

Proposed arrangements between International Power plc and AES Drax Holdings Limited

Report to the Office of Fair Trading

Introduction

This note is written in accordance with the Concordat between our two offices to set out Ofgem's views on this transaction so that you may take them into account in deciding whether the merger may result in a substantial lessening of competition.

In July 2003, International Power plc (IP) announced an offer to acquire 15% of the debt and up to 36% of the equity of the Drax power plant. On August 30th 2003, AES Drax Holdings (Drax) announced that it had entered into an exclusive arrangement with International Power to participate in the restructuring of Drax.¹ The proposed arrangements relate to the Drax power plant – a 3,945 MW coal-fired station.

Ofgem's consultation

On 1 October 2003, Ofgem placed an overview of the proposed arrangements on its website, and invited views on the issues raised by the transaction.² Ofgem opted for this more informal approach to consultation in this case due to the short time available for parties to respond together with the lack of significant competition concerns stemming from the proposed arrangements.

No comments were received by the deadline of Tuesday 7 October 2003. Ofgem's view is set out below.

Ofgem's views

Electricity Generation

The activities of the companies overlap in electricity generation. The relevant geographical market for the analysis of the proposed arrangements between IP and Drax is the England and Wales market (E&W). The Scottish and French interconnectors are included as sources of generation for the E&W system.

IP has two power stations in E&W (Rugely (coal-fired) and Deeside (CCGT)) with a total generation capacity of 1,296 MW (note that this excludes 250 MW at Deeside which is currently mothballed). With or without the mothballed plant, this represents approximately 2% of the total E&W generating capacity. For the year ended March 2003, IP's generation output was approximately 5,340 GWh which represents approximately 2% of the E&W total output.

The generation capacity of Drax is 3,945 MW, which represents approximately 6% of the total E&W generating capacity. For the year ended March 2003, Drax generated 20,143 GWh which represents approximately 7% of the total output.³

¹ Information sourced from International Power press releases 24 July 2003 and 1 September 2003, (www.internationalpowerplc.com)

² 115/03 - Proposed arrangements between International Power plc and AES Drax Holdings Limited

³ Capacity numbers are sourced from NGC's Seven Year Statement 2003. Generation output numbers are sourced from Elexon (financial year ended March 2003).

Horizontal issues and market concentration

Although the proposed arrangements will increase the horizontal overlap in electricity generation, this will be limited given the share of IP and Drax in the generation market in E&W. A useful measure of the concentration in a market is the HHI which has been calculated below for both electricity generation output and capacity in E&W.

	Output	Capacity
HHI pre-merger	970	840
HHI post-merger	990	861

The HHI indices above show that the proposed arrangements have only a small impact on concentration in the generation sector in E&W.

Concentration is only one indicator of the existence of market power and hence the possible effects of the transaction on competition in the sector. Ofgem considers that, due to inelastic demand and supply for electricity in the short run, market participants with relatively small market shares may on occasion possess significant market power. In addition, contracts between participants may also lead to greater market power than would be expected on the basis of directly owned market share. For these reasons, conduct regulation is very important in this sector, and Ofgem will continue to monitor the electricity generation sector in Great Britain (GB) through regular market surveillance and use Competition Act 1998 powers if necessary to stop anti-competitive conduct by any market participants.

It is possible that system transmission constraints could confer local market power on generators located in particular transmission zones on certain occasions. Since the relevant power plants are in separate (export) transmission zones, Ofgem considers that this transaction gives rise to no concern associated with local market power.

Conclusion

Available evidence suggests that the electricity generation sector in the UK is competitive. Due to the inelastic nature of short-run supply and demand in this market, the levels of market shares that may be likely to raise competition concerns in the electricity generation sector may be lower than in other sectors. However, in view of the relatively small increase in IP's sector share as a result of the proposed arrangements, Ofgem's view is that the proposed arrangements do not raise any significant competition concerns.