8 Views of other parties

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Introduction

8.1. We invited views from the electricity industry, Government departments, trade and consumer organizations, major electricity users, local and district councils and other interested parties. This chapter summarizes the evidence we received.

The electricity industry

An electricity supplier

8.2. An electricity supplier submitted that the merger would be against the public interest. Licence amendments would be insufficient to restrain the exercise of market power by the new group. Alternatives were either price regulation of generation and transparent contracts market; or restrictions on market share which would prevent the merger and the creation of any similarly dominant group.

8.3. The creation of a large, vertically integrated utility would very significantly distort competition in the electricity market. PG and NP already controlled prices in the Electricity Pool for the majority of the year and were the most dominant determinants of prices and availability in the wholesale electricity contract market. An enlarged group containing significant generation and supply interests was, however, in a position to act more easily against the public interest because, as a group, it was shielded from much of the risk to which companies which were only (or very largely) either generators or suppliers were exposed. This significantly different risk position arose because most customers preferred the certainty of contracts where the rates were fixed for at least a year. For non-vertically integrated suppliers, the only means of limiting the risks of volatile and unpredictable Pool prices was by negotiating CfDs with the generators. With a generator controlling both the Pool and contract markets, it was able to increase the uncertainty and risk of Pool price and therefore the premium it could demand for CfDs from third parties. Integrated RECs also had access to generator information including bidding strategies allowing them to price with greater certainty.

8.4. At the same time, generators wanted certainty of volume at acceptable prices and hence CfDs with suppliers or contracts with customers. Restricting contracts between a large generator and its REC supply business would not provide any protection to customers because, since an integrated group's REC supply subsidiary would have major access to supply customers in the competitive market, CfDs would no longer add value for the group.

8.5. In essence, CfDs were a mechanism for delivering price certainty for a particular volume between suppliers and generators irrespective of the prices in the Pool. If a vertically integrated company did not have CfDs in place, Pool price volatility did not change the overall income of the group; the Pool price simply determined the split of income between the company's generation and supply activities. For example, if the demand weighted average Pool price turned out to be higher than assumed, the generator would end up with more income and consequently more profit than if it had sold a CfD, whereas the supply subsidiary would make correspondingly less profit than if it had the appropriate CfD in place. Conversely, if Pool prices were low, higher than anticipated profits would be delivered from the supply business subsidiary and correspondingly lower profits from generation. There would be no effect on an integrated group's profitability, although the consequences of these Pool price changes (largely determined by the vertically integrated company itself) might be severe for non-vertically integrated suppliers or generators.

8.6. The ideal world for a vertically integrated company would therefore be for its supply subsidiary to contract with customers for the full output of its generating stations. It would then have the luxury of being able to increase the risks for its competitors by producing volatile Pool prices whilst not needing to offer CfDs in the market. 1998 would provide a major opportunity to exercise this market power. Such a strategy would also be a severe disincentive to new entrants.

8.7. Thus some customers (ie other suppliers) of the proposed vertically integrated group could be exposed to significant unfair competitive pressure. It was unlikely to be in customers' long-term interests to have only a few large vertically integrated companies from which to buy their electricity.

8.8. In addition to the increased scope for price manipulation which a vertically integrated company would have in the Pool, the proposed merger would also have a significant effect on the governance of the Pool. Because Pool decisions were taken by a 65 per cent majority of all votes (both generation and supply), it would be very difficult to prevent all Pool decisions being significantly influenced by the merged company, leaving other, non-vertically integrated, traders to face an increasingly difficult trading environment.

8.9. It would seem that the risks to customers in the franchise market in MEB's territory might be adequately dealt with by amendments to the supply licence. However, the regulator had a number of possible

routes open to him to attempt to reduce the other potential adverse effects of the proposed merger. None was entirely satisfactory. The option of limiting contracts between a group's supply and generation business was of no medium-term benefit and little short-term benefit as it would only affect the distribution of profits between generation and supply. Requiring PG to sell more Pool price-setting marginal generating plant would be a solution but only if in place before 1998, which seemed extremely unlikely, bearing in mind the history of protracted discussions over the existing plant sales despite their limited effect on market power. A continuing demand-weighted Pool price cap could be imposed on PG until beyond 1998, but PG's sale of some marginal plant would increase its ability to claim that it no longer controlled Pool prices.

8.10. Companies which were not vertically integrated in a substantial way were unlikely to be able to compete in power trading. The risk of them withdrawing from the supply market was dangerous for all customers, particularly at the time when the whole of the electricity market was to be opened to competition in 1998. It seemed extremely unlikely that there were sufficient large vertically integrated companies to guarantee adequate competition or scope for market entry with the consequential risks of continuing market distortions due to that market power.

8.11. A further safeguard would be to regulate generation assets by reference to the returns and profits earned, in the same way as distribution assets. Fuel costs could be a pass-through (analogous to franchise electricity purchase costs). Thus excessive generation profits would be penalized and the generating arm of the merged company would be incentivized to allow a fair profit in supply from which their supply activity would benefit. An administered and transparent market in contracts was needed alongside the short-term market in the Pool.

Eastern Group plc

8.12. Eastern submitted written evidence and attended a hearing.

8.13. Eastern's view was that the regulatory authorities should focus on the conditions for effective competition in generation and supply. Given this, it believed there were considerable benefits to the economy as a whole and to electricity customers in allowing the structure of the industry to continue to evolve as market forces took their course. Robust competition was developing well both in generation and supply. However, further stimulus was needed in generation and the completion of the PG and NP disposals was only a first step, albeit a significant one.

8.14. Eastern included Eastern Electricity, the largest of the 12 RECs in England and Wales with 3.2 million customers. Eastern Electricity was noted for its strong commitment to the competitive market and had been among the leading players in contracting for supplies outside its franchise area.

8.15. Eastern was a key player in the competitive generation market. Its 360 MW CCGT station at Peterborough opened in 1993. It had a 13.5 per cent stake in the 1 GW Barking power station which opened recently. Construction was well advanced on a 350 MW gas station at King's Lynn. It had recently announced confirmation of the purchase of two 1 GW coal-fired plants at Drakelow and High Marnham from PG as part of PG's agreed disposal of mid-merit plant. Eastern was currently subject to an own-generation limit of 1 GW and received confirmation from OFFER, in principle, that its limit would be extended to 3 GW to cover the PG deal. Eastern's strategic intention was to develop as an energy company with interests in the generation and supply of electricity and the supply of gas in fully competitive markets, as well as running a more tightly regulated regional distribution business. It was looking to expand its generation portfolio to give it the capability to compete with PG and NP in bidding mid-merit as well as baseload plant. As was intended, it considered that disposal of NP/PG plant would benefit customers by putting downward pressure on Pool prices. Eastern assumed in its scenarios that all new owners of divested plant would run the plant in a similar way to existing owners.

8.16. The 1988 privatization proposals had been put together against a strong political desire to see the entrenched monopoly power of the CEGB broken up, for competition in generation to be established and transmission to be made independent of generation. Since 1988, despite concerns about duopoly power, new entrants in the generation business had emerged, although competition would only be really effective if generators had a portfolio of plant that was flexible in both operational and commercial terms. The competitive supply market was also a major success story.

8.17. There were no strong intrinsic reasons why the structure of the electricity industry should not be allowed to evolve. The PG/NP plant disposal requirement, the privatization of NEP, the growth of integrated energy companies and the disposal of the NGC's pumped storage business all meant that competition in generation would continue to grow.

8.18. Much of the concern expressed about vertical integration was that such integration was undesirable if inadequate competition existed horizontally in any part of the supply chain. In the electricity market, the progressive move towards 1998 would ensure competition in supply. On the generation side, it was necessary for there to be effective competition for PG and NP. This would only be achieved with the emergence of new portfolio players of sufficient size. If Eastern were successful in purchasing an additional 4 GW of plant from NP it would still only generate 8 to 10 per cent of the electricity in England and Wales (compared with around 20 per cent for PG and around 25 per cent for NP).

8.19. Eastern gave estimates of ownership of price-setting plant in 1996/97 and 2002/03. It concluded that by 2002/03 PG would own only 23 per cent of price-setting plant, as contrasted with 29 per cent in 1996/97.

8.20. As more efficient plant was built, plant that was originally running at baseload would be pushed into mid-merit, and thus competition would naturally develop. Such an effect, however, was likely to take a number of years, and could only successfully occur to the extent that investment in new generation came from portfolio generators other than PG and NP. An important factor in promoting competition, however, was the ability of new entrants to achieve acceptable returns on new capital invested. Under normal circumstances the long-term trend for prices would be expected to be towards that point where new entrants would be encouraged to build plant that was either more efficient than current plant or would be available to meet increased demand. The DGES's decision to signal the end of price caps would hopefully remove an important deterrent to new entrants seeking to increase the level of competition in generation.

8.21. The possibility of a REC becoming an effective competitor in the generation market had been hampered by Condition 6 of its PES licence, which limited each PES's generation capacity to 15 per cent of its maximum demand, thus restricting their ability to compete in the mid-merit sector. Condition 6 had been introduced to address the fear that PES franchise customers might incur higher electricity costs through uneconomic deals concluded between the generation and supply arms of a PES. Eastern had felt for some time that the limits were an undue hindrance to competition in generation and that their selective removal was compatible with the aim of protecting customers.

8.22. While a balanced portfolio of generation and supply might improve the overall risk management of an electricity business, it did not mean that such players would simply trade with themselves. There were few, if any, efficiency gains from owning both generation and supply. Each player must still sell and buy all power from the Pool, and the CfD derivative market was both transparent and efficient; only on very small deals would there be some administrative advantages.

8.23. The advantages of one company owning both generation and supply came from the overall business risk of where profit was made in the overall `supply chain'. A vertically integrated business had some protection wherever the profit was made, whilst specialist generators or suppliers were gambling on the relative profitability of their part of the market and their relative skills within that market. Given the developments in competition outlined above, both generators and suppliers would have to continually strive to meet and exceed their customers' expectations at lower and lower costs. In this environment, a generator and a supplier within a vertically integrated company could not afford not to trade in the market. The supplier must buy from the lowest-cost generator at any time and this was unlikely to be the parent company's own generator at all times. If a supplier was `forced' to buy from its own company, it would quickly go out of business. If the generator did not sell to the supplier willing to pay the highest price it would similarly struggle. There was therefore no intrinsic advantage in direct trading within the company.

8.24. It was unlikely that a company like Eastern would have a one-to-one correlation between its generation and its own supply market; it would need to buy some 80 per cent of its power from outside. If, for example, PG bought MEB, the shape of the power required was not much like the shape of PG's own generation. Furthermore, customers would notice if generation was passed on to them at a price disadvantage.

8.25. Over the next few years, the number of players in the supply market might decline somewhat. One might expect there to be at least six highly active suppliers competing vigorously in all parts of this market, with a number of smaller niche suppliers imposing additional competitive pressures. The major players were likely to include PG, NP, ScottishPower/Manweb, the successor company to NEP, and (if the own-generation limits were relaxed) Eastern. This group might be augmented by merged RECs, or combined water/electricity supply companies such as NORWEB/North West Water and Welsh Water/SWALEC. The niche players would include RECs competing primarily in their own areas, other utilities with second-tier supply licences, independent generators and large customers buying directly from the Pool or from own-generators.

8.26. In this world of perhaps five or six significant players with assets and a portfolio of generating assets, there were likely to be more people who would want to trade, and that would increase the liquidity of the market.

8.27. Some concern had been expressed about the loss of MEB as an independent generator. It was likely that MEB's position as a joint venture partner in several generation projects would come under review following a successful take-over. In any case, the bidding strategies of those partnership projects were unlikely to be significantly affected. However, Eastern recognized concerns about the inconsistency of PG acquiring interests in around 600 MW of plant while disposing of 2 GW, although PG had section 36 consent to build at least that much additional plant and the key issue around the disposal was that of mid-merit plant. Nevertheless, Eastern considered that if the merger was approved, the DGES should lay down a timetable for the disposal of interests in plant currently held by MEB.

8.28. Concern had been raised in relation to the effect of the take-over on MEB's future position as a subsidiary company holding a PES licence. The DGES had drawn up, after consultation, a number of new draft licence conditions to cover the position of a subsidiary licensee within a larger group. These should give the DGES the powers needed to carry out his duties. Similarly, additional licence conditions currently in draft, to disallow direct supply contracts between ScottishPower and Manweb's franchise customer base, could be adapted to provide additional safeguards for MEB's customers to prevent the pass-through of contracts from its new generator parent which had not been properly market tested.

East Midlands Electricity plc

8.29. East Midlands Electricity plc (East Midlands) submitted written evidence and attended a hearing.

8.30. East Midlands explained that any assessment of the possible impact of the merger would have to take full account of the fact that PG enjoyed, and had used, its substantial market power to dominate mid-merit generation and thereby control Pool prices. This market power was made even more overwhelming by the fact that PG and NP had complete transparency of each other's bidding tactics and prices almost hour by hour. Such influence clearly worked against the interest of consumers by severely restraining investment in new generation and ensuring that there were no competitive CfDs available to other supply businesses. The proposed merger would further strengthen PG's position. Its influence was well documented in a number of reports by the DGES into movements in Pool prices since 1990. In consequence, PG had agreed with the DGES to dispose of 2 GW of plant and, as an interim measure, to place a cap on Pool prices. Whilst welcoming the disposal as a step towards increasing competition in generation, East Midlands pointed out that 2 GW of plant was nevertheless relatively small in comparison with the size of the overall market and with the company's remaining capacity. Even after this disposal, PG would retain a significant and unacceptable ability to influence Pool prices.

8.31. East Midlands was concerned that the merger would further distort the operation of the Pool. MEB had been the second most active REC in terms of acquiring own-generation capacity. PG's acquisition of additional generating capacity through the merger would be at odds with the undertakings it had given to dispose of capacity and at odds with the own-generation limits in MEB's PES licence. Moreover, the potential in due course for MEB's generating capacity to have a competitive impact on the Pool would be lost. In the absence of suitable safeguards, the merger would simply increase the influence and market power which PG already exerted over the Pool.

8.32. East Midlands thought the proposed merger would cause difficulties in two other areas of the Pool. First, under present arrangements, PG would hold significant power with regard to decision-making in the Pool. Secondly, as a large vertically integrated company it might be able to exert considerable influence over the cost of the non-energy services needed to allow the national grid to operate, which were paid for through the uplift between the PPP and PSP, and would reduce the balance of power in negotiations on uplift.

8.33. East Midlands said that its most serious concern about the impact of the merger related to the unfair competitive advantages which might be available to such a large vertically integrated company. It expressed an immediate concern in relation to the non-franchise market (ie over 100 kW) and concern for the future when competition for supply was extended to the franchise market in 1998. East Midlands explained that the relationships within a vertically integrated company between the generation and supply businesses would have the following adverse effects on competition between suppliers:

(a) The supply business would have considerable knowledge of the future level, profile and risks associated with future Pool and wholesale electricity prices. This knowledge stemmed from the ability of its sister generation business to influence prices and would enable the supply business to gain an unfair advantage *vis-à-vis* competing suppliers. Alternatively, its knowledge of the likelihood of significant increases in Pool prices would give it an unfair cost advantage which would enable it, for example, to undercut competing suppliers to win contracts from non-franchise customers. Over time, this unfair cost advantage would reduce competition in the industry and have an adverse impact on prices to customers and on customer choice overall.

(b) The liquidity of the wholesale market for CfDs would be adversely affected. PG would have less incentive to sell CfDs to third parties if it knew that it could always sell to its own supply business. This would increase its bargaining power and increase the price and risk for competing suppliers. Again, this would adversely affect competition between suppliers and affect prices and services to customers.

(c) The vertically integrated nature of the company would give rise to further potential problems because of the possibility of the generator deliberately selling high-price purchase contracts to the franchise market of the supply business and hence potentially increasing its profits at the expense of customers. The problem would potentially apply both to the actual franchise up to 1998 and to any residual *de facto* franchise post-1998.

8.34. In conclusion, East Midlands emphasized that its concerns were such that it considered that the merger should not be allowed to proceed. However, if the MMC did not share this view, it suggested that the merger should only be allowed if PG was prepared to agree to the following undertakings:

(a) PG should be required to dispose of further price-setting plant such that its remaining holding of such plant represented no more than, say, 20 per cent (by time as measured during 1995/96) of such price-setting plant.

(b) Since the capacity-related element of the Pool price was so sensitive to the generation/demand balance, PG should be required to continue to report to OFFER its forward plans for mothballing or closure of plant. The new owners of plant acquired through disposals should be required to provide similar reports to OFFER.

(c) The generation, supply and distribution businesses should be fully separated from each other and ring-fenced. The businesses should be required to trade between themselves on a transparent arm's length basis. Favourable terms should not be given by the generation business to the supply business unless such terms are made available to all suppliers. The exchange of information between the generation and supply business (for example, regarding future price trends in CfDs) should be prohibited. There should be similar arrangements as applied within British Gas to limit transfers of staff between businesses.

(d) The supply business should be required to purchase a significant proportion of its cover requirements from other suppliers.

(e) There should be a cap of, say, 10 per cent on the votes held by any single company or group within the Pool. Further, no such company or group should be allowed more than one seat on the PEC.

(f) PG should be required to support and facilitate the transfer of transmission services from the Pool to the NGC's regulated activities. Appropriate mechanisms to achieve such a transfer should be formally agreed as a pre-condition to implementation of the proposed merger.

(g) In order to maintain transparency the vertically integrated company should be debarred from trading outside the Pool between its generation and supply businesses even if such mechanisms for bypassing the Pool were available on a general basis.

8.35. East Midlands added that it considered undertakings to be a poor second best since they might be difficult to implement and police.

Northern Electric plc

8.36. Northern Electric plc (Northern), a shareholder in TPL (see paragraph 8.132), said that it did not see any inherent reason why MEB should be required to dispose of its generation subsidiary which held shares in IPPs including TPL. TPL was not instrumental in setting Pool prices (operating primarily at baseload). MEB's one-quarter share of TPL amounted to about 470 MW, which was not material in the market. Although, as a partner in TPL, Northern had concerns that the merged company might have different priorities, and some residual market power arising from its continuing ownership of mid-merit plant, Northern believed these concerns should be resolved by the shareholders in TPL rather than by imposing a requirement that the merged company should divest itself of MEB's existing generation portfolio. Northern believed that in practice the merged company would not use its interest in TPL to disadvantage that project.

8.37. Northern considered it most unlikely that MEB could, in isolation, materially influence the operation of Teesside power station. For all practical purposes this was in the hands of Enron which was obliged to operate it according to the agreements which were in place and the annually agreed operating plan and budgets. MEB's shareholding was too remote to influence day-to-day operational decisions.

8.38. Voting arrangements meant that a merger would not be likely to lead to the merged company being able to force decisions which would operate against other shareholders. It was also unlikely that the merged company would seek to influence matters such as output volumes, bidding behaviours, capital expenditure decisions and new power purchase agreements in a difficult manner if the merger did not proceeds. Other factors such as market conditions, other shareholders' interests and existing contractual obligations were more decisive than any change in MEB's commercial interests resulting from a merger.

8.39. Northern believed that any conflict of interest could be dealt with through existing arrangements, by MEB's TPL director being an independent appointment and by a reporting mechanism, which restricted access to confidential information.

