

**Scottish and Southern Energy plc's proposed  
acquisition of Midlands Electricity plc**

**A consultation paper**

June 2003

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# 1. Introduction

## *Purpose of this document*

### 1.1. This document:

- ◆ gives details of Scottish and Southern Energy plc's (SSE) proposed acquisition of Aquila Sterling Limited (ASL), the ultimate holding company of Midlands Electricity plc (Midlands);
- ◆ explains the merger control process for the proposed transaction; and
- ◆ requests comments on any regulatory or competition issues arising from the proposed transaction.

### 1.2. Ofgem will make recommendations to the Office of Fair Trading (OFT) in relation to any competition issues arising as a result of the proposed transaction. OFT may then make recommendations to the Secretary of State. In order to allow comments to be considered Ofgem must receive these **no later than 25 June 2003**.

## 2. Details of the proposed acquisition

- 2.1. On 22 May 2003, SSE announced that it had agreed terms with Aquila and FirstEnergy for the purchase of ASL. SSE proposes to acquire ASL, the ultimate holding company of Midlands, from Aquila Sterling Holdings LLC, which is jointly owned by Aquila Inc (Aquila) and FirstEnergy Corp (FirstEnergy). The transaction values ASL at approximately £1.1 billion, which consists of £43 million to Aquila and FirstEnergy, £567 million for holding company debt, and £502 million for Midland's debt.<sup>1</sup>
- 2.2. The transaction is subject to the holders of holding company debt (the three outstanding Avon Energy Partners (Holdings) Ltd (AEPH) bonds) agreeing to accept a cash payment from ASL in consideration for the bonds.
- 2.3. SSE is involved in the generation, distribution and supply of electricity, and supply of gas, in Great Britain (GB), and gas storage. In addition, SSE owns connections, contracting, telecoms and other businesses.
- 2.4. Midlands is primarily involved in the distribution of electricity through its wholly owned subsidiary, Aquila Networks plc, which holds an electricity distribution licence in respect of a designated area comprising the greater Birmingham conurbation and the West Midlands. In addition, it has interests in electrical contracting, metering, connection and generation businesses as well as a gas supply business.<sup>2</sup>

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<sup>1</sup> Numbers from SSE's press release dates 22/05/03.

<sup>2</sup> This document previously stated that Midlands has a telecommunications business. In 2001/02, this business was shut down and so this sentence has been removed for accuracy.

### 3. Merger control process

- 3.1. This transaction falls within the scope of UK merger control law since the value of the assets taken over exceeds the £70 million threshold under the Fair Trading Act 1973 (FTA), and the transaction does not have a European Community dimension. The transaction will therefore be assessed under the provisions of the FTA and the Secretary of State for Trade and Industry may refer the transaction to the Competition Commission if the transaction may, in the Secretary of State's opinion, give rise to significant competition concerns.<sup>3</sup>
- 3.2. It is the responsibility of the Office of Fair Trading (OFT),<sup>4</sup> to advise the Secretary of State as to whether the transaction should be referred to the Competition Commission. In accordance with the concordat between the OFT and Ofgem, the OFT will consult Ofgem before advising the Secretary of State. Where the OFT recommends that the transaction should be referred to the Competition Commission, the OFT may in lieu of such a reference advise that the Secretary of State invites binding undertakings from the parties to the transaction which would remedy any adverse effects identified by the OFT.
- 3.3. If the transaction is referred to the Competition Commission, the Competition Commission has to consider whether the transaction operates, or is likely to operate, against the public interest.
- 3.4. If the Competition Commission finds that the transaction does not, or is not likely to, operate against the public interest, the Secretary of State must clear the transaction. However, if the Competition Commission makes an adverse finding, the Secretary of State may (but does not have to) take remedial action.

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<sup>3</sup> Because this merger was notified prior to June 20 2003, it will be assessed under the Fair Trading Act 1973. Mergers notified or completed after June 20 2003 will be assessed under the Enterprise Act 2002.

<sup>4</sup> On April 1 2002, the OFT was established as a corporate body by the Enterprise Act 2002 so there no longer exists the Office of the Director General of Fair Trading (DGFT).

## 4. Details of the parties

### **SSE**

4.1. Formed as a result of the merger of Scottish Hydro-Electric and Southern Electric, SSE is a large vertically integrated energy group. SSE has significant gas and electricity interests and is also involved in utility contracting, environmental control systems and electrical retailing. SSE's principal energy businesses include:

