Proposed acquisition by MGN Networks Limited of the Wales and West Gas Distribution Network from Transco Plc

The OFT's decision on reference under section 33 given on 5 April 2005. Full text of decision published 12 April 2005

PARTIES

1. **MGN Gas Network (UK) Limited (MGN)** is a company newly incorporated for the purpose of this proposed acquisition by a consortium of eight equity investors (**the Consortium**). The Consortium consists of a number of investment funds and financial institutions led by several wholly-owned subsidiaries of Macquarie Bank Limited (MBL), a bank listed on the Australian Stock Exchange. MGN has not traded except for entering into transactions relating to this proposed acquisition.

2. In the UK, MBL has for some time traded in financial contracts related to the wholesale gas market and has recently obtained a gas shipping licence so that it can participate directly in the wholesale gas market. MBL also exercises joint control (with Siemens) over the business of Capital Meters Limited (CML), which provides gas metering services. Furthermore, MBL has limited interests in renewable electricity generation in the UK.[1]

3. **Blackwater 2 Limited (Target DN CO)** is a newly-incorporated subsidiary of **Transco Plc (Transco)**, which is itself a wholly-owned subsidiary of **National Grid Transco plc (NGT).** NGT is an international network utility group, primarily focused on energy delivery. In the UK, NGT owns and operates the high voltage electricity transmission system across England and Wales and, through Transco, the vast majority of Great Britain's high pressure gas transportation and low pressure distribution pipeline infrastructure. Target DN CO will comprise the hive

[1] Macquarie Group has recently acquired directly and through a joint venture a portfolio of renewable generating electricity plants with a total capacity of 258 MW which represents less than 0.4 per cent of total GB electricity generating capacity and less than 7 per cent of total GB renewable generating capacity.

down assets, including the statutory licence and personnel which include gas metering engineers for the business of the Wales and West gas distribution network, which serves Wales and large parts of the South-West of England. Target DN CO transports gas on behalf of gas shippers to some 2.3 million gas consumers[2] and its turnover was approximately £ 235m in the last financial year.

TRANSACTION

4. On 31 August 2004, MGN entered into an option deed with Transco to purchase Target DN CO. The extended statutory deadline for the consideration of this merger expires on 5 April 2005.

JURISDICTION

5. As a result of the transaction, MGN and Target DN CO will cease to be distinct. The UK turnover of Target DN CO exceeds £70 million, so the turnover test in section 23(1) of the Act is satisfied. Therefore, arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

BACKGROUND

6. The vertical supply chain for the gas industry in Great Britain (GB) involves several players; the following briefly described producers, shippers and suppliers.

7. *Producers* are generally located offshore and are unlicensed under the Gas Act[3] but regulated by the Department of Trade and Industry (DTI). Producers ship gas to the 'beach' from where it is inputted into the National Transmission System (NTS), the high pressure gas pipeline system owned and operated by the licensed Gas Transporter (GT), Transco. From the NTS, gas is transported via the eight Distribution Networks (DNs), one of which is the assets being considered in this merger assessment and which, until now have been owned and operated by Transco.

8. *Shippers* are gas wholesalers. They buy gas from producers at the 'beach' and sell it to *suppliers*. Shippers and suppliers are licensed under the Gas Act and are regulated by the sectoral regulator, the Office of Gas and Electricity Markets (Ofgem). Shippers are required to balance their inputs and offtakes of gas on a daily basis and buy 'flexibility' from producers in the form of variable contracts or by putting gas into storage for this purpose.

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[2] March 2003 figures.

[3] See further para 9ff. The Gas Act 1986 has been amended and supplemented by the Gas Act 1995, the Utilities Act 2000 and the Energy Act 2004 (the Gas Act).

Overview of regulation and industry restructuring

9. The gas industry in GB is subject to detailed regulation under the Gas Act under the scrutiny of Ofgem. In addition, multilateral contracts, which adopt the form of industry codes, set the terms of the contractual relationships between the different players of the gas industry.[4] Furthermore, Transco's gas transmission and distribution revenues are currently regulated through a price control system, which is set for the period 1 April 2002 to 31 March 2007.

10. The Gas Act provides for the regulation of the onshore gas regime in GB and for the separate licensing of GTs, gas shippers and gas suppliers. It imposes a number of conditions on the licensees. GTs are bound by a broad range of statutory obligations intended to prohibit them from discriminating in favour of any related business in the gas sector; in particular, to avoid any undue discrimination in the terms under which they undertake to convey gas. These obligations will apply to the DN acquirer.

