, and where possible should consign any confidential material to appendices.
- 6.3 Comments on the proposed acquisition should be sent, by 5pm on Thursday 23 August, to:

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