- ◆ **electricity generation**—extensive GB generation interests from a range of sources, including hydro, combined cycle gas turbine and CHP plants. SSE's total generating capacity in England and Wales is 1,834MW (which represents 2.7% of total capacity in England and Wales) and its GB capacity is 4,678MW which accounts for 6% of total GB capacity.<sup>5</sup>
- ◆ **electricity supply**—through wholly owned subsidiaries including SSE Energy Supply Limited and SSE Energy Limited. SSE's supply business includes the ex public electricity supplier businesses of Scottish Hydro Electric plc, Southern Electric plc and South Wales Electricity plc (SWALEC), and supplies around 3.5 million domestic customers and 300,000 small I&C (industrial and commercial) customers;<sup>6</sup>
- ◆ **electricity transmission**—ownership and operation of the electricity transmission system in the north of Scotland;
- ◆ **electricity distribution**—SSE distributes electricity in northern Scotland through its subsidiary Scottish Hydro-Electric plc and to southern England through its subsidiary Southern Electric plc.
- ◆ **gas and electricity trading**—involved in the sale and purchase of gas and electricity in the forward and wholesale markets;

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<sup>5</sup> Capacity numbers are from NGC's Seven Year Statement 2002/03.

<sup>6</sup> Supply figures provided by SSE.

- ◆ **gas supply**—through wholly owned subsidiaries including SSE Energy Supply Limited and Southern Electric Gas Limited. SSE supplies around 1.2 million domestic customers and 7,700 I&C customers.<sup>7</sup>
- ◆ **gas shipping**—through its wholly owned subsidiaries SSE Energy Supply Limited and Southern Electric Gas Limited.
- ◆ **metering**—SSE provides metering provision, operation and reading services within its distribution service areas.
- ◆ **connections**—SSE provides electricity connections services.
- ◆ **contracting services**—through SE Contracting Ltd, SSE undertakes electrical contracting, streetlighting and electrical engineering services.

## ***Midlands***

4.2. Midlands is wholly owned by AEPH which is owned by ASL. Midlands owns the UK operating companies Aquila Networks plc, Aquila Networks Services Ltd, Metering Services Ltd, MEB (Contracting) Ltd, Midlands Power International Ltd and Midlands Sales Ltd. Midlands's principal energy businesses include:

- ◆ **electricity generation**—through its wholly owned subsidiary Midlands Power International Ltd, equity stakes in UK and foreign generation plant. In particular, this includes a 26.7% equity stake in a 1,875 MW CCGT plant (Teeside).<sup>8</sup> This represents 0.7% of total capacity in England and Wales.<sup>9</sup>
- ◆ **electricity distribution**—Aquila Networks distributes power in its licensed area of Birmingham and the West Midlands of England.
- ◆ **gas supply**—Midlands supplies gas to a small number of customers (mainly I&C).

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<sup>7</sup> Supply figures provided by SSE.

<sup>8</sup> SSE press release dated 22/05/03.

<sup>9</sup> Based on capacity numbers from NGC's Seven Year Statement 2002.  
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- ◆ **gas shipping**—Midlands is active in gas shipping through Midlands Sales Ltd.<sup>10</sup>
- ◆ **metering**—Midlands provides data collection services and meter operating services to electricity and gas suppliers through its wholly owned subsidiary Metering Services Ltd.
- ◆ **connections**—Midlands carries out connections work in its distribution area.
- ◆ **contracting services**—Midlands provides electrical contracting services via its wholly owned subsidiary MEB (Contracting) Ltd. This contracting work consists predominantly of electrical, mechanical and public lighting services to local authorities.

### **Aquila Networks financial ring-fence**

- 4.3. Aquila Networks has guaranteed the payment of all amounts due and becoming due in respect of £150 million of debt issued by Midlands Electricity plc. Ofgem consented to the giving of this guarantee under standard condition 47 of Aquila Networks's electricity distribution licence. Ofgem's consent is subject to the condition that Aquila Networks must for so long as the guarantee remains in force be indemnified by AEPH in respect of any costs, losses or liabilities it may incur as a result of this guarantee, and that in addition AEPH must at all such times hold an investment grade issuer credit rating; in the event that AEPH should cease to hold such a rating, Aquila Networks must obtain an equivalent indemnity from another person holding an investment-grade credit rating, and, for so long as it does not have the protection of such an indemnity, must not make any payment or other transfer whatsoever to any affiliate or related undertaking (subject to certain exceptions defined in Ofgem's consent letter). On 24 December 2002, AEPH ceased to hold, and has not subsequently regained, an investment grade credit rating. Aquila Networks does not hold an indemnity from any other person and, accordingly, the restriction on transfers to affiliates or associated undertakings remains in force. Aquila Networks has maintained and

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<sup>10</sup> Please note that the original version of this document contained factual errors regarding Midlands' interest in gas shipping which have been corrected in this version.  
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continues to maintain an investment-grade credit rating, a requirement of standard condition 46 of its electricity distribution licence.

