

15 January 2001

**ScottishPower's proposed
acquisition of Powergen's Rye
House power station
A consultation paper**

Introduction

Purpose of this document

This document:

- ◆ gives details of the proposed acquisition of Rye House power station by ScottishPower UK plc;
- ◆ explains the merger control process for this transaction; and
- ◆ requests comments on the regulatory issues arising from the proposed transaction.

Ofgem will make recommendations to the Director General of Fair Trading in relation to the merger. In order to allow comments to be considered, Ofgem requires comments not later than 5pm on Monday 22 January 2001.

Details of the proposed acquisition

Powergen plc owns and operates a combined cycle gas turbine power station, Rye House, based in Hoddesdon, Hertfordshire. The purchase of Rye House power station is subject to the clearance by the Secretary of State, or reference to the Competition Commission.

Emerald Power Generation Limited (Emerald) operates Rye House power station with Powergen holding all the shares in Emerald and owning the station. The sale of Rye House will entail ScottishPower UK plc (ScottishPower UK) buying Emerald and taking over the generation licence held by Emerald. The sale will also include the associated gas contract and title to the land of the power station. ScottishPower UK is the wholly owned subsidiary of ScottishPower plc.

Merger Control Process

This merger falls to the UK Competition Authorities. The Fair Trading Act 1973 provides that the Secretary of State for Trade and Industry may refer a proposed qualifying merger or acquisition to the Competition Commission. It is the responsibility of the Director General of Fair Trading (DGFT) to advise the Secretary of State as to whether a merger or acquisition should be referred to the Competition Commission. Where he advises that such a reference should be made, he may also in lieu of such a reference, advise that the Secretary of State should invite binding undertakings which would remedy any adverse effects identified by the DGFT. In accordance with the concordat between the Office of Fair Trading and Ofgem, the DGFT will consult the Authority before advising the Secretary of State.

If a merger reference is made to it, the Competition Commission has to consider whether the merger operates or is likely to operate against the public interest. If it concludes that the merger would be against the public interest, the Secretary of State has the power to prohibit the merger, or seek remedies. There is no power to prohibit a merger if the Competition Commission does not identify any detriment to the public interest.

If the merger is approved by the Secretary of State the Authority will need to consider what modifications might be needed to the licence held by Scottish Power and whether any assurances and, or, undertakings are necessary.

Details of the Parties

Powergen plc

Powergen established Emerald Power Generation Limited to hold a generation licence and operate Rye House power station on its behalf. Emerald is owned by Powergen UK plc, which is a wholly owned subsidiary of Powergen plc (Powergen). Powergen is the holding company for the Powergen group of companies and is traded on the London Stock Exchange. It is a vertically integrated company with generation, supply and distribution interests in the UK. It has recently sold its assets in India and Asia Pacific to CPL Power International, but has retained those in Europe. It has just completed the acquisition of LG&E Energy Corp in the USA.

Since 1999 Powergen has disposed of 6008MW of generation capacity in England and Wales by selling Fiddler's Ferry, Ferrybridge and Cottam power stations. Including Rye House, at present, Powergen has a generation market share of around 14.5% of output and 10.5% of total generating capacity in England and Wales.

Powergen purchased East Midlands Electricity (EME) distribution and supply businesses in July 1998 and has responsibility for compliance with EME's PES licence. It currently has around 7.8% of the retail electricity supply market in the Great Britain market.

ScottishPower plc

ScottishPower plc is a vertically integrated company. Its principal business interests are:

- a) through its wholly-owned subsidiary, ScottishPower UK, the generation, transmission, distribution and supply of electricity in its authorised area of south and central Scotland;
- b) through its wholly-owned subsidiary, Manweb plc, the distribution and supply of electricity in Manweb's authorised area of Merseyside and North Wales;

- c) the supply of electricity to customers outside the authorised areas of ScottishPower UK and Manweb throughout Great Britain;
- d) through ScottishPower UK, the supply of gas to customers throughout Great Britain; and
- e) through its wholly-owned subsidiary, Southern Water plc, the supply of water and sewerage services in Southern Water's area of appointment in southern England.

It is a multi-utility company involved in the supply of water and sewerage services and is the majority shareholder in an internet and telecoms company (Thus). It also has a variety of energy interests in the US, including PacificCorp, a major US utility, with generation, transmission, distribution and supply activities and mining.

ScottishPower supplies electricity to customers across the market of Great Britain with a large number of customers concentrated in the ScottishPower and Manweb (Merseyside, Cheshire and North-Wales) areas. It supplies electricity to approximately 2.6 million residential customers, 4,900 large energy users and 137,000 small businesses, which is approximately 5% of the Industrial and Commercial market above 100KW. It currently has 11% of the retail electricity supply market in Great Britain.

ScottishPower also has 9 power stations including 2 windfarms, hydro, and combined cycle gas turbine in Scotland. There are six operational power stations in Scotland, which have a total net output capacity of 4035MW. ScottishPower has about 41% of the total generation capacity in Scotland. In addition, ScottishPower has contracted to purchase up to 74.9% of the output of British Energy's nuclear sets in Scotland, equivalent to 1888MW of capacity. After taking into account the impact of contractual obligations with Scottish and Southern Energy plc, ScottishPower has some 6400MWs of available capacity. This, when added to its own generation capacity, gives it about 65% of the total generation capacity in Scotland.

ScottishPower also owns some generation capacity in England and Wales, a 42MW gas turbine in Knapton, North Yorkshire, and joint venture interests in 3 windfarms. There is a further power station planned with South Coast Power. It is envisaged that this new station (Shoreham power station, near Brighton) will be up and running later this year with a 400MW generation capacity.