A REC

8.40. A REC submitted written evidence and attended a hearing.

8.41. The REC took the view that the merger would contribute to an important change in the structure of the electricity market in England and Wales. However, the merger should not be prohibited absolutely on competition grounds assuming that steps could be taken to ensure that regulatory effectiveness could be preserved, and PG ceased to have a dominant position in the generation market. Wherever possible, the capital markets should be allowed to operate without artificial constraints.

8.42. Vertical integration between a sizeable generating company and a sizeable REC would give that business a deep understanding of the commercial fundamentals underlying the entire supply chain. It would have expertise in the prediction of likely future Pool prices, together with experience of supplier issues in the first- and second-tier markets. Although this might give a vertically integrated company an advantage, this

would not be unfair or improper. However, where the legitimate advantages of vertical integration were accompanied by, or enhanced by, advantages which arose from a dominant position in generation, this would be grounds for serious concern and for appropriate remedies. In summary, vertically integrated companies were inherently less risky; and it was possible that the dominant market position of a vertically integrated company could be used to drive out the independent supply companies.

8.43. Given the structure which emerged from privatization of the electricity supply industry, it was inevitable that PG would have market power and considerable advantages over new entrants. As a consequence of new entry into the generation market (and also as a result of NEP's increase in output) the share of the total generation market held by PG and NP had declined significantly since 1990/91. However, notwithstanding this reduction in total market share, the DGES had concluded that the impact of new entrants had had only a minimal effect on the ability of PG and NP to determine prices in the Pool. Inquiries by the DGES into the operation of the Pool and the market power of the two dominant generators had led him to conclude, in a number of reports,[1] that they were able to determine Pool prices. PG had given an undertakings in February 1994 to dispose of 2 GW of mid-merit plant; and for a period of two years, to bid into the Pool so as to ensure that average prices did not exceed a predetermined level. The first undertaking had not yet been discharged. The fact that PG felt able to give the second of the two undertakings was evidence that, as things currently stood, it was able to influence Pool prices by its bidding behaviour.

8.44. The REC contended that the disposal of plant was critical to the proper functioning of the Pool and the market in CfDs by which suppliers and generators could hedge the risk of Pool price volatility. The DGES had reached his conclusion about the need to dispose of mid-merit plant prior to any bids being announced by the generators for RECs. The fact that MEB had substantial generation interests would justify further consideration of whether a different and higher level of disposal of mid-merit plant would be justified as a condition of the bid being allowed to proceed. Moreover, the advantages which a vertically integrated company would gain from the potential exercise of market power in the Pool and in the CfD market also gave force to the case for further disposals, above those in the 1994 undertaking. Whilst it was appropriate for further asset disposals to be considered as a pre-condition of the bid proceeding, disposal of MEB's current generating interests would not address the issue unless those assets were run as mid-merit plant.

8.45. At privatization it had been established as a fundamental principle that generation, transmission, distribution and supply should be unbundled. The combination of a dominant generator with one of the largest RECs would be a retrograde step. It would be very risky to assume that sufficient competition was about to emerge in the mid-merit generating plant through plant disposals and new IPPs, because removing the restraints on vertical integration would undermine the commercial prospects for would-be new entrants, and because announcements about intended power station construction should not be relied upon.

8.46. An integrated company, with generation interests and an equivalent-sized supply business, was effectively insured against the risks of high or low Pool prices. Introducing CfDs between that company's generation and supply businesses did not alter this. If the CfD was set at a level which was higher than Pool out-turn, then the generation business would win. If Pool prices turned out higher than the CfD, then supply would win. The position was not altered by one possible `remedy' that the supply business would not be permitted to contract for CfDs with its generation company. A rational integrated company would simply allow its generation and supply businesses to ride the Pool without CfD cover.

8.47. An integrated company would have a vested interest in Pool price instability because this would lead to non-integrated competitors in the supply business being prepared to pay a premium for CfDs (which the integrated company did not need). This made the integrated company's supply business more competitive and it could extract rent up to the level of the CfD premium that the non-integrated company was prepared to pay. If the integrated company had more generating capacity than it could back with its supply business, then, provided its generation was economic, it could take the CfD stability premium from other players for that element of its generation which was not backed by its supply business.

8.48. The merger would have the effect of reducing the volume of electricity covered by CfDs between generators and non-integrated suppliers. This would give the integrated company an incentive to increase

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[1]OFFER: *Report on Pool Price Inquiry*, December 1991; *Report on Gas Turbine Plant*, June 1992; *Report on Constrained on Plant*, October 1992; *Pool Price Statement*, July 1993; *Decision on a Monopolies and Mergers Commission Reference*, February 1994.

Pool prices. It would also lead to less liquidity in the market for CfDs. The Pool was likely to become a less effective indicator of the true `market price' of electricity.

8.49. Alternative remedies to the problem of vertical integration within the context of an imperfect generation market might include: continuing to cap Pool prices (so that non-integrated suppliers had some confidence in Pool prices and might judge CfDs against a bench-mark); requiring the integrated company to run its supply business as a totally stand-alone activity (but this would defeat one of the objects of the proposed merger by removing the synergy benefits); or reintroducing restrictions of the kind put in place at vesting on the size of PG's share of the supply market. All remedies, other than significant divestment, relied on continuous regulatory intervention in the generation market.

8.50. The present price control arrangements for the franchise market permitted the full pass-through of electricity purchase costs attributable to that market. PESs were subject to rules requiring economic purchasing, the attribution of costs to the franchise market and the prevention of cross-subsidy and price discrimination. In the case of a vertically integrated company, there was the additional concern that the generation business might not be even-handed in offering CfDs to competing supply businesses. The significant size of the merged company would leave other companies exposed to possible predatory pricing behaviour. Although barriers to entry and exit in the supply business might appear to be low, margins were also low and the risk of being stranded with an unsaleable CfD or exposed to Pool price volatility (which could be manipulated by a competitor) would disadvantage and discourage non-integrated companies from competing in the supply business. Even after market liberalization in 1998, it was to be expected that the majority of the RECs' domestic customers would not switch suppliers. Where a REC presently had a larger franchise market (as had MEB), it followed that the REC would also have a proportionately larger number of customers who were unlikely to switch supplier. The relationship between the generation capacity held by a company and the size of this `natural franchise' gave rise to a potentially significant problem of cross-subsidy and discrimination. The `natural franchise' market could bear a disproportionate share of the generation costs, leaving the company with the opportunity to offer attractively priced electricity in the actively competitive market. This could manifest itself in the final prices offered by the company's supply business to its end-customers. Without further plant disposals and effective regulatory intervention to secure a properly functioning market, the possibility of predatory pricing might lead non-vertically integrated suppliers to exit the market, leading to a diminution in competition in supply which would not be in the public interest. Confidence to compete would depend on appropriate mechanisms which would ensure regulatory effectiveness in policing predatory pricing and cross-subsidy.

8.51. In conclusion, the REC considered that the proposed merger should be permitted to proceed only if it could be demonstrated that the merged company would no longer be able to exercise significant market power in the generation market, and appropriate regulatory mechanisms were introduced to prevent cross-subsidy and predatory pricing.

Another REC

8.52. Another REC wrote to us and attended a hearing.

8.53. The REC considered that the merger was not in the public interest and should not be allowed to proceed. Although it recognized the logic of vertical integration it believed the proposed transaction would ultimately serve only to perpetuate PG's dominant position within an imperfect market, and thus act against consumers' interests in the long term.

8.54. The REC argued that at present there was no transparent market for the generation of electricity. The present Pool structure, whilst essential, was not yet a genuine market. PG's dominant position in the supply market, and its ability to cross-subsidize from the generation to the supply businesses, would enable it to offer more advantageous terms to independent suppliers and to its own supply businesses than other entrants to the market.

8.55. As to the workings of the Pool, the REC drew attention to market data which had shown that PG had an extensive ability to forecast and control the price of electricity in the Pool, as it was to some extent determined by its own corporate strategies. Theoretically competitive forces in the generation market would increase due to such factors as enforced plant disposals, surplus generating capacity, the opening up of the

franchise market and the ending of the long-term coal contracts in 1998. Moreover, the effect of these changes and those proposed for 1998 remained theoretical and uncertain.

8.56. The effect of the bid would be to make existing matters worse. Despite the forced disposal of capacity, the acquisition of the relevant REC's established customer base would enable PG to continue to optimize Pool pricing to its advantage. Even if it was not permitted to merge its supply business with that of MEB it would still gain substantial market power through ownership (and presumably management control) of MEB. The acquisition would also enable PG to self-hedge the risk of Pool price fluctuations and to protect the future profitability of its generation activities.

8.57. PG would be able to secure a significant position in the present franchise market as a base for matching its generation output with downstream supply once the franchise was removed. In addition, it would be acquiring further substantial interests in generating plant. With a substantial degree of self-hedging, PG would be less concerned about participating in the Pool and with the wholesale market generally. Thus the market for hedging contracts would become substantially less liquid, resulting in insufficient competition in supply.

8.58. In conclusion, the REC said that a restructuring of the electricity industry was necessary to permit the possibility of at least six to eight integrated companies of roughly comparable influence to operate within the market. Only then would an efficient market be achieved. The virtues of an efficient market included price and service benefits to customers as well as a greatly reduced necessity for regulation. This could not be achieved with immediate effect. If, contrary to the REC's recommendation, the merger was allowed, completion should be made conditional on a combination of substantial disposals of mid-merit generating capacity, the effective ring-fencing of any generating, distribution and supply businesses owned by PG, and much enhanced transparency in the market-place.

SEEBOARD plc

8.59. SEEBOARD plc explained, in a letter to OFFER commenting upon the proposed take-over, that the merger represented a significant change in the extent of vertical integration in the electricity industry. SEEBOARD thought the removal of MEB as a competitor in the generation market would have very little effect on that market as it was not a significant player. The non-franchise supply network was currently very competitive and again the removal of a competitor was unlikely to limit customers' choice materially. Post-1998, when full competition was introduced, new suppliers would enter the market and whether or not the merger proceeded the market was likely to be very competitive. However, SEEBOARD said that it would be concerned if PG was to use its current excess generation over supply to expand its share of the supply market and thereby restrict the availability of contract cover to others.

8.60. SEEBOARD added that whilst, in principle, it was not against a greater degree of vertical integration, it was essential that appropriate safeguards were put in place to prevent abuse of any dominant position. SEEBOARD suggested that the following aspects should be considered:

(a) Given that, in the long term, a large integrated company would tend to keep prices up, it was essential that, in the short term, the smaller, independent organizations were not squeezed out through predatory pricing which would ultimately be detrimental for customers.

(b) PG should be obliged not to show any preference between suppliers in making available contract cover. This would be of less concern if there was a proper market for CfDs but such a market did not currently exist. SEEBOARD urged OFFER to seek greater transparency in this market to prevent smaller suppliers and their customers being adversely affected.

(c) Any company involved in a merger leading to vertical integration should be excluded from purchasing any of the existing generation plant capacity.

(d) Franchise customers should be protected from the passing on of any higher generation costs resulting from any preference being given to the non-franchise market.

(e) There was a danger that the workings of the Pool could be unduly influenced by PG, possibly to the detriment of other players, customers and to the establishment of fair competition. It was essential to extend the current Pool price cap for a further two years to give maximum protection for customers until the supply market became fully competitive, with the option of extending control beyond 1998.

(f) It was essential that the ring-fencing arrangements for the distribution businesses of PESs and the concept of non-discrimination in use of system charges between suppliers continued to be enforced effectively.

(g) It was important to have a fully competitive market post-1998-at this juncture, it was impossible to predict what impact vertical integration would have on the competitive supply market post-1998. SEEBOARD therefore suggested that OFFER, in establishing the regulatory arrangements for the supply market for 1998, took into account the changes in market structure as they occurred over the next 12 months.

8.61. SEEBOARD concluded by saying that some tightening of existing licence conditions might be required to deal with some of these points, although the suggestion of placing a prohibition on new contracts between the generation and supply businesses might be unnecessarily restrictive.

Southern Electric plc

8.62. SE, in submitting views as a main party in the NP/SE merger, also gave views on the PG/MEB merger.

8.63. SE said that it understood that concern had been expressed that if the merger went ahead, then the PG/MEB merged entity might be able to enjoy an inherent advantage over RECs which were subject to Pool price risk (either directly, or indirectly, because of high prices for hedging contracts). The short answer to this was that none of these concerns could properly be laid at the door of the merger since the merger did nothing to exacerbate the situation in the generation market.

8.64. SE did not accept that PG would have sufficient market power to control Pool prices. However, if it had any residual power, it would be much less in its business interests to exercise it where it had an increased supply business. There would be particular risks in trying to push Pool prices too high. To eliminate risk the merged group would have to, so far as it could, match half-hour by half-hour generation output and supply. But to distort Pool price it would have to upset normal generation bidding behaviour, and so run considerable risk that marginal plant would be called when not intended, or not called when intended. In this way it would have one business or another exposed to a greater extent to the very risk it was trying to eliminate by vertical integration. Additionally, if Pool prices were sustained at too high a level, new entry would be attracted to redress the balance.

8.65. If a generator had sufficient market power to influence Pool prices so that they were higher than they otherwise would be, then its natural instinct to profit-maximize would lead it to use its market power. The most likely circumstances in which a generator would do this would be where it had substantially more generation than committed supply, and relied primarily on generation income linked to Pool prices rather than income from final customers. On the other hand, to the extent that a generator owned a REC's supply business in addition to its own second-tier supply business, then Pool bidding behaviour was likely to be more constrained. In other words, it was more likely that PG would want to take advantage of any market power if the merger did not take place. If the merger took place, PG's bidding behaviour in the Pool was more likely to be constrained by the risk of exposing its supply business to unexpectedly high Pool price risk. PG could anyway extend its vertical integration (assisted by any perceived imperfections in the effectiveness of regulation). It could do this by increasing its second-tier business sales in the competitive market, and even by entering what was presently the franchise market by `risk-sharing' transactions with RECs.

8.66. The generators could increase their direct second-tier supply sales without the mergers, leading to the same net result in the hedging market. However, this would be less likely than the merger to deliver the benefits in terms of increased competition among smaller customers, and to offer the prospect of more stable Pool prices. The most likely outcome, with or without the merger, was that Pool prices coupled with the cost

of hedging contracts would continue, as at present, to be an important factor in determining prices to customers. While the size and mix of the market for hedging contracts would change over time, hedging contract prices would still be determined in an active and open market. Whether or not regulation was perceived as a complete safeguard, any concern was just as likely to be justified, with or without the merger.

8.67. Permitting the merger, while retaining existing regulatory safeguards, would be a relatively sure way of giving competition the best chance to develop quickly and effectively after 1998. The danger otherwise was that a generator's supply business would continue to focus its attention on a relatively small number of middle- to larger-sized customers, where administration costs were less of an issue, and win ever larger shares. These should be enough to cover its generation output. A REC's supply business would focus first on defending its domestic customer base. Without the merger, competition in the new contestable area, particularly the smaller commercial and larger domestic customers, was not likely to get the kick-start it needed. Once competition had started, new suppliers and intermediaries (such as Direct Line Insurance and AA Services) could be expected to provide the smaller consumer with a package of competitive choices. However, new suppliers were likely to wait until they saw that real competition was developing and intermediaries could never create the competition, only facilitate it.

8.68. It was widely recognized that it would be appropriate after March 1998 to give the domestic customer some degree of regulatory price protection. Without this protection the natural wish of any supplier to maximize profits would ensure that suppliers charged the highest prices they could to consumers (particularly smaller domestic consumers, whose natural disinclination to move suppliers was likely to be greatest) without losing them to competitors. This would be the situation with or without the merger and would be common to all RECs. Consequently, the issue of protection of smaller customers was made no more urgent, or difficult, by the merger.

8.69. The merger would result in a minimal loss of competition among electricity suppliers. Effectively the supply business of PG would merge with MEB, reducing the number of major competitors from 16 to 15 and the total present number of second-tier suppliers from 33 to 32. Competition among suppliers would ensure that prices to customers were competitive.

8.70. The DGES had a wide portfolio of regulatory powers backed up by licence conditions for each aspect of the electricity market. In SE's view, the system would be able to regulate the vertical integration that had taken place so far, and which was likely to come even without the merger.

South Wales Electricity plc

8.71. SWALEC, a shareholder in TPL (see paragraphs 8.131 to 8.134), did not believe MEB was able to significantly influence the operation of Teesside power station through its position as a shareholder. However, availability to competitors of commercially sensitive information relating to the plant's development and operations strategies could clearly be prejudicial to the future value of the project. SWALEC was confident that assurances sought from MEB by TPL and its other shareholders regarding the maintenance within MEB of this information would be provided to its satisfaction.

South Western Electricity plc

8.72. SWEB, a shareholder in TPL (see paragraphs 8.131 to 8.134), told us that the types of decision about TPL requiring unanimous shareholder approval covered operation, policy and future development of Teesside power station. Although the voting provisions were such that MEB could veto such matters and thereby materially influence the operation of the plant, it was, in SWEB's view, unlikely to exercise this power differently should the merger proceed. SWEB stressed that it would feel reassured if MEB, in this event, were required to ring-fence its TPL business to make it more remote from PG's main operational business.

Yorkshire Electricity Group plc

8.73. Yorkshire Electricity Group plc (Yorkshire) pointed out that at privatization the electricity market was restructured in a way which restricted the level of formal integration between generators and suppliers. The generating and supply companies were set up as separate entities, with restrictions on the volume of supply business taken by generating companies and the share of generation by RECs. The restriction on generating companies had been removed, whilst the restriction on RECs remained, although the DGES had indicated that he would consider requests for increases in the limit on own-generation by RECs.

8.74. Yorkshire emphasized that at PG's and NP's market power had been identified as one of the weaknesses in the restructuring and privatization of the industry. This had been most apparent in the number of investigations into the Pool price, culminating in a Pool price cap and undertakings by PG and NP to dispose of some of their generating capacity. Yorkshire added that as yet there was no evidence that the steps taken would reduce PG's and NP's capability to set the Pool price on the majority of occasions in the critical winter months. A properly competitive spot market not dominated by a small number of major generators was critical for the development of competition and the delivery of better value to customers.

8.75. Yorkshire argued that vertical integration with a REC would increase this market power and the risk that it might be abused. Where generation was not sufficiently competitive, whilst supply was, there would be increased incentive for the generator to increase Pool prices and increase purchase costs for non-integrated suppliers, thereby also discouraging competition in supply. Conversely, with a relatively secure supply market with `captive customers' a generator could keep Pool prices low to discourage competition in generation and gain further market share. Yorkshire referred to the position in Scotland where there were two integrated electricity companies, no effective spot market, and insignificant competition in supply at around 4 per cent of the available market.

8.76. Yorkshire considered that the proposed merger could operate against the public interest unless the following safeguards were introduced to ensure that customers were able to obtain the full benefits of competition:

(a) a restriction on the amount of plant operated by PG, to the level envisaged in the DGES's statement of 11 February 1994 on the disposal of plant. This would involve not only the disposal of plant earmarked through the undertakings, but also disposal of capacity equivalent to MEB's interests;

(b) financial and commercial ring-fencing of PG's and MEB's separate generation and supply businesses. Separate accounting would permit some scrutiny for uncompetitive behaviour, especially when linked to disclosure to the regulator of information on contracts. Commercial ring-fencing would take the form of a requirement to demonstrate `market testing' of contracts by both the generating business in its sales and by the supply business in its purchases;

(c) statements by PG's auditors confirming that PG had not been discriminatory in offers made by its generating business as between its own supply business (including MEB) and the supply businesses of other companies; and

(d) a revision of the current constitution of the Pool to provide greater representation for the interests of customers and of independent suppliers to offset the effective double voting of allied RECs/generators.

