

**May 2002**

**Mergers in the electricity  
distribution sector**

**Policy statement**

## Executive summary

This document sets out Ofgem's policy for dealing with the ongoing regulatory issues raised by mergers or comparable transactions in the electricity distribution sector.

Ofgem's principal objective is to protect the interest of consumers, where appropriate by promoting effective competition. In the case of distribution companies which are network monopolies, the promotion of effective competition can be interpreted as building on the rivalry which exists between them and making effective use of comparisons between these companies in setting price controls.

Consumers can benefit from mergers if the combined grouping generates efficiency savings or improvements in quality of service which are either greater than or are generated more quickly than those that would have been incurred by the separate entities. However, each merger also reduces the number of independent groups operating or owning distribution companies and hence limits the role which comparisons between companies can play at or between price control reviews.

Following a merger companies will continue to provide some information on a separate basis. This will enable some of the comparisons which were possible prior to the merger taking place still to be made. However, the value of those comparisons is weakened because they no longer reflect the efforts of different independent management teams trying to improve the way they operate in terms of cost and quality. Fewer independent management teams means there is a reduction in the number of rivals and in the scope for effective comparative competition between the distribution companies. This could result in the efficiency frontier being pushed forward more slowly than would otherwise be the case and so efficiency savings being passed back to customers more slowly.

Regulation should not seek to inhibit companies from adopting corporate solutions, such as mergers, that promote greater efficiency. However where these solutions result in a detriment to customers, it is appropriate to consider whether any remedies are available to offset the detriment. Calculating the size of detriment associated with a loss of comparator is not straightforward. The November 2001 consultation paper on mergers in the electricity distribution sector set out one method. It compared the efficiency savings which were returned to customers through the price control review of NGC and Transco – where no comparisons are possible – with those returned to

customers through the distribution price controls. Repeating this analysis for future price control periods suggested that the detriment of being able to make no comparison was approximately £384 million (in 2001/02 prices) or the equivalent of £32 million for each further merger in the distribution sector. For many reasons this amount may underestimate or overestimate the actual detriment. Detailed analysis carried out in the water sector and considered by the Monopolies and Mergers Commission indicated that the loss of comparator was potentially orders of magnitude higher.

Ofgem recognises that there is ambiguity over the size of the detriment caused by consolidation in the sector and that mergers may also provide the opportunity for greater efficiency savings to be achieved to the longer term benefit of customers. However, it is clear that mergers reduce the scope for meaningful comparison between distribution companies and that this gives rise to a detriment for customers. In addition distribution companies are also keen to see a clear framework established. As part of its ongoing regulation of the sector, following a merger or comparable transaction, 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.

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# 1. Introduction

## *Purpose of this document*

- 1.1 There are fourteen regional distribution companies operating within Great Britain. Since 1995, a number of mergers have taken place in the electricity distribution sector. At present the number of independent groupings of distribution companies is nine. Further corporate transactions, including mergers, are likely in the future.
- 1.2 Ofgem provides advice to the UK merger authorities on the impact of mergers in the electricity sector, although it has no formal merger control powers. In November 2001, Ofgem published a consultation paper as part of its ongoing regulation of the electricity distribution sector on:
- ◆ the issues raised by further consolidation in terms of its potential impact on customers; and
  - ◆ a possible approach to adopt for addressing these issues.

The purpose of the consultation was to establish a clear and predictable framework for dealing with these transactions as a means of helping the distribution companies plan for the future.

- 1.3 The consultation recognised that customers could benefit from mergers if they resulted in efficiency savings or improvements in quality which are either greater or are generated more quickly than those achieved by separate entities. However each merger also reduces the number of independent groups operating or owning distribution companies. This limits the role which comparisons can play at or between price control reviews (when the amount of revenue companies are allowed to collect and the level of service they are expected to deliver to consumers in return is determined). It was concern over this reduced ability to make comparisons between companies which led Ofgem to propose that companies who merge should compensate customers through a reduction in the regulated revenue they collect.

