

Scotia Gas Networks proposed acquisition of gas distribution networks Ofgem consultation

The purpose of this paper is to consult upon the proposed acquisition of two of National Grid Transco (NGT) gas distribution network (DN) businesses by a consortium known as Scotia Gas Networks plc. The acquisition is subject to the merger control provisions of the Enterprise Act 2002, and, in accordance with the Concordat between Ofgem and the Office of Fair Trading (OFT), Ofgem will advise the OFT on whether the proposed acquisition could give rise to competition concerns.

Background

In May 2003, National Grid Transco announced that it would consider the sale of one or more of its DNs if such a transaction would maximise shareholder value. Under the terms of its licence the Authority's consent was required to such a sale.

Following this announcement Ofgem has undertaken a consultative process associated with the development of a proposed regulatory, commercial and operational framework that could be implemented to protect the interests of customers within a divested industry structured. This process has included conducting industry meetings, issuing a number of Regulatory Impact Assessments for consultation on this structure as well consulting upon a proposed licensing framework.

As part of its sales process, in August 2004, NGT announced that it had reached agreements on the sale of four of its DN businesses, namely:

- ◆ Scotland
- ◆ South East of England;
- ◆ Wales and West; and
- ◆ North of England.

These agreements have been entered into with the following purchasers:

- ◆ a consortium known as Scotia Gas networks plc (Scotia Gas) involving Scottish and Southern Energy plc (SSE), Borealis Infrastructure Management Inc (Borealis) and Ontario Teachers Pension Plan Board (Ontario Teachers). This consortium plans to acquire gas distribution network (DN) Scotland and DN South East of England. SSE, the main shareholder, is involved in a range of activities within the gas and electricity sectors including gas supply and shipping, gas storage, as well as the generation, supply, transmission and distribution of electricity;
- ◆ a consortium led by the Macquarie European Infrastructure Fund (a wholesale fund managed by a member of the Macquarie Bank Group) which has agreed to purchase the Wales and West DN

- ◆ a consortium led by Cheung Kong Infrastructure Holdings Ltd and including United Utilities plc which has agreed to the purchase of the North of England gas distribution network.

In November 2004 Ofgem issued a Final Impact Assessment on potential DN sales. The Final Impact Assessment represented the culmination of a detailed examination of the potential costs and benefits to customers arising from the sale of one or more DNs by NGT. It also set out a proposed regulatory, commercial and operational framework that could be adopted to protect customers within a divested industry structure.

On 20 January 2005, the Authority met to consider four applications made by Transco plc for consent to dispose of four of its relevant DNs to four wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers.

After careful consideration of the applications and respondents' views on the various consultations initiated by Ofgem, including the November 2004 Final Impact Assessment, the Authority granted its consent. The consent was granted on a conditional basis. These conditions relate to amongst other things the modification of each of Transco's six Gas Transporter (GT) licences.¹

Proposed licence conditions

In September 2004 Ofgem issued an informal consultation document regarding the proposed restructuring of Transco's six GT licences.² The document invited views on possible modifications to these licences that would be required in the context of a potential sale to ensure that the scope of the regulatory framework was sufficient to protect the interests of customers within a divested industry structure.³

Following this, Ofgem issued a 'next steps' consultation on the licence in November 2004 in which, having considered respondents' views on the September consultation, Ofgem refined its proposals with respect to the licence modifications required to implement DN sales.⁴ This document included an informal consultation on the licence modifications that would be proposed through a section 8AA notice to be issued under the Gas Act 1986 with respect to the transfer of four of the relevant DN licences that NGT is proposing (as part of DN sales) to transfer from Transco to four relevant wholly owned Transco subsidiary companies. It is intended that the shares in these companies be subsequently transferred to the third party purchasers. The document also invited views on a formal section 23 notice regarding the separation of the price control provisions between each of Transco's six GT licences.⁵

¹ A detailed discussion of the Authority's decision and the conditions to consent can be found in the Authority's February 2005 decision document, '*National Grid Transco – sale of gas distribution networks: Transco plc applications to dispose of four gas distribution networks*'.

² In November 2004 (pursuant to applications from Transco in connection with DN sales), without fettering the discretion of the Authority in relation to DN sales, five additional licences were granted to Transco. As a result, Transco currently holds six GT licences.

³ See '*National Grid Transco – Potential sale of gas distribution network businesses – Initial thoughts on restructuring of Transco plc's Gas Transporter licences – Consultation document*', Ofgem, September 2004.