Nuclear Electric plc

8.77. NEP wrote to us and attended a hearing.

8.78. NEP explained that it was shortly to be separated into two parts: Magnox Electricity plc, which would own the Magnox nuclear power stations; and Nuclear Electric Limited, which would own the AGR and PWR nuclear power stations. Nuclear Electric Limited would form one of the subsidiary companies of British Energy, Scottish Nuclear Limited being the other. Given the broadly similar interests of all these companies, NEP said that it represented the views of its successor companies. NEP explained that it presently had approximately 10 GW of nuclear generating plant and in 1994/95 produced slightly over 22 per cent of the total electricity requirements for England and Wales.

8.79. NEP pointed out that if the proposed merger and that of NP/SE were to proceed, the England and Wales electricity sector could quickly become dominated by vertically integrated groups. Based on the 1994/95 market shares, PG and NP would together hold more than 60 per cent of the generation market, 30 per cent of the supply market, and 20 per cent of the total distribution business turnover in England and Wales. Although PG and NP had expressed intentions regarding the divestment of approximately 6 GW of plant, its acquisition by a group with PES interests (such as Hanson/Eastern) would further increase the extent of vertical integration in the electricity industry.

8.80. NEP said that vertical integration through the proposed merger would create the potential for `self-dealing' between the REC supply business and its associated generating business. In principle this might not be considered a concern in a wholly competitive supply market as envisaged post-1998. However, NEP emphasized that it had yet to be established whether this market would in the event prove to be fully competitive. In this context, NEP noted that the recent OFFER proposals on 1998 supply competition had commented on the possibility of a `captive' market remaining beyond that date, and the consequential need for continuing price restraint. This implied that there would be a continuing need for safeguards, both to protect consumers and to protect competition, and the need for such safeguards would become greater if the proposed merger was to proceed.

8.81. NEP explained that its concern, and that of the successor nuclear companies, was the possibility that they might be excluded from (or treated in a discriminatory way) a significant part of the England and Wales supply market. This concern could be reinforced to the extent that a large vertically integrated group could take advantage of its dominant position within the host REC territory in order to expand its supply business in other geographical areas. Whilst in the absence of effective supply competition safeguards could no doubt be put in place to protect consumers and discourage self-dealing, NEP questioned the extent to which these would either be easy to monitor or effective in practice.

8.82. NEP added that a further concern it had regarding the proposed merger was that effective competition in supply depended critically on equality of access to the distribution network. If a monopoly distribution network owner had interests in supply and generation it would have an incentive to discriminate against its competitors. Some regulatory safeguards already existed in view of RECs' engagement in both distribution and supply. However, the value added (and the asset base) in REC supply businesses was comparatively low. NEP believed that vertical integration with generation and the inclusion of a much more substantial generation asset base in the vertical chain would be likely to increase the incentive for distribution network owners to abuse their position, by discriminating against competing suppliers. NEP stressed that this was clearly a significant regulatory issue which was likely to require additional safeguards to protect consumers and to maintain competition. NEP urged the MMC to address the question of what additional regulatory safeguards would be required to ensure adequate protection.

8.83. Finally, NEP expressed concern over the effect the proposed merger might have on the Electricity Pool. The workings of the Pool were of fundamental importance to nuclear generating plant as price takers in that market. PG had adjusted its pricing to meet the DGES's cap and as a consequence had caused time-weighted and demand-weighted prices in the Pool to diverge since 1994. NEP argued that it was very important for competition in generation and for an efficient electricity industry that the pricing wholesale market should be transparent, and should effect the economically efficient dispatch of plant in an integrated network. The Pool already provided these functions and, in NEP's view, should continue as the primary wholesale market. NEP considered that any marginalization of the Pool, through, for example, direct trading between the generation and supply businesses within a vertically integrated company outside the Pool (if this was permissible), could lead to anti-competitive behaviour. This would result in a less transparent and less efficient market to the detriment of effective competition. NEP added that whilst vertical integration in itself did not necessarily undermine the Pool, it had been concerned at public positions taken by parties seeking to promote trading outside the Pool. NEP believed the MMC should consider safeguards to protect the continuation of a transparent wholesale market for all generation.

BNFL UK Group

8.84. BNFL UK Group (BNFL UK) pointed out that there were a number of current imperfections in the electricity market of which the MMC should be aware. In particular:

(a) The Pool had not yet operated in an undistorted fashion in that:

- it was subject to the DGES's `price cap' up to March 1996. This cap was in recognition of PG's and NP's market power to control Pool prices which might be diminished by the plant divestment commitments made;

- the majority of generators were `price takers' and not `price makers'; and

- a number of generators were indifferent to Pool prices as a result of their hedging contracts (CfDs).

(b) The CfD market was largely opaque, in contrast to the Pool. It could cause distortions arising from the coal-backed contracts (expiring in 1998) and excess contract cover, particularly if coupled with market power in the Pool.

(c) The domestic franchise was intended to be removed in 1998. However, BNFL UK had serious doubts about this being achieved because:

- the changes required to achieve competition in domestic supplies were technically complex and progress so far was not encouraging;

- not all parties were fully committed to the process;

- if PG was allowed to vertically integrate its current commitment to the success of 1998 might diminish; and

- there were significant barriers to the entry of new supplier to the domestic market.

For these reasons, BNFL UK said that it believed a significant *de facto* franchise would continue to exist into the next century.

8.85. BNFL UK explained that many of its concerns about the proposed merger related to the vertical integration achieved by combining the company's generating, supply and distribution activities. BNFL UK argued that in a fully competitive market it would be difficult to mount compelling arguments against an electricity company achieving a large measure of vertical integration. However, such a market did not exist at present and the proposed merger was likely to hinder or even prevent the development of fully competitive markets. Therefore, BNFL UK argued, the proposed merger would be a retrograde step in the progress to a fully competitive market for the UK as a whole and might also be against the interests of MEB's domestic customers.

8.86. BNFL UK thought if the merger was allowed to proceed certain regulatory safeguards would be required to maintain progress to a more competitive market:

(a) PG would have to divest itself completely of the 2 GW of plant required by the DGES;

(b) subsequent Pool trading should be monitored to ensure competitive price making;

(c) trading outside the Pool should not be extended beyond the current *de minimis* exceptions; and

(d) maximum competition in the domestic electricity market should be encouraged as soon after 1998 as feasible.

Safeguards to mitigate the anti-competitive consequences of vertical integration should be based on:

(a) the retention of the `economic purchase' obligation on the RECs, together with a requirement for them (and perhaps all suppliers) to institute formal competitive systems for the purchase of wholesale electricity; and

(b) for a generator-supplier, where formal contracts between the generation and supply interests might be irrelevant, testing of economic purchase to be against the wholesale component in prices to final customers.

BNFL UK added, however, that though the above should, in theory, provide adequate safeguards, it was not fully convinced of their ease of administration or of their practical effectiveness.

Scottish Hydro-Electric plc

8.87. Scottish Hydro-Electric said that in considering the implications of the proposed merger, it was helpful to consider the distribution, generation and supply businesses separately. MEB had distribution businesses which were already ring-fenced from its supply businesses with separate accounts and non-discrimination provisions in its licence. The existing powers of the DGES allowed him to regulate the monopoly distribution businesses appropriately and the proposed merger would have no effect on this.

8.88. PG had been established as a generator although it had since developed a supply business. Concern had been expressed over the dominant position of PG in the generation market and it had agreed with OFFER to dispose of some generating plant. As a consequence it should not have a market share in generation exceeding 25 per cent. The proposed merger would not result in a significantly increased market share for PG since MEB had only a small generation interest. The DGES had already concluded that in the interests of competition it would be reasonable to require PG to restrict its market share in generation and the plant disposal should therefore go ahead. The proposed merger did not directly affect concerns over PG's market share and whether or not the merger took place it was appropriate to restrict PG's market share.

8.89. With regard to PG's supply business, the licence condition already forbade discrimination in the terms on which energy was made available to second-tier suppliers. PG was obliged to make energy available to second-tier suppliers on the same terms as energy was made available to its own supply business. This licence condition was necessary to ensure that other suppliers (including RECs) could compete in the supply market which might otherwise become dominated by the large generators. The licence obligation covered not only price but other conditions of sale since some of these, such as the profiling of CfDs, were quite as important as price. The enforcement of this licence obligation was important but this would not be materially affected by the proposed merger.

8.90. Vertical integration was common throughout industry and most producers of products and services retained sales and service teams since producers needed to ensure a market for their products. In the electricity industry, the supply businesses formed the sales and service teams of generation businesses. Vertical integration could be seen as a natural development in a competitive market. Vertical integration already existed in Scotland and had been handled satisfactorily so far. In the MMC inquiry into Scottish Hydro-Electric's price controls,[1] the MMC had found no evidence that customers in Scotland had suffered from a lack of competition or higher prices.

8.91. In one respect customers could be expected to benefit from vertical integration between generation and supply. At present, generators and suppliers usually hedged their risks against price fluctuations in the Electricity Pool: generators needed to protect themselves against possible low prices and suppliers against high ones. At the present time, fluctuations were particularly extreme. Protection was largely achieved through CfDs. The cost of these ultimately had to be borne by customers.

8.92. Vertical integration introduced a natural hedge to Pool price variations. The generation business knew its expected production costs and the supply business consequently knew the volumes and costs of what it had for sale. Neither business needed to hedge its risks through CfDs. Costs associated with these would no longer apply, and the price benefit would pass to customers.

8.93. The regulator would need to satisfy himself on three counts. First, there should be no cross-subsidy between monopoly and competitive businesses. As the MMC had already seen in the case of Scottish Hydro-

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[1]*Scottish Hydro-Electric plc: a report on a reference under section 12 of the Electricity Act 1989*, HMSO, ISBN 0-11-701932-1, June 1995.

Electric, it was perfectly feasible to put adequate safeguards in place and ensure that each separate business was separately viable. Second, there might need to be safeguards to ensure that income from monopoly areas was not diverted into (say) overseas ventures. This could be handled by licence modifications similar to those which were being implemented in the case of the other mergers and acquisitions within the industry. Third, the regulator would need to ensure that no company's market share was excessive in generation or supply. None of these aspects raised fundamental difficulties, nor fundamentally changed the principles of regulation.

8.94. Scottish Hydro-Electric concluded that the merger would not materially affect competition in the England and Wales electricity market. Existing licences forbade cross-subsidy between businesses and required the major generators not to discriminate in sales to supply businesses. Provided these safeguards continued in force, and provided no company was allowed to achieve an excessive market share, Scottish Hydro-Electric saw no reason why the merger should not take place. Scottish Hydro-Electric also believed the merger might benefit customers in terms of price.

ScottishPower plc

8.95. ScottishPower told us that competition had been introduced into two separate segments of the electricity market in England and Wales, namely generation and supply, and through the mechanism of the Pool. From vesting, generators had been encouraged to enter into competition for supply, via second-tier supply business, though restrictions were initially placed on the market share they could take away from individual RECs. Competition was now limited to over 100 kW customers and all restrictions on market share had been removed from generators. Similarly, RECs had been encouraged to enter into competition for generation but with a limit of owning no more than 15 per cent generation capacity of the maximum demand on their network. Although the electricity industry in England and Wales was disaggregated in advance of privatization, reintegration was clearly anticipated, hence the rules to control that development. The proposed merger was merely a further step in that direction.

8.96. ScottishPower noted that the number of competing generators would be reduced as a result of the merger. PG had already given undertakings to divest itself of 2 GW of generating capacity: this capacity was greater than the amount it would acquire through the merger and was likely to be of a different merit order to the acquired plant. The merger was therefore unlikely to have any effect on competition in generation since the number of significant players would either stay the same, or might even increase with the divestment.

8.97. As to supply, ScottishPower explained that suppliers purchased electricity from the Pool to meet the demands of their customers in each half-hour at the ruling PSP. Since all suppliers purchased electricity at an identical price from the Pool, competition in supply depended on suppliers keeping their costs, and hence their price component, low and offering added value services. The number of suppliers post-merger would effectively decrease by one but there were already a large number of players. ScottishPower argued that the supplier resulting from the merger would be larger than the other players but not so large as to dominate. Competition in supply would change because of the various changes in the industry and vertical integration was just one of the variables in a changing industry. Customers should still have a sufficient choice of suppliers of electricity.

8.98. ScottishPower pointed out that the electricity market in Scotland was already vertically integrated. The creation of a vertically integrated company in England and Wales would not have any impact on competition in Scotland. The Scottish market was effectively isolated from the England and Wales market because of the limited capacity of the interconnector between the two countries.

8.99. ScottishPower added, however, that the market for CfDs was one area where competition might be reduced. Because of its access to an increased customer base PG might not have the need to secure CfDs to the same extent as previously. The opportunity for suppliers to secure CfDs would be reduced but so also would the number of suppliers seeking contracts. Overall, ScottishPower thought there would still be a sufficient number of active suppliers to ensure active competition.

8.100. On the subject of pricing, ScottishPower explained that because PG and NP owned the vast majority of mid- and low-merit plant they tended to be the price setters in the Pool. The divestment of 6 GW of generation capacity would change the ownership of a significant proportion of this category of plant and

would increase competition in bids into the Pool for marginal plant, which should result in PG setting the Pool price on fewer occasions. ScottishPower added that the merger itself was unlikely to affect pricing because the generation plant acquired from MEB would be predominantly CCGT which, because of its associated `must take' gas contracts, was baseload and did not set price. ScottishPower thought that though the day-to-day operations of the Pool were unlikely to be affected by the merger there were Pool governance issues which would arise from the merger. These were, however, currently being addressed because of earlier measures and revised arrangements were expected to be in place with effect from 1 April 1996.

8.101. ScottishPower thought the merger was unlikely to adversely affect the regulatory process. OFFER was accustomed to working with the two vertically integrated Scottish companies. By modifying PG's and MEB's current licences to ensure that separate accounting was maintained for the separate businesses, OFFER should have no increased difficulty in monitoring regulatory issues.

8.102. In conclusion, ScottishPower said that if the merger was allowed it should at a minimum be subject to the same assurances sought by the President of the Board of Trade in allowing its own merger with Manweb.

National Grid Company plc

8.103. The NGC explained that it was a wholly-owned subsidiary of the National Grid Group plc. It owned and operated the high-voltage electricity system in England and Wales and the English portions of the interconnections to France and Scotland. It was required to provide open access to the transmission systems on a non-discriminatory basis.

8.104. The NGC said that it sought to minimize the cost of meeting its statutory and licence obligations, whilst satisfying customers' requirements. It did this by acting as a facilitator of the electricity market in England and Wales and by providing the framework by which buyers and sellers traded electricity in a competitive market, so, in principle, allowing customers to enjoy lowest prices.

8.105. The NGC pointed out that the overall electricity markets comprised a number of separate trading arrangements, all of which operated in addition to the PPP defined in the Pooling and Settlement Agreement. In addition, the NGC purchased services from generators and some large customers to provide a secure and stable system. The financial impact of these arrangements could depend upon the NGC's actions. The NGC said that it had sought to adopt an overtly independent role, seeking as far as possible to strike an equitable balance between competing interests in the market. The NGC stressed that it regarded this as vitally important to market operation and development, particularly as distinctions between suppliers and generators were diminishing with the result that previous precepts were invalid.

8.106. The NGC explained that as well as diluting the distinction between suppliers and generators, further industry consolidation would create larger combined electrical utilities. The NGC had always sought to act equitably regardless of the size of the individual companies. Similarly, the existing Pool governance was designed to provide protection for smaller players in the market. The NGC had been able to establish procedures whereby providers could compete with each other to provide reserve. Not only did this cause generators to compete with each other, but it developed load management by customers as a viable alternative to generation.

8.107. The NGC considered that the proposed merger could still be consistent with the original privatization aims, provided that certain safeguards were applied. Until all customers were able to choose their own supplier, regulation of the RECs' supply businesses would need to continue. Once the REC franchises were removed, the existence of a competitive and transparent electricity market should provide adequate protection for customers; thus there was a need to ensure that the present open market structure, based on, among other principles, non-discriminatory access to the network, was retained.

8.108. The NGC pointed out that the merger would increase PG's influence on the development of the trading arrangements established through the Pooling and Settlement Agreement. In particular, if PG was to exercise more control on the supplier side of the industry as a result of the merger, the interests of its shareholders would not necessarily be served by giving the NGC strong incentives to reduce constraint costs. The NGC supported OFFER's objective to remove the transport element of uplift from the Pool so that these

costs became part of the NGC's regulated transmission business. The NGC added that should the merger foreshadow the consolidation of the industry into a small number of vertically integrated players, the interests of Pool members could align and would not necessarily coincide with those of customers. There would, therefore, need to be mechanisms to ensure that all changes were made in customers' interests and that measures to promote improvements in the market's efficiency were not obstructed.

8.109. The NGC concluded by saying that it believed the proposed merger was consistent with the customers' interests, as long as the NGC's ability to operate the system and facilitate competition was not compromised, a transparent market for electricity existed, transmission uplift was removed from the Pool and the protection of customers' interests in the Pool were enhanced.

Powermet Ltd

8.110. Powermet Ltd, a meter operator, argued that ownership of a REC by a major generator was inconsistent with the principle that effective competition in the electricity market could only be maintained if supply and distribution were kept under separate ownership from generation. The existence of a vertically integrated group would be likely to restrict the development of a vigorous wholesale market for electricity and might also adversely affect non-discriminatory access to the electricity industry network for other parties. At the retail end, a vertically integrated supplier might not feel entirely free to purchase power from other generators at the most economical prices, with consequent deleterious effects on consumers.

8.111. Powermet also thought that if PG acted as buyer and seller in the Pool it would distort the operation of the Pool. A further consideration was that if the merger went ahead, the DGES would be deprived of valuable comparative data which were now available via the accounts of the existing separate companies. Powermet concluded that, in the light of the above comments, the only practicable safeguard it could suggest was that the merger should be prohibited altogether.

Enron Europe Limited

8.112. Enron wrote to us and attended a hearing.

8.113. Enron explained that it was actively engaged in the independent development of gas-fired power stations in the UK, the provision of energy merchant services and trading, which included the physical and financial side of natural gas and electricity, and the long-term structuring of natural gas sales and financing to gas-fired power stations in the UK and Europe. Enron was a major shareholder of TPL and operated TPL's gas-fired power station at Wilton, Teesside.

8.114. Enron argued that despite many successful aspects of the restructuring of the electric power industry in England and Wales, the market was not yet fully competitive. In particular, PG and NP had a dominant market position and were able to exercise undue influence on market prices, which they consistently did. The proposed merger would create a vertically integrated company which would exacerbate an already imperfectly competitive market.

8.115. Enron pointed out that the proposed merger would further increase PG's already high concentration in the UK generation market. In 1995 PG supplied about 24 per cent of the total demand for power in England and Wales, and about 41 per cent of all demand above baseload (which was the capacity most critical to setting the marginal pool price). MEB had a significant interest in gas-fired generation through its participation in IPP projects. Thus, the merger would further increase PG's share of plant capacity by nearly as much as its planned divestiture of 2 GW of coal- and oil-fired plants. Enron emphasized that the increased market concentration from the proposed merger exacerbated problems that had already emerged with the vertical integration of ScottishPower and Eastern.