- 1.4 Seventeen consultation responses were received. A list of the non-confidential respondents is set out in Appendix 1 and copies of those responses can be seen on Ofgem's website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)). Meetings have also been held with some of the distribution companies to discuss in more detail the issues raised in their consultation responses.
- 1.5 Ofgem has considered the issues raised by respondents and in the light of those responses prepared this policy statement which sets out the approach it proposes adopting in considering the regulatory issues raised by future mergers in the distribution sector. The document sets out:
- ◆ a summary of the main issues raised by the consultation responses (Chapter 2);
  - ◆ Ofgem's proposed approach when dealing with the regulatory issues raised by mergers in the distribution sector (Chapter 3); and
  - ◆ the implementation issues raised by its proposed approach including the consultation process it will follow in considering future distribution mergers (Chapter 4).
- 1.6 In considering future mergers in the electricity distribution sector, the policy set out in the rest of this proposals document will be applied. Further consultation on the regulatory issues raised by mergers in the electricity distribution sector will only be carried out if there are new issues not included in the scope of this consultation exercise or a material or unforeseen change in the way the distribution sector operates or is regulated.
- 1.7 Any comments on this document, should in the first instance be sent to:
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## 2. Summary of consultation responses

- 2.1 Ofgem received seventeen responses to its November 2001 consultation. Responses were received from twelve of the fourteen electricity distribution licensees and from NGC and Transco. The Electricity Association (EA) commissioned Europe Economics to review Ofgem's proposed policy and a report from Europe Economics was submitted as part of the EA's response. Six of the eight electricity distribution businesses who responded to the consultation supported the EA's submission.

### *General*

- 2.2 Generally respondents welcomed Ofgem's consultation on mergers in the electricity distribution sector, recognising the importance of establishing a clear framework for addressing the issues raised by future merger activity.
- 2.3 Several respondents commented that it was important to ensure that any policy did not have the effect of deterring future merger activity within the sector, arguing that the considerable savings that mergers generate for customers would be lost if merger activity were to cease. Several of the respondents took the view that the proposed policy amounted to a levy or penalty on existing distribution businesses, arguing that this would place them at a disadvantage compared to new entrants to the electricity distribution sector, as future acquisitions would cost incumbent electricity distribution businesses an additional £30 million.
- 2.4 In relation to the question of whether mergers of three or more distribution businesses within a single group should be treated differently, the respondents who commented took the view that no such distinction was necessary. One respondent commented that Ofgem should not allow the number of comparators to be reduced to below five.

### *Is there a detriment associated with a merger?*

#### **Role of comparators**

- 2.5 Views on the role that comparators have to play in the regulation of the electricity distribution businesses were varied. Generally respondents agreed

that comparators do have a role to play in discovering efficient cost levels and that they can also stimulate innovation. It was also generally accepted that comparators have a role to play on quality of supply issues. One respondent questioned the role of comparators in achieving savings, commenting that considerable cost savings have been achieved in gas transportation despite a lack of comparators.

### **The detriment arising from the loss of a comparator**

- 2.6 A number of respondents (including the EA) commented that the role of comparators in future price regulation, and as such the detriment that may arise from the loss of comparators, will depend on the approach that is adopted at the next Distribution Price Control Review (DPCR). It was suggested that until a decision had been taken on the approach to the next DPCR it would not be possible to assess whether any detriment would actually arise from the loss of a comparator or to value any such detriment.
- 2.7 Some respondents said that it was important to consider the extent to which a comparator had been lost following a merger given that the distribution businesses would continue to hold separate licences. Separate data would continue to be available which could be used to make comparisons and so the impact of a loss in comparator is reduced.
- 2.8 It was observed that the value of any comparator, and as such the detriment that might arise from the loss of that comparator, is dependent upon the quality of the data that is used for comparative assessment. Any comparative assessment made using inaccurate or inconsistent data is weakened and so any resulting detriment would be lessened. Some respondents suggested that consolidation within the sector could actually increase the value to comparators as it could improve the consistency of data and possibly reduce statistical noise. It was also suggested that international benchmarking, perhaps through the Council of European Energy Regulators (CEER), could be helpful in maintaining the role of comparative analysis.
- 2.9 Two of the distribution businesses said that any detriment arising from the loss of a comparator would also be dependent upon the quality of the actual comparators, arguing that if none of the distribution businesses involved in the



transaction was at (or near) the frontier then no detriment would occur. Similarly, it was argued that the merger of two (or more) frontier businesses could result in the creation of a super-efficient comparator, which could bring additional benefits to customers, through increased efficiency, rather than result in a detriment.

