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To: Distribution licensees, potential investors and other interested parties

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RE: Electricity Distribution Mergers

In the light of recent speculation on mergers in the electricity industry and discussion of the treatment of merger efficiencies during the last electricity distribution price review, Ofgem considers that it may be helpful to draw together certain aspects of its policy on electricity distribution mergers.

This letter only comments on Ofgem's policy relating to mergers of electricity distribution licensees and no inferences should be drawn from this letter regarding Ofgem's policy on mergers involving other licensees. No assurance can be given that Ofgem's policy on electricity distribution mergers will not change in future but, if any changes are considered, Ofgem would expect to consult widely before making any changes.

Ofgem's policy on electricity distribution mergers is set out in "Mergers in the electricity distribution sector – Policy statement" published in May 2002. This states that "Ofgem will seek to:

- modify the licences of each of the companies in the merged group to reduce their regulated revenue by a total of £32 million (in 2001/02 prices) spread equally across all the distribution companies in the merged group and over a period of five years from the time the merger has completed; and
- pass back the efficiency savings that the merger is expected to generate as they arise through the price control review process and not to differentiate between merger savings and any other types of savings."

The first part of this is relatively well understood and has been applied in previous mergers. The £32m adjustment applies for each loss of comparator and impacts in five equal instalments in real terms starting in the first full regulatory (April to March) year after the year in which the merger occurs. The licence drafting can be found in special condition B1 of all the ex-PES distribution licences as modified following DPCR4 (see the sub-documents under Ofgem document 95/05 in the Distribution Price Control area of work at www.ofgem.gov.uk).

The second part of the policy relates to the treatment of efficiency savings or other improvements resulting from a merger in a subsequent price control review. Any such efficiencies that relate to the merger that are either already achieved or projected by Ofgem may be taken into account in setting operating cost allowances (or where relevant capital expenditure allowances or output targets) for the period after 2010. For avoidance of doubt, there should be no expectation that cost allowances or other targets relating to the period after 2010 will provide for retention of cost savings or other improvements achieved before 2010.

Ofgem would also expect any cost savings or other improvements achieved due to a merger in the period up to 2010 to be treated in the same way as if they were achieved in any other way – i.e. they would not impact on cost allowances for the period 2005-2010 but may be subject to existing incentive mechanisms as set out in Appendix 1 to the DPCR4 Final Proposals, November 2004, including the rolling capex incentive and opex incentives.

Ofgem is currently working to improve cost reporting for the electricity distribution companies. Following on from this, in the lead up to the next electricity distribution review, Ofgem would expect to review its methodologies for determining cost allowances for the period after 2010. In any event, as set out in Appendix 1 of the DPCR4 Final Proposals, no assurance has been given as to the methodology that will be used to set cost allowances at future price controls, other than that it will be consistent with Ofgem's statutory duties at that time.

Further, as set out in the initial consultation on DPCR4, July 2003, paragraph 6.43, in setting cost allowances at future reviews: "Ofgem will consider whether projections of costs should take account of prospective savings from any mergers which create greater scope for economies of scale than currently available in the sector."

In addition, Ofgem set out in the DPCR4 final proposals (paragraph 7.80) that, in relation to capital expenditure incentives: "If the ownership of any DNO changes after the review concludes, consideration would need to be given to which rates to use – the default option will be to use the lowest [incentive] rate applying to any of the merging companies prior to the transaction for all companies in the new group."

Finally, Ofgem notes that the merger of parent companies does not in any way alter the obligations on licensees to maintain adequate records and understanding of historical data (including, without limitation, information required under standard condition 52 of the distribution licence).

If you have any questions in relation to this letter, I can be contacted on 020 7901 7255 or at martin.crouch@ofgem.gov.uk.

Yours sincerely

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