

August 2001

**Innogy Holdings plc's proposed
acquisition of the electricity supply
business of Northern Electric plc**

A consultation paper

1. Introduction

Purpose of this document

- 1.1 This document:
- ◆ gives details of the proposed acquisition of Northern Electric plc's supply business, by Innogy Holdings plc (Innogy);
 - ◆ explains the merger control process for this transaction; and
 - ◆ invites comments on the regulatory issues arising from the proposed transaction.
- 1.2 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 needs to receive these not later than 5pm on Thursday 23 August 2001.

2. Details of the proposed acquisition

- 2.1 Northern Electric plc (NE), the holding company of which is CE Electric UK plc (CEE), is an integrated UK energy business with a public electricity supply (PES) licence covering both a supply and a distribution business. Innogy is proposing to acquire the gas and electricity supply businesses from NE. As part of this acquisition Innogy will also assume the power purchase agreement with Teeside Power Limited, under which Teeside agreed to supply power to NE until 2008.
- 2.2 This consultation paper focuses on the proposed acquisition of NE's supply business by Innogy. A separate consultation paper deals with the proposed acquisition by NE of the Yorkshire Electricity Group plc's (YEG) distribution business, a merger which falls within the jurisdiction of the EC Merger Regulation.
- 2.3 On 10 August, the parties notified the proposed supply business transaction to the Office of Fair Trading (OFT) for a decision by the Secretary of State to clear the transaction or to refer it to the Competition Commission.

3. Merger Control Process

- 3.1 This transaction falls within the scope of UK merger control law since the value of the NE supply business assets exceeds the £70 million threshold under the Fair Trading Act 1973 (FTA). The transaction will therefore be assessed under the provisions of the FTA. The Secretary of State for Trade and Industry may refer the transaction to the Competition Commission if the transaction may, in the Secretary of State's opinion, give rise to significant competition concerns.
- 3.2 It is the responsibility of the Director General of Fair Trading (DGFT) to advise the Secretary of State as to whether the transaction should be referred to the Competition Commission. In accordance with the concordat between the OFT and Ofgem, the OFT will consult Ofgem before advising the Secretary of State. Where the OFT advises that the transaction should be referred to the Competition Commission, the OFT may advise that in lieu of such a reference the Secretary of State invites binding undertakings from the parties to the transaction which would remedy any adverse effects on competition identified by the OFT.
- 3.3 If the Secretary of State decides to refer the transaction to the Competition Commission, the Competition Commission has to consider whether the transaction will operate, or is likely to operate, against the public interest. If the Competition Commission concludes that the proposed merger is not expected to operate against the public interest, the Secretary of State has no power to prevent the merger. If the Competition Commission decides that an adverse effect can be expected, the Secretary of State has the power to block the merger or attach conditions to it, or to ask the DGFT to negotiate undertakings to be given by the parties to counter the adverse effects identified; though the Secretary of State is under no obligation to exercise these powers.
- 3.4 In advising the OFT, Ofgem will need to consider what modifications might be needed to the licences held by the Innogy and Northern groups and whether any assurances might be necessary should the merger proceed.

4. Details of the parties

Innogy Holdings plc

4.1 Innogy was originally established to hold the UK assets of the former National Power plc. At present its principal businesses are:

- ◆ **electricity generation** – the operation of seven wholly owned major power stations (and 3 minor ones) in the UK with total capacity of 8,500MW;
- ◆ **electricity supply** – a national electricity supply business currently including the recently acquired supply businesses of YEG and the former supply business of National Power, Midlands Electricity and Independent Energy, supplying approximately 4.3 million domestic electricity customers;
- ◆ **electricity distribution** – pending the sale of YEG’s distribution business, Innogy owns and operates, through YEG, the distribution business serving the YEG authorised area, with approximately 2.1 million customers connected to the network ;
- ◆ **metering services** – Innogy is involved, through YEG, in providing electricity metering services. These are data aggregation, data processing, data collection, meter provision and meter operation;
- ◆ **electricity and gas trading** – Innogy is involved in the sale and purchase of electricity and gas in the wholesale and forward markets;
- ◆ **gas supply** – Innogy has a national gas supply business including the former gas supply businesses of Calortex Limited, Independent Energy (principally York Gas) and YEG, supplying 1.3 million domestic gas customers;
- ◆ **gas shipper** – Innogy has four shipper licences; Innogy plc, npower commercial gas limited, npower direct limited and npower gas limited, plus two owned by YEG; Yorkshire Energy Ltd and YE Gas Ltd; and

- ◆ **other gas activities** – YEG own a 6.97% equity stake in the Armada offshore gas field.
- 4.2 Innogy's generation business accounted for 12.4% of installed generation capacity and output in England and Wales in 2000. Innogy's supply business has approximately 19.6% of supply to domestic electricity customers in Great Britain (GB) by volume (15% by number of domestic customers), and about a quarter of the supply market to Industrial and Commercial (I&C) electricity customers in GB by volume consumed. Innogy has a much smaller share of the gas market, with market share below 10% in both domestic and I&C markets.

Northern Electric plc

- 4.3 The immediate holding company of NE is CE Electric UK plc, which is the UK subsidiary of Mid American Energy Holdings Company, a US-based group. NE's principal activities are:
- ◆ **electricity distribution** - operation of an electricity distribution business in the NE authorised area, with approximately 1.5 million customers connected to the network;
 - ◆ **electricity supply** - operation of an electricity supply business supplying customers in NE's authorised area as well as customers in other parts of England, Wales and Scotland, supplying over 1 million domestic electricity customers;
 - ◆ **electricity trading** – NE's supply business is involved in the purchase of electricity under NETA;
 - ◆ **gas supply** - operation of a gas supply business both in the NE's authorised area for electricity supply and in other parts of England, Wales and Scotland, supplying 0.46 million domestic gas customers;
 - ◆ **gas shipper** – NE holds a gas shipper licence;
 - ◆ **metering services** – NE's supply business is active in operating metering services. These are, in electricity, data aggregation, data processing, data

collection, meter provision and meter operation and a gas and water metering service; and

- ◆ **retailing of electrical and gas appliances** – through Northern Electric Retail Ltd.