8.116. Enron said that it believed the proposed merger would decrease the number of alternative power suppliers. In particular, MEB's customers would lose PG as a viable second-tier supplier. Given that PG was one of the largest non-REC supply companies and MEB was among the four largest RECs, this would significantly decrease competition in the power supply market. Furthermore, the proposed merger would dramatically increase MEB's incentive to procure power from PG and thus decrease its incentive to

investigate a broad range of power alternatives for the supply of its customer load. This could potentially increase costs for customers whose present needs were greater than 100 kW, and for all consumers after 1998. Enron added that the RECs already had an inherent incentive to discriminate against second-tier suppliers. Vertical integration would enhance this incentive since upstream generation assets would be at risk if the RECs lost load. Undoubtedly, this discrimination would have to come in the form of subtle non-price terms that might be difficult to detect. Also, given MEB's affiliation with gas supply companies, its local market position in the supply of energy services would be reinforced further, given PG's diverse gas supply portfolio.

8.117. Enron considered that vertical integration of a major generator such as PG with MEB would significantly decrease development opportunities for IPPs. Its acquisition of MEB provided it with a natural hedge for generation. As a result, MEB would have no incentive to enter into long-term CfDs with other suppliers. Therefore, the merger would effectively eliminate one of the key components of independent power plant development. Enron explained that the development of IPPs hinged critically on the ability to sign long-term contracts which were secure enough to allow project finance. Under such financing, the plant was capitalized largely with long-term debt that was secured solely by revenues from the project itself. The current merger proposal would vertically integrate one of the country's largest RECs and, judging from supplier-weighted Pool voting shares, effectively remove a significant amount of that growth from participation in the new capacity market. Considering that other suppliers were already vertically integrated, the merger would further discourage IPP developers and make that market less active and competitive than it could be.

8.118. Enron said that a further concern regarding the merger was that it might impede the development of efficient trading markets for electricity, by reducing liquidity and by preventing the creation of financial instruments such as electricity futures. Enron stressed that the physical and financial trading of commodities greatly increased market efficiency. Unfettered, active trading was a prerequisite for liquid spot markets and efficient commodity prices. Financial instruments and liquid electricity trading markets offered competitive alternatives to direct contracts with generators. Because active trading markets were difficult to establish in the presence of market power, the adverse effects of the merger would impede further development of an efficient market for electric power.

8.119. Enron also expressed concern that the proposed merger would increase PG's influence on Pool price setting. Enron emphasized that the Pool had a critical role in defining the electricity market in England and Wales. The merger might bring under PG's control additional peak-load resources at a time when it already controlled about 41 per cent of the mid-merit and peak-load supply-side resources. Whilst end-users and suppliers would benefit from Pool operations that would decrease the market price of electricity, it was in PG's best interests to preserve Pool operations that allowed it to keep prices above competitive levels. Enron added that the electricity industry had already recognized this conflict and had embarked upon a complete review of the Pool voting and governance procedures. Therefore, if the merger was approved Enron argued that its impact on procedures should be carefully examined to avoid further dominance in Pool decision-making.

8.120. Enron concluded by saying that allowing the proposed vertical integration could only compound and confuse the current programmes to improve and increase electricity competition. The proposed merger would increase already problematic industry concentration and generator market power, thus effectively frustrating the public policy vision. Enron recommended that the MMC should prohibit the proposed merger.

8.121. On the operation of Teesside power station, in which MEB had an interest both as a shareholder and as an electricity purchaser, Enron told us that as presently constituted, TPL shareholders were privy to its full commercial position, operating plans and intended actions. Enron was very concerned that PG should not be able to gain access to this information were the merger with MEB allowed to proceed.

8.122. The voting arrangements for shareholders meant that the power of `negative control' arising from unanimity required for certain decisions could lead to a shareholder influencing aspects of the operation or the future development of the plant. Although it could only speculate on the likelihood of a merged company exercising such powers in a manner detrimental to TPL or to competition, the potential was very real.

8.123. Enron considered that were the merger allowed to proceed, any problems could be overcome by confidentiality measures and appropriate structural ring-fencing measures. MEB's investment in TPL would

have to be of the nature of a `portfolio investment', ie it would be shorn of rights to confidential information and to participation in decision-making, leaving it essentially with the rights conferred upon an ordinary investor in a public company.

ICI Chemicals & Polymers Limited

8.124. ICI, a shareholder in TPL (see paragraphs 8.131 to 8.134), believed it was unlikely that MEB as a minority shareholder could in practice on its own substantially influence TPL's day-to-day operations in a way that would be inconsistent with TPL's interests as an independent generator.

8.125. In contrast, MEB could potentially have a significant influence on TPL's future development, particularly decisions on capital investment, new power purchase agreements and modifications to existing agreements. It was possible that this could affect indirectly how TPL operated its existing contracts, and hence the plant's operation and bidding behaviour.

8.126. ICI believed that if suitable undertakings could be obtained from PG, and that MEB's interest in TPL was operated separately from PG's other generation interests, it was unlikely that the merged company would influence TPL's development in a way that would prevent TPL from acting as an independent competitor. MEB's power purchase agreement with TPL in any case provided some incentive for the merged company to act consistently with TPL's interests.

IVO Energy Limited, Tomen Power Corporation (UK) Ltd

8.127. IVO and Tomen, shareholders in the Humber project, told us that if the merger were allowed to proceed, MEB alone would be unlikely to be able to influence the independent operation of the plant during the 15-year term of the existing power purchase agreements and at its present 25 per cent shareholding.

8.128. If MEB were to increase its holding to 33.33 per cent or more, the merged company would have direct influence on additional capital expenditure. This included the major expenditure necessary for the phase 2 expansion of the plant, for which Humber already had consents, and it was vital to the non-MEB shareholders that this proceed.

ABB Energy Ventures BV

8.129. ABB, a shareholder in the Humber project, said that once the contracts for the project, including phase 2, were completed, Humber's operations would be largely contractually defined and substantially independent, and until then the project was still open to interference. An increased shareholding at any stage by a party would allow it to impose non-project priorities on other shareholders.

Edison Mission Energy Limited

8.130. Mission said that it had only recently acquired First Hydro and was in the process of discussing in detail the approach which had been adapted by the present management team in bidding into the Pool. Its initial view was that it was unlikely to change its approach but believed that in a competitive market it must react to the requirements of customers and to the dynamics of the Pool.

Teesside Power Limited

8.131. TPL wrote to us and attended a hearing.

8.132. TPL explained that it was a joint venture company, the equity shareholders of which were Midlands Power (TPL) Limited (a subsidiary of MEB), three subsidiaries of other RECs (Northern, SWEB and SWALEC) and TPHL (of which Enron held 85 per cent and MEB the remaining 15 per cent). Also, ICI owned a special preference share in Midlands Power which gave it voting rights and the right to appoint

directors. TPL owned one gas and steam turbine power station at Wilton, Teesside, with a grid registered capacity of 1,875 MW.

8.133. TPL said that it had specific concerns about the proposed merger, resulting from MEB's position as one of its indirect shareholders. TPL emphasized that when the project documentation had been negotiated, it had not been contemplated by any of the parties that the separation of generation from distribution and supply, put in place at privatization, might effectively be undone by allowing the privatized generators to acquire RECs. Further, in setting up the joint venture, one of the issues considered was the ability of the RECs to gain generation interest in competition with the major generators. Although the project documentation contained elaborate provisions dealing with the transfer of shares, it did not specifically address the possibility of one of the REC shareholders itself being acquired by one of the privatized generators. TPL stressed that the acquisition of MEB by PG had serious implications for its business and operational strategies because of the risk of confidential information about such matters being made available to PG by MEB, and further, the ability of the MEB appointed director to inappropriately influence decision-making at Board level in certain situations, where unanimous decisions were required.

8.134. TPL submitted that this risk in itself would justify an adverse finding in relation to the merger. If, however, the MMC were minded to allow the merger, TPL suggested that an essential safeguard should be imposed which would be a modification to MEB's generation licence, preventing, *inter alia*, the disclosure of confidential information by MEB to PG about TPL's power purchase agreements or its business and operational strategies, and preventing MEB and PG from exercising inappropriate control in decision-making in certain circumstances. TPL recognized, however, that this suggestion could raise questions about the ability of any regulator to monitor or enforce compliance, unless TPL was satisfied that suitable confidentiality and structural ring-fencing measures were to be put in place. TPL would only be satisfied with such measures if it were to be properly involved in discussions about the scope of such measures and in the detailed drafting process. TPL further submitted that, while it was opposed to the merger, if the merger were to proceed, divestment by MEB of its indirect shareholding in TPL would be of concern to TPL, and that TPL was confident that ring-fencing and confidentiality measures (developed strictly as referred to above) would, in such circumstances, be more appropriate, and could be made to be adequate to overcome potential problems.

Thames Power Limited

8.135. Thames wrote to us and attended a hearing.

8.136. Thames said that it was a 51 per cent shareholder in Barking Power Limited, which owned and operated the 1 GW Barking power station. The remaining shares in Barking Power were held by SE (22.05 per cent), Eastern and London Electricity (13.475 per cent each). The shareholders of Thames were BICC plc and CU Power Generation Limited, a Canadian utilities company.

8.137. Thames considered it essential to the public interest that the competitive position of IPPs such as Barking should not be placed in jeopardy by vertical integration. Such a change in the structure of the industry was likely to inhibit if not stifle competition in generation.

8.138. Thames stressed that at the time of privatization, when many IPP projects, including Barking, were formed, the Government saw a clear and urgent need for new and competitive sources of power for the RECs. The RECs had subsequently supported this objective as shareholders and power purchasers in all the IPP projects which had since come to fruition. The absence of vertical integration was vital. Thames argued that had there been RECs in the hands of the former CEGB generators at vesting, such RECs would never have been allowed by their parent companies to support IPPs. (MEB had participated in 1 of the 12 IPPs.) Thames considered that the example of the industry in Scotland, which was vertically integrated, was instructive as there no IPPs had been developed.

8.139. Thames argued that the existence of IPPs in England and Wales, and the potential for further such projects, had met the Government's objectives and had been instrumental in driving down contract prices, by providing real competition to the former CEGB generators. Vertical integration would further increase PG's ability to act anti-competitively in relation to the operation of the Pool, which had already been the subject of

regulatory action. Thames emphasized that this would be to the detriment of the working of the Pool and the effectiveness of those RECs and generators not so vertically integrated, and thus the interests of consumers.

8.140. Thames explained that at present IPPs were still at a very early stage of developing their competitive strength. On the other hand, the market power exercised by the major players had been all too apparent since privatization. It had resulted in the need for OFFER to regulate price capping and force divestment of generation. PG and NP had used their considerable financial resources and other advantages to build new plant equalling the total capacity installed by all 12 IPPs. The stronger these major players became, the easier it would be for them to squeeze the smaller players through market manipulation. Thames argued that the developing IPP resource base must be preserved and its growth nurtured if the generation sector, and through it the entire electricity industry, was to achieve full competition.

8.141. Thames emphasized that the Government's clear intention at privatization was to keep generation and supply separate to maximize competition in both sectors. The proposed merger would represent a fundamental restructuring of the industry which would reduce and distort competition in generation and would be against the interest of consumers.

8.142. Thames suggested that if the merger went ahead a safeguard should be applied: to protect existing and encourage new IPPs, all PES licence-holders should be required to put out to open tender all future CfDs and other offtake arrangements with appropriate restraint on the contract market share of all the major generators.

Association of Electricity Producers

8.143. The Association of Electricity Producers (AEP) wrote to the MMC as the trade association representing the generating sector of the industry. The AEP said that its membership covered generating companies of almost every size and included, notably, NP, PG and Southern Electric Power Generation Limited. The AEP argued that, if permitted, the merger would increase PG's financial strength, making it more competitive in the emerging international electricity markets.

8.144. The AEP said that it did not object to the proposed acquisition, subject to the following safeguards:

(a) other generators seeking to sell power competitively to MEB would continue to have a fair opportunity to do so and the DGES should satisfy himself that the financial arrangements between the merged businesses did not preclude that;

(b) the economic purchasing requirements which applied to RECs should be applied no less stringently to RECs that purchased electricity from parent companies that were also generating businesses; and

(c) the DGES should be asked to make explicit the mechanism by which he would judge economic purchasing in the circumstances which would arise from the proposed merger and to consult the industry on the subject.

8.145. The AEP attached importance to the continuation of the transparency of trading in electricity provided by the Electricity Pool of England and Wales.

RJB Mining Plc

8.146. RJB Mining explained that in December 1994 it had acquired the substantial part of British Coal Corporation's mines and opencast sites in England. In addition to its coal sales to PG and NP, which represented 87 per cent of RJB Mining's sales in the first six months of its operations, as a major user it had considerable interest in the workings of the electricity market.

8.147. RJB Mining provided an analysis of the electricity market since privatization. RJB Mining argued that the analysis had shown that there were numerous distortions in the way that competition had evolved/been encouraged in the electricity markets, many of which worked to the disadvantage of the UK

coal industry. RJB Mining contended that long-term electricity could be produced from existing coal-fired power stations at a production cost of 1.8p per kWH versus higher prices for gas-fired CCGT stations. Due to contract and market structures, coal plant was unable to contest a large slice of the electricity market supplied by those gas stations. Furthermore, nearly all of the electricity price reductions over this period were as a consequence of falling coal prices, not the passing on of reductions in operating costs in the electricity industry.

8.148. RJB Mining considered that the two issues of plant sales and REC purchase were inextricably linked. Vertical integration was the norm in Scotland and appeared to offer the Scottish companies an advantage in their management of electricity sales risks. Such benefits should lead to lower prices. RJB Mining thought that if this was an appropriate structure in Scotland then there was no reason why it should not work in England and Wales. RJB Mining added that Eastern had been encouraged to take over PG plant and had become a vertically integrated company.

8.149. RJB Mining concluded that:

(a) it did not object to the proposed merger;

(b) current contractual frameworks including long-term coal supply contracts for a proportion of PG's future requirements should be extended beyond March 1998 to protect electricity consumers' long-term interests;

(c) the anomalies in the electricity market should be removed by scaling back or disallowing uneconomic CCGT contracts to encourage fair and equal competition in the electricity and gas markets; and

(d) an energy and environmental framework should be developed that set out broad parameters on fuel mix into the 21st century, meeting the national requirements on sustainability and security of supply. As part of such a framework a target capacity of clean coal capacity of 2 GW by 2001 and 5 GW by 2003 should be adopted.

An independent investor group

8.150. An independent investor group, with major generation assets in operation and under construction, raised concerns regarding the proposed merger, given its implications for independent power projects in the England and Wales electricity market.

8.151. The group argued that a vertically integrated company would seek to balance its own portfolio interests as distinctions between vertically integrated companies and independent generators disappeared within the Pool. It anticipated that PG, and other vertically integrated companies, would be able to influence bidding practices, Pool rules, grid rules and charges and the regulatory framework itself, which would have severe implications for smaller, independent generators.

8.152. The group stressed that unless PG was prohibited from selling its own generation to MEB customers, the market for resale would potentially contract. It noted that whilst, in principle, this might be partly remedied by licence conditions, it would be impossible in practise to prove that someone had breached such a condition.

8.153. The group argued that the proposed merger would result in PG's `infiltration' of independent generator ownership. By securing MEB's IPP assets, PG would inevitably exert a direct influence on the Boards of these independent projects, thereby creating clear anti-competitive implications.

8.154. The group concluded that, although licence conditions would assist as a means of ensuring that the remaining IPPs were not disadvantaged by the proposed merger, PG should be required to divest MEB's UK generation activities from its portfolio.

Government departments

Electricity Directorate, DTI

8.155. The DTI's Electricity Directorate (ED), in its capacity as sponsor division for the electricity supply industry in England and Wales, provided background information on electricity privatization and the structure of the electricity industry in England and Wales. In summary, the main points concerning electricity privatization and the subsequent development of the industry were that:

(a) The electricity privatization arrangements reflected the principle that decisions about the supply of electricity should be driven by the needs of customers, and the nature of those arrangements reflected the belief that competition was the best guarantee of the customers' interests.

(b) Horizontal competition was introduced into generation through the division of the CEGB into three successor generating companies, namely NP, PG and NEP.

(c) Competition in generation was also provided from a number of other sources, and would be increased by the sale of plant by NP and PG and by the restructuring of NEP's generating stations between two companies prior to the forthcoming privatization of British Energy.

(d) Horizontal competition in supply was being introduced in three stages, in 1990, 1994 and 1998.

(e) The independent National Grid, which had been floated by the 12 RECs, had a duty to facilitate competition in generation and supply, and ensured non-discriminatory dispatch of gensets. It did this by reference to the level of generators' bids into the Pool. Bid prices and Pool prices were transparent.

(f) From the outset the privatization regime had permitted vertical integration between generation and supply, though this had been subject to transitional restrictions (ie on supply by PG and NP to customers, and by any second-tier suppliers within the RECs' franchises). It had also permitted vertical integration between supply and generation, again subject to transitional restrictions (ie the 15 per cent limit on own-generation by RECs).

(g) Under their PES licences the RECs were permitted to generate some of their electricity requirements. Most RECs had diversified into generation.

(h) It was implicit in the privatization arrangements that the RECs would be subject to the disciplines of the market, including the possibility of take-overs and acquisitions, when the Government's special shares expired in March 1995.

8.156. The ED considered that the main areas of possible concern if the merger was allowed related to direct reductions in competition, the effects of vertical integration and its effects on regulation.

8.157. On the question of competition, the ED pointed out that since privatization PG's share of the generation market had fallen from 30 to 26 per cent in 1994/95 and was expected to fall to 17-18 per cent when the proposed disposals of plant were completed. The generation market was one where there had been an enormous shift towards competition since privatization, where there was more competition already in the pipeline, and where there remained considerable potential for new entrants both at the large and small end of generation. PG's market power was declining; like NP, it was strong but not dominant.

8.158. If the merger went ahead, the ED explained that there would be an increase in PG's market share, but the effects would be small. MEB was involved in joint ventures which gave it around 2 per cent of the generation market. Because it was part of a consortium it should not be in a position to influence the operation of the businesses. To the extent that the power purchase contracts (to which the DTI was not privy) would give PG power to influence the operation of MEB's generation interests, the ED suggested that it should be possible to obtain undertakings from PG to meet these concerns.

8.159. The merger would also reduce by one the number of potential entrants (or joint venture partners) into generation. However, the ED argued that there would still be scope for new entry into generation. In

addition to the existing and currently growing levels of competition NP would remain a strong competitor and there would be a number of possible new entrants. US generators were actively interested in entering the UK market; British Gas and the Scottish companies were also likely entrants. Two new nuclear companies would be created as part of the process of privatization of British Energy. The entry conditions might be changed if the bid went ahead, but the level of competition and the threat of entry could still be significant. Also, the prospects for entry should be enhanced by the DGES's decision not to seek any extension of the generators' undertakings on prices.

8.160. The ED added that there were still some Pool issues, even after the disposal of plant in respect of the ownership of price-setting plant, but these were not changed by the proposed merger. After its disposal of generating capacity PG would still have a strong, if reduced, position in the ownership of non-baseload plant which set Pool price, with about one-third of this segment of the generation market. These problems were, however, likely even with the DGES's undertakings on plant disposal.

8.161. The ED stressed that the effect on the Pool was difficult to determine and was an important issue because the effective operating of the Pool as a price-setting mechanism was an important part of the current market structure in England and Wales. The merger on its own would have a small impact. The ED explained that the merger would not alter the requirement for PG to bid into the Pool, nor would it significantly affect PG's market position. It could alter the balance of Pool membership which might in turn allow PG more opportunity to press for changes in Pool rules which were to its benefit but not to the advantage of consumers. The ED admitted that there was some risk but it was constrained by other Pool members who could not easily be marginalized and by the role of the DGES in hearing appeals against changes to the Pool rules.

