

**November 2002**

**Powergen plc's completed acquisition of the  
UK assets of TXU Europe Limited  
A consultation paper**

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# 1. Introduction

## *Purpose of this document*

1.1 This document:

- gives details of Powergen plc's completed acquisition of the UK assets of TXU Europe Limited;
- explains the merger control process for the transaction; and
- requests comments on any regulatory and competition issues arising from the transaction.

1.2 Ofgem will make recommendations to the Director General of Fair Trading (DGFT) in relation to any competition issues arising as a result of the transaction, and will also consider whether the transaction has any implications for the way in which Ofgem carries out its regulatory functions. The DGFT may then make recommendations to the European Commission. In order to allow comments to be considered Ofgem must receive these **no later than 5pm on Tuesday 26 November 2002.**

## **2. Details of the completed acquisition**

- 2.1 Powergen UK plc (Powergen) acquired the UK electricity and gas supply business and the UK generation assets of TXU Europe Group plc (TXU Europe) on 21 October 2002. The transaction was valued at approximately £1.6 billion (£1.37 billion for the assets plus £245 million relating to securitised receivables).
- 2.2 Powergen (whose ultimate parent company is E.ON AG (E.ON) of Germany) is involved in the generation, distribution and supply of electricity in the UK and the shipping and supply of gas in the UK. In addition, Powergen is involved in telecommunications in the UK, providing a telephone service and an internet package "Surf & Save".
- 2.3 The transaction included much of TXU Europe's UK retail and generation assets but did not include TXU Europe's continental European businesses, its trading operation (TXU Europe Energy Trading) or all of its portfolio of contractual obligations.
- 2.4 The European Commission granted a derogation under Article 7(4) of the European Community Merger Regulation (ECMR) on 18 October 2002 allowing the transaction to proceed prior to formal notification to or approval from the European Commission. The transaction was notified to the European Commission on 15 November 2002 for a decision to clear the transaction within one month or to initiate a Phase II investigation under the ECMR.

### 3. Merger control process

- 3.1 Under the ECMR (Council Regulation 4064/89 as amended by Council Regulation 1310/97), a merger having a 'community dimension' should be appraised by the European Commission with a view to establishing whether or not it is compatible with the common market.<sup>1</sup> Powergen's acquisition of TXU appears to meet the relevant criteria for a merger having a 'community dimension' as the turnover of both TXU and E.ON satisfies the turnover requirements set out in Article 1.2 of the ECMR. Under the ECMR the European Commission has one month from the date of receipt of a complete notification to decide whether the transaction raises serious doubts as to the acquisition's compatibility with the common market (a Phase I investigation). If the European Commission concludes that there are serious doubts it can initiate an in-depth investigation of the transaction under the ECMR (a Phase II investigation).
- 3.2 The European Commission, in considering the transaction, will consult with the national competition authorities. The relevant authorities for the UK are the Secretary of State for Trade and Industry and the DGFT. The DGFT will inform the European Commission of any competition concerns that the acquisition may raise for the UK and, in preparing his advice in relation to acquisitions within the gas and electricity sectors, will consult with Ofgem. As of 3 September 2002, the Office of Fair Trading (OFT) has sole responsibility for all UK competition advice to the European Commission on cases falling to the ECMR and for decisions on whether to request the referral of an ECMR case to the UK under Article 9 of the ECMR. The Secretary of State will only remain responsible for decisions on mergers raising specific national interest considerations (such as the protection of national security).

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<sup>1</sup> A concentration which does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared compatible with the common market.

- 3.3 Article 9 of the ECMR provides for the Commission to refer a merger to the competent authorities of a Member State where, on application of that Member State:
- 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.
- 3.4 If a merger is referred back to the Member State under Article 9, the Member State may only take measures strictly necessary to safeguard or restore effective competition in the market concerned. Unless the European Commission decides to refer the merger to the UK, the UK will be precluded from applying its national legislation on competition to the merger.
- 3.5 Article 21 of the ECMR provides for a Member State to take appropriate measures to protect legitimate interests other than those taken into consideration by the ECMR—for example, national security concerns.