- 2.10 A number of the electricity distribution businesses noted that any detriment arising from the loss of a comparator would depend upon the number of comparators remaining within the sector and a number of respondents argued that, if there was considered to be a detriment from the loss of a comparator, that detriment would increase as the number of remaining comparators decreased.
- 2.11 It was observed that the role of comparators would decrease over time as inefficiencies continue to be driven out of the distribution businesses through successive price controls and merger activity.

### *Calculating the detriment*

- 2.12 Respondents took the view that any calculation of the detriment associated with the loss of a comparator would need to take into account a number of matters. Possible factors suggested by various respondents included: the extent to which separate data remains available and the quality of that data (which may be improved as a result of the transaction); the role of comparators within future price reviews; the quality of the available information; and the number of comparators remaining within the sector.
- 2.13 Several respondents argued that Ofgem's £30 million proposal for compensating customers did not take account of the fact that there might be other reasons for the 1.3 per cent difference between required efficiency savings for the distribution businesses and those for Transco and NGC (rather than just the lack of comparators for Transco and NGC). It was argued that the different characteristics of the network businesses could account for the variance and that the considerable cost savings that have already been achieved for NGC and Transco mean that there are less potential savings for NGC and Transco, as compared to electricity distribution. Comment was also made that any assessment should not be based upon a single round of price controls as the equivalent figure for the previous round of price controls was –3 per cent.

- 2.14 energywatch took the view that the proposed basis for compensation was good but that it would become less reliable as consolidation within the distribution sector continued. It suggested that Ofgem should seek to obtain company projections of merger savings at the time that the acquisition is being considered under merger legislation and that Ofgem should seek to monitor the delivery of those projected savings.
- 2.15 Two respondents highlighted the difficulties that have been experienced in relation to quantifying the value of a loss of a comparator in the water industry.

***How should customers be compensated?***

- 2.16 A number of respondents commented that it was necessary to balance any detriment that arose from the loss of a comparator against the benefits that will result from the merger in order to assess what compensation, if any, should be provided to customers. Such an approach would ensure that the net detriment of a particular acquisition was not overstated. Several respondents commented that where the detriment of a particular merger outweighed the expected benefits then the merger should not be allowed to proceed.
- 2.17 One respondent suggested that in considering the benefits it was important to consider the wider benefits that would result from the merger such as increased possibilities for distributed generation.
- 2.18 Four of the licensed respondents specifically stated that no compensation would be required for customers, taking the view that the benefits received by customers in terms of improved service and efficiency savings were sufficient.
- 2.19 A number of respondents commented that any compensation should be paid to all customers rather than just to the customers of the distribution businesses involved in the merger, given that the loss of the comparator would affect all customers.
- 2.20 Several distribution businesses, and the EA, suggested that any creation of a comparator, through the demerger of a merged distribution business should result in a payment of £30 million to the demerging distribution businesses.

- 2.21 One respondent suggested that an appropriate way to compensate customers could be to shift the 'frontier' forward, with the extent of any shift dependent upon the quality of the comparator that had been lost. It was proposed that where actual efficiency savings exceed the revised frontier no further compensation would be required.
- 2.22 With regards to the timing of any compensation to customers responses were mixed with nine respondents arguing that any compensation payment should not be payable on completion of the merger. Several respondents argued that no payment should be made until the next price review as the detriment would only occur at that time.
- 2.23 One respondent took the view that any payments should be paid immediately and that the policy should be retrospectively applied to previous merger activity.

### ***Dealing with efficiency savings***

- 2.24 Several licensees commented that the November consultation document was unclear as to whether or not Ofgem's proposed compensation for customers would be in addition to the efficiency savings that businesses would be expected to pass on to customers after a five year period.
- 2.25 A number of respondents took the view that Ofgem should allow companies five years in which to recover the cost of a merger and to allow efficiency savings to begin to emerge before requiring that some of those savings are passed back to customers. However, one respondent took the view that most efficiency savings would normally have been realised within the first two years.
- 2.26 A number of licensees argued that the separation of efficiency savings achieved through a merger from any compensation payment to be made to customers as a result of the loss of a comparator could result in 'double-counting' and could further discourage incumbent distribution businesses from pursuing future acquisitions within the distribution sector.