8.162. In the supply market and the related market in CfDs, the ED thought it important to look at the various segments of the market. As far as the franchise market was concerned the position was largely already pre-empted until 1998 when the current coal contract CfDs expired. Those contracts were in place and fed through to domestic and other small user prices and would not be changed by the merger. In addition, those RECs with involvements in IPPs, including MEB, had contracts which ran until 2005 or thereabouts. Those elements in the market would remain uncontestable for the duration of the contracts.

8.163. In the non-franchise market, both the generators and the RECs had been active. The generators had been more successful in the larger end of the market, whilst the RECs had been more active in the smaller-scale 100 kW market. The ED emphasized that this was an active competitive market, with plenty of competitors and plenty of informed buyers, not a market into which anyone could sell overpriced electricity. Looking ahead, and assuming that the merger went ahead, the ED envisaged that there would still be a significant number of players, both vertically and non-integrated, in the supply market, with no single company or group of companies in a dominant position.

8.164. On the effects of vertical integration, the ED said that there were two main issues:

(a) would the merger provide the opportunity to foreclose parts of the market in a way which would affect competition and therefore consumers; and

(b) would the merger give PG access to monopoly profits which could be used to create a competitive advantage in another part of the market?

8.165. On the foreclosure issue there were two counters to the suggestion that there would be adverse effects. First, that all generators would continue to operate through the Pool and this would continue to provide a market price for electricity through the bidding system, and that there would continue to be a market price for electricity from the Pool bidding system. Second, that there was a competitive supply market in which there would continue to be a large enough number of operators to provide effective competition both now and in the immediate future. In such circumstances any attempt to use the foreclosure option to gain an advantage would be undermined by the transparency of the Pool system and the existence and ability of competitors to respond.

8.166. To sustain the second concern about cross-subsidy out of monopoly profits elsewhere in the vertical chain, specific areas of market power had to be identified which might be exploited and where excess profits could be earned. In the ED's view, the distribution and generation activities of the merged business appeared to provide the principal candidates such an opportunity. However, in distribution profits

were limited by the regulatory process. The need for such regulation was not changed by the proposed merger. In generation, if the proposed disposals of plant went ahead and if nuclear privatization also proceeded, there would be significantly more competition in 1996 than there had previously been in the period since privatization.

8.167. The ED identified two main regulatory issues:

(a) whether, in this and other major acquisitions, the sort of licence modifications obtained in mergers to date were adequate; and

(b) whether there was an issue over loss of comparators.

8.168. The ED, whilst noting that the DGES would no doubt be commenting on these points, thought the issues of transparency and financial support which arose when RECs became subsidiaries of larger companies had largely been resolved in establishing the appropriate licensing regime for the REC mergers which had already occurred. The main remaining regulatory concerns were likely to be dealt with by licence conditions to deal with foreclosure and the enforcement of existing licence provisions relating to third party access and non-discrimination. More generally, there was a concern that increasing reliance on regulatory mechanisms to offset possible public interest concerns was putting undue pressure on the regulatory framework. At the same time the ED did not want mergers, reflecting the operation of the markets, to be an occasion for a significant extension of regulation.

8.169. Finally, on the possible loss of yardstick competition, the ED was not clear, where this was concerned with comparison of operational performance, whether this was a real issue. Operating units would remain distinct entities for regulatory purposes and their performance would be identified for comparative purposes. There might be an issue over identifying the appropriate cost of capital for the regulated business. The more this activity was incorporated into a larger business, the more difficult it might become to disentangle the cost of capital for the regulated business from the larger operation. Strict separation of accounts for regulatory purposes would not necessarily overcome this problem. Nevertheless, allowing all participants in the market to be open to capital market pressures put its own discipline on to the regulated businesses.

8.170. In conclusion, the ED made the following points:

(a) The emphasis in the electricity privatization arrangements was on competition (and, where competition was not possible, regulation) as the safeguard of the consumers' interest. It was acknowledged from the outset that this did not rule out vertical integration. However, horizontal competition was encouraged in both generation and supply.

(b) Since privatization horizontal competition had developed in both the generation and supply markets, with further increases in prospect. Provided that there were adequate safeguards the present merger would neither increase nor decrease competition in electricity generation.

(c) If the merger were to go ahead there would still be significant competition in both the electricity generation and supply markets, which would constrain the merged company from exploiting its position in the market. The proposed merger would be likely to increase competition in electricity supply, particularly in the present franchise market after it was opened to full competition in 1998.

(d) There were precedents for tackling the regulatory issues that arose when a REC was subsumed within a larger group, through assurances that the acquirer would consent to licence modifications; there was also a precedent for tackling the regulatory issues that arose from a limited degree of vertical integration through such assurances.

(e) The merger would enhance the status of PG as a world class company, and would expand the field within which it could compete in overseas markets.

(f) It was for the MMC to consider the balance of advantage and whether the seeking of undertakings from PG would be desirable.

Trade union

UNISON

8.171. UNISON submitted written evidence and attended a hearing.

8.172. UNISON explained that it was a significant trade union within the UK electricity industry, with 28,000 members across the industry, including the RECs, the Scottish companies, the generators and the National Grid and members in both PG and MEB.

8.173. UNISON thought that, given the importance of the industry, rather than examine the take-over of electricity companies on a piecemeal basis, the whole industry should be subject to an overall review to consider the changes and the impact of recent take-overs, and to establish a framework of rules, the aim being to provide a range of safeguards for customers and at the same time provide equitable treatment for all employees in the industry who always appeared to suffer adversely as a result of take-overs.

8.174. UNISON pointed out that, if it went ahead, the merger would create a new all-purpose generation, distribution and supply company and would extend the principle of vertical integration further. Whilst UNISON was not opposed to the principle of vertical integration, which had worked well in Scotland and many other countries for several years, it believed the new structure must not be subjected to lesser safeguards than those contained in the original regulatory system. UNISON strongly disagreed with the view expressed by some commentators that after 1998 there would be no need for a regulatory system because the interests of customers would be protected by competition.

8.175. As to competition in the generation market, UNISON said that since privatization in 1990 PG's market share had declined significantly as a result of increased output by NEP and the increasing involvement of IPPs. Adding to this the DGES exerted constant regulatory pressure wherever possible. UNISON thought the trend towards a more even spread of market share and greater competition would continue with PG and NP disposing of a number of its power stations, as required by the DGES, and the continued growth of IPPs. The arrival of the open market in 1998, when all electricity users, including domestic users, would be able to `shop around' for a supplier, would lead to competition becoming even more fierce.

8.176. In UNISON's view, it was clear that one of the reasons why PG was buying MEB was to provide it with an `off-the-shelf' solution to gaining direct access to the new open domestic market in 1998. UNISON emphasized that, to ensure competition was not distorted, leading to certain types of customers suffering adversely, mechanisms needed to be put in place which were open to inspection to ensure equality of pricing and to discourage predatory discounting. This meant that whilst encouraging competition in the provision of electricity to all types of users, the DGES could monitor and take action if he felt that the merged company was acting in a manner detrimental to consumer interests.

8.177. Commenting on the effect of the merger on suppliers and customers, UNISON pointed out that in some cases regional and national companies had the same supplier, particularly for equipment. Clearly the newly enlarged company would have stronger purchasing power, especially in the areas where common equipment was used. However, UNISON did not expect the situation to be exploited and thought PG and MEB would take a balanced approach and would continue to use local suppliers. On the positive side, if PG was able to expand overseas, as predicted, then the opportunities for suppliers would be enhanced. As to customers, UNISON stressed that RECs provided a range of services to customers, both large and small, eg providing customer service centres, and tariff advice, and there should be no diminution of such provisions if the merger went ahead. PG lacked the direct experience of dealing with millions of individual customers. Therefore, the current REC structures should be retained and guaranteed by the new owner.

8.178. As to the effect of the merger on exports and imports, UNISON noted that PG and MEB were anxious to develop business overseas and there had been a steady growth in this area of work, as there had been in relation to other electricity companies. The overseas market was evidently very competitive and often difficult to operate in. UNISON thought the merged company's competitive position would be enhanced by it being able to offer a complete range of experience in the generation, distribution and supply markets. However, UNISON argued, there would need to be guarantees within the regulatory framework to

ensure that profits from the domestic market were not diverted to enhance foreign investment at the expense of UK customers.

8.179. On the question of prices, UNISON pointed out that the regulatory pricing scheme in the industry provided a framework under which the different users of electricity were treated equitably in terms of what they paid. However, UNISON noted that OFFER's consultation document on the proposed merger had raised a number of possible concerns, in particular that one part of a business could favour another part of a merged company, with the end result that higher prices could be passed on to customers. UNISON recommended the establishment of a highly transparent monitoring facility and the granting of any additional powers the DGES might require to overcome any possible abuses in this area. These would include the maintenance of separate and distinct accounts for each subsidiary, published not just for use by the DGES but also available to the wider public and company employees.

8.180. UNISON thought the merger was unlikely to affect the working of the Pool in the short to medium term. However, in the longer term PG might seek to expand and build long-term contracts directly with clients, which would have the effect of bypassing and diluting the role of the Pool. If this were to happen there could be a shift in emphasis in company priorities which could favour direct clients in larger numbers at the expense of the wider UK electricity requirments.

8.181. UNISON raised several concerns regarding employment. UNISON emphasized that the employees were important stakeholders in PG and MEB and many were shareholders too. Since privatization 44,000 jobs right across the industry had disappeared and more reductions were planned. The take-over process had a major destabilizing effect on employees and the morale of the remaining staff had been undermined by constant fears about their job security. This inevitably had an impact on customer services.

8.182. UNISON's main concern was that the management of the merged company would attempt to make even further reductions, especially as both would have headquarters in the same region and some corporate functions would inevitably be duplicated. To avoid any further damage, UNISON said that it required assurances on a range of issues, with long-term guarantees that pensions and pension assets, equal pay, health and safety standards, sharesave schemes, in addition to the maintenance of all aspects of their current contract of employment, were safeguarded. UNISON hoped that the MMC would pursue these aims.

Trade associations

Association of Manufacturers of Domestic Electrical Appliances

8.183. The Association of Manufacturers of Domestic Electrical Appliances (AMDEA) wrote to the MMC as the trade association for all the UK manufacturers of storage heating and the majority of manufacturers of other forms of electric heating appliances. AMDEA expressed its support for the proposed merger arguing that it would benefit consumers, the manufacturers of heating solutions and their employees, and the shareholders of the companies involved.

8.184. AMDEA argued that the merger would make PG less dependent on its generation income and allow it greater exposure to final customers. The merged company would increase competition in supply, thereby benefiting customers by reducing unit prices and customers' overall bills through energy efficiency.

8.185. The enlarged PG group would have the size, the long-term commitment to electricity and the direct contact with customers to make a significant contribution to developing new electrical solutions, and encourage innovation and product improvement. Competition between vertically integrated companies and other fuels, principally gas, would create pressure to improve the efficiency and performance of electrical products.

8.186. AMDEA noted that generators would continue to supply other distributors thereby ensuring competition in the Pool and added that the integration of skills and commercial expertise resulting from the merger ought to result in opportunities outside the UK.

Energy Industries Council

8.187. The Energy Industries Council said that, after due consideration, it was of the opinion that the merger would have no overall effect on the interests of its members.

Energy Intensive Users' Group

8.188. The Energy Intensive Users' Group (EIUG) wrote to the MMC as a representative of ten trade organizations whose members consumed very large amounts of energy or for whom energy was a significant proportion of total costs.

8.189. The EIUG said that the proposed merger would reduce the number of potential suppliers with whom customers could sign supply contracts and added that under the current structure vertical integration would not benefit customers. The EIUG stressed that this would reduce competition in the market as the vertically integrated company could always sell into the Pool and thus did not have to worry about losing supply contracts. The EIUG suggested that if trading outside the Pool was allowed PG would be forced to compete for large customers, encouraging, in the long term, customers and suppliers to work together to reduce energy use.

8.190. The EIUG argued that the merger would alter the balance of power in the Pool's decision-making forums and could affect the long-term development of the market. The merger would jeopardize the existing pressure exerted by PG on RECs to reduce charges in line with customer interests. The EIUG maintained that the Pool should be fully reviewed and altered in such as way as to give customers official and proportional power within the Pool's decision-making bodies, giving them the proper opportunity to influence market developments.

8.191. The EIUG said that the merger would strengthen PG's market share of baseload generating capacity, through acquisition of MEB's generation interests. The EIUG indicated that this would run counter to the regulator's divestment requirement and argued that, if the merger was to proceed, PG should be required to divest additional capacity at least equal to the capacity gained through the merger. The EIUG argued that PG would continue to be a dominant Pool price setter if PG's enforced divestment of 2 GW of generating capacity was operated at baseload, rather than at the margin, by its new operators. The EIUG stated that there were arguments for requiring additional divestment of the peaking plant, rather than CCGTs, in order to encourage more competition at the margin.

8.192. The EIUG stressed that if the merger was to proceed, there should be modifications to PG's licensing conditions to ensure the availability of information required for regulation. PG should separate its generation and supply businesses from its distribution activities, to protect against cross-subsidization and prevent unfair competition. The EIUG added that there should also be assurances of the continued viability of the monopoly business and OFFER should be satisfied that it had full access to the information it required to regulate effectively.

Energy Saving Trust Ltd

8.193. Energy Saving Trust Ltd said that it was an independent company set up by the Government, the RECs and British Gas with the objective of stimulating the efficient use of energy in the UK.

8.194. The Trust pointed out that the new company resulting from the merger would become both an electricity producer and a supplier. Prior to 1998 it would also have a monopoly of electricity services in the under 100 kW demand market in the region it served. The Trust was concerned that the merger might encourage the new company to produce and sell more electricity, unless controls were in place prior to completion of the merger. This could have a detrimental effect on total resource usage and on the production of CO_2.

8.195. The Trust was also concerned about the consequences of the merger on its Efficiency Standards of Performance programme. The DGES had provided the RECs with a special revenue allowance, currently set at £1 per franchise customer for each of the four years of the supply price control, for expenditure on energy

efficiency. The Trust did not want MEB's obligation to achieve its Standards of Performance for energy efficiency altered because of the merger.

Major Energy Users' Council

8.196. The Major Energy Users' Council (MEUC) wrote to us and attended a hearing.

8.197. The MEUC explained that it was the largest organization in the UK representing industrial and commercial consumers. Its members were engaged in a broad range of business activities in both the private and public sectors.

8.198. The MEUC said that competition occurred in the UK electricity market at two levels: at the wholesale market level where generators sold to RECs which in turn sold on their purchased electricity to the domestic (tariff) and non-domestic competitive markets, and at the competitive retail market level where both generators and RECs competed for the supply of electricity to end-customers.

8.199. The MEUC argued that whilst it did not believe the merger was against the public interest in itself, it believed that if the merger proceeded there should be additional safeguards for customers, particularly in the industrial and commercial sectors.

8.200. At the wholesale level, the MEUC argued that it was imperative that controls were in place to ensure that there were no special deals between PG and MEB which would enable the merged company to gain an unfair advantage. If PG agreed to provide the entire requirements of MEB, that would, in effect, take a substantial proportion of the UK electricity market out of the competitive market. To prevent the merged company gaining an unfair competitive advantage over other generators or RECs, the MEUC believed it was essential to ensure that the two parts of the businesses were managed as separate business entities in the commercial arena. The MEUC said that the DGES had already introduced measures whereby PG had been required to divest a substantial proportion of its generating capacity to third parties to increase competition in the electricity market. It would be wholly improper if, as a consequence of the merger, PG was able to circumvent the DGES's measures by absorbing MEB's current generation capacity.

8.201. As to the number of electricity suppliers, the MEUC considered that the potential sources of supply after the merger would provide sufficient competition in the market to ensure that appropriate pressures were placed upon suppliers. MEUC hoped that if the merger proceeded the merged company would be able to introduce significant economies of scale which would improve its efficiency and enable it to offer more competitive prices.

8.202. The MEUC considered that the Electricity Pool was a seriously flawed mechanism for determining prices. Should the merger proceed, it might become even more difficult to make amendments to the Pool rules. The MEUC suggested that if the merger went ahead a review body should be set up to develop a workable procedure whereby Pool rules could be amended to meet the needs of the industry and customers alike. Under current rules opportunities existed whereby windfall profits could be gained by the manipulation of Pool procedures which customers had to pay for.

8.203. The MEUC was also concerned that the work of the DGES might be made more difficult if the potential effects of the merger were not balanced by additional safeguards and powers. The MEUC believed the DGES's work was complicated by the multitude of price elements charged for by RECs as part of their cost mechanisms and suggested that these should be simplified.

The Paper Federation of Great Britain

8.204. The Paper Federation of Great Britain wrote to us and attended a hearing.

8.205. The Federation explained that through its member companies it represented over 90 per cent of the entire paper and board manufacturing industry. The industry was a substantial one comprising 65 companies, operating 100 pulp and paper mills throughout the UK. It had some 25,000 employees and generated a combined turnover in excess of £3 billion. At present, the main energy purchases of the industry were electricity, natural gas and coal and, to a lesser extent, oil products, the whole amounting to around £300 million each year. Of this, electricity purchases were in excess of £150 million. The Federation stressed that electricity was a crucial component of the day-to-day activities of the industry and needed to be readily available at internationally competitive prices.

8.206. The Federation argued that whilst the process of privatization had given customer choice it had not always delivered lower prices. Some competition existed and industrial customers could now shop around for supplies where hitherto they were constrained to their Local Area Boards. In the main, customers in the 1 to 10 MW class had used this competition to secure lower prices than under the previous regime, but customers above this range had encountered difficulties. Indeed, the largest users in the paper industry and elsewhere had seen prices rise rather than fall. Some large users were today paying substantially more for electricity than at privatization. The Federation pointed out that its regular survey of prices for electricity for paper mills throughout the country had shown that, on average, mills were paying 16 per cent more than at privatization. An equivalent survey throughout Europe had shown that only Germany delivered higher prices. The Federation explained that to some extent the relatively high price in Germany was understandable because of high social and labour costs combined with the need for deep-mined expensive coal. In contrast, the UK had seen a substantial fall in the real price of fuels into the power station. Moreover, the privatized electricity industry, and particularly PG and NP, had substantially reduced overheads and labour costs. The Federation argued that these factors, in combination, should be delivering lower prices. Instead, prices had continued to rise for large users, thus adversely affecting their international competitive position. This was a fundamental concern and was, the Federation believed, a result of an imperfect market and the lack of true competition, particularly in generation.

8.207. The Federation told us that there were, in effect, only three substantial generators in the present electricity industry: PG, NP and the nuclear sector. The latter was guaranteed to run at baseload, leaving the remaining generators to operate as a duopoly. The Federation added that the Pool system gave no respite since the bidding behaviour of either party was clear to the other and, in any event, was easily understood considering both were until relatively recently within a single company. PG and NP effectively controlled Pool prices and from this the contract market which tended to follow behind the price regime of the Pool. Because of this, the Federation said that it welcomed the DGES's initiative to introduce a cap mechanism to hold down Pool prices and the agreement by PG and NP to dispose of 6 GW of plant, itself an admission of the inadequacy of competition in generation.

