To energy network companies, investors, customer groups and other interested parties

Promoting choice and value for all gas and electricity customers

25 May 2010

Dear colleagues,

Public statement on Ofgem's network company merger policy

On 2 February 2010 Ofgem published a letter[1] suspending its policy for mergers between network companies following a consultation[2]. We said that we would review our policy and that during the review we would consider any mergers on a case by case basis. This letter sets out the outcome of this review.

Ofgem's merger policy

Ofgem's case by case approach to mergers ends from today. After this date Ofgem will advise the merger authorities and Government on any relevant mergers based on the relevant factors surrounding the merger in question. We think there is a potential detrimental impact from mergers on our ability to regulate effectively and protect the interests of present and future consumers – where relevant we will set out these concerns as part of our advice. We set out some supporting information on why we think there is a potential detriment from mergers between network companies in the same sector in the Appendix to this letter.

We think that the potential impact of mergers on our ability to regulate effectively in the interests of consumers is a legitimate factor that should be considered by the merger authorities as part of the merger assessment process. This factor is already a relevant consideration in the water sector which has a special merger regime. We would therefore support legislative change that incorporates the impact of mergers on our ability to regulate into the merger regime for energy networks. Such changes would allow the merger authorities to consider the full range of relevant considerations that affect the consumer interest when assessing mergers. We think that this would best protect consumers and be compatible with the role of Ofgem and the merger authorities in the merger regime.

Mergers may bring net benefits to consumers. For example, the potential detriment from a merger identified above could be outweighed by efficiency and quality of service improvements that a new management team could bring to a company. In these cases, it is in the consumer interest that such mergers go ahead. The legislative change that we support would not prevent this from happening but would ensure that the merger authorities can consider the full range of relevant factors that affect the interests of consumers when reaching their decisions. This would allow the merger authorities to block mergers that they judge to be against the consumer interest, to impose remedies where

[1] Available from http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=266&refer=Networks/Policy
[2] Available from http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=261&refer=Networks/Policy

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they deem appropriate, and to allow mergers to go ahead without any action where there are no concerns.

From today, Ofgem will not seek to reduce allowed revenues following a merger by a predefined amount (known as the merger tax in electricity distribution). We think that any remedies to mergers are best applied by the merger authorities as part of an assessment of all the relevant factors. We also think that any benefits from the merger should be automatically shared with customers in the same way that efficiencies from other initiatives are shared as part of the price control framework. The price control for electricity distribution (DPCR5) automatically passes around 50 per cent of any network cost efficiency saving during the period to consumers. The sharing factors are different in the transmission and gas distribution sector. We will re-set these factors as part of the forthcoming price controls in gas distribution (GDPCR2) and gas and electricity transmission (TPCR5). We do not think it is necessary for Ofgem to take any action beyond equalising sharing factors across the parties to a merger[3] and allowing these sharing mechanisms to operate in the way they were intended.

These policies above apply to all of the network sectors that Ofgem regulates: electricity distribution, gas distribution, and transmission.

We have identified some potential conflicts of interest that may arise in the event of a merger between a transmission and a distribution company in the same sector. These potential conflicts only arise where the transmission business connects to more than one distribution network. In this situation the transmission company may have an incentive to unduly discriminate in favour of its own distribution networks when taking particular decisions. This ownership structure already exists in the gas sector where there are licence conditions in place to prevent any undue discrimination. We think that these licence conditions, suitably amended, could be used to address any concerns if the same ownership structure were to emerge in electricity. We would also act to ensure that a company controlling both transmission and distribution networks could not game any of Ofgem's incentives.

We have not identified any significant issues with mergers between gas and electricity distribution companies beyond concerns over cost allocation issues. Our only response to such mergers would be to ensure that the cost allocation methodologies are fit for purpose.

Our review has also looked at mergers involving independent network operators in the gas and electricity sectors (IGTs and IDNOs). We have not identified any relevant issues for mergers involving these companies beyond those already covered by competition law.

