ACQUISITION OF LONDON ELECTRICITY PLC
BY EdF INTERNATIONAL S.A.

A paper by the Office of Electricity Regulation

Introduction

The EU Commission announced on 27 January 1999 that, following consideration in accordance with the European Community Merger Regulation, it had cleared the acquisition of London Electricity plc by EdF International S.A., a wholly-owned subsidiary of Electricite de France (EdF). In its formal decision on this case, the Commission noted certain concerns raised by the UK Government, and confirmed that the UK may take appropriate measures to address these concerns. In this paper, OFFER sets out concerns raised by the acquisition and the measures the Director General of Electricity and Gas Supply now proposes to take.

Consultation

OFFER published a consultation paper about the regulatory issues raised by the acquisition on 7 December 1998. Responses were received from 25 interested parties, including electricity generators and suppliers, industrial consumers, the Electricity Consumers' Committees and other consumer representatives.

Nearly all respondents expressed concerns about the present arrangements relating to the cross-Channel Interconnector and barriers to entry into the French market, and the potential distortion of the UK electricity market which these imply. Because of these concerns, a number of respondents were opposed to the acquisition. A respondent representing UK coal producers said that it would be inappropriate to permit EdF to acquire London Electricity's interests in independent power producers while the latter were the subject of a complaint to the EU Commission regarding their gas contracts.

A number of respondents also raised concerns about the increase in vertical integration between generation and supply that results from the acquisition and its implications for the further development of competition in these markets. A number of respondents were of the view that it would be important to ensure adequate ring-fencing safeguards to prevent cross-subsidy and to protect London Electricity's financial resources. Some referred to the lower cost of capital that EdF enjoys by virtue of its state ownership, compared to private sector utilities, stressing the advantage this would confer on London Electricity.

OFFER's Proposals

General

Concerns about the Interconnector and the French electricity market would appear to exist independently of this merger. Also, they are not in general matters where the DGES has the ability to exercise powers or functions.

As regards competition in generation, the increase in concentration arising from EdF's acquisition of London Electricity's generation interests is small. It is not clear that the acquisition affects or prejudices the complaint about gas contracts which coal producers have made to the EU Commission.

Matters relating to EdF's cost of capital will be considered in price control reviews.

Internal Trading

OFFER shares the view that there are potentially adverse effects of the vertical integration between London Electricity's supply business and EdF's generation businesses. In 1997/98, EdF had a 5.7 per cent share of the generation market in England and Wales, measured by output. It is a member of the Pool and participates in the contracts for differences and electricity forward agreement markets. Within its own area, London Electricity is the dominant supplier to customers with demand below 100kW, and has shares of 52 per cent and 42 per cent respectively of the 100kW to 1MW and over 1MW markets.

Unless action is taken, EdF will be free to hedge a significant part of its sales of power into the Pool by means of internal trading arrangements with London Electricity. This would result in a reduction in the volume and variety of contracts for differences traded at arm's length in the market. Such internal trading arrangements might also make it more difficult to detect and prevent onerous, discriminatory or predatory pricing by London Electricity as the dominant supplier in its area.

In other cases where acquisitions have resulted in significant vertical integration between generation and supply, the DGES has issued directions to exclude the parent company's interest in generation from the calculation of the PES's own-generation limit on condition that no new contracts are entered into between the generation businesses of the group and the PES's supply business, and existing contracts are not varied. This condition obliges the PES supply business to buy and sell contracts at arm's length in the market. It would be appropriate to make a similar direction in respect of London Electricity.

Embedded Generation

OFFER is also concerned that, as a result of the acquisition, London Electricity will have incentives to discriminate in favour of EdF as regards connections to its distribution system, to the detriment of competition in generation, particularly with respect to combined heat and power, renewable energy sources and small peaking generation plant. This might be done in a variety of ways, including anti-competitive flows of information between London Electricity's distribution business and EdF's generation business, and would be difficult to police.

In some similar cases where a substantial generator has acquired a PES, OFFER has taken steps to prohibit the PES from connecting to its distribution system new generating plant in which it or any affiliate has an interest. This is intended to remove any incentive to discriminate against competitors. It would be appropriate to place a similar prohibition on London Electricity.

Ring-fence

In common with other PESs that have been taken over, London Electricity's PES licence already contains provisions to ring-fence its financial resources and prevent them being diverted elsewhere. However, at present London would be free to use its resources to invest in generation plant. This has not hitherto been a matter of concern in view of London Electricity's relatively small interests in generation. This acquisition raises the possibility, however, that London Electricity's resources could be used to finance generation projects undertaken by EdF, in the UK or elsewhere, or to meet costs and liabilities associated with its existing generating plant, including, for example, decommissioning and other costs associated with its substantial portfolio of nuclear plant.

In other cases where a PES has been acquired by a generator or where the PES has itself become a significant generator, OFFER has taken steps to remove the possibility of financial support from the PES to the generation activities, by amending the PES licence so as to place generation outside the ring-fence. It would be appropriate to take similar steps in the case of London Electricity.

Conclusion

OFFER has identified three specific areas of concern arising from the acquisition of London Electricity by EdF, relating to internal trading in electricity price hedges, connection to London Electricity's distribution system of generating plant in which the EdF group has an interest and potential diversion of London Electricity's financial resources to support EdF's generation activities. OFFER proposes to make appropriate modifications to London Electricity's PES licence to provide appropriate protections.

3 February 1999