8.208. The Federation added that it remained concerned that as yet no disposal had taken place of the surplus generating stations and that the withdrawal of these stations from the system had, at times, led to insufficient system margin, leading to high prices. Moreover, these stations which were old, inefficient and relatively poor from an environmental standard, once freed from their previous ownership and cost overheads, would be run at a disproportionately low price to ensure baseload operation and a return for the new owners. This would in effect, through the present Pool price mechanism, drive up prices. The Federation also complained that customers were poorly represented in the Pool and had little power. The Pool required a greater number of large players and transparency if it was to become a trusted component of the electricity pricing mechanism.

8.209. The Federation thought the proposed merger would have an adverse impact on the work of the DGES. The merger would bring further concentration in the market and an increase in generation capacity when the DGES was trying to make the company divest itself of generation capacity. The further concentration was likely to result in the need for further close scrutiny of the operations of the new company because there was a greater opportunity for it to behave in an uncompetitive manner.

8.210. The Federation considered that any further consolidation of the industry, particularly between RECs and generators, should be discouraged, but not the widening of ownership, which gave obvious

benefits. The Federation emphasized that any change of ownership should be seen in the context of the intended further liberalization of the electricity industry in 1998. The Federation supported the general extension of competition in the energy markets and proposals to extend the freedom of choice to all electricity consumers. Nevertheless, it had a number of concerns with these proposals. Not least of these was the shambles that occurred in the recent extension of the competitive market from 1 MW down to 100 kW, which involved only a few thousand additional customers. The expansion of the competitive market by 20 million customers would clearly create vast technical and administrative difficulties. The additional cost of such an exercise was likely to increase costs to industrial users rather than improve the present position. The Federation stressed that the present structure did not take proper account of large users and, when the tariff structure was effectively ended in 1998, there would inevitably be some further discrimination against larger users. The Federation argued that this should be addressed before there was any further extension of the market.

8.211. The Federation concluded by saying that privatization of the electricity industry provided the industry with the opportunity to reduce its prices, provide a better service and to increase its ability to compete more effectively on the world scene. However, for large users many of these benefits remained elusive and would not appear until further restructuring of the electricity industry took place. This included the establishment of greater competition in generation, a fundamental review of the Pool mechanism and a continuation of the stronger regulatory regime than had been seen recently. The Federation believed that a privatized electricity industry was undoubtedly the way forward and should function to the benefit of all. This would not be advanced by the proposed merger.

Utility Buyers' Forum

8.212. The Utility Buyers' Forum (UBF) explained that for the purposes of this inquiry, it spoke on behalf of electricity consumers buying competitively in the 100 kW and above market, which accounted for approximately half the total quantity of electricity supplied in the UK.

8.213. The UBF said that, for large users, the crucial competitive area in the medium and longer term was generation rather than the less significant supply business. The UBF considered that in the light of the main pricing methodology within the Pool, the vital area for price competition was in the mid-merit price-setting plant.

8.214. The UBF noted that MEB's generation interests lay essentially in baseload (CCGT plants) and as such its acquisition by PG would not increase its dominance of mid-merit plant. Nevertheless, the UBF argued that should the proposed merger be allowed to proceed, PG should be required to divest itself of MEB's generation interests, in order not to increase its market share further.

8.215. The UBF argued that if the merger was allowed to proceed, the disposal to independent third parties of the 2 GW of plant must be an essential pre-condition and that consideration should be given to further generation divestment to ensure a more competitive market. The UBF feared that, given the growing surplus of baseload plant, PG's undertaking to dispose of 2 GW of plant and the entry of new players, there might be more competition at the margin, but without noticeable price reductions when primary fuel costs were low. The DGES would accordingly be less well placed to influence prices or to make a reference to the MMC.

8.216. The UBF said that it did not regard the loss of one supplier as critical to the well-being of the current competitive supply market. The UBF noted that the crucial question for the current franchise market was the likely effectiveness of competition after 1998. The UBF feared that competition would not be fully effective after 1998 and questioned whether customers in the MEB region would be significantly worse protected than customers elsewhere. The UBF argued that customers would be better protected if supply price controls on RECs after April 1998 employed electricity purchase price yardsticks, allowing the DGES to have access to the prices of generation contracts within the MEB region and empowering the DGES to intervene directly if necessary.

8.217. The UBF argued that consumers had insufficient representation in the Pool and their protection would be further eroded if PG's bid was allowed to proceed. The UBF thought these were not grounds for refusing the bid, only because it believed the Pool itself must be subjected to MMC scrutiny. The UBF noted

that the alternative option for pricing of `pay as you bid', instead of marginal pricing, had the potential to reduce PG's price dominance at mid-merit stations and to enhance competition and should be subjected to serious analysis and consultation.

8.218. The UBF supported the introduction by the DGES of further licence conditions but argued for a closer scrutiny of vertically integrated and multi-utility companies, regulating such matters as dividend policies and internal transfer prices more effectively through the creation of a single utility regulatory body.

8.219. The UBF concluded that with the above provisos taken into account, it did not regard the merger as against the public interest.

Consumer organizations

Electricity Consumers' Committees, Chairmen's Group

8.220. The Electricity Consumers' Committee, Chairmen's Group (ECCCG), submitted written evidence and attended a hearing.

8.221. The ECCCG stressed the importance of competition in the supply of electricity, in particular:

(a) Electricity customers expected to benefit from competition in the electricity market. New entrants would be welcome to stimulate competition in the supply market, opening to competition for all customers from 1998.

(b) Competition in supply was the goal to which all electricity consumers had been geared since privatization in 1990. Competition offered choice for consumers, and prices and services were expected to adapt to meet customers' preferences, as experienced in the 1 MW and over 100 kW markets.

(c) New entrants to the supply market were necessary to enhance competition. New entrants brought innovations, and would stimulate a more dynamic market for electricity, so customers' interests lay with ensuring that nothing inhibited the development of that anticipated competition in the supply market.

(d) With real competition in supply, consumers' interests were safeguarded. No customer, or group of customers, could be disadvantaged over any period of time by their supplier if there were other suppliers competing for their business. Supply competition would bring price and service benefits and safeguard customers' interests. The ECCCG argued that there must be effective competitors to achieve these benefits, and no development before 1998 should be permitted if it inhibited or prevented competition in supply.

8.222. The ECCCG explained that, if it went ahead, the bid would put a distribution and supply business in the hands of a major generator. The ECCCG thought the most immediate effect would be to reduce slightly the existing competition in electricity supply (by the loss of PG's separate supply business) and marginally to increase concentration in generation by absorbing MEB's current IPP generation capacity. This loss of competition in generation would be more than offset by the increase in competition which would follow the sale of PG's 2 GW of power. The ECCCG emphasized that the disposal would bring about greater competition in generation and greater consumer benefits than at any time since privatization. No merger involving PG should be permitted without completion of this sale.

8.223. The ECCCG thought competition in generation would bring the greatest possible gains for electricity customers. Once completed the disposal would deliver lower prices in generation which would flow to all consumers provided suppliers were competing effectively in the market. Supply would drive generation gains to all customers.

8.224. However, the ECCCG stressed that, until customers were able to choose their suppliers, it was important that any company which included both a generation and a supply business was not able to dominate the market. The proposed merger would not only increase PG's market power and increase its ability to monopolize (at least a region), but might inhibit also the entrance of new suppliers to the market.

Regional dominance on that scale might reduce the attractions of the market to other suppliers, national or regional.

8.225. The ECCCG appreciated that the proposed merger (together with that of NP/SE) would add impetus to the development of the electricity market and could result in a UK energy supplier large enough and with sufficient resources to drive benefits to reach domestic customers. These benefits would flow more slowly from the entrance of other competitors in the supply market.

8.226. The ECCCG said that, in principle, it was not opposed to integration of generation and supply. The two Scottish electricity companies were already vertically integrated and the purchase of generation plant by Eastern was integration by another route. If there were sufficient numbers of integrated groups competing effectively, customers would benefit from lower prices. The ECCCG stressed, however, that it was essential that competition in supply also safeguarded customers' interests. Without safeguards, customers were at risk from a dominant supplier. After 1998, with other (possibly non-generating) suppliers active in the market, the risk to customers would diminish.

8.227. The ECCCG stressed that it regarded the possible impact of competition on supply as the issue which distinguished the proposal for this merger from other mergers in the industry. However, in common with other bids, MEB would become a subsidiary of a larger group which raised other concerns for consumers on which it sought the firmest guarantees:

(a) that MEB would continue to honour its economic purchasing obligation to provide an `economical system of supply' so that the company could demonstrate annually that it was purchasing electricity from the cheapest source;

(b) that MEB would complete the whole of the five-year capital expenditure programme planned and provided for in the recent distribution price control;

(c) that the company would set targets to improve quality of supply and could demonstrate improvements each year, capable of being monitored by the Consumers' Committee;

(d) that MEB would remain identifiable as a comparator;

(e) that the regulated accounts would be transparent, and that dividends paid to the parent company would be published; and

(f) that cost savings would be shared between customers and shareholders.

Midlands Region Electricity Consumers' Committee

8.228. The Midlands Region Electricity Consumers' Committee (MRECC) said that it had no reason to change its initial view expressed to the DGES that MEB should remain an independent REC rather than become a subsidiary of a group, particularly a group consisting primarily of a UK electricity generator.

8.229. The MRECC stressed that the paramount concern of the consumers it represented was that they should receive a cheap, efficient, reliable and high-quality supply of electricity. They were also concerned that the outcome of any bid should not compromise MEB's ability to purchase electricity at the most advantageous price possible and that the needs of customers should take precedence over the needs of shareholders, who had enjoyed considerable benefits, entirely funded by customers, since privatization. The MRECC emphasized that some electricity consumers required greater protection than others. Some of the poorest, least able members of society, because of their dependence on cheaper and older housing with inefficient heating and thermal insulation, were relatively large consumers of electricity. A Code of Practice existed, aimed at ensuring, for example, that customers who found it difficult to pay their electricity bills were not arbitrarily disconnected. The MRECC stressed the importance of such codes and of the existence of organizations such as itself able to monitor their observance and effectiveness.

8.230. The MRECC stressed the importance of MEB's capital expenditure programme to update existing overhead lines, particularly to rural areas, and argued that this programme should continue whoever was the

owner. The MRECC suggested that any approval of the merger should be conditional on the requirement that the capital expenditure programme be specified year by year, for a minimum ten-year period, and should include clear targets for improvements in the quality of supply, capable of being monitored by the MRECC. The MRECC added that it would also object to any diminution in the research carried out into the efficient use of energy, by both domestic and industrial customers, by MEB's Energy Technology Centre.

8.231. The MRECC considered that electricity customers should benefit from any reductions in the price of electricity as the result of the emergence of a more competitive generation and supply market. It was essential that MEB would continue to purchase its electricity on the most economical basis in the open market: it should certainly not tie itself to PG as a major supplier if the merger proceeded.

8.232. The MRECC also stressed the importance that, if the bid succeeded, there should be a clear separation of the accounts of both companies, to enable the DGES to continue to carry out his statutory responsibilities as regulator of the industry and to make proper comparisons with the performances of other electricity companies. The MRECC said that it supported the DGES's proposals to modify licence conditions to deal with financial ring-fencing of the different businesses, restrictions on activities, availability of resources, disposal of assets and provision of information, as the minimum necessary to permit him to carry out his responsibilities. The MRECC suggested that the MMC might also consider imposing a requirement on companies to provide information to the Consumers' Committees relevant to their statutory responsibilities.

National Consumer Council

8.233. The National Consumer Council (NCC) stressed that the service provided by the electricity industry was essential for everyday life and that domestic consumers were in a vulnerable position as they were a captive market. Consequently, it was vital that the interests of domestic consumers were fully protected with regard to any restructuring which might take place. Moreover, the NCC added, the cost of paying for electricity fell especially heavily on low-income consumers, who spent disproportionately more of their weekly income on fuel than those on higher incomes.

8.234. The NCC argued that the merger and that of NP/SE would represent a significant increase in the extent of vertical integration in the electricity industry in England and Wales. The merger also raised broader issues regarding competition than other recent bids for RECs. The NCC said that it was concerned about the potential for anti-competitive practices which could come about by PG offering more favourable terms to its own businesses, at the expense of its customers and other competitors. In particular, in the franchise market-which consisted mainly of domestic customers-the supply business could pay higher prices to the generation business than it would to other generators, and would pass these higher prices on to consumers. The NCC thought it likely that this ability would remain after the end of the franchise in 1998, as the market power of the PES's supply business would not diminish immediately.

8.235. The NCC was also concerned that the merged company's activities and accounts would become less transparent as a result of the merger giving it the opportunity to cross-subsidize and making the DGES's regulatory activities more difficult to carry out. Customers would want to be confident that the revenues they paid to the core businesses were ring-fenced and not used to cross-subsidize other parts of the group's activities. The NCC considered it essential that there was utmost transparency surrounding the core businesses and their relationship to the parent company. Similarly, the NCC said that it would be concerned if MEB's separate stock market quotation disappeared because of the merger and the effect this loss of information might have on investors' ability to view separate parts of the overall business and on their ability to make comparisons.

8.236. In conclusion, the NCC said that its overall view was that the MMC inquiry would need to identify the potential costs and benefits for consumers and for regulation of the merger. The merger should not be approved unless it was concluded that:

(a) tangible benefits would accrue to all domestic customers as a result, in both the short and long terms, and that no group of domestic customers would be adversely affected; and

(b) the DGES would have the necessary powers and duties to guard against potential anti-competitive behaviour; to protect consumers' interests; and have the ability to acquire essential information from PG on the activities of the separate businesses, including powers to ensure full transparency of activities and accounts.

Southern Scotland Electricity Consumers' Committee

8.237. The Southern Scotland Electricity Consumers' Committee (SSECC) pointed out that it acted for an area in which ScottishPower-a vertically integrated company-was the PES. Although the SSECC did not have a direct interest in MEB's supply area, PG held a second-tier supply licence for Scotland, and its generation licence was not limited to generation in England and Wales. The SSECC explained that it was divided in its views on vertical integration-some members were opposed to it believing it could be against the public interest, though some believed it did give economies; some were resigned to the inevitability of the electricity industry forming itself into large multinational companies.

South Eastern Region Electricity Consumers' Committee

8.238. The South Eastern Region Electricity Consumers Committee (SERECC) said that it opposed the merger for a number of reasons:

(a) There was no obvious gain for the public interest. The merger was certainly (and understandably) not motivated by it. Electricity was of major economic importance and a basic utility for domestic customers. No risk should be taken with its structure and particularly not at this time. The industry had still to digest other major changes. With preparations for 1998 already somewhat insecure, this was not the time for such a major change as vertical integration on a large scale.

(b) The SERECC was sceptical about the likely benefits from vertical integration. Although in principle management control over sequential steps would be expected to lead to a cheaper final product, in reality pricing decisions could be distorted particularly by single sourcing and prices could be forced up. Single sourcing, though not inevitable, was likely. The MEB region would be most affected but because of the competitive market the consequences would be felt by consumers throughout the country.

(c) If the take-over was permitted, it would have an undesirable impact on competition. PG already had a significant share of today's non-franchise supply market, and would be in a dominant position for the opening up of the market for domestic consumers in 1998. The SERECC argued that its presence would tend to shrink the size of that market. New small suppliers would fear to compete against a vertically integrated company, and even other established RECs might hesitate.

(d) It was widely acknowledged that any significant reduction in prices in 1998 would come from pressure on the generators' prices, as these were about half the final amount, whereas supply margins were small. When generation costs could not be automatically passed on, as would be the case in the competitive market, the pressure on the generators would be intensified. The SERECC stressed that it was essential that nothing was done to reduce this, particularly as the current excess generating capacity gave the promise of a favourable climate for price reductions in 1998 when many fixed price cost rates ended.

(e) Any strengthening of a generator as important as PG had implications for Pool prices. Its bidding strategies could directly affect not only price but also volatility. Increased volatility affected assessments of risk, and risk had to be paid for. A ripple in the Pool could have a powerful end effect on prices-it was not desirable for big Pool players to be strengthened unless remedial action was taken. The SERECC emphasized that decision-making by the Pool was a collaborative affair in which the interests of the various parties were balanced. A reassessment of procedures would be essential if the merger went ahead.

Major electricity users

BOC Gases

8.239. BOC Gases (BOC) stressed the importance of the cost of electricity to its business. Electricity represented an overwhelmingly large portion of the direct cost of pipeline gases and a very significant proportion of that delivered in liquid form.

8.240. BOC considered that at present there was insufficient competition within the UK electricity market. The Pool price was still under the effective control of PG and NP and this had a significant bearing on general market prices. BOC thought the proposed merger was unlikely to lead to greater competition. If the merger was allowed the amount of competition was likely to be reduced.

8.241. As to prices, BOC pointed out that since privatization PG had dramatically reduced its cost of generation due to efficiency gains and lower fuel prices. These gains had been reflected in benefits to shareholders rather than to customers, with the exception of some smaller industrial and commercial users. Prices to large intensive customers such as BOC were shown in Government statistics to have risen at nearly twice the rate of general retail prices and, if comparison was taken back to before pre-privatization price levels, the levels had risen even more dramatically. BOC stressed that it was greatly concerned at the international competitiveness of electricity prices. Recent data had shown great disparity between the prices to like examples of large intensive electricity customers in the UK and many continental countries, with the higher prices being paid in the UK.

8.242. BOC thought the work of the DGES might become more difficult as a result of the merger but should still be effective, provided existing safeguards were upheld which provided for the separation of generation, distribution and supply businesses. A smaller number of electricity companies to regulate might also allow the DGES to consider matters in greater depth and do a better job.

8.243. In conclusion, BOC said that whilst it did not object to the merger it would not like the situation to progress to the point where there were less than six electricity supply companies operating in England and Wales. If combining the supply businesses brought about efficiency gains which were shared with customers this would be a positive benefit.

Boots Contract Manufacturing

8.244. The Boots Contract Manufacturing, a division of The Boots Company PLC, thought that clearly any merger which allowed vertical integration in terms of generation and distribution should result in reduced costs and prices. However, this might allow PG to give preferential rates to its own distribution business and would provide it with an unfair advantage. This in turn might result in other RECs being forced out of business. Boots preferred generators to concentrate on producing electrical energy and RECs to concentrate on distribution. Boots added that there would also clearly be a reduction in the number of tendering companies in the electricity supply market which would have a detrimental effect on competition.

British Steel plc

8.245. British Steel, as a major consumer of electricity, expressed a strong interest in securing reliable supplies of electricity at the keenest prices. It said its main dissatisfaction with electricity was the higher prices paid by large UK users compared with most of their European competitors.

8.246. British Steel primarily raised concern about the need to reform the Pool and its monopoly to bring about lower prices. It was less concerned with vertical integration but listed the following potential disadvantageous aspects:

(a) the acquisition of MEB's generation interests by PG, which would run counter to the divestment policy agreed with OFFER;

(b) fewer suppliers offering contracts; and

(c) fewer champions of lower distribution use-of-system charges.

8.247. British Steel concluded that substantially lower prices that might result from reform of the Pool would outweigh any disbenefits caused by vertical integration, particularly if the MMC were to address point *(a)*.

Chemical Industries Association

8.248. The Chemical Industries Association (CIA) wrote to the MMC as the association for one of the UK's most successful manufacturing industries with a vested interest in securing access to internationally competitive electricity prices.

8.249. The CIA explained that to a large extent the question of the merger was secondary to the central and underlying problem of the electricity supply industry-the extent to which the machinations of the Pool prevented the development of a truly competitive market in electricity supply contracts between customers and suppliers.

