# Macquarie's proposed acquisition of the Wales and West gas distribution network

# Ofgem's advice to the OFT

MGN Gas Networks (UK) (MGN) is proposing to acquire the assets and the licence for the Wales and West gas distribution network (DN) from National Grid Transco (Transco). MGN is a holding company established for the purpose of this transaction of eight investors established by Macquarie Bank Limited (MBL) which is an investment bank listed on the Australian stock exchange. Other investors include a number of investment funds and financial institutions, some led by subsidiaries of Macquarie Bank.

MGN currently has no interests in other parts of the gas industry. MBL has recently obtained a gas shipping licence and is authorised to trade in wholesale gas. The Macquarie Group is currently involved in the provision of metering services through its interest in Capital Meters Limited, a joint venture with Siemens.

Wales and West distribution network is one of the four regional DNs in Great Britain that Transco envisages selling.

The purpose of this note is to set out Ofgem's views on this transaction, in accordance with the concordat between our two offices, so that the Office of Fair Trading (OFT) may take them into account in deciding whether the acquisition may result in a substantial lessening of competition.

**Consultation**

On 3 March 2005, Ofgem placed an overview of Macquarie's potential acquisition of the DN on its website and invited views on the issues raised by the proposal. Ofgem received no responses to the consultation.

It should be noted that in addition to Ofgem's formal consultation on the proposed acquisition, we have undertaken an extensive consultation on NGT's planned disposal of DN assets. This consultation process has been over a period in excess of 18 months and during this period interested parties have had the opportunity to comment on all aspects of the potential transactions.

**Ofgem's view**

In this section we set out Ofgem's view on MGN's proposed acquisition of the Wales and West DN with respect to its impact upon gas distribution as well as its impact upon competition in the wholesale gas market and in metering.

## Gas distribution

Transco currently owns the eight regional DNs monopolies in Great Britain as well as the National Transmission System (NTS). If the proposed sale proceeds, Macquarie will acquire one of the four DNs which Transco is proposing to sell. Irrespective of whether this acquisition occurs, all DNs are currently and will remain natural monopolies subject to regulation by Ofgem. A feature of the regulatory regime is that, the DNs will be subject to a regular price control review (typically once every five years) that determines the allowed revenue that can be recovered through its transportation charges. The DN licensees are also subject to a number of statutory and licence requirements, such as to ensure no undue discrimination between users of its network. A failure to comply with either the statutory or licence requirements can result in Ofgem taking enforcement action and potentially imposing financial penalties up to 10 per cent of group turn over.

Ofgem expects that the entry of MGN and the other new DN purchasers[1] into the regulated market for gas distribution is likely not only to protect the interests of customers but actually result in customer benefits. These benefits are expected to take the form of lower transportation charges for the future use of gas distribution networks as a result of comparative regulation which has already been a feature of the electricity and water sectors since privatisation.[2]

The separate ownership of the gas distribution businesses should enable Ofgem to compare the performance of DNs through the price control process that occurs every five years. The additional information created through separate ownership would enable Ofgem to set the allowed revenues that DNs can recover on the basis of the costs of the most efficient network, rather than on the basis of one company's costs (i.e. Transco's costs). As a result, Ofgem would expect the DN allowed revenues set in future price controls to be relatively lower, compared to the scenario where Transco continues to own all DN businesses. Ofgem also expects that the introduction of independent management teams to the DNs will stimulate innovation and generate greater efficiency savings than if Transco continues to own all the DNs.

Ofgem's analysis suggests that the net benefits to customers could potentially be in the order of £225 million, in present value terms, if the sale of the four relevant DNs to three purchasers were to proceed. It is expected that these potential benefits would be primarily derived from comparative regulation.[3]

## Impact on competition in related markets

*Wholesale gas markets*

MGN has no direct interests in gas shipping. MBL, which owns some of the subsidiaries in the consortium, has recently taken up a gas shipping licence and is authorised to carry out to trade in Great Britain. []This is not expected to raise any competition concerns.

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[1] These are the Cheung Kong Infrastructure Holdings consortium's acquisition of the North of England DN and the Scotia Gas Networks acquisition of Scotland and South of England DNs. These are subject to separate merger control procedures by the European Commission and the OFT respectively. They are considered by Ofgem in separate advice to the OFT.
[2] *National Grid Transco - Potential sale of gas distribution network businesses Final Impact Assessment,* Ofgem, November 2004, Chapter 4.
[3] See Chapter 10 of Ofgem's November Final Impact Assessment. The potential net benefits were calculated in net present value terms over the period between 2005/06 and 2002/23.

Currently all onshore gas trades are conducted by shippers at the National Balancing Point (NBP), which is a notional point on Transco's gas network. These trades are conducted by shippers on an over the counter basis or through specialist trading exchanges. The NBP is a deep and liquid gas market with both spot and forwards wholesale gas prices being based on the trades that occur at this notional hub. The volume of trades at the NBP amounts to approximately six times the throughput of gas on Transco's network and has facilitated price discovery.

