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Powergen UK plc's proposed acquisition of Midlands Electricity plc

Report to the Office of Fair Trading

Introduction

On 21 October 2003 Powergen UK plc (Powergen), a subsidiary of E.ON, announced that it has agreed terms for the acquisition of Midlands Electricity plc (Midlands) for a total price of £1.146 billion. The price included a payment of £36 million to Midlands' owners Aquila Inc and FirstEnergy Corp of the US, together with £626 million to the bondholders in AEPH, the company through which Aquila and FirstEnergy own Midlands. Powergen will also assume £484 million of existing debt.[1]

This note is written in accordance with the Concordat between our two offices to set out Ofgem's views on this matter so that you may take them into account in advising the European Commission.

Consultation

On 23 October 2003 Ofgem issued a consultation paper seeking views on the acquisition. Four responses were received to the consultation exercise, one of which is confidential.

Ofgem's initial view

Ofgem stated in its consultation document that it intended to apply its distribution company mergers policy should this transaction proceed, to deal with regulatory issues arising in respect of comparative regulation of electricity distribution businesses. Ofgem's initial view was that the transaction raised no significant competition concerns, and no regulatory issues beyond those covered by its distribution company mergers policy.

Details of the parties

Powergen

Powergen plc is a vertically integrated energy company, primarily active in the UK and the USA. In July 2002 it was acquired by E.ON, a large, vertically integrated German company active in a total of 20 countries (including the UK and the US). E.ON's core business is in the production and/or supply of electricity and gas.

Powergen's principal businesses in the UK include:

- **electricity generation**—Powergen owns about 9 GW of registered generation capacity.[2]

- **electricity distribution**—through its subsidiary East Midlands Electricity distribution, Powergen distributes electricity to 2.4 million customers in the former East Midlands distribution service area.

- **electricity supply**—Powergen supplies electricity to around 6 million domestic and small business customers through Powergen UK plc and Powergen Retail Ltd. [3]

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[1] Powergen website (www.powergenplc.com).
[2] NGC's seven year statement 2003
[3] Powergen website (www.powergenplc.com).

- **gas supply**—through Powergen UK plc, Powergen Retail Ltd and Powergen Gas Ltd, Powergen supplies gas to a large number of domestic and I&C customers.

- **gas shipping**—in 2001/02, Powergen shipped less than 5% of the total gas shipped through the NTS system.[4]

- **metering**–Powergen owns non-half-hourly meters located in the East Midlands area, but has outsourced all activities associated with those meters.

- **connections**–Powergen provides electricity connections services, principally in the East Midlands Distribution service area.

- **contracting services**–Powergen provides new un-metered connections and repairs existing connections, both of which are non-contestable activities.

Powergen is also active in telecommunications, providing a telephone service and an internet access package.

Midlands

Midlands is wholly owned by AEPH which is owned by Aquila Sterling Limited (ASL). Midlands owns the UK operating companies Aquila Networks plc, Aquila Networks Services Ltd, Metering Services Ltd, MEB (Contracting) Ltd, Midlands Power International Ltd and Midlands Sales Ltd. Midland's principal energy businesses include:

- **electricity distribution**—Aquila Networks distributes power in its licensed area of Birmingham and the West Midlands of England.

- **electricity generation**—through its wholly owned subsidiary Midlands Power International Ltd, Midlands has equity stakes in UK and foreign generation plant. In particular, this includes a 26.7% equity stake in a 1,875 MW CCGT plant (Teesside). This represents 0.7% of total capacity in England and Wales.[5]

- **gas supply**—Midlands supplies gas to a small number of customers (mainly I&C).

- **gas shipping**—Midlands is active in gas shipping through Midlands Sales Ltd.

- **metering**—Midlands provides data collection services and meter operating services to electricity and gas suppliers through its wholly owned subsidiary Metering Services Ltd.

- **connections**—Midlands carries out connections work in its distribution area.