### 3. Ofgem's proposed approach

#### *Introduction*

3.1 In the light of the responses received to the November consultation paper, the purpose of this chapter is to set out Ofgem's proposed approach to consideration of the regulatory issues raised by further mergers in the distribution sector. The main issues that were raised in the consultation paper were:

- ◆ the role which comparison played in the ongoing regulation of the electricity distribution companies and the extent to which this was compromised by the reduction in the number of separate groupings owning distribution companies;
- ◆ the method for calculating the detriment associated with a reduction in the number of comparators and the timing of when the detriment occurred;
- ◆ the assessment and treatment of efficiency savings which arise from mergers; and
- ◆ compensation due to customers following the completion of a merger.

3.2 Each of these issues is considered in turn in this chapter followed by a summary of Ofgem's proposed approach for dealing with the regulatory issues raised by further mergers in the distribution sector.

#### *The role of comparators*

3.3 In setting network price controls regulators typically consider four main issues. These are:

- ◆ the overall level of capital and operating costs that are likely to be incurred by an efficient business;
- ◆ how the recovery of these costs should be financed;
- ◆ what are the appropriate quality of supply targets and associated incentives; and

- ◆ whether the overall balance of incentives created by the price control regime is appropriate.
- 3.4 The ability to compare distribution companies can be particularly helpful in assessing operating and capital costs and quality of supply targets and incentives. In the November consultation paper examples were given of how extensive comparative analysis had been used at the last distribution price control with respect to the forecasting of controllable operating costs. This analysis was used as the basis for calculating the detriment associated with losing a comparator and is considered in more detail later in this chapter.
- 3.5 In addition the paper also gave examples of how comparisons were made and common assumptions used in analysing and forecasting capital costs and how increasingly following the Information and Incentives Project, comparisons were used to incentivise improvements in quality of service. Indeed with respect to the quality of telephone service which is the main point of contact between distribution companies and customers, an incentive scheme has been put into place which deliberately builds on the rivalry that exists between companies. Companies are remunerated or penalised entirely on the basis of their performance relative to their peers.
- 3.6 Most respondents accepted that comparison did have a role to play in setting price controls as well as in enhancing the performance of individual businesses. However some important points were made, in particular that:
- ◆ comparison would still be possible following a merger because information could continue to be gathered and presented by each individual licence holder; and
  - ◆ a value could only be attributed to comparisons which would be made in the future once a method for using comparisons at future price controls was decided upon.

### **Comparisons following a merger**

- 3.7 Ofgem agrees that following a merger and subject possibly to the appropriate ringfencing arrangements being put into place, comparisons can continue to be made between different geographical areas. However it is Ofgem's view that

the comparison is of less value because it no longer reflects the impact of different management strategies but instead the application of the same management strategies to different areas. So while it remains possible to carry out some benchmarking analysis Ofgem's concern is that a reduction in the number of independent management teams operating in the distribution sector means that the efficiency frontier may be pushed forward more slowly than would otherwise be the case.

- 3.8 Some respondents said that it was not possible to say whether or not there was a detriment from a reduced number of comparators until Ofgem had specified the method it proposed adopting at the next price control review. Ofgem does not agree that this is the case. At the last price control review a decision was taken to make extensive use of comparison because it was considered that this was the most effective way of meeting Ofgem's duties to protect customers interests. Since then further work has been carried out to extend the role comparisons could play, for example, in quality of supply. All other things being equal, comparators would be expected to play an important role at the next price control.
- 3.9 In practice, however, the number of genuine comparators available will be reduced which will limit the role of comparators and potentially change the methods used by Ofgem to set the price control. The appropriate basis for measuring the detriment is not therefore the approach that will be used for setting the price control review but the approach that ideally would be used if no further mergers had taken place.

### ***Calculating the detriment of a reduced number of comparators***

- 3.10 In the November consultation paper the detriment associated with a reduction in the number of comparators was calculated by comparing the outcome from the recent distribution price control review with those reviews also carried out by Ofgem but where no comparators are available – namely NGC and Transco.
- 3.11 As part of the last price control review Ofgem estimated the controllable operating costs for distribution as a whole as being £1027 million in 1997/98.

The price control settlement included an annual reduction of 4.3 percent. For Transco and NGC the comparable reduction was 3 per cent. For this analysis it was assumed that the difference of 1.3 per cent represents the benefit which can be derived from using comparisons in setting price controls. In net present value terms this represents a cumulative benefit of £231 million (in 1997/98 prices) for the current price control period. Replicating this analysis for the next three price control periods results in a total benefit of approximately £351 million (in 1997/98 prices), which could arguably be attributed to the role of comparators in regulation. This suggests that for each future merger it may be appropriate for £32 million (in 2001/02 prices) of compensation to be passed back to customers. Further details of this calculation are given in Appendix 2.