Under the present balancing arrangements shippers have financial incentives, through 'cash-out' prices, to balance their inputs and offtakes on the gas system on a daily basis with Transco acting as a residual gas balancer. In undertaking this role Transco is able to buy and sell gas on an 'on the day commodity market' to ensure that the gas network remains in balance on a daily basis.

Following extensive consultation on the regulatory, commercial and operational arrangements associated with DN sales, Ofgem concluded that the present NBP arrangements should be retained with Transco retaining its role as residual energy balancer. In reaching this view, Ofgem concluded that the creation of a number of separate balancing points as a result of the DN sales process could potentially reduce liquidity at the NBP and hamper price discovery. In extremis, nine such balancing points could arise if each DN were to insist that shippers balance on its individual network. Ofgem considered that this would represent a departure from the present trading arrangements and would reduce competition by segmenting the wholesale market. Ofgem's conclusions were subsequently endorsed by the Authority at its January 2005 meeting in which it provided its conditional consent to DN sales. [4]
Ofgem would also note that the governance arrangements for the newly owned networks would not allow a new DN company to develop its own balancing arrangements for its network without consultation and Authority approval.

It is noted that, following extensive consultation undertaken through the DN sales process, each DN will be responsible for the operation of its own DN business.[5] This will include system planning and maintenance as well as system operation which includes congestion management. An important part of congestion management includes contracting for interruption on each DN.
Even if MBL were able to influence the activities of the MGN consortium in the management of the DN, via its subsidiaries, the effect on competition in the wholesale market will be constrained by the regulatory regime. Ofgem has proposed licence conditions that would require all DNs to separate and ring fence its DN businesses from related businesses including related gas shipping. These proposed licence conditions have been described below.

**Existing and proposed regulatory protections**

[4] Ofgem *National Grid Transco -Sale of Gas Distribution Network*, Authority Decision, Transco plc application to dispose of four gas distribution networks, February 2005.

[5] See *National Grid Transco – Potential sale of network distribution businesses – Allocation of roles and responsibilities between transmission and distribution networks, Regulatory Impact Assessment,* Ofgem, April 2004. See also Ofgem's conclusions document on this issue, namely, *National Grid Transco – Potential sale of network distribution businesses – Allocation of roles and responsibilities between transmission and distribution networks, Regulatory Impact Assessment*, Ofgem, May 2004.

The Wales and West DN proposed to be acquired by MGN will be bound by a broad range of statutory obligations intended to prohibit them from discriminating in favour of any related businesses in the gas sector.

Without limitation, the key relevant statutory obligations on GTs are:

- to develop and maintain an efficient and economical pipeline system (s9(1)(a)of the Gas Act 1986 (the Gas Act));
- to facilitate competition in the supply of gas (s9(1)(A) of the Gas Act); and
- to avoid any undue preference or undue discrimination in the terms on which it undertakes to convey gas (s9(2)(b) of the Gas Act).

*Proposed licence obligations*

In addition to its statutory obligations it is proposed the Wales and West DN will also be subject to a series of (additional) licence obligations that are also intended to prevent them from discriminating in favour of any related businesses. It is also proposed that they will be subject to the equivalent licence obligations that currently apply to Transco in respect of the publication of transportation prices and charging methodologies.

In February 2005, Ofgem published its formal licence consultation, under Section 8AA and Section 23 of the Gas Act, regarding the modifications that would need to be made to Transco's existing GT licence to support a potential DN sale. As part of this Ofgem is formally consulting on proposed licence conditions that would seek to address issues associated with the potential for new DN owners to exercise undue discrimination as well as a number of business separation licence conditions that would, if implemented, apply to both Transco and the new DN companies. Ofgem's consultation closes on 15 April 2005. Under the conditions attached to the consent to the DN sales transaction[6] that was granted by the Authority in January 2005, Transco must accept the proposed licence changes and any additional changes that may be required before it may transfer its DN assets to the four wholly owned Transco subsidiary companies.[7]

It is noted that as part of this process, under Section 8AA of the Gas Act, Ofgem is also consulting upon the transfer of the four DN licences, in respect of the businesses that are to be sold, from Transco to four wholly owned Transco subsidiary companies. Subject to the outcome of this consultation process, it is envisaged that the transfer of these licences (including the business separation conditions) would occur on 1 May 2005. At this point, the four DN companies would become the holders of the relevant DN licences in respect of the four DN businesses albeit under the common ownership of Transco plc. Once transferred, it is proposed that approximately one month later completion will occur as the shares in these four relevant wholly owned subsidiary companies (which will at that stage also own the relevant DN assets) would

[6] A detailed discussion of the Authority's decision and the conditions to consent can be found in the Authority's February 2005 decision document, *National Grid Transco – Sale of gas distribution networks: Transco plc applications to dispose of four gas distribution networks Authority decision,* February 2005 21/05

[7] References to Standard Special GT licence conditions are references to the proposed licence arrangements that will apply in the event that Transco's proposed disposal occurs. Similar conditions already apply under Transco's existing GT licence.

subsequently be acquired by the third party purchasers including MGN. Once completion occurs, subject to a number of exceptions, the GT licences can only be modified with agreement from Ofgem (or, if this is withheld, following a successful reference to the Competition Commission).