8.250. The CIA raised the concern that the proposed merger might undermine the competitive structure of the industry established by electricity privatization and result in more regulation in order to prevent greater control of the electricity market by PG. The CIA commented that the proposed merger would further stretch the resources of the regulator by requiring more stringent licence conditions, ring-fencing, protection against unfair dealings and market scrutiny.

8.251. The CIA noted that the excess baseload generating capacity in the market had not significantly contributed to Pool price determination and feared that the proposed merger would increase the potential for gaming in the Pool to the disadvantage of UK high load users and consumers. The CIA stressed that the merger would change the weighting of votes in the Pool thereby increasing the existing domination by PG and further preventing the development of a truly competitive market in electricity supply contracts between customers and suppliers.

8.252. The CIA said that the Herfindahl index, which provided a measure of competition in a market, would be reduced by the proposed merger by lessening the number of suppliers and increasing vertical integration. The CIA feared that the merger would allow PG to capture the *de facto* market of MEB, and thus reduce competition. The CIA added that this ran counter to the objectives set out at the time of privatization and to those implicit in the proposed break-up of the nuclear sector. The CIA commented that vertical integration in Scotland had not resulted in significantly lower prices and that there was little evidence of proactive competitive tendering by either of the two Scottish generators outside their franchise areas.

8.253. The CIA argued that those IPPs affected by the merger could be neutralized as far as real competition was concerned and stressed that the own-generation limits set out at the time of privatization should be reviewed and all further deals affecting the structure of the industry be suspended until after the MMC inquiry.

8.254. The CIA considered that PG's prime motive for the merger, in the light of the developments in 1998, was to increase its control of and shares in the domestic market. The CIA feared that the resulting competitive gains would be at the expense of industrial, and especially large industrial, consumers.

8.255. The CIA expressed the view that should the merger be cleared there would be fewer champions of lower distribution use-of-system charges and further REC take-overs. The CIA suggested that the regulator should impose conditions ensuring that at least 50 per cent of the efficiency savings were passed on in the form of lower prices.

Co-operative Retail Services Ltd

8.256. Co-operative Retail Services Ltd commented that the proposed merger would not significantly affect competition in the over 100 kW electricity supply market, due to the ability to contract for supply outside the REC's geographical area. For demand under 100 kW, including the domestic market, until further deregulation a monopolistic situation already existed. The electricity industry might be unable to cope with further deregulation.

Energy Purchasing Associates

8.257. Energy Purchasing Associates (EPA) said that whilst the entry of outside and foreign interests into the British electricity market could stimulate competition it was concerned to see that large slices of the utility industry were now being run by non-British companies and, in some cases, that this business formed only a small part of their overall portfolio.

8.258. Regarding competition, EPA said that the proposed merger could have two possible effects on the electricity market:

(a) The merger would give PG a greater direct consumption base. But as a generator with spare capacity to market to other RECs, a two-tier pricing structure could evolve to protect MEB's existing business. Some customers could benefit from price reductions resulting from greater efficiency, but others might lose.

(b) If on the other hand, after shedding some generating capacity, PG still had a major share of the generating market, with a captive outlet via its own REC partner it could be tempted to manipulate pricing levels, which would not be in the end-users' interest.

On balance, EPA concluded that the merger would not be detrimental to the interests of the electricity consumers, but added that this would need to be tempered by the granting of extra powers to the DGES.

The General Electric Company plc

8.259. The General Electric Company plc (GEC) said that overall it was in favour of the proposed merger. Since privatization, and with the introduction of competition, it had benefited from lower prices brought about by the availability of choice of suppliers. However, GEC added that it was conscious of the risk that too wide a choice of suppliers for exactly the same product could lead to confusion in the selection of a suitable supplier. There had been occasions recently when a supplier had leaned heavily on GEC sites within its area by suggesting that failure to select that supplier could lead to a reduction, or even loss, of business which GEC presently enjoyed with the supplier.

8.260. GEC therefore thought there was some attraction in having national electricity companies to deal with, rather than dealing with individual RECs, particularly as GEC had sites in all areas. Group contracts could be more freely negotiated when location was not an issue.

8.261. GEC said that its final comment concerned the negative effect that a highly competitive market could have on energy conservation measures. The lower the price of power, the less incentive there was for the recipient to invest in conservation methods, as the paybacks became longer.

Marley Plc

8.262. Marley said that, on the assumption that PG sold off 2 GW of capacity as directed by the DGES before any merger was allowed to proceed, the structure of the proposed new business would remain such that competition in the supply market would remain strong. Even with a potential source of supply removed from the market, a significant choice for commercial customers would remain. However, Marley thought further mergers or acquisitions to form companies of similar structure to the proposed merged entity would be preferable to the present structure and would give a better structure to the market.

8.263. Marley believed the proposed merger would be for the long-term benefit of the electricity industry, its customers and the UK economy. Incorporating both generator and supplier into one company could and should lead to more meaningful and longer-term customer/supplier relationships. Marley stressed, however, that the DGES would have to maintain very tight controls during the period of change until the industry had stabilized.

Local and district councils

Birmingham City Council

8.264. Birmingham City Council said that the proposed merger, if approved, would combine one of the largest generators and one of the largest suppliers of electricity to industrial and domestic users in the UK. The geographic area covered by the merger was one of the most densely populated areas in the UK.

8.265. The Council explained that it was both a supplier and a user of electricity. It supplied electricity generated from waste incineration to energy contracts placed through third parties. It would not want to see any changes that might be financially detrimental to its interests. However, it would welcome changes that would consolidate a long-term commitment to electricity generated from waste materials.

8.266. On the question of prices, the Council pointed out that it was also a major consumer of electricity. It would not welcome any price increases resulting from the merger. Similarly, it was concerned for the interests of residents and the business and industrial communities within its area and would not want to see significant increases in the price of electricity paid by them, at present or in the long term. It would, however, welcome a lowering of tariffs and overall costs to all classes of users and a more even balance on the price of energy from whatever source. The Council thought a key factor affecting electricity prices would be the amount of available baseload of generating electricity capacity. Recent sudden price increases due to demand indicated that there was insufficient capacity to cope with sudden increases in demand in cold weather conditions. A further point to consider was how electricity was to be sold relative to the Pool price and whether this mechanism would work to the advantage of the consumer if the merger was approved.

Bromsgrove District Council

8.267. Bromsgrove District Council said that it opposed the proposed merger and considered it to be contrary to the public interest. The merger went against what was said to be the motive of privatization-the promotion of competition-and it would set an unsatisfactory precedent.

City of Worcester, Policy and Resources Committee

8.268. The Committee opposed the merger. It considered that the merger would result in the removal of competition in the supply of electricity which would be to the detriment of consumers and against the wider public interest.

Forest of Dean District Council

8.269. Forest of Dean District Council said in a formal resolution that it opposed the merger and stressed that the separation of the generation and distribution sectors of the electricity industry was in the public interest and necessary for consumer protection.

8.270. In reaching this decision, the Council explained that the production and supply of electricity had previously been public sector monopolies and the basic principle behind the privatization of the industry had been that the production and distribution functions should be kept separate in order to create a genuine market. The proposed merger would result in electricity distribution being in the hands of the second largest generation company and would create a huge, unworkable monopoly, to the detriment of the consumer and against the public interest.

Hereford and Worcester County Council

8.271. Hereford and Worcester County Council explained that it would be directly affected by the merger. At present, after competitive bids, all the 100 kW supplies to the Council's properties had been awarded to MEB. The Council said that its concern with the merger was to ensure that the service it received did not deteriorate at the grass roots level. It had been evident from recent power cuts that MEB had struggled in severe weather to restore power. Any rationalization of services might make matters worse, particularly in rural areas. The Council feared that the merger could be used as an excuse for rationalization and customers often suffered in any so-called streamlining.

8.272. The Council said that it was also concerned that any reduction in suppliers did not affect competition in the market. If electricity suppliers continued to merge, the industry could become a private monopoly, as with the gas industry, which would be undesirable. A final concern was that a merger between a generator and a supplier would deter other suppliers, and competition and service would suffer as a consequence.

Oxford City Council

8.273. Oxford City Council submitted evidence from an anti-poverty perspective and argued that electricity, as an essential commodity, had to be supplied in a humane way that respected need.

8.274. The Council submitted the following responses to the merger proposal:

(a) the need for standards and safeguards to ensure fair competition and protect public interest;

(b) competition within Britain's electricity market should not lead to concentration on economic and profit considerations or to to a reduction in the quality of services and staffing levels;

(c) customers should have access to high-quality customer care services and affordable electricity;

(d) all customers should benefit equally from discount schemes, and research and development projects;

(e) the regulator should be given enhanced powers to monitor and take action if agreed standards were not being met; and

(f) PG should possess sufficient capital and resources to maintain the efficient running of companies ensuring stability in supply, quality of services, high health and safety standards for long-term investment.

Portsmouth City Council

8.275. Portsmouth City Council argued that the impact of the merger would be against the public interest on the following grounds:

(a) Competition within the UK electricity market would be severely restricted, possibly forcing up prices; this might be a precedent to encourage other mergers.

(b) Larger consumers would suffer because the merger would create a monopoly situation; the merger also acted against the original policy of localizing the electricity generation/supply.

(c) Exports and imports from CHP sites would be more difficult. RECs were already unco-operative in this area and were likely to be more so within a restricted market.

(d) Prices tended to increase after such mergers.

(e) The Electricity Pool would suffer and the authority of the DGES might be curbed.

The Council added that it was unable to offer any suggestions for safeguards should the merger take place.

Sandwell Metropolitan Borough Council

8.276. Sandwell Metropolitan Borough Council considered that the proposed merger would be against the public interest. The Council was particularly concerned that the integration of the generation and supply of electricity could result in the establishment of private monopolies which could be to the disbenefit of the borough and other areas. The Council also referred to the requirement for local authorities to separate client and contractor functions for services subject to compulsory competitive tendering and suggested that central Government should apply the same principle to privatized utilities.

Staffordshire County Council

8.277. Staffordshire County Council said that the proposed merger might well have some implications in relation to its energy purchasing policy. The Council purchased most of its electric energy from MEB and the merger might mean that MEB would be locked into purchasing its energy from PG rather than maximizing any cost advantage by having a choice of suppliers.

8.278. The Council explained that recent changes in electricity supply had given it the opportunity to purchase electricity from other RECs. The Council's concern was that concentration of electricity generation with a REC might make purchasing at cost advantage from other RECs less effective.

Walsall Metropolitan Borough Council

8.279. Walsall Metropolitan Borough Council thought the proposed merger would reduce competition for supplies to larger customers and would, therefore, deprive the Council of the benefits of competition which had so far been realized only in part. The Council explained that though competition within the electricity industry generally was still in its infancy its experience to date suggested that, if the perceived benefits of competition were to accrue in the longer term to the consumer, in both quality of service and price, then further market development was necessary. This was particularly the case in the electricity industry where only very limited competition had taken place when the 1 MW and 100 kW contract supplies were triggered at April 1990 and April 1994 respectively. The Council added that price reductions secured through competition had, to date, been far more significant in relation to gas supplies rather than electricity supplies.

Wrekin Council

8.280. Wrekin Council's views were that:

- the interests of the consumer should be protected in terms of maintaining a reliable supply at a reasonable price;

- the creation of a single company should not remove the ability to assess and compare with other companies the performance of both the generation and distribution activities; and

- matters of public safety and environmental protection were of paramount importance and should be covered by adequate safeguards.

Other interested parties

An MEB customer

8.281. A customer of MEB raised concerns that should the monopoly status of MEB, with regard to the provision of an electricity distribution network, be enhanced by way of a merger or acquisition, protection provided to customers under MEB's stated terms and conditions of trading might be further eroded from what it already considered to be an unacceptable level.

8.282. The customer detailed an ongoing contractual dispute between itself and MEB, in which it had incurred direct quantifiable losses while undergoing a power supply upgrade during 1995. This arose as a result of MEB subcontracting civil works to a third party contractor who, in the course of work, severed the power supply cable. MEB maintained that it did not accept liability for the negligence of its subcontractors, a position which the customer found wholly unacceptable, inconsistent with the law, and an abuse of MEB's monopolistic position.

8.283. The customer argued that the principle of liability for the actions of MEB's subcontractors needed to be addressed where customers had no alternative service provider available to them.

British Gas plc

8.284. British Gas plc (BG) said that it had an interest in the merger and its potential impact from a number of standpoints:

(a) It was a major player in the gas market where PG and MEB also competed.

(b) It had planning consent to build a large gas-fired power plant at Seabank in south-west England. Should this project proceed, it would be a competitor in the generation market.

(c) It was now a holder of a second-tier supply licence and was considering the possibility of being a supplier to the electricity market.

BG drew attention to the criteria set out by OFFER, in its recent consultation document,[1] which said that arrangements for 1998 must establish access to effective competition for all groups of customers and should: protect the interests of all consumers; encourage new entrants during the transition to fully effective competition; be cost-effective and in particular minimize cost and inconvenience to customers seeking second-tier supply; and must be capable of satisfactory implementation by 1998.

8.285. BG stressed that it was keen to see that full competition was available to benefit consumers in both the gas and electricity markets and that there was a consistent approach for both markets from 1998 onwards.

8.286. In conclusion, BG said that in considering the impact of the proposed merger the MMC might wish to satisfy themselves that:

(a) there were no cross-subsidies, not only between various parts of the electricity market but also between gas and electricity supply;

(b) there was a clear definition in terms of accounting separation between the (monopoly) distribution business and the (competitive) electricity supply business. This would require the means for ensuring compliance. BG's own experience of this type of separation was that it was an effective method of ensuring that there was no advantage conferred on the supplier by virtue of its common parentage with a monopoly transporter/distributor; and

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[1] *The Competitive Electricity Market from 1998: Consumer Protection, Competition and Regulation*, November 1995.

(c) there was no loss of `liquidity' in the electricity contract market compared with the situation before the merger. Should the contract market become `thinner' as a result of the merger, then it might be more difficult for new entrants to contract for competitive electricity supplies.

GNI Ltd

8.287. GNI explained that it was a leading broker in financial derivatives, including electricity contracts. GNI had developed the EFA, a forward two-way CfD on standardized terms. Initially, the EFA market had operated alongside the CfD market as a mechanism for the RECs to fine tune cover, but as EFAs developed they were also viewed by a number of RECs and generators as an alternative avenue for mainstream contracting.

8.288. GNI argued that an important issue facing the MMC was the relationship PG should have with MEB, particularly with regard to the level of internal transfers of contracts. The present system, with its clear distinction between generating companies and distribution companies, provided an avenue for competition for contract cover. Vertical integration removed the necessity for some companies to access the open market and would bring difficulties in monitoring costs/profits derived from separate areas of a vertically integrated organization.

8.289. GNI proposed that the EFA market, with its transparent pricing, could become an important mechanism in establishing market value of contract prices, particularly if generators were obliged to offer contract cover via the open market, with value of internal transfer of contract cover being priced in the open market. This would allow other generators to compete in the process as well as giving RECs the chance of `best execution' in the market at that moment.

8.290. GNI believed that if this course of action was adopted it would have a significant effect on competition in the industry as a whole and in particular it would:

(a) provide a useful comparator to evaluate the performance of vertically integrated electricity companies by ensuring that internal contracts were at market levels;

(b) encourage the generators and RECs to be more consistent in their use of the EFA market;

(c) further enhance the credibility of the EFA market, increasing the depth of liquidity, thereby attracting more new participants and encouraging competition; and

(d) promote price transparency in wholesale contract trading, which would improve competition, and extend the understanding of the system among large users of electricity.

Irwin M Stelzer Associates

8.291. Irwin M Stelzer Associates submitted two papers on the dangers of vertical integration in the electricity industry. The first, entitled *It's a new world so what's a utility to do*, argued that the vertically integrated structure of the US electric utility industry ought to be changed, because, as things stood, new entrants into power generation had to move their electricity over transmission and distribution wires owned by the very utilities with which they aimed to compete. The second, entitled *Lessons for UK Regulation from recent US experience*, argued that regulation should not be allowed to stifle competition.

Southampton & Fareham Chamber of Commerce & Industry

8.292. The Chamber said that there appeared to be no serious objections to vertical integration in general or to the merger, although fears were expressed regarding the erosion of competition. In this respect, the Chamber stressed the need for careful regulatory control to avoid any exploitation of a monopoly position. The Chamber added that responses had suggested that the merger might lead to some economies of scale and would strengthen investment in research and development. An opinion was also expressed that if British companies failed to acquire electricity companies, foreign companies might well do so.

Lord Tombs, ex-Chairman of the Electricity Council

8.293. Lord Tombs wrote to the MMC as a former chairman of the South of Scotland Electricity Board and of the Electricity Council for England and Wales.

8.294. Lord Tombs explained that privatization took place on the basis of separation of generation from distribution, with the result that no company recognized the overall costs of supplying electricity and therefore investment decisions were fragmented. Lord Tombs argued that no electricity company in England and Wales operated with an adequate knowledge of its cost base or investment needs.

8.295. Lord Tombs concluded that the bid by PG was a logical and desirable development which would go far to restoring coherence and genuine competition in the electricity industry.

Vectis Energy Systems

8.296. Vectis Energy Systems argued that the merger should be allowed to proceed since it would improve competition in the supply market. It would also improve or be likely to improve price and technology by direct customer access to manufacturing source.

Members of Parliament

Mr Peter Luff, MP for Worcester

8.297. Mr Peter Luff MP said that he had received no representation in his constituency expressing opposition to the merger and a number of expressions of support for the merger.

Dame Jill Knight DBE, MP for Edgbaston, Birmingham

8.298. Dame Jill Knight thought the merger would be in the public interest and would benefit her constituents and also the Midlands area. The merger would create a strong Midlands-based energy group committed to the region and with the joint aim of achieving growth in both the UK and overseas electricity markets. Customers in the Midlands (and indeed nation-wide) would benefit from the merger; sufficient regulatory safeguards were in place to ensure their protection. It was important that British companies like PG should be able to play a full role in the restructuring of the electricity industry, with the increasingly diversified range and mix in management as well as strategies now within the industry.

Electricity Panel members

Dr M W Kennedy

8.299. Dr Kennedy said that the merger proposal would clearly lead to a concentration of market power among generators by the removal of a small but growing generator from the market which would *prima facie* lead to a reduction in competition in that market. The DGES recognized that privatization had left too much power in the hands of PG and now required it to manipulate the Pool to deliver an average price that he decided was appropriate. A larger number of generators would give the Pool more chance of becoming a real market-place.

8.300. Dr Kennedy added that the present market for electricity was largely in the form of CfDs. In view of PG's ability to manipulate the Pool price, consideration should be given to requiring that CfD prices and terms be published, and ideally that PG be broken up into a large number of competing generators.

8.301. Dr Kennedy thought a situation in which there were a small number of vertically integrated companies dominating the market would require more, not less, monitoring and would make the DGES's task substantially more difficult. Also, current franchise customers in a REC's area who, either by choice or indolence, remained with their local REC after 1998 could be disadvantaged if the REC was owned by a generator which attempted to obtain higher prices in this sector of the market.

Dr Gill Owen, Energy Policy Consultant

8.302. Dr Owen said that the proposed merger raised a number of concerns resulting mainly from the effects of the horizontal and vertical integration. These concerns focused particularly on:

(a) the ability to pass on to captive customers unnecessarily high generation costs from an integrated company's generating capacity;

(b) the reduction in the number of competing suppliers;

(c) the scope for undue preference between parts of the merged company to the detriment of other suppliers/generators;

(d) the likely size and dominance of the merged company; and

(e) the increased difficulties which might face the DGES, due both to the loss of some comparators and the complexities of separately identifying and monitoring the different activities.