3.12 A number of respondents were critical of the method used to estimate the detriment of losing a comparator in particular they considered that:

- ◆ the method lacked robustness;
- ◆ other factors may explain the difference in the forecast operating cost savings;
- ◆ it failed to take into account Ofgem's continued ability to make comparisons subsequently within commonly owned businesses;
- ◆ it assumed that all mergers would give rise to an equal detriment; and
- ◆ the detriment occurred when the next price control was carried out and not when the merger took place.

### **Strengths and weaknesses of the proposed method**

3.13 On the basis of its experience in price regulating a number of network monopolies and for the reasons set out in the November consultation paper and reiterated above, Ofgem is in no doubt that the ability to make comparisons enables it to regulate more effectively to the benefit of customers than if none were available. However it also recognises that putting a value on the role of comparisons and the sense of rivalry which exists between those independently

owned businesses is very difficult. This is an issue which has been considered in detail by the Competition Commission (formerly the Monopolies and Mergers Commission) with respect to the water sector. The methods which it has considered reflect the greater emphasis in the setting of water price controls on econometric analysis. However as with the approach put forward by Ofgem the focus tends to be on the role which comparators play in setting operating expenditure. The Commission has noted that there are many different techniques for considering this question. It has not been able to quantify the detriment of removing one water and sewerage company from the comparative process, instead finding that the loss was so great that there were no off-setting remedies and that the only approach was to block the mergers.

*Other factors explain the difference*

3.14 The November consultation paper set out a number of factors which may lead to above average cost reduction in a privatised utility and so possibly explain the difference of 1.3 per cent. These include:

- ◆ in the years immediately after privatisation there may be greater scope for efficiency savings as obvious inefficiencies are removed;
- ◆ if a company has reduced its costs relatively slowly in the immediate past there may be increased scope for introducing new techniques and practices designed to increase efficiency;
- ◆ the cost base of a company may be inflated by one-off costs, accounting charges or costs relating to other activities;
- ◆ if the level of technical progress and innovation within the industry is high then there will be scope for above average efficiency gains; and
- ◆ where demand is increasing rapidly there may be more opportunity to take advantage of economies of scale.

3.15 These factors do not appear to apply to electricity distribution companies over the period of the new price controls. Privatisation was in 1990, ten years before the present price controls were introduced. Over the period 1995/96 to 1999/00 many companies had already reduced costs very significantly. Before



setting the targets for cost reduction over the new price control period very significant adjustments were made to the base data to take account of one-off costs, accounting charges and the costs relating to activities such as metering, supply and corporate costs. The rate of technical progress and demand growth in electricity distribution is broadly in line with the economy as a whole. It remains Ofgem's view that the evidence suggests that the dominant factor in determining the rate of projections of cost reduction underlying the 1999 distribution price control review was the scope for comparative assessment.

*Overestimating or underestimating the benefit of comparisons*

- 3.16 The method that has been put forward may in some respects overestimate the benefit of comparators because it does not separately identify the benefit which arises from being able to make comparisons between those businesses which are commonly owned. In other respects it may underestimate the benefit, for example, by looking only at the role which comparisons play in forecasting operating costs and not taking into account the role they play with respect to capital expenditure and quality of supply.
- 3.17 Ofgem has considered whether further analysis would increase the accuracy of the method which it has adopted. Comparators within electricity distribution have been used in the statistical exercise of benchmarking operating costs but more importantly they are used throughout the price control process:
- ◆ to make sure that Ofgem and its consultants are asking the companies the right questions;
  - ◆ to challenge on a bottom-up basis the assumptions made by companies with respect to all aspects of their business; and
  - ◆ to demonstrate to companies who are not leaders in terms of costs or quality of service what can be done.
- 3.18 Given this very broad role for comparators, further analysis focusing on the statistical role played by comparators in setting expenditure and quality at future price controls is unlikely to identify more accurately the value of comparators. In addition there is merit in establishing a clear and predictable framework which

gives certainty to distribution companies planning further transactions within the sector which would be delayed by further analysis.