- **contracting services**—Midlands provides electrical contracting services via its wholly owned subsidiary MEB (Contracting) Ltd. This contracting work consists predominantly of electrical, mechanical and public lighting services to local authorities.

[4] From Transco data

[5] NGC's seven year statement 2003

Issues arising from the completed acquisition

Electricity Distribution

Ofgem's May 2002 policy on electricity distribution company mergers identified a detriment to consumers that arises from the impact of distribution company mergers on comparative regulation in the sector. In order to compensate customers for this detriment, it specified a one-off charge of £32 million (in 2001/02 prices) payable over five years from the date of the completion of the merger and spread equally across all distribution companies in the merged group. This policy was applied for the first time in relation to the London Electricity–Seeboard merger on 20 November 2002.

Ofgem's initial view was that this transaction does not raise any competition issues in relation to electricity distribution or any regulatory issues in relation to electricity distribution that are not covered by its mergers policy, which it intended to apply in this case.

Metering

Due to the small scale of Powergen's involvement in metering services, Ofgem considers that the proposed transaction will not have a significant effect on competition in this sector.

Connections

Currently the vast majority (approximately 99%) of electricity connections are performed by the local distribution company. Although the majority of connection work is contestable, some remains non-contestable and can only be undertaken by the relevant DNO. Ofgem expects competition in the provision of connections services to develop over time, and does not expect the proposed transaction to affect significantly the development of competition in these services.

Respondents' views

Electricity Generation

Two responses (including the confidential response) expressed concern that Powergen will assume a substantial equity share in Teesside Power Limited (TPL). TPL owns and operates a 1875 MW CCGT in the North East of England. It produced [0-5%] of electricity in 2002/03.[6] Midlands Power TPL Limited, a wholly owned subsidiary of Midlands, holds a direct shareholding of almost 20% in TPL and an indirect shareholding of 7.5%.[7]

One respondent wishes to see consistency of treatment with other parties that may have interests, either as owner or customer, in the Teesside plant.

Another response points out that, if the proposed transaction is completed, Powergen will be in a position to influence the operation of TPL's business through a shareholders' agreement containing certain veto powers. The response also states that, in its capacity as shareholder in TPL, Midlands has available to it confidential information which is not available to other market participants but which is, or might be, electricity market sensitive.

A response from a consumer group states, "It is our understanding that Ofgem is already investigating the behaviour of the Company's (*Powergen's*) generation strategy."

[6] Elexon
[7] www.gpupower.co.uk/gpu/teessidepower

Electricity Distribution

One response expressed concern over Ofgem's policy on electricity distribution mergers, expressing the opinion that the policy "is flawed and simply because it is in existence is no reason to follow it."

The response also stated that applying the distribution merger policy would "appear to involve Ofgem in assuming power which it is not entitled so to do in the absence of express derogation from the EC Commission from its exclusive competence to consider the merger".

Other issues

A consumer group stated "Powergen has made no secret of the fact that it is being selective in the supply business to an extent that it is declining to offer to supply to new and even some long established customers. The reason given is the need to integrate the TXU business within Powergen." (In October 2002, Powergen acquired the customer supply business of TXU UK Ltd in an asset purchase, plus certain other UK assets of the TXU Europe Group.Ltd). The respondent is concerned that the acquisition of Midlands will accentuate the problem, which it believes "creates an artificial barrier to competition and inevitably has an effect on prices."

A response from an integrated energy company expressed the wish that "Powergen will be obliged to ensure that the name used for the newly acquired distribution business will be distinct both from the Powergen supply brand and the former Midlands Electricity name, to avoid any confusion to customers."

Ofgem response

Generation

Powergen currently has about 9 GW, or 13.5%, of generation capacity in England and Wales. For the year ended March 2003, it generated [10-15%] of electricity. If the proposed acquisition goes ahead, Powergen would acquire a 26.7% equity stake in Teesside Power, which has a capacity of 1875 MW and in the year to March 2003 generated approximately [0-5%] of electricity.