8.303. Dr Owen explained that concerns about customer interests arose primarily where there was a supply monopoly. If the customers of the merged company could go elsewhere to buy their electricity, then it would be much less easy for the merged company to pass on inflated costs as it would risk losing customers. Dr Owen pointed out that at present customers with an electricity demand of over 100 kW were free to choose their own supplier, many actively shopped around and might be expected to continue to do so. The ability of the merged company to pass on inflated generation costs to these larger customers should therefore in theory be limited. Dr Owen noted that the fact that the merger would reduce the number of competing suppliers was a factor that needed to be borne in mind, although the actual impact of this merger might be small. Customers with a demand in excess of 1 MW would still have a choice of suppliers if the merger went ahead. As PG had concentrated on the above 1 MW market, the merger would not reduce the number of active competitors supplying customers with a demand between 100 kW and 1 MW.

8.304. Dr Owen added, however, that customers with a demand of less than 100 kW would have no choice of supplier until 1998 and, even then, it was as yet uncertain how much competition there would be for these smaller, particularly domestic, customers. Dr Owen stressed that there was therefore a real risk that the merged company could pass on excessive generation costs to customers in the under 100 kW market, without the risk of losing customers to competitors.

8.305. A concern to other suppliers would be that the merged company would gain access to generation on preferential terms, which were denied to competitor suppliers. Similarly, other generators would be concerned that the generating arm of the merged company would be able to get particularly favourable terms from the supply business, to the detriment of other generators. Dr Owen emphasized that what was likely to be of particular concern in this case (other major electricity companies were also involved in both supply and generation) was the size of the generating business. Smaller independent electricity generators (which were not involved in supply) already had concerns about the terms of their access to the market and these concerns might be exacerbated by the increase in access to in-house generation in the merged company.

8.306. Dr Owen added that a major concern for other generators, particularly small independent ones, would be the access which PG would gain to the local distribution system. Use of system charges had been an area of contention for some time. PG might be granted preferential terms for access to the distribution system which were not available to competitors who had no choice but to use this local monopoly.

8.307. Dr Owen also noted that PG already controlled much of the non-nuclear generation capacity in the country; if the merger went ahead it would also include respectively MEB's (albeit small) generating capacity. This would reduce the effectiveness of the DGES's recent requirement for PG to divest itself of a certain amount of generating capacity and would increase, by virtue of its size, PG's ability to manipulate the Pool price for electricity. As a supplier, the merged company would clearly be much larger. PG, which had previously concentrated on over 1 MW customers, would be involved in supply to customers at all levels; MEB would gain a number of very large customers. However, given the existence of other large competitors, Dr Owen thought the issue of size *per se* might not be so detrimental to the supply business-indeed it might bring benefits in terms of stimulating competitive responses.

8.308. Dr Owen said that whilst vertical and/or horizontal integration were not *per se* detrimental to energy efficiency she had some concerns about the potential impact of the merger on energy efficiency and on the environment. She explained that, currently, if a REC supply business invested in energy efficiency for its customers, its distribution business lost revenue due to fewer kWh being distributed through the system. Whilst accounting separation could alleviate the problems it could not remove them-REC management and its shareholders were concerned with total profit and if more was lost from distribution than was gained from supply, then energy efficiency would not be looked upon favourably. The proposed merger could exacerbate this problem as it would result in an increase in the volume of supply business undertaken by a company with control of, and hence interest in, the profitability of electricity distribution. If customers valued energy efficiency they could go to another supplier. However, where competition was absent or ineffective, there was a danger that energy efficiency would suffer.

8.309. In conclusion, Dr Owen said that if the merger were to proceed there would be adverse effects to the public interest in terms of competition, prices charged to customers, efficient use of electricity and protection of the environment. Adverse effects would result from the size and market power of the merged company, the absence or effectiveness of competition in parts of the supply market which could be further weakened by the merger and the control by the merged company of the natural monopoly elements of distribution and transmission.

8.310. As to possible safeguards or remedies, Dr Owen said that it was a moot point whether there was an ideal structure for the electricity industry; no particular market structure should be seen as immutable and the best obtainable circumstances could change and structure would have to change with them. However, Dr Owen thought, it was desirable to separate out the natural monopoly from the competitive parts of the industry. Combining supply and generation in the same business would often make sense, particularly where gas and electricity suppliers were combined, and it would open up opportunities for the supply of integrated energy services, bringing customer and environmental benefits. Provided that competition remained effective and excessive concentration was avoided, integration of supply and generation raised no substantial concerns. Combining supply and generation with transmission and distribution was, however, another matter. The DGES had already made his view clear that the national grid should not be owned by companies with other electricity interests and his view that it would be inappropriate for the merged company to hold shares in the national grid should be supported. This would, however, still leave PG with control of local distribution and this gave a considerable degree of monopoly power over other suppliers and generators. As supply was further opened up to competition it raised a serious question about the wisdom of allowing control of distribution to remain in the hands of a company which was also a supplier.

8.311. Dr Owen thought therefore that, if the merger were to proceed, the MMC should consider whether the adverse effects on the public interest might be prevented by requiring more effective separation of distribution from supply and generation. A requirement for internal separation might make the DGES's job easier although the information asymmetry between the DGES and the relevant company meant that regulatory mechanism of this sort would always be of limited effectiveness. If there was no potential for abuse of ownership/control of the monopoly element, then the main remaining concern in the case of the merger would be the size of the generation part of its business, increasing the potential for manipulation of Pool prices and passing on excessive generation costs to captive customers, particularly prior to full supply liberalization in 1998. Dr Owen considered that this adverse effect could be mitigated by requiring the merged company to sell or dispose of a significant part of its generating capacity.

Academics

Professor David M Newbery, Department of Applied Economics, University of Cambridge

8.312. Professor Newbery wrote to us and attended a hearing.

8.313. Professor Newbery explained that the distinctive feature of electricity privatization was that generation was separated from transmission and distribution. NP, PG and NEP were to compete with each other in the Pool by bidding prices each day at prices which they were willing to generate. This was supposed to provide incentives for competition. However, almost all the time the price was set by stations owned by PG and NP and hardly ever by NEP, the French, or the new gas-fired independents. Professor Newbery stressed that competition was an excellent idea, and had delivered large productivity gains in generation, even in NEP, but there was too little of it.

8.314. Professor Newbery added that PG's and NP's power to raise Pool prices was only restrained by the very real threat that high prices would encourage new entrants, and that the DGES would refer them to the MMC. To try to prevent a reference, they had agreed to sell 6 GW of plant to encourage real competition in the price-setting part of the market.

8.315. Professor Newbery thought that to date the DGES had done his best against difficult odds to discharge his duty under the Electricity Act `to promote competition in the generation and supply of electricity'. The proposed merger would put this at risk. Professor Newbery argued that the proposed merger represented a drastic reversal of the philosophy of separating competitive generation from the unavoidable monopoly transmission and distribution, both of which needed careful regulation. To allow a merger between generation and distribution meant extending regulation to generation. Without integration the RECs had an incentive to contract for the best deals for their customers, but an integrated company would be tempted to pass high generation prices on to its customers, and would need to be carefully policed to prevent abuse. Customers would have less to fear about signing contracts with non-integrated RECs, as they would have a wide range of choice of generator with whom to sign contracts, and would be able to fall back on buying in the Pool without having to worry that prices there might suddenly move against them, but customers of integrated RECs would need to incur extra costs to switch to other non-integrated RECs as suppliers, and these costs would give the incumbent integrated RECs the ability to raise prices to their own customers.

8.316. Professor Newbery added that the DGES would be better placed to compare the terms offered to captive customers against the reasonable number of alternatives available. At the moment this was difficult and the DGES had proposed a prohibition on new contracts between PG's and MEB's customers. In practice, this remedy would force MEB to buy its peak-time supplies from NP giving that company an unnatural monopoly which the DGES would have to monitor. Having more generating companies would avoid this.

8.317. Professor Newbery had other concerns about the proposed merger. Larger customers of unintegrated RECs might suspect that they were being offered less favourable contract terms than the integrated REC, as the unintegrated RECs lacked inside information about the generators' bidding behaviour in the Pool. Customers would either switch to the integrated RECs, increasing their market share and market power, or they would decide to buy directly in the Pool. If they bought in the Pool, the generator would sell

less on contract. The more a generator sold at variable Pool prices, and the less it sold at predetermined contract prices, the greater its incentive to raise Pool prices. If the contract market was destabilized by the different market positions of the integrated and unintegrated companies, PG would acquire more market power in the Pool. Again, the merger would reduce competition.

8.318. Another worry was that as more electricity was traded in-house, rather than through the market, the Pool would wither away, making the market opaque, more open to manipulation and harder to regulate. Professor Newbery thought the end point of this process might be a cartelized industry on the German model, which had some of the highest domestic electricity prices in Europe.

Professor Catherine Waddams, Warwick Business School

8.319. Professor Waddams explained that there were two main potential sources of benefits arising from the proposed merger, ie those that benefited all parties, rather than one party at the expense of another. The first could arise from economies of scale between the different production stages, which would reduce the total costs of production. An integrated electricity company which incorporated stages of production from generation to supply, including distribution, would have some economies of scale, particularly in load balancing. The volatile nature of energy demand made meeting peaky demand a costly exercise, and the costs of co-ordination were one reason why electricity had traditionally been organized on an integrated basis. Moreover, Professor Waddams added, there were certain economies offered by more efficient management or by geography, eg by combining headquarters functions.

8.320. Professor Waddams thought the second potential benefit from the merger was the removal of the so-called double monopoly mark-up: if there was monopoly power both in generation and supply, separate firms would each add a monopoly mark-up of price over cost to maximize their gains; an integrated company would internalize this effect, and the total mark-up would be lower, improving the total welfare (and the profit for the integrated company).

8.321. Professor Waddams believed that both the potential benefits of the merger also posed considerable dangers in a market moving towards increased competition and deregulation and in particular threatened the development of a regulatory framework within which the markets could work. Economies of scale in supply gave an integrated company a cost advantage over its rivals. The integrated company would have a competitive advantage in both the upstream and downstream markets *vis-à-vis* other generators, especially new non-integrated entrants, and `independent' RECs. The intervention of the DGES in capping pool prices indicated that the generation market remained dominated by PG and NP, and the supply monopoly had not yet been removed from the RECs. An integrated player with substantial cost and operational advantages would create distortions in the electricity supply market as it was further opened and would need to be carefully managed by the DGES. The merger would inevitably increase the workload of the DGES and decrease the reliability of cost allocations, so making it difficult to operate the condition preventing price discrimination, and leaving very little effective regulation.

8.322. Professor Waddams pointed out that comparisons between RECs depended on identifying efficient electricity suppliers as comparators to others. To the extent that MEB was among the most efficient, in one respect or another, the DGES would lose vital information if he could not include it as a meaningful comparator. Prices would be higher as a consequence of increased monopoly power and problems of regulation and consumers were likely to suffer. Moreover, the problem would spill over into the gas market as the gas and electricity markets became increasingly integrated.

8.323. Professor Waddams suggested that, if the merger were allowed, PG should agree to undertakings to keep its generation and supply operations separate; substantial cost reductions should be passed on to customers in the immediate future; and the merged company would be expected to perform consistently better than independent companies in delivering benefits to consumers in the future, to reflect its lower costs and to counteract use of its increased market power.

Members of the public

The Allison family

8.324. Members of the Allison family wrote in as small shareholders in PG and MEB.

8.325. The Allisons noted that since privatization the electricity supply and generation industries had improved their efficiency and lowered their pricing levels to a marked extent in addition to payments of refunds and a National Grid bonus of £54.00. Both consumers and shareholders had benefited from these improvements. Shareholders, and particularly small shareholders, had taken a risk in supporting the privatization programme. The Allisons thought the electricity industry should continue to run as efficiently as possible in the best interest of shareholders, consumers and those who worked in the industry. In their opinion this would be best achieved if the merger was allowed to proceed. It seemed unlikely that a monopolistic situation would be created by the merger as the combined company would have less than 25 per cent in generation and 15 per cent in supply and these percentages were set to drop, particularly in generation with more companies competing in this area in the future.

Dr P H Clarke, University of Durham

8.326. Dr Clarke said that his major concern, as a buyer for the University of Durham, was to have sufficient electricity suppliers willing to compete for contracts. He estimated that at least six such suppliers would ensure a competitive market. Dr Clarke was unconvinced that regulation could be used to separate generation from supply in a single company. From the customer's viewpoint, it would be healthier to have independent companies, without internal regulations or Chinese walls, which could compete openly with each other. Dr Clarke suggested that this could be achieved by requiring that any generator owning a REC should not be allowed at the same time to own more than 15 per cent of the country's generating capacity.

8.327. Dr Clarke also expressed concern that the present Pool mechanisms could lead to artificially high prices because of the small number of generators, although the annual price was capped by OFFER. The proposed merger would not help the present situation and could make it worse. This concern would be allayed if there were more major companies playing an active role in the generating market. Dr Clarke added that the Pool pricing structure, whilst transparent, was a mystery to most people.

Mr K E Brown of Stroud, Glos

8.328. Mr Brown opposed the merger, as he considered it would make the regulator's job more difficult.

Mr George R J Guise, a consultant on international privatization and former member of the Prime Minister's Policy Unit

8.329. Mr Guise was concerned that the Government's basic objectives in the development of a competitive market could be frustrated if the merger went ahead. The Government had recognized that there would be much duopoly power in generation at the outset, hence the importance of the DGES and the independent operation of the Pool. It had, however, expected that much of the market distortion resulting from the initial duopoly would be resolved before 1998, when all consumers would have access to a diverse supply market, thereby effectively ending the concept of tied customers, even though local suppliers would continue to have an obligation to distribute electricity at a regulated charge in their franchise area.

8.330. Mr Guise pointed out that the outcome had been different for two principal reasons. Until these were resolved the proposed merger could diminish the opportunity for customers in the MEB franchise area, and non-franchise customers elsewhere, to obtain an optimum long-term electricity price, even though the immediate effect might be a lower price for non-franchise customers in the short term:

(a) The 6 GW of new generation from owners other than PG and NP, including MEB, which had entered the market since privatization had been predominantly fuelled by gas delivered according to `take-or-pay' contracts which had the effect of reducing the marginal cost of gas nearly to zero. This

new capacity was therefore all baseload rather than price-setting and had no effect on the ability of PG and NP to set Pool prices most of the time. New entrants to generation, therefore, had minimal power to affect the PPP which was almost entirely set by the duopoly. Furthermore, because of the method of negotiating uplift, vertical integration of PG with any REC would enhance the power of PG to manipulate uplift to the inevitable detriment of the PSP. This situation would continue despite the proposed divestment of baseload plant by the duopoly.

(b) In order to limit their exposure to Pool price volatility, generators and suppliers had developed a system of mutual hedging contracts, where the sale took place outside the Pool, with each effectively betting against the other on the behaviour of the short-term Pool price. With such an increase of volume traded under secret contract agreements, it followed that no one actually knew the wholesale price of electricity.

8.331. Mr Guise stressed that if PG was allowed to acquire its own supply and distribution company it would be in a position to enter into such secret contracts in effect with itself. The supply business could then make hedging decisions on the basis of inside information about the likely future behaviour of PSPs. Since this information would not be available to competing suppliers, it was logical to suppose that non-franchise customers would get a better deal from integrated suppliers, a fact which such customers would instantly realize and therefore cease bothering to shop around for a better deal. Consequently, the non-franchise market would rapidly become less competitive, after which prices would rise to higher levels than those in a competitive market. The adverse effects on prices in the franchise market would be immediate because PG would impose contracts, at higher prices than it could obtain elsewhere, upon its supply business, which it could then pass on to franchise customers.

8.332. In conclusion, Mr Guise said that the proposed merger could reasonably be expected to frustrate the Government's intention at privatization to establish a regime under which effective competition in generation and supply would develop. In general, take-overs, and the threat of take-overs, led to improved management efficiency which benefited shareholders and, under free market conditions, customers alike. In this merger, this was not the case. Mr Guise thought undertakings were an inappropriate remedy and doubted whether they could be properly monitored and enforced.

Mr David Mayers, electricity consultant

8.333. Mr Mayers welcomed the proposed merger as a rational development towards a desired end. He argued that market prices would inevitably lead to the industry regrouping in a commercially more appropriate way in which a predicted group of five or so vertically integrated companies, of roughly equal size, would provide a better framework for competition.

8.334. He stressed that without distribution involvement, PG would continue to be incomplete as an electricity utility company and would be commercially disadvantaged and vulnerable. He thought the proposed merger would have benefits both at home and abroad. The prime benefit at home would result from the integration of the interests and strengths of the generator and the distributor. The merged company would be better suited to the development and operation of smaller, more efficient, locally integrated and more environmentally acceptable power plants, and it expected PG to become more sensitive to the views of the public and end-users under the influence of its distribution partner.

8.335. Mr Mayers said that a vertically integrated UK company would benefit in overseas tendering from being able to offer a full range of electrical utility services, including consultancy.

8.336. Mr Mayers concluded by listing a series of further benefits which would accrue from the proposed merger. These included: focusing research and development; being neutral to the workings of the Pool; assisting the DGES by reducing the number of company interfaces; encouraging the generators to invest in total system solutions including reduction of distribution losses, sharpening prices, benefiting suppliers and customers, and enhancing the ability of the merged UK company to fight its loss of market share and survive in the long term.

8.337. Mr Mayers added that should the proposed merger be prevented, he considered that other mergers, probably less desirable and involving a further transfer of UK assets to foreign ownership, would inevitably take place.

Ms M Pickering of Wrexham, Clwyd

8.338. Ms Pickering believed the merger would be against the public interest. She pointed out that before privatization electricity companies had the right to erect power lines after only limited negotiations between the company and the landowner. These `rights' had been transferred to the new private companies and would gain more significance. Small companies, such as those wishing to generate power from wind turbines, had no such rights and could be refused access. Ms Pickering recommended that all electricity companies should be able to compete on an equitable basis and therefore these rights should be removed from the newly privatized companies.

Mr T Plume of Billericay, Essex

8.339. Mr Plume considered that the merger was against the public interest and against the original objectives of privatization. Utility companies should not be trying to trade outside their specialist areas. If the merger was approved, generators would be able to buy up all the electricity distributors, creating a private, instead of a public, monopoly. Consumers would lose any choice of supplier and the DGES would find it more difficult to monitor the combined companies.

8.340. Mr Plume thought electricity prices were too high to both industrial and domestic customers. Companies, especially heavy users, were disadvantaged against continental competition, and domestic customers were still waiting for the promised benefits of privatization to show up in their bills, including the benefit of cheaper gas rather than coal-generated electricity. Mr Plume recommended the Government to review its current policy for all privatized industries, publish it and appoint one regulator for all. Its objective would be to ensure greater fairness between for the user and the supplier.

Mr R Wilson of Bracknell, Berkshire

8.341. Mr Wilson stated as a shareholder that he had voted against the merger. PG's Chairman had claimed that the merger was unanimously approved by shareholders; this was clearly untrue.

G D W ODGERS *(Chairman)*

R O DAVIES

D J JENKINS

J S METCALFE

P A HODGSON, being a member of the Group, dissents from the conclusion for the reasons set out in the note of dissent included in this report.

A J NIEDUSZYNSKI *(Secretary)*
29 March 1996