Anticipated acquisition by Scotia Gas Network plc of the Scotland and South of England gas distribution networks from National Grid Transco

The OFT's decision on reference under section 33(1) given on 25 April 2005. Full text of decision published 30 April 2005.

PARTIES

1. **Scotia Gas Networks plc (SGN)** is a consortium in which **Scottish and Southern Energy plc (SSE)** will hold 50 per cent of the equity with the remaining equity being equally split between two Canadian pension funds: **Borealis Infrastructure Management Inc (Borealis)** and **Ontario Teachers' Pension Plan Board (Teachers).** SGN is the holding company for the businesses being acquired.

2. **SSE** is a public company limited by shares, incorporated in Scotland. Its ordinary share capital is listed on the London Stock Exchange. Its principal businesses through the following wholly-owned subsidiaries are:

   (i) through SSE Power Distribution Ltd, the transmission of electricity in its Authorised Area of Northern Scotland and the distribution of electricity in its Authorised Areas of Northern Scotland and Southern England;
   (ii) through SSE Energy Supply Limited, gas shipping and the supply of electricity and gas throughout Great Britain;
   (iii) through SSE Generation Limited, the generation of electricity throughout Great Britain. SSE is the second largest generator in Great Britain;
   (iv) through SSE Hornsea Ltd, the provision of gas storage services at the Hornsea gas storage facility and at a new storage facility presently being developed at Aldbrough;
   (v) through SSE Pipelines Ltd, ownership and operation of a number of small, embedded gas mains and services networks throughout Great Britain;

SSE also has interests in electrical contracting, retailing and telecommunications.

3. **Borealis** is a wholly-owned subsidiary of the Ontario Municipal Employees Retirement System (OMERS), a large Canadian pension fund, with approximately C$34.0 billion[1] in net investment assets. It provides retirement benefits to 340,000 members on behalf of 900 local government employers across Ontario through investments in its public equities portfolio. These include small direct and indirect investments in UK publicly-listed energy companies.

4. **Teachers** is one of Canada's largest financial institutions with assets of C$79 billion at 30 June 2004. It invests to secure the retirement income of over 250,000 active and retired teachers in the province of Ontario. Teachers has global infrastructure and timberland assets of C$2.3 billion and is actively seeking to expand its portfolio. It has minimal UK energy investments.

5. The licensed businesses being acquired by SGN consist of two gas distribution networks (DNs) from **Transco plc (Transco)**, which is itself a wholly-owned subsidiary of **National Grid Transco plc (NGT).** NGT is an international network utility group, primarily focused on energy delivery. In the UK, NGT owns and operates the high voltage electricity transmission system across England and Wales and, through Transco, the vast majority of Great Britain's high pressure gas transportation and low pressure distribution pipeline infrastructure.

6. Each DN will be a wholly-owned subsidiary of SGN each with their own Gas Transporter (GT) licence, trading as **Scotland Gas Networks (Scotland DN)** and **Southern Gas Networks (Southern DN)** respectively. The DNs will comprise the hive down assets, including the statutory GT licences and personnel, which will be held in these subsidiaries. The Scotland DN consists of around 20 sites across Scotland and comprises around 24,000km of gas mains, delivering gas to 1.7m industrial, commercial and domestic customers. It also has statutory responsibility to supply gas to a number of independent undertakings in the Highlands and Islands. In the year to March 2004, it distributed around 63TWh of gas. The Southern DN covers an area from Milton Keynes in the North, to Dover in the East and Lyme Regis in the West, including London boroughs to the south of the River Thames. It operates from over 30 sites. It comprises around

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[1] At date of notification

49,000km of gas mains, delivering gas to around 3.9m industrial, commercial and domestic customers. In the year to March 2004 it distributed 124TWh of gas.

TRANSACTION

7. After their hive-down into wholly owned subsidiaries of Transco, the entire issued share capital of the Scotland and the Southern DNs will be sold to SGN, with SSE acquiring a 50 per cent interest.

8. The administrative deadline for the consideration of this merger is 25 April 2005.

JURISDICTION

9. As a result of this transaction, SSE, Borealis, Teachers, SGN and the Scotland and Southern DNs will cease to be distinct. The UK turnover associated with the two DNs is greater than £70 million so the turnover test in section 23(1) of the Enterprise Act 2002 (the Act) is met. Therefore, arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

BACKGROUND

10. The vertical supply chain for the gas industry in Great Britain (GB) involves several players. The following briefly describes how producers, shippers, storage facilities, DNs and suppliers interact.

11. *Producers* are generally located offshore and are unlicensed under the Gas Act[2] but regulated by the Department of Trade and Industry (DTI). Producers ship gas to the 'beach' from where it is inputted into the National Transmission System (NTS), the high pressure gas pipeline system owned and operated by the licensed GT, Transco. *Shippers* are gas wholesalers. They buy gas from producers at the 'beach', transport it through the NTS and the DNs, and sell it to both gas and electricity *suppliers*, the latter using some of this gas for the purposes of generation. *Storage facilities* are used by shippers as a means of managing peaks in gas demand. Across GB, there are eight DNs, which are used to transport gas from the NTS. Two of these are the subject of the proposed acquisition which is considered in this merger assessment and which until now have been owned and operated by Transco.

