

# **GAS DISTRIBUTION NETWORK SALE**

## **OFGEM POLICY ON FUTURE MERGERS OF GAS DISTRIBUTION NETWORKS**

### **Introduction**

During discussions with potential purchasers of the gas distribution networks (DNs), Ofgem has received a number of questions regarding its likely approach to future mergers or comparable transactions between DNs at some point after the initial sale by Transco plc (were it to proceed). More specifically, potential purchasers have queried whether Ofgem would seek to take the same approach that it has taken in electricity distribution network mergers.

This note outlines the principles Ofgem would seek to adopt in the event of any future merger or comparable transaction between two or more DNs.

### **Ofgem's objectives**

Ofgem's principal objective is to protect the interests of consumers wherever appropriate by promoting effective competition. In the case of DNs which are monopolies, the promotion of effective competition can be interpreted as building rivalry between them and making effective use of comparisons between them in setting price controls. Ofgem will, therefore, seek to ensure that customers interests are protected throughout its work on gas distribution issues.

The Authority believes that the sale of up to four DNs by Transco is, in most circumstances, likely to bring net benefits to customers. This is largely due to the additional comparative information that would be available to the regulator from which it will be able to assess more accurately the efficient level of costs a DN should incur. Importantly, a greater number of separately owned businesses provides Ofgem with commensurately more information as to what the efficient level of costs for a distribution business should be. This comparison in regulation will benefit customers as, in aggregate, the revenue that distribution businesses are permitted by the regulator to recover through charges on customers will be lower than would be the case were NGT to continue to own all of the gas distribution businesses. In turn, this should result in lower charges to customers.

The change in DN ownership will result in a number of costs being incurred by the industry. Most of these costs will be incurred by all market participants before the sale can proceed and are, for the main part, unaffected by the number of DNs sold by NGT. Hence, there could be risk, were the benefits of comparative regulation to be low, that the benefits to customers are less than the costs that are incurred by customers in the DN sale. Ofgem perceives this risk to be most acute where only one comparator emerges through the sales process.

## **Proposed “safety net” approach**

For this reason, the Authority has proposed the consumer “safety net” which would be implemented in the event that the sales process resulted in only one comparator to Transco’s gas distribution businesses. The consumer safety net would, if necessary, be implemented by means of a reduction to Transco’s allowed revenue on its National Transmission System (NTS) price control by an amount agreed ex-ante between Transco and Ofgem at the time of the next price control. While, the precise terms of the safety net are still to be agreed by Ofgem and Transco, there has been agreement in principle to the mechanism.

Accordingly, Ofgem would seek to ensure the principle of customer protection is extended to any subsequent mergers or comparable transactions between two or more gas DNs. Clearly any merger or comparable transaction of this nature would reduce the number of comparators available for comparative regulation and, therefore, have the effect of increasing the risk of a consumer detriment deriving from the sale of the DNs. Customers would not be protected from the costs of the change in DN ownership if, for instance, the independent DNs were to merge shortly after the sale by NGT

## **Ofgem approach in event of subsequent DN mergers**

It is clear that mergers or comparable transactions would reduce the scope for meaningful comparison between DNs and that this is likely to give rise to a detriment for customers. Accordingly, following a merger or comparable transaction between two or more DNs, Ofgem would seek:

- to modify the licences of each of the companies in the merged group to reduce their regulated revenue by a sum which will be spread equally across all gas distribution companies in the merged group and over a period of five years from the time the merger or comparable transaction has completed; and
- to pass back the efficiency savings that the merger or comparable transaction is expected to generate as they arise through the price control review process and not differentiate between merger savings and any other type of savings.

Ofgem would seek to apply the same treatment were NGT, for any reason, to reacquire a DN.

The precise details, including the level of any reduction of regulated revenue, would be derived at the time, but Ofgem would seek to ensure that the principle of protecting the interests of consumers is maintained. For the sake of further clarity, it is important to note that the level of any reduction in regulated revenue of DN entities would not necessarily be related to the level of the safety net agreed by Transco and Ofgem prior to the sale of the DNs.