## 5. Issues arising from the proposed transaction

- 5.1. In examining proposed mergers, acquisitions or other comparable transactions it is important to consider what effect the proposed transaction may have on the level of competition present within any relevant part of the GB gas and electricity sectors, as well as any regulatory issues that would arise as a result of the transaction.
- 5.2. A merger or acquisition might raise concerns when the purchaser and the companies that it is acquiring have overlapping activities within GB as the overall level of competition within a particular sector may be reduced if two companies combine.
- 5.3. In relation to SSE's proposed acquisition of Midlands, Ofgem considers that the most obvious area of overlap is in electricity distribution but that it is additionally necessary to consider the competition effects of the proposed acquisition in relation to:
- ◆ connections;
  - ◆ metering;
  - ◆ contracting; and
  - ◆ generation

### ***Electricity Distribution***

- 5.4. Ofgem's May 2002 policy on electricity distribution company mergers<sup>11</sup> identifies a detriment to consumers that arises from the impact of distribution company mergers on comparative regulation in the sector. In order to compensate customers for this detriment, it specifies a one-off charge of £32 million payable over five years from the date of the completion of the merger and spread equally across all distribution companies in the merged group. This policy was applied for the first time in relation to the London Electricity–Seeboard merger on 20 November 2002.

- 5.5. Ofgem's initial view is that this transaction does not raise any competition issues in relation to electricity distribution or any regulatory issues in relation to electricity distribution that are not covered by its mergers policy, which it intends to apply in this case.

## ***Connections***

- 5.6. Currently the vast majority (approximately 99%) of electricity connections are performed by the local distribution company. Although the majority of connection work is contestable, some remains non-contestable and can only be undertaken by the relevant DNO. Ofgem expects competition in the provision of connections services to develop over time.
- 5.7. Ofgem's initial view is that the transaction will not have a significant impact on competition in connections, and is not likely to impede the development of competition in this area.
- 5.8. Ofgem would welcome views on any competition issues arising from the proposed transaction in relation to electricity connections.

## ***Metering***

### **Meter provision and operation**

- 5.9. Meter provision and operation are contestable activities, and Ofgem expects competition in this area to develop over time. Currently all electricity distribution network operators provide meter provision and meter operation to almost all domestic and small I & C supply points connected to their networks and this activity is regulated as part of the distribution price control.
- 5.10. Post acquisition, according to the number of customers connected to the network, SSE would provide meter provision and meter operation services to approximately 20% of all electricity supply points in Great Britain.<sup>12</sup>
- 5.11. All distribution network operators (DNOs), including SSE and Midlands, are likely to face more competition in this area in the future. At least one supply

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<sup>11</sup> *Mergers in the Electricity Distribution Sector: Policy Statement*, 1 May 2002.

company has contracted out the provision of metering services to its domestic and small I & C customers in the SSE and Midland areas. Ofgem anticipates that more suppliers will appoint alternative metering service providers in the future.

- 5.12. Competition in the provision of metering services to large I & C customers is better developed. Large I & C customers have been more active in appointing a meter operator other than the host DNO.

### **Meter reading**

- 5.13. Meter reading is competitive and electricity suppliers have been appointing their own meter readers for a number of years. Ofgem considers that competition in this area is well developed.
- 5.14. Ofgem's initial view is that this acquisition would not impact significantly on competition in meter provision, operation and reading services.
- 5.15. Ofgem would welcome views on whether the proposed acquisition raises any significant competition concerns in relation to electricity metering or meter reading.

### **Contracting**

- 5.16. Both SSE and Midlands have contracting businesses which work predominantly in electrical, mechanical and public lighting services. Public lighting is not contestable and therefore the acquisition will have no impact on competition in the supply of public lighting (or unmetered) connections. A number of firms, including general electrical and mechanical engineering service providers are active in other areas of the contracting business.
- 5.17. Ofgem's initial view is that the proposed acquisition will have no substantial impact on competition in relation to the provision of contracting services.

### **Generation**

- 5.18. If the acquisition proceeds, SSE will increase its generating capacity in England and Wales from 1834 MW (approximately 2.7% of total capacity in England and

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<sup>12</sup> SSE has approximately 20% of customers connected to its networks in its supply services area. Scottish and Southern Energy plc's proposed acquisition of Midlands Electricity plc  
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Wales) to 2335 MW (approximately 3.5% of total capacity in England and Wales).<sup>13</sup>

- 5.19. Competition in the generation sector is well developed and Ofgem's initial view is that SSE's proposed acquisition of Midlands will not result in any significant impact on competition in electricity generation.
- 5.20. Ofgem would welcome any views on any competition issues arising from the proposed transaction.

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<sup>13</sup> Based on figures from NGC's Seven Year Statement 2002.  
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## 6. Conclusion

- 6.1. Ofgem is seeking the views of interested parties on SSE's proposed acquisition of Midlands, so that it may inform any recommendations made by the OFT to the Secretary of State.
- 6.2. Ofgem intends to apply its distribution company mergers policy should this transaction proceed. Ofgem's initial view is that the transaction raises no significant competition concerns, and no regulatory issues beyond those covered by its distribution company mergers policy. In addition, Ofgem would welcome resolution of the uncertainty currently facing Midlands.
- 6.3. 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.
- 6.4. Comments on the acquisition should be sent, by 5pm on 25 June 2003, to:

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