## 4. Details of the parties

### *TXU*

- 4.1 TXU Europe is a wholly owned subsidiary of TXU Corporation, a holding company headquartered in Dallas, Texas. The principal activities of the TXU Corporation are the provision of services in the gas and electricity sectors, energy trading, energy marketing and telecommunications. These activities are carried out by subsidiaries primarily in the United States, Europe and Australia.
- 4.2 On October 21, TXU announced an agreement by TXU Europe to sell its UK operations. Prior to the completed transaction, TXU Europe's principal businesses in GB included the following activities.
- **Electricity generation**—TXU Europe Power owned outright four generation stations in the UK, which have a combined capacity of just under 3 GW (not including Shotton, a 215 MW combined heat and power (CHP) plant which provides power to a local paper mill, exporting any excess power onto the system).<sup>2</sup> TXU also had a 13% stake in Barking Power Station, which has a capacity of 1,000 MW.
  - **Electricity supply**—in GB, TXU UK Limited, TXU Energi and TXU Direct Sales supply several million domestic customers, as well as a large number of industrial and commercial (I&C) customers.
  - **Gas supply**—wholly owned subsidiaries included NB Gas Limited and TXU UK Limited, supplying more than 1 million domestic gas customers and a significant number of I&C customers.
  - **Energy trading**—TXU Europe Energy Trading has been one of the largest energy traders in the UK.
  - **Gas shipping**—TXU Europe Energy Trading Limited shipped a small volume of gas through the NTS in 2001/02 (less than 1% of the national total).

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<sup>2</sup> Capacity figures are taken from NGC's Seven-Year Statement 2002/03.

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### ***Powergen***

- 4.3 Powergen plc is a vertically integrated energy company, primarily active in the UK and the USA. In July 2002, it was acquired by E.ON, a large, vertically integrated German company active in a total of 20 countries (including the UK and the US). E.ON's core business is in the production and/or supply of electricity and gas (although it also has interests in water, chemical products, the provision of telecommunications services, and real estate management). E.ON's primary activities in the UK are carried out by Powergen.
- 4.4 Powergen's principal businesses in the UK include:
- **electricity generation**—Powergen owns over 7 GW of registered generation capacity.
  - **electricity distribution**—through its subsidiary East Midlands Electricity distribution, Powergen distributes electricity to 2.5 million customers in the former East Midlands distribution service area.
  - **electricity supply**—Powergen supplies electricity to several million domestic and small business customers through Powergen UK plc and Powergen Retail Ltd.
  - **gas supply**—through Powergen UK plc, Powergen Retail Ltd and Powergen Gas Ltd, Powergen supplies gas to a large number of domestic and I&C customers.
  - **gas shipping**—in 2001/02, Powergen shipped less than 5% of the total gas shipped through the NTS system.
- 4.5 Powergen is also active in telecommunications, providing a telephone service and an internet access package.



## 5. Issues arising from the completed transaction

- 5.1 In examining mergers, acquisitions or other comparable transactions, Ofgem considers what effect the transaction may have on the level of competition in any part of the GB gas and electricity sectors, and on the way that it regulates these sectors.
- 5.2 In particular, a merger or acquisition might raise concerns when the transaction involves companies that have overlapping activities within GB, as the overall level of competition may then be reduced if two such companies combine.
- 5.3 In relation to Powergen's completed acquisition of TXU, Ofgem considers that it is necessary to consider the effects of the completed acquisition in relation to:
- horizontal issues
    - competition in electricity and gas supply
    - competition in electricity generation
    - gas and electricity trading
  - vertical issues
    - integration of electricity generation and supply
    - integration of gas shipping and supply
    - integration of energy trading and the rest of the supply chain
- 5.4 Ofgem's initial view is that the transaction does not raise any competition concerns in relation to Powergen's electricity distribution business.

### ***Horizontal issues***

#### ***Competition in electricity and gas supply***

- 5.5 The electricity supply sector has generally been considered as split into domestic and I & C sectors, with most suppliers active across the whole of GB (including Powergen and, before this acquisition, TXU).

