

18 August 2000

**The sale of Swalec's supply business to
Scottish and Southern Energy plc**

A consultation paper

1. Introduction

Purpose of this document

1.1 This document:

- ◆ summarises details of the acquisition of Swalec's supply business by Scottish and Southern Energy;
- ◆ explains the merger control process for this transaction; and
- ◆ requests comments on the regulatory issues arising from the proposed transaction.

1.2 Ofgem is required to 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 25 August 2000.

2. Details of the proposed acquisition

- 2.1 Scottish and Southern Energy plc (SSE) has acquired British Energy Retail Markets Limited (BERM) from British Energy plc (BE). The acquisition of BERM by SSE was completed on 7 August 2000. The SSE group currently holds the PES licences for the Scottish Hydro and the Southern areas and generation interests.
- 2.2 BERM carries on Swalec's supply business. The supply business is currently licensed under a PES licence held by South Wales Electricity plc, which is presently owned by Hyder plc. Because of the supply and distribution elements of a PES licence can not be licensed separately, there is an agency agreement in place between South Wales Electricity plc and BERM. Under this BERM fulfils the supply obligations contained in South Wales Electricity's PES licence for the supply of customer services. There is also a contract for the supply of customer services by Hyder Services to BERM which remain in place. SSE is also acquiring the SWALEC brand, which it intends to continue to use for marketing in South Wales.
- 2.3 In parallel, BE and SSE have agreed a 10 year electricity take-off contract commencing April 2001. Under this agreement BE will sell to SSE 10 TWh per annum for the first five years, reducing to 7.5 TWh per annum thereafter. This will supersede an existing arrangement between SSE and BE.
- 2.4 BE will retain its industrial and commercial supply business with sales of approximately 8 TWh per annum, established prior to its acquisition of Swalec, together with a power purchase agreement relating to Teesside Power Ltd acquired with Swalec.

3. Merger control process

- 3.1 The Fair Trading Act 1973 provides that the Secretary of State for Trade and Industry may refer a proposed or completed merger or acquisition to the Competition Commission. It is the responsibility of the Director General of Fair Trading (DGFT) to advise the Secretary of State as to whether a merger or acquisition should be referred to the Competition Commission. Where he advises that such a reference should be made, he may also advise that the Secretary of State should invite binding undertakings in lieu of such a reference, which would remedy any adverse effects identified by the DGFT. In accordance with the concordat between the Office of Fair Trading and Ofgem, the DGFT consults the Director General of Electricity Supply (DGES) before advising the Secretary of State.
- 3.2 If a merger reference is made to the Competition Commission, the Competition Commission must consider whether the merger operates or is likely to operate against the public interest. If it concludes that the merger operates or may be expected to operate against the public interest, the Secretary of State has the power to prohibit the merger, or seek remedies. There is no power to prohibit a merger if the Competition Commission does not identify any detriment to the public interest.
- 3.3 As the merger has already been completed the DGES needs to consider what modifications are needed to the licences held by members of the SSE group, BERM and the Hyder group (especially South Wales Electricity plc) and whether any assurances and undertakings are necessary.
- 3.4 The sale of BERM by BE was unconditional. SSE has not received merger clearance for the acquisition. Should merger clearance not be given, the Secretary of State will make a reference to the Competition Commission.
- 3.5 SSE has agreed assurances to ensure that Swalec's supply business remains intact until merger clearance is granted so that should clearance not be granted, the business can be sold on. The assurances also require that until such time licence modifications are made, SSE and its subsidiaries will act as if such modifications are in place. These proposed modifications will change SSE's second tier supply licence, to prevent second tier supply to designated customers in the Swalec authorised area, and to BERM's second tier supply licence to prevent second tier supply to designated customers in the SSE and Southern PES areas. Ofgem will also seek licence modifications to Scottish-Hydro Electric and

Southern Electric's PES and second tier electricity supply licences as a consequence of this transaction.