If you have any questions on this letter then please contact Geoffrey Randall, Head of Network Special Projects, Ofgem, on 0207 901 7106.

Yours sincerely,

Stephen Smith
Senior Partner, Local Grids and RPI-X@20

[3] Equalising the sharing factors is necessary to avoid incentives for the network companies to allocate costs to the licensee where they get the most favourable treatment. This is a continuation of the policy set out by Ofgem in October 2005 relating to electricity distribution mergers: http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR4/Documents1/11703-Elec%20Dist%20Mergers%20061005.pdf

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Appendix – Potential detrimental impacts of mergers on Ofgem's ability to regulate in the consumer interest

Ofgem has concerns over future mergers within the energy network sectors as the number of independent groups within a sector brings significant benefits to consumers in terms of the ability it gives Ofgem to set effective price controls. It is these very concerns that lie behind the existence of the special merger regime in the water sector and also behind Ofgem's motivation for approving the sale of four gas distribution networks by National Grid which, through creating four independent groups, has delivered significant benefits to consumers.

We set out below in more detail some of the concerns about how a merger can impact on our ability to protect consumers' interests.

Concerns over the loss in diversity following a network merger

When we regulate the energy networks they hold significantly more information than us about their costs and risks that they face, and what is possible in terms of service delivery. One of the key ways we have to unlock this and ensure we get a fair deal for consumers is through comparing the companies against each other. The more independent companies that we have to compare the more likely it is that one of them will reveal information that will allow us to set allowed revenues at an efficient level for all companies and/or that will support us in setting higher quality standards. In addition, the more information that we have from independent sources then the more confident we can be in our cost assessment work meaning that we do not need to err on the side of caution if we only see one network group being able to achieve a particular level of costs or service quality.

These independent groups and their management teams are compared against each other not just by Ofgem, but by investors and consumers as well. This creates competition between these management teams to become the leading performers in terms of efficiency and service quality. The more independent management teams there are competing to be the leading company the fiercer this competition is and consumers benefit from this through improvements being made more quickly than they otherwise would in the absence of that competition.

This is the essence of comparative regulation – Ofgem needs to use regulatory tools to try and replicate the competitive pressures that do not naturally exist in monopoly businesses. These competitive pressures are much stronger the more independent companies that we have in a sector.

Mergers between energy network companies within a sector, such as electricity distribution, may reduce the diversity in management approaches. This is because, with few exceptions, management teams tend to apply the same strategies and processes to all networks that they operate. A merger will also result in a reduction in the number of opinions/views within the sector which can be very useful for making progress in introducing new ideas or generally in policy development itself. This diversity was particularly useful at DPCR5, for example in terms of outputs development and the discussions that we had over the cost of capital (WACC).

There are significant qualitative benefits where Ofgem is able to make comparisons between companies in terms of the ideas and policies that they are proposing. It only takes one company to demonstrate that a proposal such as the DPCR5 outputs can be implemented or bring forward evidence that supports a fairer settlement for consumers on issues such as the cost of capital. Behaviours such as these were very valuable at past price controls and the RPI-X@20 proposals seek to build on such comparisons.

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Concerns over increased market share within the energy network sectors

We also have concerns over mergers leading to groups controlling a significant share of the market. These concerns again primarily relate to our ability to use benchmarking to identify an efficient level of costs at price controls.

Under our current approaches to benchmarking in distribution, each licensee is modelled separately. There may be scope for a group that controls a significant share of the market to 'game' this benchmarking by allocating costs in a particular way between its licensees that maximises its total allowed revenues to the detriment of consumers. There may also be issues of comparability between network groups if their scales vary significantly.

A large group would also have a significant impact on any benchmarks that we set. If such a group were inefficient and had a high level of costs throughout its networks, there are two possible risks to consumers:

- The overall level of the benchmarks could increase in response to a higher average cost base within the sector. This would lead to higher bills for all consumers within the sector.

- It would be more difficult to identify that a company was inefficient if it exerted a strong influence on the benchmarks that were set for it. This could adversely affect the consumers using these networks.

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