Scotia Gas Networks proposed acquisition of two gas distribution networks

Ofgem's advice to the OFT

The Scotia Gas Networks consortium (Scotia) has agreed to purchase the gas distribution networks (DNs) in Scotland and the South of England. Scotia is comprised of Scottish and Southern Energy (SSE) which has a [ ]% interest in the consortium, as well as Borealis [ ] and Ontario Teachers [ ]. SSE, which retains majority share in the consortium, is involved in a range of additional activities within the gas and electricity sectors including gas supply, gas wholesale and gas storage, as well as wholesale, supply, transmission and distribution of electricity. The Scotland DN and South of England DN are two of the eight regional monopoly gas DNs currently owned by Transco plc (Transco) in Great Britain.

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.

It is important to note that nothing in this submission fetters or limits the discretion of the Gas and Electricity Markets Authority (the Authority) in the discharge of its functions, including, without limitation, the decisions it may take in the future in respect of the proposed modifications of Transco's Gas Transporter (GT) licences.

Consultation

On 21 February 2005, Ofgem placed an overview of Scotia's potential acquisition of two DN companies on its website, and invited views on the issues raised by the proposal. Ofgem received one response to the consultation that was also copied to the OFT. The respondent raised concerns that SSE may be able to use the commercially sensitive information, collected from its operation of the two relevant DNs, to obtain an unfair commercial advantage in the electricity wholesale market. The respondent also suggested that an approach to business separation, based on the arrangements that apply in electricity, may not be sufficient to address issues that may arise in relation to this transaction. These concerns are considered in Ofgem's advice below.

It should be noted that in addition to Ofgem's formal consultation on the proposed acquisition for Scotia network, 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 Scotia's proposed acquisition of two DN companies with respect to its impact upon gas distribution as well as its impact upon competition in the markets in which SSE participates, namely the wholesale gas market, the wholesale electricity market, and the retail gas market. We also consider the potential impact that the proposed acquisition could have in relation to competition in metering.

Gas distribution

Transco currently owns the eight regional DNs monopolies in Great Britain as well as the National Transmission System (NTS). This differs from the industry structure in electricity where National Grid owns the NTS but other companies own and operate the electricity DNs. If the proposed sale proceeds, Scotia will acquire two 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, each DN 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 the licensee's turnover. [1]

Ofgem expects that the entry of Scotia and the other new DN purchasers[2] 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.[3]

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 efficiency savings relative to the scenario where Transco continues to own all DNs. New efficiency savings could also arise as a result of economies of scope, i.e., the synergies that may be achieved as a result of owning and operating multiple infrastructure networks in a given area (for instance, SSE owns electricity distribution networks that overlap with the two relevant gas DNs).

---

[1] Section 30A of the Gas Act 1986 and Statutory Instrument 2002/1111 The Electricity and Gas (Determination of Panalties) Order

[2] These are the Cheung Kong Infrastructure Holdings consortium's acquisition of the North of Englans DN and the Macquarie European Infrastructure Fund consortium's acquisition of the Wales and West DN. 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.

[3] *National Grid Transco - Potential sale of gas distribution network businesses Final Impact Assessment,* Ofgem, November 2004, Chapter 4.

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.[4]

Impact on competition in related markets

SSE, the main shareholder of the Scotia consortium, has a variety of interests in the gas industry, including retail, shipping, and storage. SSE also has electricity industry interests, including electricity generation, supply, distribution and transmission. As multiple ownership of different gas and electricity interests is not uncommon in the energy sector, regulatory provisions already exist to address the issues that arise in these circumstances.

This section of Ofgem's advice:

- ♦ explains the regulatory protections that exist or which are proposed to be put in place that would prevent SSE using its interest in the two relevant gas DNs to obtain an unfair advantage in related markets;
- ♦ explains in more detail a key element of the proposed regulatory arrangements known as the business separation regime; and
- ♦ considers whether the proposed acquisition may be expected to give rise to competition concerns in any of the other related markets, including the gas retail, gas wholesale, electricity distribution and metering markets.

Existing and proposed regulatory protections

It is important to note that the two relevant DN companies proposed to be acquired by Scotia as the prospective holders of Gas Transporter (GT) licences in respect of Scotland and South of England 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 that the two relevant DN companies to be acquired by Scotia will also be subject to a series of licence obligations that are also intended to prevent them from discriminating in favour of any related businesses. It

[4] 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.

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. The proposed business separation licence obligations that are being consulted upon are largely modelled on the business separation regime which currently exists in the electricity and are discussed further below. Ofgem's consultation closes on 15 April 2005.

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

Under the conditions attached to the consent to the DN sales transaction that was granted by the Authority in January 2005, Transco must accept the proposed licence changes before it may transfer its DN assets to the four wholly owned Transco subsidiary companies.[5] It additionally must consent to any further changes to the licence that are required prior to completion.

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);[6]

[5] 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.

[6] 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.

- 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);[7] 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 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

---

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

- 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.