4. Details of the Parties

4.1 SSE's principal group businesses comprise:

- ◆ the generation, transmission, distribution and supply of electricity in its authorised area of Northern Scotland;
- ◆ the distribution and supply of electricity in its authorised area of Southern England;
- ◆ the supply of electricity on a second tier basis outside the authorised areas;
- ◆ the supply of gas to customers throughout Great Britain; and
- ◆ the ownership of generation assets in England and Wales.

4.2 SSE supplies approximately 2.7 million domestic electricity customers and 0.5 million domestic gas customers. It also supplies around 9,300 non-domestic electricity customers and supplies gas to less than 10 industrial and commercial customers.

4.3 BERM's principal business comprises:

- ◆ the supply of electricity within Swalec's authorised supply area in South and Central Wales;
- ◆ the supply of electricity to customers in Great Britain outside Swalec's authorised area; and
- ◆ the supply of gas to customers throughout Great Britain.

4.4 BERM supplies approximately 785,000 domestic electricity customers and 300,000 domestic gas customers. It also supplies around 65,000 non-domestic electricity customers and supplies gas to around 4,000 industrial and commercial customers.

4.5 BE's principal activities are the generation and supply of electricity in Great Britain. It has operations overseas, principally in North America.

4.6 South Wales Electricity plc is a subsidiary of Hyder plc. It announced the disposal of its electricity and gas supply business, including its first tier electricity supply business to BE in 1999. It retains the statutory and licence obligations relating to that business. BERM

operates this business as South Wales Electricity plc's agent pursuant to an Agency Agreement.

- 4.7 Apart from the commercial arrangements noted above, SSE also purchases output from BE's Scottish nuclear stations under the Nuclear Energy Agreement (a pre-privatisation contract). This contract is due to expire in 2005 but Ofgem has announced that it aims to reduce the output subject to this contract from April 2001.

5. Issues arising from the proposed acquisition

- 5.1 The acquisition should be assessed in the context of a number of different activities:
- ◆ the supply of gas and electricity to domestic and small business customers in each of the relevant PES areas and Great Britain;
 - ◆ the supply of gas and electricity to industrial and commercial customers in each of the relevant PES areas and Great Britain; and
 - ◆ generation and wholesale trading.
- 5.2 SSE's acquisition of the Swalec supply business will make it the first supplier to own the supply businesses of three PES's. It is therefore, particularly important to assess the effect on competition of this merger.
- 5.3 SSE will have approximately 14.9% of the electricity supply sector in Britain. The table below shows the electricity and gas shares of SSE as a result of this proposed transaction in comparison with BGT, the largest independent competitor. As a result of the transaction SSE will have approximately 10% of the domestic gas and electricity supply, whereas BGT would remain 3 to 4 times bigger.

Name of Company	% share of electricity sector	% share of gas sector
Scottish-Hydro	2.7	-
Southern Energy	8.9	2.9
Swalec (BE)	3.2	1.5
SSE + Swalec	14.9	4.4
British Gas Trading	10.4	71.7
Others	74.7	23.9
Possible Total Share	100	100

The supply of gas and electricity to domestic and small business customers

- 5.4 This merger increases SSE's share of the domestic and small business electricity supply market from 11.7% to 14.9%, and the share of the domestic gas market from 2.9% to 4.4%. However, it will only slightly increase its share of the 'dual fuel' market, bearing in mind the relatively small number of Swalec 'dual fuel' customers. To assess the effect of the merger on competition, Ofgem has assessed the effect of the merger in each of the three PES areas.
- 5.5 Swalec is not competing for customers in the Scottish Hydro-Electric area, so the merger does not effect the current level of competition in this area, although it eliminates a potential future competitor. This may be a particularly relevant consideration given Ofgem's published aim that BE should become more active in marketing output from its Scottish stations in Scotland.
- 5.6 Swalec has a relatively small market share in the Southern area, although for most customers it offers one of the most competitive tariffs. The merger would eliminate these competitive offers, but the evidence suggests that Swalec has not been widely marketing this offer to customers.
- 5.7 SSE is a relatively strong competitor in the Swalec area with relatively competitive price offers. However, even with the elimination of this choice, customers will still have a choice of a range of competitive offers. Overall this merger appears to increase SSE's ability to compete in the domestic gas and electricity supply markets without removing a significant competitor.