11. Due to the changes to the structure of the gas industry that flow from this and similar transactions, Ofgem and the industry participants, including proposed purchasers of the DNs, have been reviewing and negotiating modifications to the regulatory, commercial and operational framework for over 18 months. At present, Ofgem is formally consulting on a series of additional non-discrimination GT licence obligations including for the publication of transportation prices to gas network users; and for business separation licence conditions that put the onus on the licensee to develop managerial and operational systems which prevent any relevant supplier or shipper from having preferential access to confidential information. [5]

12. Ofgem retains the right to veto any sale if Transco does not consent to any licence modifications and implement any other regulatory, commercial and operational changes that Ofgem considers are necessary in order to ensure that the interests of the customers are protected. Ofgem also has enforcement powers, including imposition of penalties, with respect to licensees in breach of their license or relevant obligations.

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[4] For example, the Uniform Network Code, once the current draft version based on Transco's existing Network Code is finally agreed and implemented, will comprise a single set of commercial terms for gas transportation services which will apply to the NTS and all DNs and will govern the relationship between NTS, DNs and shippers. This will include the terms dealing with the allocation and charging of NTS exit, NTS entry, NTS offtake and Local Distribution Zone capacity.

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

RELEVANT MARKET

13. MBL, its subsidiaries and sister companies (Macquarie Group) are active at several levels of the gas supply chain which are considered below. For the reasons discussed below, in relation to the gas supply chain, the relevant frames of reference in this case are the transportation of gas through the Wales and West DN and the shipping of gas in GB.

Onshore transportation of gas

14. GTs own and operate gas pipeline systems. In GB, the high pressure national transmission system (NTS) connects to eight low pressure distribution networks (DNs).

15. At present, DNs are regional natural monopolies that do not compete with each other; the geographic frames of reference thus correspond to the regional area to which the respective DN's licence applies, which in the present case is Wales and large parts of South-West England. Given the absence of pre-existing competition between DNs, the merger cannot therefore be said to have any anticompetitive effect in this respect.

16. It should be noted that the break-up of the gas distribution network under Ofgem's oversight is intended to introduce a degree of so-called benchmarking competition between the monopolies by having at least four different undertakings and management teams operating the eight DNs. Thus, while DNs will remain regional natural monopolies, regulation is designed to stimulate efficiency improvements that the competitive process generates in other sectors not characterised by natural monopolies. This regulatory context does not alter the conclusion that the merger has no detrimental effect on competition.

Shipping of gas

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

18. MBL has recently acquired a shipping licence and will be involved in gas shipping throughout GB.

Supply of electricity

19. Macquarie Group's interests in the UK wholesale supply of electricity are limited to renewable plants which represent less than 0.4 per cent of total GB generating capacity. Accordingly, this issue is not examined further.

HORIZONTAL ISSUES

20. This transaction raises no horizontal issues.

VERTICAL ISSUES

21. Given that members of the Macquarie Group are present at several levels of the supply chain, the possibility of a loss of competition arising from vertical issues has been analysed.

22. MBL intends to use its newly-acquired shipping licence to conclude long term beach contracts with North Sea gas producers and to secure sale contracts with large customers. It estimates that its shipping activities will represent less than 1 per cent of the total volume throughput. Given this minimal share in the gas shipping sector it is not considered that it would be economically rational for MGN to foreclose MBL's downstream shipping competitors. Furthermore, if MGN were to offer, in breach of its regulatory obligations, MBL's shipping business more favourable terms or excess to confidential information in relation to its competitors, this would not have any material impact, as MBL's shipping activities would have to grow substantially before it would be able to influence the pattern of competition in the sector.

THIRD PARTY VIEWS

23. Several third parties expressed some concerns given the potential vertical relationship between MGN and some of MBL's shipping activities but they all also considered that given the regulatory framework would address these effectively.

ASSESSMENT

24. Transco has held a monopoly of the gas distribution network in the UK, for both high- and low-pressure distribution, which it operates under a licence pursuant to the Gas Act. Transco's monopoly essentially comprises a system of multiple regional DN monopolies. This system is to be broken up by the sale of four of the eight regional low-pressure DNs, each of which will remain a regional monopoly. This merger entails the acquisition by MGN of one such DN, covering Wales and large parts of South-West England.

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

26. In terms of possible vertical effects, MGN has no incentive in the foreseeable future to foreclosure downstream shipping competitors because of its minimal presence in this sector. Furthermore, while there is a theoretical possibility that MGN could discriminate in favour of its downstream shipping business or provide it with access to confidential information in breach of its regulatory obligations, this would have no material impact on the pattern of competition. In any event, there are no grounds to believe that the regulatory regime to which MGN will be subject if the transaction proceeds will not be effective in addressing these concerns.

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

DECISION

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