#### *Treating all mergers equally*

- 3.19 A number of respondents commented that the impact of a merger which say reduced the number of comparators from three to two companies was greater than one which reduced it from nine to eight. Ofgem recognises that there may be a differential impact depending on the number of remaining comparators. One approach to address this concern would be to attempt to modify the amount of compensation to be received by customers to reflect this. However the disadvantage of such an approach is that the regulatory framework may then create an incentive on companies to merge more quickly than would otherwise be the case to take advantage of a smaller reduction in its regulated revenue. In doing this they may chose to undertake mergers which do not necessarily give rise to the greatest opportunity in the medium and long term for future efficiency savings.
- 3.20 An alternative approach may be to express the detriment in percentage terms, for example, as a percentage of regulated revenue. This would mean that in general as firms merged, and by implication there are fewer comparators left, this would tend to lead to a higher amount of compensation being calculated. The disadvantage of this approach is that if a specific percentage is agreed in advance different amounts will tend to be recovered from the companies depending on the pattern of mergers. This will break the link between the detriment which consolidation in the sector gives rise to and the amount of compensation paid to customers.
- 3.21 On balance Ofgem's preferred approach is to seek the same adjustment from each merger which takes place given that each merger removes one independent management team from the electricity distribution sector regardless of the size of the merger or the number of remaining comparators.

#### *Timing*

- 3.22 Some respondents argued that the detriment of companies merging occurred not at the time of the merger but when comparators were next used in the price

control process. Any compensation should be passed back as part of the price control which follows the merger taking place. Ofgem considers that the loss of comparator occurs when a merger takes place but that its impact is spread over a period of time. The sense of rivalry is diminished as soon as the merger completes and this is reflected in the data used as part of the next price control. The impact on customers with respect to costs is not experienced until the next price control come into effect. In the light of this Ofgem is proposing spreading the compensation to customers over a period of five years from the year following the completion of the merger.

### ***Efficiency savings***

- 3.23 Mergers can lead to benefits for customers if they generate efficiency savings which are greater (or are achieved more quickly) than would otherwise be the case. In the November consultation paper, it was suggested that these savings should be passed back to customers as part of the price control process together with other savings generated over the previous period. Consultees generally agreed with this approach. Some suggested that savings should be passed back in accordance with an agreed schedule.
- 3.24 In considering some previous distribution mergers, Ofgem has said that a minimum of £12.5 million of efficiency savings arising from the merger should be passed back to customers whether or not those savings have been incurred. It remains Ofgem's intention to apply this policy to these companies at the next price control, although it recognises that it will need to give guidance to these companies on what is considered to be a merger saving.
- 3.25 For all mergers which take place following the publication of this policy statement, Ofgem's policy will be to identify savings arising from the merger as part of its work on operating and capital cost efficiency more generally. Savings from mergers will not be separately identified. At the last price control review a commitment was made that companies would be allowed to keep the efficiency savings from capital expenditure on a five year rolling basis. Operating cost savings were passed back at the price control review. The treatment of efficiency savings at a price review is part of this year's work preparing for and carrying out the next review.

## *Other issues*

### **Mergers with specific characteristics**

- 3.26 In the November consultation paper, the issues raised by mergers which cover three licensed areas or are between contiguous licensed areas were considered. Consultees generally agreed that these raised no special issues. Ofgem does not propose differentiating between these types of mergers and others.

### **Modifying standard distribution licences**

- 3.27 Following the Utilities Act 2000, standard distribution licences were introduced. These licences will normally only be modified if a proportion of distribution companies do not object. The manner in which this is to be applied has still to be determined by the Secretary of State. A merger will make it more likely that a single grouping will be able to block a modification where this was previously not the case. Ofgem will need to consider how to address any concerns that this might raise when the modification process is introduced.

### **Demergers**

- 3.28 Some respondents suggested that this policy should be applied to companies on a symmetric basis so that in the event an owner of two businesses sold one and created a new comparator they should receive £30 million. It is for companies to decide whether to demerge or not. They will take this decision depending on whether or not it is in the best interests of their shareholders. Ofgem does not propose to provide additional incentives and will not be providing compensation from customers to companies in the event that a company seeks to demerge.