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[2] The Gas Act 1986 has been amended and supplemented by the Gas Act 1995, the Utilities Act 2000 and the Energy Act 2004 (the Gas Act).

Overview of regulation and industry restructuring

12. The gas and electricity industries in GB are subject to detailed regulation under the scrutiny of the sectoral regulator, the Office of Gas and Electricity Markets (Ofgem). The Gas Act provides for the regulation of the onshore gas regime in GB and for the separate licensing of gas shippers and gas suppliers. Shippers are required to balance their inputs and offtakes of gas on a daily basis and buy 'flexibility' from producers in the form of variable contracts or by putting gas into storage for this purpose.

13. DNs, as monopoly distribution network businesses, are subject to specific regulation through the GT licence. Licensees are bound by a broad range of statutory obligations intended to prohibit them from discriminating in favour of any related business in the gas sector; in particular, to avoid any undue discrimination in the terms under which they undertake to convey gas. These obligations will apply to the DN acquirer.

14. Due to the changes to the structure of the gas industry that flow from this and similar transactions, Ofgem and the industry participants, including proposed purchasers of the DNs, have been reviewing and negotiating modifications to the regulatory, commercial and operational framework for over 18 months. Ofgem has been formally consulting on a series of additional non-discrimination GT licence obligations. These include business separation licence conditions that put the onus on the licensee to develop managerial and operational systems which prevent any related gas or electricity supplier, trading and other related businesses, or shippers, from having preferential access to confidential information relating to the DN business.[3] At the end of April, Ofgem will embark upon a further round of consultation on additional licence amendments to extend the prohibition to prevent the sharing of confidential information between the DN businesses and related electricity generation businesses.

15. Ofgem retains the right to veto any sale if Transco does not consent to any licence modifications or implement any other regulatory, commercial and operational changes that Ofgem considers are necessary in order to ensure that the interests of the customers are protected. The DN operator must have in place a statement, approved by Ofgem, describing how these requirements will be secured. Ofgem also has enforcement powers,

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[3] Further details relating to the current consultation described and other aspects of Ofgem's regulatory oversight of the gas industry are available from Ofgem: see www.ofgem.gov.uk.

including imposition of penalties, with respect to licensees in breach of their license or relevant obligations.

16. Finally, to minimise duplication costs to shippers, suppliers and retail customers associated under the new fragmented structure, Ofgem has created an agency, Xoserve, to be owned by Transco and the DNs, to provide on a centralised basis many of the services that Transco currently provides, including customer transfer processing.

RELEVANT MARKET

17. SSE is active in several stages of the gas and electricity supply chains, which are considered below.

Storage of gas

18. Shippers can draw on gas held in storage facilities such as Hornsea, owned by SSE, as a source of flexibility to manage peaks in gas demand. Absent regulation, it would be possible that information could be exchanged between SSE's storage facilities and the DNs to the advantage of either of those businesses or SSE's related businesses. The above-mentioned non-discrimination licence conditions and business separation obligations are intended to address this.

Onshore transportation of gas

19. GTs own and operate gas pipeline systems. In GB, the high pressure NTS connects to eight low pressure DNs.

20. At present, DNs are regional natural monopolies that do not compete with each other; the geographic frames of reference thus correspond to the regional area to which the respective DN licence applies, which in the present case are the relevant parts of Scotland and Southern England. Given the absence of pre-existing competition between DNs, the acquisition between two DNs by SGN will have no horizontal impact on competition in relation to the on-shore transportation of gas.

21. Indeed, the break-up of the gas distribution network under Ofgem's oversight is intended to introduce a degree of so-called benchmarking competition between the regional monopolies by having at least four different undertakings and management teams operating the eight DNs. Thus, while DNs will remain regional natural monopolies, regulation is

designed to stimulate efficiency improvements that the competitive process generates in other sectors not characterised by natural monopolies.

Shipping of gas

22. Until now, shippers have contracted with Transco to transport the gas they buy from producers and then sell on to suppliers and have paid transportation and other charges for this service. Shippers may also store gas with storage operators to balance supply and demand and hence avoid incurring imbalance charges levied by the GTs. Shippers balance their portfolios on a daily and GB-wide basis. The geographic scope of shipping may be regarded as GB-wide.

23. SSE has a shipping licence and is involved in shipping in GB. Potential vertical issues in relation to gas shipping are considered below.

Electricity generation

24. Gas shipped through the NTS and DNs may be used in gas-fired power stations. As SSE has interests in electricity generation, potential vertical competition issues are discussed below.