It is noted that the Authority's consent to Transco's proposed disposal of four DNs is contingent upon Transco's consent to the licence modifications considered necessary to protect the interests of customers in a divested industry structure. Therefore, the business separation licence conditions described above will need to be in place before Transco is permitted to sell its DNs to Scotia, and the two relevant DNs will need to comply with the provisions from the date on which Scotia takes ownership. For this to occur, prior to completion, the two relevant DNs must produce compliance statements and obtain approval for the compliance statement from the Authority.

In the event of 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. [8] There are therefore strong incentives on SSE to ensure compliance.

A copy of the proposed licence conditions relating to business separation in the document by National Grid Transco "Potential Sale of Gas Distribution Network Businesses – Formal Consultation under section 23 and section 8AA of the Gas Act 1986 February 2005 45/05".

Consideration of specific markets

Gas Retail Market

In the absence of effective regulation, there is a risk that SSE could use its control of the operation of the South of England DN and Scotland DN to hamper customers switching from SSE to competing suppliers. However, in the case of DN sales, Ofgem considers that this risk has been removed by the establishment of an Agency (Xoserve) which has been introduced as an entity that would be owned by Transco and the DNs and would provide many of the services that Transco currently provides on a centralised basis, including supply point administration (ie customer transfer processes). The scope of the Agency arrangements, which include supply point administration, can only be changed with the approval of the Authority.

The purpose of the Agency is to minimise and mitigate the costs to shippers and suppliers, and therefore customers, associated with moving to a fragmented industry structure. In the absence of the Agency, the sale of DNs could require significant changes to supply point administration systems as well as data management and system operation information interfaces as shippers and suppliers would need to develop their own systems to interface with separately owned DNs. The concept of an Agency was originally proposed by Transco and has been consulted upon by Ofgem[9] over recent months. In January 2005, as part of its decision to provide conditional consent to DN

---

[8] Statutory Instrument 2002/1111 The Electricity and Gas (Determination of Penalties) Order

[9] National Grid Transco – Potential sale of network distribution businesses Agency and governance arrangements *Regulatory Impact Assessment April 2004 83/04* and National Grid Transco – Potential sale of gas network distribution businesses - Agency and governance arrangements *Decision document May 2004 120/04*

sales, the Authority endorsed the scope of the Agency arrangements that were set out in Ofgem's November 2004 Final Impact Assessment.

Notwithstanding the Agency arrangements, it is noted that SSE's shares of the GB gas retail markets is fairly small, and amount to approximately [ ] per cent of the market for domestic supply.

In the light of the above analysis, it is Ofgem's view that competition in the gas retail market will largely remain unaffected by the change in structure in gas distribution.

Wholesale gas markets

Scotia's acquisition of the South of England DN and Scotland DN is not expected to raise competition concerns with respect to the gas wholesale market. 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 be harmful to competition. Ofgem's conclusions were subsequently endorsed by the Authority at its January 2005 meeting in which it provided its conditional consent to DN sales.

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.

On the basis of these conclusions, it is Ofgem's view that Scotia's acquisition of the two relevant DNs should have no impact upon the wholesale gas market. In any event, Ofgem considers that SSE's share of the gas shipping market is comparatively low. By way of example, analysis undertaken by Ofgem indicates that SSE's share of throughput across Transco's network as a shipper is small and less than [ ] %.[10]

[10] This is based upon an assessment of SSE's share of User Daily Offtake Quantities from the gas network for the months of July and December 2004. For the month of July 2004, SSE's share of offtake from the gas network is approximately % and for the month of December 2004 this share is approximately %.

It is noted that, following extensive consultation undertaken through the DN sales process, each DN company will be responsible for the operation of its own DN business.[11] 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.

In the absence of effective regulation, there is a risk that SSE, through its interest in Scotia, could use its position to discriminate and unfairly interrupt sites supplied by competing shipper businesses, thus conferring an unfair commercial advantage on SSE's own shipping arm.

However, Ofgem has sought to address this risk by proposing the introduction of licence conditions that would require Scotia to separate and ring fence its DN businesses from related businesses including related gas shipping and gas supply businesses. These proposed licence conditions have been described above.

Wholesale electricity market

SSE retains approximately a [ ] per cent share of the wholesale market for electricity in Great Britain. As noted in Ofgem's advice on previous acquisitions, a common system for electricity trading will be implemented from April 2005 across the whole of Great Britain.[12] As noted above, one respondent raised concerns that SSE, through its interest in Scotia would be able to use its operation of the two relevant DNs to gain commercially sensitive information about gas fired electricity generation businesses that it competes with in the wholesale electricity market.

Ofgem notes the concerns raised by this respondent that the current proposed business separation licence conditions do not prevent the sharing of confidential information between the DN business and any related generation businesses. As noted above, Ofgem is now formally consulting (through the section 8AA and associated section 23 process) on a number of licence conditions related to business separation and will consider views on the robustness of the proposed licence conditions. Nevertheless, Ofgem has reviewed the concern that has been raised and has reached an initial view that the proposed business separation licence conditions do not adequately address the potential for confidential or commercially sensitive information to be shared as between the DN and any related wholesale electricity business including a generation businesses. As such, and subject to a more detailed review of the licence drafting, Ofgem would expect to address these deficiencies in the proposed licence conditions prior to the completion of the sale of the DN businesses to Scotia and the other buyers.