- 5.6 Regional characteristics remain within the electricity supply sector, as a result of its historical organisation into 14 regional price-controlled areas. Ofgem considers that, in reviewing acquisitions involving the former PES supply businesses, it is necessary to examine what effect, if any, the completed transaction might have on competition, taking into account these regional characteristics. In considering Powergen's acquisition of TXU, Powergen's former PES region is East Midlands, while TXU's are Eastern and Norweb.
- 5.7 The industry structure at the time of privatisation was different in gas supply, with one national monopoly supplier rather than 14 regional monopolies, and has always operated on a national basis. As such Ofgem considers that it is sufficient, for the purposes of considering the effect of the completed transaction, to examine the gas supply sector on a GB basis.
- 5.8 Concentration ratios are a way of measuring the distribution of market shares in an industry or sector. They simply sum the shares of the leading companies (they can be done for any number of companies, but usually look at the top 4, 6 and/or 8). The Hirschman-Herfindahl Index (HHI) is a slightly more sophisticated measure of concentration, calculated by summing the *squared* shares of all the firms in the industry. The higher the result, the higher the level of concentration within the sector, a figure of 10,000 relating to a single supplier (or perfect monopoly). A market with an HHI between 1,000 and 1,800 is generally considered to be moderately concentrated, and a rise of over 100 points within that range as a result of a merger is often viewed as potentially raising competition concerns.<sup>3</sup>
- 5.9 The pre-merger C4s in the Eastern, Norweb and East Midlands regions were 93%, 94%, and 94% respectively. Across GB as a whole, the average regional share of the former monopoly suppliers is around 65%.
- 5.10 Given that most suppliers are active on a GB-wide basis, it may also be helpful to examine the impact of the merger on this basis. Table 1 provides an assessment of concentrations on a GB-wide basis.

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<sup>3</sup> Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, 1992.

**Table 1: Concentration in electricity and gas supply**

		ELECTRICITY		GAS	
		Domestic	Small I&C	Domestic	I&C
C4	Pre-merger	68%	68%	86%	70%
	Post-merger	76%	78%	90%	77%
C6	Pre-merger	92%	89%	95%	81%
	Post-merger	99%	98%	99%	85%
HHI	Pre-merger	1,551	1,530	4,279	1,787
	Post-merger	1,760	1,752	4,334	2,108

note: small I&C refers to all non-domestic customers without half-hourly meters (by meter numbers)—possible sub-sectors within I&C are discussed below; I&C figures for gas are Ofgem estimates and relate to supply points.

5.11 The concentration information in Table 1 is a snapshot of the gas and electricity markets in GB, which have been evolving, and are continuing to evolve, away from monopoly. The evolution of market shares over time is discussed further below.

## ***Electricity supply***

### **Domestic customers**

5.12 As a result of the completed transaction, Powergen now supplies about 5.5 million domestic electricity customers, of which the majority are in the former PES areas of Norweb, Eastern and East Midlands. As a result of the transaction Powergen becomes one of the largest domestic electricity suppliers in GB. Following the completed transaction there are eight electricity suppliers active in the domestic supply market, of which six have a significant share.

5.13 In November 2001, Ofgem published the results of its 2001 review of competition in the domestic electricity and gas supply sectors.<sup>4</sup> The state of competition was assessed across a range of indicators (including switching, price and non-price competition, market shares, barriers to entry, and actual market entry). Overall the findings of the review indicated that competition was effective, and the best way of protecting consumers' interests.

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<sup>4</sup> 'Review of domestic gas and electricity competition and supply price regulation: evidence and initial proposals' Ofgem November 2001.

## Pricing

- 5.14 In principle, prices charged by competing firms reflect both underlying costs and competitive pressures that apply in the relevant sector. The ability of a firm to price independently of its rivals, or to deter new entry by lowering its price below cost, would be considered to signal a degree of market power.
- 5.16 Ofgem analysis suggests that the average cost of supplying a domestic customer maybe around 10–14% lower (in real terms) than prices charged at market opening in 1998. The average price offered by the incumbent suppliers in their former PES areas has fallen by 8% (real) over this time, and the average of the cheapest competing offers is about 17% (real) below prices at market opening.
- 5.17 This suggests that all domestic electricity customers are benefiting from the introduction of competition. Suppliers offer keener prices out-of-area, where they are seeking to build market share, than to in-area customers. This may reflect the level of competition, although it may also reflect different market conditions in different regions which lead to different prevailing price levels.