Connections

25. Independent licensed gas transporters (IGTs) are gas networks which are connected to DNs for the transportation of gas to end customers. These are therefore complementary to DNs. Shippers request capacity on IGTs in the same way as they do on the main network and the capacity has to be made available to third party shippers.

26. SSE operates an IGT business through its subsidiary SSE Pipelines Ltd.

27. The only issue in relation to the IGT and DN businesses is the exchange of commercially sensitive information. Since the business separation licence conditions will prevent a DN from sharing commercially sensitive information with its related businesses, this issue is not considered further.

Retail supply of gas and electricity

28. Gas shipped through the NTS and DNs is used to supply retail gas customers. Electricity generated by gas-fired plant is used to supply electricity customers. As SSE is active in retail gas, potential vertical issues are considered below.

29. SSE is also active in retail electricity. Since electricity retail is so far down the supply chain (which is regulated at every stage) from the DNs, the possibility of any impact arising as a result of this merger is considered too remote.

HORIZONTAL ISSUES

30. This transaction raises no horizontal concerns.

VERTICAL ISSUES

Shipping of gas

31. SSE's share of supply of gas throughput across Transco's network as a shipper is less than 7 per cent. Given this minimal share in the gas shipping sector, it is not considered that it would be economically rational for SGN as owner of the two DNs to foreclose all of SSE's downstream shipping competitors. In any event, the proposed regulatory regime going through the process of consultation, including a series of licence obligations, is intended to prevent DNs such as SSE from discriminating in favour of any related businesses, such as by offering its own shipping business better terms than those offered to its competitors or access to confidential information in relation to its competitors.

Electricity generation

32. SSE, as the second largest generator in GB, has around 13 per cent share of the wholesale supply of electricity in GB by installed capacity or output generated.

33. It has been suggested that absent regulation, SGN would have the incentive and ability to discriminate against SSE's competitors in the wholesale electricity sector and thereby distort competition by interrupting the gas supplies they need to generate electricity SSE disputes that this is the case. It has argued that SGN's ability to act in this way is limited since most gas-fired generation plants are connected to Transco's NTS rather than to the DNs. Furthermore, SGN has no incentive to act in this way since SSE only has three small power stations in the DN areas and therefore would not be in a position to capitalise on the situation to any material degree.[4] In any event, gas interruptions are rare and would be

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[4] One in Fife, producing 120MW and two in Chickwell and Burghfield, generating 45MW each.

transparent to the generator concerned, raising a serious risk of enforcement action by Ofgem.

34. In any case, the above-mentioned proposed regulatory regime going through the process of consultation, including business separation, is aimed at preventing any such discrimination. The transaction does not therefore appear to raise vertical concerns in this respect.

Retail supply of gas

35. SSE's GB share in gas retail is around 8 per cent. SSE estimates that in dual-fuel sales, it supplies around 12 per cent of retail sales in the Scotland DN area and 13 per cent in the Southern DN area. The proposed regulatory regime, in particular business separation, is aimed at preventing SGN from discriminating against SSE's downstream competitors in the wholesale gas market.

36. SGN, as owner of two DNs will be responsible for transferring customers who wish to switch from SSE to competing suppliers. The non-discrimination obligation to which SGN will be subject under the regulatory regime is designed to prevent it hindering the transfer of customers to the disadvantage of SSE's gas supply competitors. In addition, one of the purposes of Xoserve, the agency established by Ofgem and jointly owned by Transco and the DNs, is to facilitate customer transfer processing.

THIRD PARTY VIEWS

37. Only one third party raised a general theory of competition harm, relating to the passing of confidential information between the DN and related businesses such as connections and also related generation businesses, to SSE's commercial gain, but was unable to provide sufficient evidence to support these claims. Moreover, the proposed licence conditions, including business separation obligations, which are subject to Ofgem's ongoing consultation, are aimed at preventing this type of harm from happening.

ASSESSMENT

38. Transco has held a monopoly of the gas distribution network in the UK, for both high-pressure distribution and for eight low-pressure DNs, which it operates under a licence pursuant to the Gas Act. This system is to be broken up by the sale of four of the DNs, each of which will remain a regional monopoly. This merger entails the acquisition by SGN of two DNs, Scotland and Southern.

39. The merger raises no horizontal competition concerns in relation to onshore gas distribution or at any other level of gas supply chain.

40. There is a theoretical possibility that SGN could discriminate in favour of SSE's downstream shipping business by offering it more favourable terms, and in favour of its gas retail business by delaying the transfer of customers from SSE to its competitors. In addition, the exchange of confidential information between SSE and SGN could result in the distortion of competition generally. However, these concerns are either addressed by existing regulation or are the subject of licence modifications which Ofgem is seeking to introduce. Likewise, regulation is or will in place to address any possible post-merger vertical concerns in other sectors identified above, notably electricity generation and retail gas supply. Accordingly, the OFT has no reason to believe that the regulatory regime, to which SGN and SSE will be subject if the transaction proceeds, will not be effective in preventing vertical competition concerns from materialising.

41. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

42. This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.