

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

Report to the Office of Fair Trading

Introduction

On 22 May 2003, Scottish and Southern Energy Limited (SSE) announced that it had agreed terms with Aquila Inc (Aquila) and FirstEnergy Corp (FirstEnergy) for the purchase of Aquila Sterling Limited (ASL). 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.

Consultation

On 10 June 2003 Ofgem issued a consultation paper seeking views on the acquisition. One response was received to the consultation exercise. Copies of the response can be provided on request.

Since the original publication of Ofgem's consultation paper, two minor factual errors in the paper have been pointed out. The paper stated that Midlands is active in gas shipping through a number of licencees, whereas in fact it only holds one gas shipping licence – registered to Midlands Sales Ltd (para 4.2). The paper also incorrectly stated that Midlands owns a telecoms business, whereas that business was in fact closed down in 2001/02. These errors have now been corrected in the document that appears on Ofgem's website.

Ofgem's initial view

Ofgem stated in its consultation document that it intends to apply its distribution company mergers policy should this transaction proceed, to deal with regulatory issues arising in respect of comparative regulation of electricity distribution businesses. Ofgem's initial view was that the transaction raises no significant competition concerns, and no regulatory issues beyond those covered by its distribution company mergers policy. In addition, Ofgem stated that it would welcome resolution of the uncertainty currently facing Midlands.

Details of the parties

SSE

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.
- **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;

- **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;
- **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.
- **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

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). This represents 0.7% of total capacity in England and Wales.
- **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).
- **gas shipping**—Midlands is active in gas shipping through Midlands Sales Ltd.
- **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.

Issues arising from the completed acquisition

Electricity Distribution

Ofgem's May 2002 policy on electricity distribution company mergers 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 (in 2001/02 prices) 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.

Ofgem's initial view was 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

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, and does not expect the proposed transaction to significantly affect the development of competition in these services.

Metering

Meter provision and operation

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.

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.

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 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.

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

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.

Contracting

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.

Generation

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 Wales) to 2335 MW (approximately 3.5% of total capacity in England and Wales). Ofgem considers that competition in the generation sector is well developed.

Ofgem's initial view was that SSE's proposed acquisition of Midlands will not result in any significant impact on competition or the development of competition in any of the above areas.

Respondent's views

The respondent has no significant objections to the proposed transaction proceeding, although it urged Ofgem to scrutinise from a regulatory viewpoint the vertical issues arising from SSE having a significant presence in generation, distribution and supply. It is concerned that SSE might be able to use its ownership of generation and distribution to discriminate in the downstream markets. The respondent said that the focus of regulatory scrutiny in this transaction must be to continue to ensure open, transparent and non-discriminatory access to distribution networks.

Ofgem response

Ofgem agrees there should be open, transparent and non-discriminatory access to electricity distribution networks, and believes that this is currently the case in Great Britain. Ofgem further considers that this transaction will not prejudice these important principles, and that the existing regulatory regime contains safeguards to ensure that the common ownership of generation, distribution and supply does not threaten competition in either generation or supply. Ofgem will continue to use its regulatory powers to ensure that these safeguards remain adequate and effective.

Conclusion

Ofgem's view remains that no significant competition concerns arise from the proposed acquisition, and welcomes any resolution of the current uncertainty facing Midlands. Ofgem intends to apply its distribution company mergers policy should the transaction proceed.