4.4 NE's supply business supplies just under 5% of domestic electricity customers in GB. The acquisition of NE's supply business would increase Innogy's domestic electricity customer base to approximately 5.5 million, supplying a quarter of the GB domestic electricity market by customer numbers. Within its authorised area, NE is the largest supplier of domestic electricity, supplying approximately two-thirds of customers.

5. Issues arising from the proposed acquisition

5.1 Ofgem believes that this acquisition will raise three issues for consideration:

- ◆ competition in supply;
- ◆ vertical integration of generation and supply;
- ◆ metering services.

It will also have an impact on the PES distribution businesses involved, by separating the supply and distribution activities.

The potential effect of this acquisition on each of these issues is discussed below.

Competition in supply

5.2 Should the proposed transaction proceed, Innogy would be the largest electricity supplier in GB. It would serve approximately a quarter of the domestic electricity customers in GB by volume (one fifth by number of domestic electricity customers), and have a total share of the I&C electricity sector of just over one-third by volume. The merger will have relatively little impact on Innogy's share of gas supplied to I&C customers, increasing it by about 1%. It would also increase Innogy's share of the domestic gas sector from just over 7% to about 9% by customer numbers. This acquisition will reduce the number of active domestic electricity players to around eleven.

5.3 The increase in the size of Innogy's supply business following the proposed merger may allow it to achieve economies of scale in its operations. It is likely that any cost savings resulting from the merger will only be passed on to customers if competitive pressures are strong enough. However, given that Innogy is a particularly competitive player through its brand power, the removal of NE from the supply field may not necessarily reduce the effectiveness of competition. This is particularly so as market share information indicates that, at a domestic and small business level, NE is principally a regional rather than a national player.

5.4 Ofgem would welcome views on the impact of the proposed transaction on the competitive gas and electricity supply markets, particularly the I&C markets.

Vertical Integration of generation and supply

- 5.5 Ofgem recognises, when assessing mergers and acquisitions, the possibility that companies with market power in one or more activities may use this power to distort, restrict or prevent competition.
- 5.6 The acquisition of NE's supply business will reinforce the position of Innogy as a vertically integrated company, largely through extending Innogy's supply base. Ofgem recognises the benefits of integration but believes that the market must be sufficiently competitive to mitigate against the possible negative effects associated with integration and that appropriate safeguards through licence modifications and assurances may be required. However, as a result of the acquisition by NE of the distribution business of YEG, Innogy will no longer be involved in electricity distribution.
- 5.7 To the extent that the acquisition has detrimental effects on competition Ofgem might, as it has done in relation to previous mergers, need to consider whether assurances and/or modifications to the licences of NE and Innogy are necessary.
- 5.8 Ofgem would welcome views on whether this merger raises any concerns about the development of competition in generation or supply as a result of the creation of a much larger supply business within a vertically integrated business.

Metering competition

- 5.9 The acquisition of NE's supply business includes the operational electricity metering services business, but excludes the metering assets which will remain with NE. The NE distribution business will fulfil its obligations to provide metering services by contract with the Innogy group. In addition Innogy will retain the metering services business of YEG but not the assets. Ofgem will have to consider how Innogy will manage the operational metering services business. Of special concern will be the arrangements for the ring fencing of information obtained by the metering services business, from other suppliers and the distribution business from other businesses of the company.
- 5.10 Whilst competition in half-hourly metering is well established, competition in non-half hourly meter operation is still in its early stages, with PESs retaining a de facto monopoly within their respective areas. Ofgem welcomes views on

how metering competition will be affected by this transaction, particularly considering the contiguous nature of the borders between the authorised areas of Yorkshire Electricity and Northern Electric.

Separation of distribution and supply activities

- 5.11 Under schedule 7 of the Utilities Act 2000, PESs are preparing transfer schemes by which they will ensure that their new distribution and supply licences are held by legally separate companies. The existing PES licences will be modified by licensing schemes to become new standard supply and distribution licences held respectively by the PES supply and distribution successor companies. Once the new supply licence is in place NE's supply successor would be transferred to Innogy. However, if the merger takes place prior to this date an agency agreement between NE as holder of the PES licence and Innogy, who will be fulfilling the supply obligations of that licence on NE's behalf, will be required. As in previous similar acquisitions, Ofgem will need to consider appropriate assurances and/or amendments to the relevant licences.
- 5.12 Ofgem will also need to consider the separation plans for the distribution businesses of NE and Yorkshire to ensure that they reflect changes in the relevant company structures.

6. Conclusion

- 6.1 In this document Ofgem is seeking the views of interested parties on the acquisition of Northern Electric's supply business by Innogy, so that it may make recommendations to the Director General of Fair Trading.
- 6.2 Responses will normally be made available in the Ofgem library unless there are good reasons why they must remain confidential. Consultees should mark any part of their response (or the whole response) which is to remain confidential, if this is the case, and where possible should consign any confidential material to appendices.
- 6.3 Comments on the proposed acquisition should be sent, by Thursday 23 August 2001, to:

Rachel Graham
Ofgem
9 Millbank
London
SW1P 3GE

Fax: 020 7301 7197
E-mail: rachel.graham@ofgem.gov.uk