In 1999/2000 ScottishPower's share of the total generation capacity, including the interconnectors, was 1.16%, and 2.2% of output in England and Wales. Comparatively on the Great Britain market this was 5.64% of total generation capacity and 4% of total output.

Rye House power station

The Rye House power station is a 715 MW combined cycle gas turbine power station at Hoddesdon in Hertfordshire. The station was developed and commissioned in 1993 and in 1999 generated 5.4 TWh of electricity. At present Powergen owns and operates the power station, which contributes to 1.11% of the total electricity capacity available in England and Wales.

5. Issues arising from the proposed acquisition

Concentration of generation interest in Great Britain

Ofgem will need to consider whether the acquisition of Rye House power station represents an unacceptable concentration of generation interests in ScottishPower plc in the Great Britain market.

ScottishPower has at present 72.8% by output (including nuclear) and 44.2% of total generating capacity in Scotland (including the interconnector). In the Great Britain market, ScottishPower plc has a total generation capacity of 5.64% and 4% of total generation output. As a result of the Rye House acquisition ScottishPower will increase its total generation capacity to 6.58% and total output to 5.6% in Great Britain. ScottishPower's market share of generation capacity in England and Wales will increase to 2.2%, or 2.52% if its share of the Shoreham power station is included. Its share of total output would rise to 4%, or 4.5% including Shoreham.

The Scottish electricity transmission system is connected to the England and Wales transmission system by an interconnector. At present the maximum capacity of the Scottish interconnector is 1,800 MW, which accounts for approximately 2% of total capacity available to the Pool, in England and Wales or 18% of total capacity available in the Scottish generation market. However, it is planned to increase the capacity of this interconnector to 2,200 MW, representing 23% of total generation capacity in Scotland and 3% of total generation capacity in England and Wales.

The current arrangements for access to the interconnector and the costs of generation in Scotland relative to England and Wales have meant that historically, the predominant direction of flows has been exports of generation from Scotland to England and Wales. However, with the introduction of New Electricity Trading Arrangements in England and Wales and the introduction of new arrangements for access to the interconnector with continental Europe,

patterns of flows may change over time. Ofgem intends to address its concerns about the arrangements for access to the Scottish interconnector as part of the British Electricity Trading and Transmission Access (BETTA) project. Over time, Ofgem would expect prices in the Scottish and England and Wales markets to converge. Ofgem therefore believes that it is appropriate to consider the impact of the merger on concentration in generation in Scotland/England and Wales (during the transition to a GB market) and in the GB market.

In assessing previous mergers in the generation sector, Ofgem had indicated that it considered that many of the issues raised by further concentration in the generation market could be addressed by introducing a prohibition on market abuse in to the licences of generators who, following a merger, met Ofgem's criteria for the inclusion of the condition. Following this proposed acquisition, Scottish Power would have met this criteria for the inclusion of a Market Abuse Licence Condition (MALC).

However, following the Competition Commission's decision on Ofgem's proposal to introduce a MALC in to the licences of AES and British Energy, we are unable to use the MALC to address any competition concerns raised by further concentration in the generation market. Ofgem remains convinced that there remains considerable scope for generators, who by normal competition standards have relatively low market shares, to commit abuse and damage competition and/or harm customers. Ofgem continues to believe that this is a result of the special features of the electricity market, including the inability to store electricity other than at very high cost and relatively inelastic demand and supply conditions, particularly close to real time.

In the absence of a MALC, there are limited regulatory safeguards against Scottish Power abusing substantial market power in particular in relation to the potential gaming of transmission constraints, intertemporal price discrimination or the withdrawal of generation capacity. Ofgem will therefore have to carefully consider the impact of the proposed acquisition on competition in the wholesale electricity market given these concerns.

Restriction on own generation capacity

Unlike the public electricity supplier licences in England and Wales, ScottishPower's licence does not set a limit on own generation capacity. As in previous acquisitions, restrictions on electricity sale contracts between supply and associated generation businesses will need to be considered. At the time when ScottishPower plc acquired Manweb, Ofgem issued a direction on restricting Manweb supply entering into contracts with ScottishPower. Ofgem needs to consider whether this direction should be revisited to prohibit the output from Rye House being contracted to Manweb or another company group. If an application for a new generation licence is made Ofgem will need to consider whether it is appropriate to consent to a fixed limit and, if so, on what terms.

Vertical integration

Consideration will need to be given to whether, in the light of the already vertically integrated nature of ScottishPower plc's businesses, the acquisition of Rye House power station will have any material effect on competition in the Great Britain market. ScottishPower plc will have approximately 11% of the Great Britain market for the retail supply of electricity and will be the fifth largest competitor in this market (after TXU/Norweb, British Gas, Scottish and Southern Energy and Seeboard/Yorkshire Electricity).

Gas purchase contract

Rye House power station is supplied with gas under a take-off agreement with Mobil Gas Marketing (UK) Limited. As part of the acquisition ScottishPower UK will be taking over the gas purchase contract with Mobil Gas Marketing at Rye House. The contracted gas purchase agreement expires in September 2008. Ofgem will need to consider whether the continuation of the contract for 8 years gives rise to any competition concerns.

Conclusion

Ofgem is seeking the views of interested parties on the acquisition of Rye House power station by Scottish Power, so that the Authority may make recommendations to the Director General of Fair Trading.

Responses will normally be available in the Ofgem library unless there are good reasons why they must remain confidential. Consultees should mark the part of their response (or whole response) which is to remain confidential, if this is the case, and where possible should consign any confidential material to appendices.

Comments on the proposed acquisition should be sent by 5pm on Monday 22 January 2001 to:

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