Following this review Ofgem intends that the proposed licence obligation on the two DNs to be acquired by Scotia would apply equally to electricity wholesale business (generation and supply) as well as to gas shipping and gas supply.

---

[11] 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.

[12] The implementation of the common GB electricity transmission and trading arrangements is subject to subject to the commencement of the relevant provisions of the Energy Act 2004.

Ofgem notes that the respondent has also indicated that it is not convinced that the replication of the electricity business separation requirements in the gas sector is sufficient given SSE's business interests across this sector. Ofgem would note however that the business separation arrangements that are proposed for the gas sector are more stringent than those that apply in electricity. In particular, under the proposed licence conditions each DN would have a best endeavours obligation to comply with its business separation statement as opposed to the reasonable endeavours obligation that applies in the electricity sector.

Ofgem also considers that, even in the absence of effective business separation requirements, the ability of SSE, through its interest in Scotia, to distort competition in the wholesale electricity market is likely to be limited given that most gas fired generation plants are connected to Transco's National Transmission System rather than the DNs.

In view of the above analysis, Ofgem considers that the sale of gas DN businesses to Scotia should not have any significant impact on competition in the wholesale electricity market in Great Britain.

Metering

With regard to the impact of the proposed acquisition on metering services, Ofgem agrees with SSE's assessment 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 may promote the entry of new providers into a sector where competition is developing.

Conclusion

It is Ofgem's view that the acquisition of the South of England DN and Scotland DN by Scotia will not lead to a substantial lessening of competition in gas distribution or any related markets.

With respect to the gas distribution sector, Ofgem considers that the acquisition should provide benefits to customers in the form of lower transportation charges resulting from comparative regulation undertaken by Ofgem in reviewing the price controls of each DN business.

Further, any ability of SSE to use its monopoly control of the two relevant DN networks to affect competition in the gas wholesale, gas retail or electricity wholesale markets will be constrained by the proposed regulatory framework governing the sale.

The gas wholesale market will continue to exist on a GB wide basis for which prices will continue to be determined by trades at the NBP. The DN sales process will not result in the introduction of regional DN balancing markets in which individual DNs have responsibility for the residual balancing of their systems. On this basis, Ofgem does not consider that SSE, through its interests in Scotia, would have an ability to distort competition in the wholesale gas market as it would not have any residual gas balancing role.

Ofgem recognises that in the absence of regulation there could be a risk that SSE would use its control of the two relevant DN networks either to interrupt (for constraint or congestion management purposes) competing shippers using the network, or interrupt the delivery of gas to competing electricity generators. However, Ofgem is currently consulting on proposed business separation licence conditions, which are designed to ensure that the DN is managed and operated separately from the other parts of the business and that the DN operator does not restrict, prevent or distort competition. The two DNs acquired by Scotia will also be obliged to appoint a compliance officer to monitor the system and investigate complaints.

In terms of the gas retail market, an Agency is being set up to manage the customer transfer processes on a centralised basis. This Agency will be owned by Transco and the DNs and as such, SSE will not be able to use its interests in Scotia to hamper customer transfer processes in order to favour its own supply business.

It is also important to note that it is envisaged that the two relevant DN companies to be acquired by Scotia, who are the prospective holders of two DN licences will also be subject to a series of statutory and licence obligations intended to ensure that their transportation charges and methodologies are transparent and which would ensure that they cannot discriminate in favour of related downstream or upstream businesses.

Compliance with the various proposed licence conditions outlined in this submission would be enforced by Ofgem. Ofgem has powers to investigate complaints and impose financial penalties for breaches of licence conditions. A breach of these licence conditions will potentially subject a DN company to penalties of up to 10% of the licensee's turnover.

It is noted that the Authority's consent to Transco's proposed disposal of four DNs is contingent upon Transco's consent to the licence modifications considered necessary to protect the interests of customers in a divested industry structure. Therefore, the business separation and other licence conditions described above will need to be in place before Transco is permitted to sell its DNs to Scotia, and the relevant DN companies will need to comply with the provisions from the day they take ownership.

In respect of business separation, it is noted that the relevant DN companies must produce that statement and obtain approval for the compliance statement from the Authority prior to the completion of the share sale. Scotia is due to produce a draft of the compliance statements, which will be applicable to its two DN companies, shortly. Ofgem would be happy to share this document with the OFT.

Once the DN businesses are sold, subject to a number of exceptions, Scotia can only seek subsequent modifications to the DN licences, which will be held by the DN companies, with Ofgem's agreement or, where that is denied, following a reference to the Competition Commission.

In summary given the regulatory regime that is in place it is Ofgem's view that the transaction does not give rise to a substantial lessening of competition in any of the markets concerned.