## *Compensating customers – Ofgem's proposed approach*

### **General approach**

- 3.29 Some respondents have suggested that the general approach set out in the November consultation paper is flawed. In particular they have suggested that Ofgem should consider for each case the detriment that a particular merger gives rise to and the off-setting benefits in terms of efficiency savings. If the detriment

exceeds the benefits, then Ofgem should seek to prevent the merger, otherwise the merger should be allowed to go ahead with no compensation for customers.

- 3.30 The purpose of this consultation exercise is to provide a clear framework within which companies are able to plan and develop their businesses. These businesses are network monopolies. It is clearly the case that price controls can be set whether or not there are comparators. Yet for the reasons set out above, Ofgem considers that it does make it more difficult to set effective price controls and that efficiency savings will be passed back to customers more slowly than would otherwise be the case.
- 3.31 Ofgem's proposed approach is likely to make mergers undesirable if the companies merging consider that the transaction will lead to savings of less than £32 million. In such a case customers will be better off than if the merger took place because of the use that can be made of comparators in setting the price control and regulating the businesses on an ongoing basis.

### **Compensating customers**

- 3.32 Some respondents pointed out that it was all customers that suffered a detriment as a result of a merger taking place and not just the customers of the merging companies and that the compensation should therefore be given back to all customers. Ofgem agrees that this is the case but has not been able to identify a mechanism by which this can be delivered. In practice the greater the extent of consolidation in the sector, the greater the number of customers that will be compensated. On this basis it is satisfied that the approach of reducing the regulated revenue paid indirectly by customers of the merged companies is the right one.
- 3.33 Ofgem has recognised that the amount of compensation which should accrue as a result of each merger is difficult to measure and contains an element of judgement. In addition to the work which Ofgem has carried out in terms of the method of calculating the detriment, it is also important to consider whether the adjustment proposed is reasonable. To reach a view on this it has looked at:
- ◆ the estimates which have been produced in the water industry for the loss of comparator;

- ◆ the adjustments made previously within the distribution sector in the context of mergers; and
- ◆ the impact on the businesses as a proportion of regulated revenue.

3.34 Work carried out in the water sector (which clearly reflects the specific nature of its regulatory regime) and presented to the Competition Commission has indicated that the loss of one comparator can be substantial. In the case of South West Water inquiries, the numbers produced by Ofwat suggested that the detriment for operating expenditure only would fall in the range of £200 million to £770 million (in 1994/95 prices). In some cases voluntary abatements were agreed where mergers were allowed to go ahead. For example, in the case of the General Utilities, Colne Valley and Rickmansworth merger, the inquiry recommended that the merger be allowed to go ahead if the benefits of the expected savings of £60 million (1989/90 prices) were taken into account in the setting of its price control revenue. The effect of this would be for water charges to be at least 6 per cent lower at the end of a ten year period than if the merger did not go ahead.

3.35 In considering mergers as part of the last price control review, Ofgem reduced the revenue of those companies that had merged by a sustained reduction of £12.5 million (in 1997/98 prices) to take account of the reduction in fixed costs which the merger gave rise to. This led to a 2 per cent reduction in the revenue of Scottish Power and Manweb (given that the takeover was in 1995/96) and a half per cent reduction in revenue for Southern Electric and Scottish-Hydro Electric (given that the takeover was in 1998/99). In subsequent cases, Ofgem has indicated that a minimum of £12.5 million will be passed back to customers as a result of the savings arising from the merger.

3.36 The policy proposed in this statement is for a one off reduction in revenue to be spread over five years to compensate customers for the detriment of losing a comparator. This will produce an annual reduction of £6.4 million in 2001/02 prices. Spread over the average regulated revenue of two distribution companies this is equivalent to an annual reduction of approximately 1.5 per cent. In addition efficiency savings arising from the merger will be passed back to customers through the price control process.

## Summary of proposed approach

- 3.37 Following this consultation, Ofgem's proposed approach is to seek, via a modification of the price control licence condition, a one-off reduction of £32 million in regulated revenue spread over five years across all of the distribution companies which will as a result of the merger come under common ownership. This approach will be applied to future mergers and comparable transactions which reduce the number of independent management teams, regardless of whether it brings together two or more licensed areas. Transactions which result in a new independent management team i.e. demergers will not receive a reward. Efficiency savings incurred as part of the merger will not be treated differently from other savings. The price control process will continue to be used to pass back efficiency savings to customers.