The supply of gas and electricity to industrial and commercial customers

- 5.8 Competition in the industrial and commercial electricity supply market has been open to competition for longer than the domestic and small business electricity market. As competition has developed PES's have lost market share to new entrants at varying speeds. However, bearing in mind the relatively small number of active competitors and barriers to entry, Ofgem is concerned about the future prospects for competition, particularly for customers consuming between 100kW to 1 MW sector.
- 5.9 Between October 1998 and April 2000, SSE's market share in the Southern area fell from 54% to 49% by sites supplied and from 32% to 31%¹ by volume supplied. In the Scottish Hydro-Electric area the share by sites supplied fell from 76% to 66% and by volume supplied from 79% to 70% over the period. As with the domestic and small

¹ These figures are preliminary analysis of information supplied in response to Ofgem's April 2000, "2000 Industrial and Commercial Electricity Market Survey".

business electricity market, Swalec was not a major competitor in either of these areas over the period. Swalec's market share in its own area fell from 35% to 33% by sites supplied and 23% to 14% by volume supplied over the period of the survey. SSE was not a major competitor in the Swalec area over this period.

- 5.10 It should be noted that BE is retaining its own industrial and commercial supply business (with sales of about 8TWh per annum) established prior to its acquisition of Swalec. BE will therefore continue to be a competitor for industrial and commercial customers.
- 5.11 Until supply and distribution activities are separated as required by the Utilities Act 2000, South Wales Electricity plc's PES supply responsibilities in-area will continued be carried out by BERM. Proposed licence modifications include a condition preventing second-tier supply to designated customers in South Wales Electricity's authorised area. Swalec has already undertaken to surrender its second-tier supply licence.
- 5.12 Ofgem will also need to re-consider the separation plans for the supply businesses to ensure that they reflect the changes resulting from the merger, and to consider the need for assurances to extend to include SSE's compliance with the separation programme for supply and distribution.
- 5.13 Ofgem would welcome views on the effect of the merger on supply competition in each of the relevant PES areas and in Great Britain more generally, in both the domestic and industrial and commercial markets.

Generation and wholesale trading

- 5.14 Ofgem will need to consider the effect of the addition of Swalec's supply business to the SSE. SSE is a wholly vertically integrated company carrying on generation, transmission, distribution and supply activities. Southern's associated generation interests are already ring-fenced from its supply and distribution activities. It is for consideration whether any additional assurances, undertakings or licence modifications are appropriate in the context of the addition of the Swalec supply business to the generation and other activities of the group.
- 5.15 SSE also announced that it has entered into an agreement with BE which includes a 10 year electricity take-off contract for 10 TWh per annum for the first five years, reducing to 7.5 TWh per annum thereafter. Since the contract is parallel to the acquisition, and not part of it, Ofgem believes that issues relating to the contract should be considered separately and on their own merits from time to time. Such issues might include; its

impact on the liquidity in the wholesale market, whether the contract, taken in conjunction with the acquisition of BERM, leaves SSE in position of self-supply which licence modifications applied to BE following its acquisition of Swalec (preventing BE from selling its generation to Swalec's first tier customers) were designed to prevent.

5.16 Ofgem is seeking any views on the impact of the transaction on the generation wholesale trading of electricity.

6. Conclusions

- 6.1 The acquisition of Swalec's supply business may represent a further concentration of supply interests within a vertically integrated group. Ofgem is seeking the views of interested parties so that the Director General of Electricity Supply may make his recommendations to the Director General of Fair Trading. Comments will be placed in the Ofgem library for public access, unless marked confidential.

Comments on the proposed acquisition should be sent by 25 August 2000 to:

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