## Switching

- 5.18 In order for competition to work effectively, it is essential that consumers are able to switch suppliers easily. The number of consumers who have switched, and are continuing to switch, show that switching is indeed relatively easy. (This finding is supported by direct consumer research, which has shown that 90% of switchers consider the process to be easy or very easy.)<sup>5</sup> Switching rates may also indicate the direction in which the structure of the market could evolve over time.
- 5.19 A distinction can be drawn between gross switching, which is the total number of customer transfers in any one period, and net switching, which is the net change in market share of a supplier in a given period.
- 5.20 In electricity, Ofgem estimates that, across GB as a whole, the average monthly total number of switches (ie, gross switching) for the last five months of 2001

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<sup>5</sup> Experience of the competitive domestic electricity and gas markets – research conducted for Ofgem by MORI – Ofgem (72/01), November 2001.

was about 620,000, and that the former monopolists lost about 240,000 net in-area customers each month (ie, net switching). Taking an average over the five months to July 2002, Ofgem estimates that there were about 470,000 gross switches per month, and about 110,000 net switches.

- 5.21 The available data indicate that the rate of switching has moderated during the last 12 months, but remains high. Ofgem estimates that around 1–2% of all customers currently change supplier each month. This level is considerably higher than in other comparable sectors, such as banking.<sup>6</sup>
- 5.22 The erosion of former monopolists' in-area market shares continues, although its pace has slowed from the levels of 2001, owing partly to a reduced rate of switching across the market as a whole, and partly to increased switching back to the in-area former monopolist. Although switching rates vary from one region of GB to another, none of the three regions in which Powergen or TXU is the largest supplier stand out as exceptional.
- 5.23 As a result of the acquisition there will only be a slight increase (less than 5%) on TXU's previous position in the Eastern and Norweb areas. Similarly, Powergen's position in the East Midlands area will only increase slightly (less than 5%). Ofgem estimates that the rate at which former monopolists' in-area market shares is currently falling is, on average across GB, between 0 and 1% per month.
- 5.24 If current rates of switching were to continue, increments of market share resulting from this transaction would be lost within a year. However, as noted above, switching rates appear to be slowing; were this trend to continue, erosion of the increment associated with this transaction would be likely to take longer.
- 5.25 On this basis, Ofgem's initial view is that the increases in regional shares resulting from the acquisition do not threaten effective competition. Ofgem would welcome views on whether the completed acquisition raises any competition concerns in the domestic electricity supply sector, either in relation to one or more of the relevant former PES supply areas, or in relation to GB as a whole.

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<sup>6</sup> 'Competition in gas and electricity supply – separating fact from fiction': Ofgem Factsheet January 2002.

## ***I & C customers***

- 5.26 Ofgem's most recent assessment of the state of competition within the I&C electricity sector took place in December 2000.<sup>7</sup> Following this assessment Ofgem concluded that competition in the I&C supply sector is developing well. However, Ofgem is committed to ongoing monitoring and review of this market sector.
- 5.27 There are several suppliers that specialise in supplying electricity to I & C customers and after the merger there are 24 suppliers active in the I & C electricity supply sector. Furthermore, Ofgem believes that I & C customers are, in general, better informed and have larger purchasing power than domestic customers.
- 5.28 Ofgem is currently investigating whether sub-sectors may usefully be distinguished within the I&C electricity sector. It may be reasonable to define markets based upon a set of behavioural characteristics such as consumption level or intensity of energy use.
- 5.29 Ofgem would welcome views on whether the completed transaction could raise any competition concerns in the I & C electricity supply sector. Ofgem would also be interested in views on whether and how the sector should be divided into sub-sectors for the purposes of this and future transactions.

## ***Gas supply***

### **Domestic supply**

- 5.30 As a result of the acquisition, Powergen supplies about 2.4 million domestic customers in GB, increasing its share of the domestic gas supply sector to 12%.
- 5.31 Ofgem considers that competition in domestic gas supply has developed well and is continuing to develop, with 11 suppliers remaining active after the completion of this transaction (of which six have significant shares). The HHI for GB domestic gas supply increases from 4,279 to 4,334 as a result of the merger.

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<sup>7</sup> *A review of the development of competition in the Industrial and Commercial electricity supply*, Ofgem, December 2000.