Assigning the entire capacity and output of Teesside to Powergen would increase its share of capacity from about 13.5% to 16.0% and its share of output from around [10-15%] to [15-20%]. Ofgem considers that it is appropriate to assign capacity and output from the plant in proportion to Powergen's equity stake. This would move Powergen's share from 13.5% to 14.0% by capacity, and from [10-15%] to [10-15%] by output.[8] The Hirschman-Herfindahl Index (HHI) of concentration increases only very slightly as a result of the proposed transaction – from 802 to 816 for capacity, and from 876 [by less than 50] for output.

Ofgem has noted previously in its advice to the OFT regarding the proposed arrangements between International Power and Drax[9] that the market shares that may be likely to give rise to competition concerns in the electricity generation sector may be lower than in other sectors due to the inelastic nature of short-run supply and demand in this market. Nevertheless Ofgem's view

[8] All capacity numbers are from NGC's Seven Year Statement 2003. Powergen's output numbers are from Elexon. Capacity market shares are rounded to the nearest 0.5%.
[9] Proposed arrangements between International Power plc and Drax Holdings Limited – Report to the Office of Fair Trading, October 2003.

is that the increase in generation capacity and output as a result of the proposed transaction raises no significant competition issues.

Furthermore, Ofgem considers that Powergen's access to information as a result of the transaction does not raise any additional competition concerns. Ofgem considers that agreements between investors and customers of the plant are commercial matters for those parties.

Ofgem conducts ongoing market monitoring of all generation companies, but is conducting no separate investigation into Powergen's generation strategy.

Distribution

Ofgem's policy on electricity distribution mergers has been approved by the Gas and Electricity Markets Authority, in consultation with industry and interested parties. Ofgem has set out its reasons for adopting the policy and has stated its intention to apply it to all future mergers in the sector. Ofgem's policy has not changed since it was announced in March 2002. It should be noted that the policy considered the case of more than two distribution companies being involved in a merger, and concluded that the £32m reduction should be applied for the loss of each comparator.

In correspondence between Ofgem and the Commission in relation to the Ofgem distribution companies' mergers policy, the Commission agreed that licence modifications subsequent to a distribution company transaction are an application of Ofgem's ongoing regulatory practice. Therefore, Ofgem considers that the exercise of its licence modification powers is not aimed at the concentration, which is within the Commission's exclusive jurisdiction under the ECMR. Accordingly, we are of the view that Ofgem may initiate the licence changes in this case without prejudice to the Commission's exclusive jurisdiction, as they are part of the ongoing regulatory process. The Commission agreed with this view in the case of London Electricity's acquisition of Seeboard in 2002, and Ofgem has written to the Commission to gain confirmation of this view in relation to the current proposed transaction.

Other Issues

We note the concern that Powergen has had difficulties in integrating the recently-acquired TXU company into the rest of the business. In July 2003 Ofgem published its initial findings of a review of the non-domestic supply sectors. [10] That review considered factors including those mentioned by the respondent and found that these sectors appeared broadly competitive. Ofgem does not therefore consider that respondents' views raise grounds for concern in the supply sector.

Standard Licence Condition 39 of the electricity distribution licence requires licensees to publish and implement a policy setting out how they will maintain the branding of the distribution business so that it is fully independent from the branding used by any affiliated supplier or shipper. In view of the level and scope of the Group's involvement in energy supply markets, Ofgem agreed with Aquila Networks that the public perception of the distribution business as a separate entity from the supply businesses would not be compromised by the distribution business using the Aquila brand. Should this transaction proceed, the licensee will be affiliated with a major retail supply business, and Ofgem is currently in discussions with Powergen about the application of Condition 39 should the proposed transaction proceed.

[10] Review of competition in the non-domestic gas and electricity supply sectors. Initial findings. Ofgem 72/03

Conclusion

Ofgem's view remains that no significant competition concerns arise from the proposed acquisition. Ofgem intends to apply its distribution company mergers policy should the transaction proceed.