## 4. Next steps and implementation

### *Next steps*

- 4.1 Ofgem's November consultation paper on mergers in the electricity distribution sector provided the opportunity for Ofgem, the industry and interested parties to consider the issues relating to mergers within the sector over a period of several months. Following that consultation process this policy statement sets out Ofgem's policy on mergers in the distribution sector that will be applied from this point onwards.
- 4.2 Where a distribution merger takes place Ofgem will bring forward proposals under section 11 of the Electricity Act 1989 to modify the special conditions of those distribution licensees involved in the transaction in order to provide a compensation payment for customers of £32 million, to be recovered over a five year period.

### *Consultation process for future mergers within the distribution sector*

- 4.3 Respondents to the November consultation were generally supportive of Ofgem's approach of establishing a clear policy for future distribution mergers. Such an approach provides a clear framework within which companies are able to plan and develop their businesses.
- 4.4 A further advantage of such an approach is that it provides the opportunity for Ofgem, the industry and interested parties to consider potential issues arising from consolidation within a particular sector over an extended period of time. In preparing its advice on a particular transaction to the Director General of Fair Trading (DGFT), Ofgem will consult the industry and the wider public under the merger regime on issues arising from the transaction. These consultations, due to the time constraints imposed by UK and EC merger control rules, invariably have a consultation period of less than 10 working days and in some cases the consultation period has been just 3 working days. Developing a regulatory policy framework within which future mergers within the distribution sector will be considered has enabled Ofgem, the industry and interested parties to undertake a fuller analysis than may have been possible under the tight timescales to which all parties have to work to under the merger control rules.



- 4.5 Going forward Ofgem does not intend to issue consultation papers on specific mergers within the distribution sector unless issues are raised by a particular transaction which have not been considered in formulating this policy. Where new issues are raised Ofgem will consult with interested parties in formulating its advice to the DGFT.
- 4.6 Where no specific consultation exercise is to take place Ofgem will post details of the transaction on the Mergers & Acquisitions page on the Ofgem website and will invite interested parties to submit any comments that they wish to make within a prescribed time period. These will be taken into account in preparing any advice for the DGFT.

## **Appendix 1 List of respondents to the November 2001 consultation paper**

Centrica plc and British Gas Trading Limited  
East Midlands Electricity Distribution plc  
Electricity Association  
energywatch  
GPU Power Networks (UK) plc  
Innogy plc  
London Electricity Group plc  
National Grid Company plc  
Northern Electric Distribution Limited and Yorkshire Electricity Distribution Limited  
Scottish and Southern Energy Group  
ScottishPower (Scottish Power plc)  
SEEBOARD plc  
Transco plc  
TXU Europe Distribution  
United Utilities plc  
Wisenergy

## Appendix 2 Detailed calculation of adjustment to regulated revenue following a merger

**Table 1: Initial assumptions**

Controllable operating costs in 1997/98	£1027 million
Controllable operating costs in 2004/05 (if reduced annually by 4.3%)	£755 million
Discount rate	6.5%
Number of effective comparators at the last price control*	13
Retail price index for 1997/8	158.8
Retail price index for 2001/02	173.9

\*The last price control review was carried out using 1997/8 base data. At this time only one merger had taken place in the sector and there were in effect 13 independent management teams.

**Table 2: Calculating the cumulative effect of a 3% and 4.3% reduction in operating costs**

DPCR 4	PV in 1999/00	2005/06	2006/07	2007/08	2008/09	2009/10
Operating costs reduced by 3% pa		732	710	689	668	648
Operating costs reduced by 4.3% pa		723	691	662	633	606
Cumulative difference	182	10	29	56	91	133
DPCR 5		2010/11	2011/12	2012/13	2013/14	2014/15
Operating costs reduced by 3% pa		588	570	553	537	520
Operating costs reduced by 4.3% pa		580	555	531	508	486
Cumulative difference	107	8	23	45	73	107
DPCR 6		2015/16	2016/17	2017/18	2018/19	2019/20
Operating costs reduced by 3% pa		472	458	444	431	418
Operating costs reduced by 4.3% pa		466	446	426	408	391
Cumulative difference	62	6	19	36	59	86
Total	351					

Note: All costs in millions in 1997/98 prices

**Table 3: Final results**

Total detriment in 1997/98 prices	£351 million
Total detriment in 2001/02 prices	£384 million
Detriment per merger in 2001/02 prices	£32 million
Annual reduction spread over 5 years in 2001/02 prices	£6.4 million