Without limitation, the proposed relevant licence conditions that are currently being consulted upon include conditions on each DN requiring that:

- it conducts its transportation business in a manner best calculated to secure that neither it nor its affiliates and related undertakings obtain any unfair commercial advantage, including, in particular, any advantage from a preferential or discriminatory arrangement (Standard Special Condition A6 of the Gas Transporter (GT) licence); [8]

- it uses a charging methodology that reflects the true costs incurred by the licensee in its transportation business (paragraph (5)(a) of Standard Special Condition A5 of the GT licence);

- it publishes and keeps up to date a charging statement, which it will be obliged to apply on a non-discriminatory basis to all users of the gas distribution networks (Standard Special Condition A4 of the GT licence);[9] and

- it complies with a business separation regime, including by carrying out managerial, operational and informational separation and by appointing a compliance officer (Standard Special Conditions A33 and A34 of the GT licence).

**Proposed business separation licence conditions**

As noted above, in developing the proposed licence arrangements, Ofgem has had careful regard to the potential impact of the proposed transaction on competition, and has developed, where appropriate, licence obligations relating to the separation of monopoly and competitive activities. These proposed licence conditions are referred to as the 'business separation regime' and are discussed in more detail below.

In essence, these proposed licence conditions put the onus on the licensee to:

- develop managerial and operational systems which prevent any relevant supplier or shipper from having preferential access to confidential information, and
- manage and operate the DN business in a way that does not restrict, prevent or distort competition.

In addition, under the proposed conditions, the licensee would be required to have in place a statement describing the practices, procedures and systems it has adopted to ensure that these conditions are met. Under the proposals, the statement must be approved by the Authority and set out how the licensee shall maintain full managerial and operational independence of the distribution business from any relevant shipper, supplier or generator including separate branding, and (so far is required to ensure compliance with the provisions) separate premises, systems, equipment, facilities and

[8] Transco's charging statement is available on Transco's website at
http://www.transco.co.uk/pricing/ChargesDocs/Transportation_Charges_1004_v2.pdf

management and operations staff. Licensees would be required to use their best endeavours to comply with the statement.

Further, under the proposed conditions, the licensee would be required to appoint, following consultation with the Authority, a compliance officer whose function is to facilitate compliance with the DN's business separation and no undue discrimination obligations. A failure to implement these provisions adequately would result in the removal of the officer. Compliance officers must be given access to resources and information to enable them to fulfil their functions. Among other things, it is proposed that the duties of the compliance officer include:

- monitoring the effectiveness of the practices, procedures and systems adopted in accordance with the statement referred to above;
- investigating any complaints received in relation to the licensee's business separation arrangements; and
- providing an annual report to the directors of the licensee.

Finally, under the proposed conditions, the licensee would be required to provide an annual report to the Authority setting out its compliance with the business separation and no undue discrimination obligations, and its compliance with the statement. Any breach of these licence obligations Ofgem has a range of enforcement powers including the ability to impose a penalty of up to 10% of the licensee's turnover in the last financial year.

*Metering*

With regard to the impact of the proposed acquisition on metering services, Ofgem agrees with the assessment by the parties that the acquisition does not raise competition concerns. Following Ofgem's Review of Gas Metering Arrangements, competition has now been introduced in relation to the provision of gas metering services. Transco has provided the majority of these metering services in the past and currently continues to do so. Under the new arrangements, Transco will continue to have an obligation in its GT licence to act as a meter provider of last resort. It is proposed that these obligations will likewise be inserted into the licences of the new DN companies. In this context we consider that the proposed acquisition is unlikely to raise competition concerns. The introduction of meter provider of last resort obligations on the new DN companies is likely to be pro-competitive as it will encourage the entry of new providers into a sector where competition is developing.

**Conclusion**

Ofgem does not expect the acquisition of Wales and West distribution network by MGN to raise any competition concerns at this time. MGN has no other interests in the production, shipping, transportation or supply of gas. MBL, which wholly owns some of the subsidiaries in the MGN consortiumhas a gas shipping licence . However, any potential risks of MBL being able to influence the operation of the DN to give its shipping arm an unfair commercial advantage are constrained by the regulatory regime established by Ofgem. The acquisition is also unlikely to present any competition concerns with regards to metering.