From: Upton, Neil [nupton@london.whitecase.com]
Sent: 31 October 2003 16:50
To: Ben Woodside
Subject: Powergen's Proposed Acquisition of Midland's Electricity

Dear Mr. Woodside

I am responding to the announcement of the proposed acquisition by Powergen UK plc (Powergen) of Midland's Electricity plc (Midlands) and, in particular, I am responding to the notification that Ofgem intends to apply its policy on electricity distribution mergers including a compensation and a specific charge of £32million spread across the distribution companies of the merged group. I acknowledge that this policy was applied in relation to the London Electricity - Seeboard merger and your intention to apply it again in this case.

My interest in this is purely, as I am sure your own is, the application of appropriate regulatory standards and an appropriate exercise of the powers and obligations of Ofgem.

In order to implement your proposals, you will need to seek licence modifications to reduce the regulated revenues of Powergen's existing distribution business as well as the Midland's Electricity Business which is acquired. Presumably, in line with the position on the London Electricity/Seeboard transaction and your merger policy, Ofgem will be arguing that it is doing this as part of its ongoing regulation of the sector. It will seek the modifications and consent will be invited and, if that consent is received, then the modifications will take effect. In the absence of consent of course, Ofgem would need to make a reference of the licences to the Competition Commission in accordance with the procedures laid down under the Electricity Act.

The Ofgem proposal to the licence modification requiring a £32million reduction in revenue is as a consequence of the changed structure of the two distribution businesses brought about by the merger. The Ofgem justification lies in the loss of comparators. In the case of the London Electricity/Seeboard merger, there were of course three distribution businesses involved (including that of the Eastern region). Ofgem appears therefore, to already be indicating that the same loss of comparator and the same effect occurs when there is a merger which involves three distribution businesses as with one which includes two. That cannot be correct either as a matter of underlying costs or as a consequential economic effect on those businesses. Further, Ofgem already has powers to amend and adjust distribution revenues at price control. The more appropriate means would be to look at those businesses at the price control review in April 2005 and then determine precisely what the regulated revenue should be for each of the distribution areas at that time.

Ofgem's proposal, even if it is consistent with its own policy is quite clearly arbitrary, perverse and ill conceived. Further, that policy itself is flawed and simply because it is in existence is no reason to follow a policy which should never have been adopted in the first place.

Also, I cannot be alone in believing that the implementation of that policy can only have the effect of double jeopardy on any business to which it is applied. In effect, Ofgem seeks to take the benefits of reduced synergies in the business by putting two systems together. It then further applies a £32million levy over a 5 year period. As a matter of practice, that is precisely the type of regulatory policy which leads to the problems which have been experienced recently in the north east of the United States and in Italy/France as monopoly businesses are compelled to cut costs in ways which they otherwise would not do. That cannot be an appropriate exercise of a regulator's powers.

The merger policy, is of course based upon Ofgem's contention that the loss of a comparator has a particular cost to it. That policy itself recognises that there is "ambiguity over the size of the detriment". The reason that there is ambiguity is of course that it is manifestly unfair and unreasonable and the use of the word "ambiguity" is an under statement. No two distribution businesses have the same basis of costs and neither are they equivalent comparators as against other Distribution businesses. Further, the application of the loss of the comparator test where you have, I believe still some seven distribution groups giving plenty of opportunity to compare one business against another should not prevent the setting of appropriate price controls. If it is true that the loss of a comparator creates a difficulty in setting a reasonable and relevant price control then how can it possibly be that National Grid and Transco have price controls set for their monopoly systems (without any comparators whatsoever) and where Ofgem has never, to my knowledge, claimed that it has difficulties in setting an appropriate price control.

In conclusion, the whole policy that Ofgem has adopted is fundamentally flawed. It is ill conceived, unreasonable and unlawful. The appropriate way for Ofgem to behave in these circumstances is to calculate on the basis of an individual circumstance and only up to the next price control. It should then reset price controls for the distribution business in line with the circumstances that exist at that time and only at that time and in line with its existing powers and duties.

In this response, I am addressing only the basics of the £32million arbitrary policy and make no comment on the procedure which Ofgem is following although that would also 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.

Please take these thoughts and concerns into consideration as part of the consultation process. Please also note that, I have no relationship to any existing distribution business and am only interested in the proper application of regulation and regulatory policy within the industry in which I work.

Yours sincerely
Neil Upton