- 5.32 Switching levels in gas have been slowly falling over the last few months. In 2001/02 there were about 320,000 gross switches per month on average, and 67,000 net switches per month. In the six months April to September 2002, the figures had fallen slightly to 298,000 and 66,000 respectively.
- 5.33 The leading supplier (Centrica) serves well over half of customers in GB, so this merger may have a positive effect on competition by creating a more effective competitor to Centrica. In view of this, and of the level of competition in the sector, Ofgem's initial view is that the completed transaction does not raise any significant competition concerns in domestic gas supply.

### **I & C supply**

- 5.34 Following Ofgem's last review<sup>8</sup> of competition in gas supply to the I & C sector, Ofgem concluded that competition is generally well developed and that it is continuing to develop. Ofgem is committed to ongoing monitoring and review of this market sector. There are more than 20 active suppliers within the sector following the completed transaction. In view of the number of competitors within the sector, the relatively lower degree of concentration, and the nature of the customer groups, it is Ofgem's initial view that the completed transaction does not raise any significant competition concerns for I & C gas supply.

### ***Competition in electricity generation***

- 5.35 The transaction increases Powergen's generating capacity from around 8 GW to somewhat over 10 GW, and Powergen will, based on 2002/03 figures, account for around 15% of total England and Wales capacity (an increase of over 4%), and a somewhat lower share by output.
- 5.36 Competition within the generation sector has developed well and concentration is relatively low within the sector. There are more than 40 companies currently active, and the transaction does not significantly increase the degree of concentration in electricity generation.

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<sup>8</sup> 'A review of the development of competition in the Industrial and Commercial gas supply market' Ofgem August 2000.

- 5.37 Ofgem's initial view is that the transaction does not raise concerns with respect to concentration in electricity generation.

### ***Vertical Issues***

- 5.38 It is important that vertical issues resulting from the transaction are analysed in order that companies are not able to lever market power at one level to gain an advantage at another, and that there is no substantial loss of liquidity in the trading markets. Ofgem's view is that, given effective competition at the various levels of the energy supply chain, vertical integration itself should not pose a threat to competition.

### ***Electricity***

- 5.39 Before the transaction, TXU supplied significantly more electricity than it generated, and Powergen supplied roughly the same volume as it generated.
- 5.40 The transaction therefore does not appear to represent an opportunity to combine a net long position with a net short position. The combined group's requirement for external purchases is no different, and so the overall level of vertical integration across the market is unaffected (although this view is not based on an analysis of the parties contractual positions).
- 5.41 Ofgem is currently reviewing its regulation of vertical integration, and has taken an initial view that the current rules limiting wholesale contracts within a group should be removed. Ofgem's initial view with regard to the transaction is that it will not be material to a decision to remove, modify, or retain regulation of self-supply.

### ***Gas***

- 5.42 Powergen is active in both the shipping and supply of gas. In 2001/02 it shipped less than 5% of the total gas shipped through the NTS, and supplied a somewhat larger volume. TXU did not ship a significant quantity of gas. As for electricity, the combined group's requirement for external shipping is no different, so the overall level of vertical integration across the market should be unaffected.



## *Summary of Ofgem's initial views*

- 5.43 Ofgem's initial view is that the transaction does not raise any competition or regulatory concerns with respect to electricity generation, electricity distribution, or trading of gas and electricity.
- 5.44 In respect of competition in retail supply of gas and electricity, the transaction has reduced the number of major competitors to six. In assessing the possible impacts of the transaction on competition, Ofgem considers that the following could be relevant factors:
- market shares of the former monopolists continue to fall;
  - the rate of switching suggests that customers find the switching process relatively easy, which is confirmed by consumer research;
  - consumers can make substantial savings by switching, and price competition has produced a good range of offers available to all consumers; and
  - switching rates remain high relative to other industries, but have fallen in recent months.
- 5.45 Ofgem's initial view is that this transaction is not likely to place Powergen in a position of dominance, or to strengthen Powergen's existing position, as a result of which competition would be significantly threatened.

## 6. Conclusion

- 6.1 Ofgem is seeking the views of interested parties on Powergen's completed acquisition of TXU, so that it may advise the OFT on any recommendations made to the European Commission.
- 6.2 Responses will normally be made available in the Ofgem library and on the Ofgem website unless respondents request that they should 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 acquisition should be sent, **by 5pm on Tuesday 26 November 2002**, to:

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