⁴ '*National Grid Transco – Potential sale of gas distribution network businesses, Licensing: Next Steps – Formal consultation under section 23 and informal consultation under section 8AA of the Gas Act 1986*, Ofgem, November 2005.

⁵ The licence modifications contained in this notice were subsequently directed by the Authority on 1 February 2005.

Having considered respondents' views to the 'next steps' consultation as well as further views received by Ofgem from industry participants and other interested parties through the Ofgem chaired DN sales Development and Implementation Steering Group meetings, Ofgem issued its formal consultation under section 8AA on 14 February 2005. In addition, on 14 February, an associated formal section 23 modification process was initiated proposing the modification of the two remaining Transco GT licences in respect of Transco's National Transmission System and retained DN businesses.⁶

A key element of the consultation process on the licence framework has been to consider the potential impact of the transaction on competition, and to develop, where appropriate, licence obligations relating to the separation of monopoly and competitive activities.

As a result of this consultative process Ofgem is now formally consulting (through the section 8AA and associated section 23 process) on a number of licence conditions related to business separation that would, if implemented, apply to both Transco and the new DN owners. This consultation closes on 15 April 2005.

The proposed business separation licence obligations that are being consulted upon are modelled on the business separation regime which currently exists in the electricity industry. In essence, it puts the onus on the licensee to:

- ◆ develop managerial and operational systems which prevent any relevant supplier or shipper from having preferential access to confidential information, and
- ◆ manage and operate the distribution business in a way that does not restrict, prevent or distort competition.

In addition, under the proposed conditions the licensees would be required to have in place a statement describing the practices, procedures and systems it has adopted to ensure that these conditions are met. Under the proposals, the statement must be approved by the Authority and set out how the licensee shall maintain full managerial and operational independence of the distribution business from any relevant shipper, supplier or generator including separate branding, and (so far as is required to ensure compliance with the provisions) separate premises, systems, equipment, facilities and management and operations staff. Licensees would be required to use their best endeavours to comply with the statement.

Further, under the proposed conditions the licensee would be required to appoint (following consultation with the Authority) a compliance officer whose function is to facilitate compliance with the DN's business separation and no undue discrimination obligations. Compliance officers must be given access to resources and information to enable them to fulfil their functions. Among other things, the duties of the compliance officer include:

- ◆ monitoring the effectiveness of the practices, procedures and systems adopted in accordance with the statement referred to above;
- ◆ investigating any complaints received in relation to the licensee's business separation arrangements; and
- ◆ providing an annual report to the directors of the licensee.

⁶ *National Grid Transco – Potential sale of gas distribution network businesses, Formal consultation under section 23 and section 8AA of the Gas Act 1986, February 2005, 45/05.*

Finally, under the proposed conditions the licensee would be required to provide an annual report to the Authority setting out its compliance with the business separation and no undue discrimination obligations, and its compliance with the statement.

Scotia Gas acquisition of DNs

As noted above, Scotia Gas plans to acquire DNs Scotland and South East of England. SSE has a 50% interest in the Scotia Gas consortium, whereas Borealis and Ontario Teachers each have a 25% interest. It is noted that SSE, the main shareholder is also involved in a range of activities within the gas and electricity sectors including gas supply, shipping, gas storage, as well as the generation, supply, transmission and distribution of electricity.

Ofgem would welcome views from interested parties to assist it in preparing its advice to the OFT on the Scotia Gas acquisitions. In particular, we would appreciate views on whether, taking into account the proposed business separation licence conditions outlined above, the acquisition has an impact on competition in:

- Gas wholesale markets, including competition between shippers;
- Gas retail markets, including competition between suppliers;
- Gas storage, including the impact on competition between the operators of gas storage facilities;
- Electricity wholesale markets, including competition between generators;
- Electricity retail markets, including the impact on competition between electricity suppliers.

Submissions should be sent to Pamela Taylor (pamela.taylor@ofgem.gov.uk) and must be received **by 5pm on Friday 25 February 2005**. Any submissions will be forwarded to the Office of Fair Trading and will also be placed on Ofgem's website (www.ofgem.gov.uk) unless respondents request otherwise. Interested parties may also copy submissions directly to Teresa Krajewska (Teresa.krajewska@oft.gsi.gov.uk) at the Office of Fair Trading.

Yours sincerely

Maxine Frerk
Director Enforcement, Consumer and Fuel Poverty Policy