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Date: 29 October 2019

Dear colleague,

**Request for Schedule B of Special Condition AA to no longer have effect in RWE Generation plc's Electricity Generation Licence**

On 19 September 2019, RWE Generation plc ("RWE") wrote to Ofgem<sup>1</sup> to request that Schedule B of Special Condition AA no longer have effect in their Electricity Generation Licence. RWE is currently subject to Schedules A, B and C of this licence condition, which came into effect on 31 March 2014. Schedule B relates to the Market Making Obligation ("MMO").

RWE's argument in support of their request relates to changes in the company's structure following the sale of their shareholding in Innogy SE to E.ON on 18 September 2019.

We have assessed RWE's request against our rationale for applying the licence condition originally and the non-exhaustive factors outlined in our guidance document on the condition. This letter sets out the request and explains our reasons for consenting to it. To give effect to the changes, pursuant to Paragraph AA.2 of the Special Condition, today we have published a Direction addressing the Electricity Generation Licence held by RWE<sup>2</sup>. We

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<sup>1</sup> References to the "Authority", "Ofgem", "we", and "our" are used interchangeable in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day work. This decision is made by or on behalf of GEMA.

<sup>2</sup> [https://www.ofgem.gov.uk/system/files/docs/2019/10/RWE\\_Schedule\\_B\\_Direction.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/RWE_Schedule_B_Direction.pdf)

have considered our statutory duties and in particular our principal objective to protect the interests of existing and future electricity and gas consumers in making this decision.

## Background

Special Condition AA: Liquidity in the Wholesale Electricity Market (“the Secure and Promote licence condition”) first became effective on 31 March 2014.<sup>3</sup> Liquidity is an important feature of a well-functioning market for a number of reasons. Liquid wholesale energy markets give market participants the confidence that they can buy and sell at prices that reflect underlying demand and supply conditions. They allow firms to manage risk effectively and reduce the scope for market manipulation. Importantly, they also provide transparent prices on which non-vertically integrated generation and supply businesses can base their investment decisions, and potential entrants can assess opportunities to enter the market.

Special Condition AA aims to improve liquidity in three ways:

- **Schedule A - Supplier Market Access Rules:** Seeks to improve the availability of products that support hedging, by requiring the eight largest electricity generating companies to follow a set of rules when trading with small independent suppliers. These include defined standards for dealing with requests for trading agreements, pricing, products and minimum clip-sizes.
- **Schedule B - Market Making Obligation:** Seeks to ensure the availability of robust reference prices for wholesale electricity products along the forward curve. Three<sup>4</sup> large vertically integrated generation and supply companies are required to simultaneously post bids (buy) and offers (sell) orders for specified forward wholesale electricity products on energy trading platforms throughout two daily trading windows.
- **Schedule C - Reporting Requirements:** Monitors forward and near-term market liquidity by imposing reporting requirements on obligated licensees.

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<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/direction-gas-and-electricity-markets-authority-under-paragraph-aa.2-special-generation-licence-condition-aa-all-schedules>

<sup>4</sup> These are Scottish and Southern Energy plc, EDF Energy and RWE Npower plc. Schedule B was originally included in E.ON's licence condition, but it was removed in November 2016 following E.ON's divestment of Uniper. Schedule B was originally included in generation licences held by the Centrica corporate group but was removed in August 2018 following significant and sustained changes in their generation market share. Schedules A, B and C were originally included in generation licences held by the ScottishPower corporate group but were removed in January 2019 following changes in the group's strategy.

## Assessment Criteria

We have assessed RWE's request by considering our June 2013 Final Proposals document on wholesale electricity market liquidity<sup>5</sup> in which we set out our rationale for applying the condition; and our 2014 Guidance<sup>6</sup> on the condition, which sets out the non-exhaustive factors that we take into account when considering whether to remove the licence obligations or add them in the generation licences of companies in additional corporate groups.

Paragraph 1.10 of the Guidance Note contains the criteria that we will use as the basis of any decision on whether to remove or add Schedules A, B or C of the licence condition. These criteria are:

- i. **Changes to generation market share:** Any significant and sustained changes in the generation market share or generation output of a company group, taking into account its relative market share and overall size.
- ii. **Disproportionate risks or costs:** An indication that an existing Secure & Promote (S&P) licensee will face disproportionate costs and risks in continuing to meet the licence condition, or that a potential new S&P licensee could meet the costs and risks proportionately.
- iii. **Success of the licence condition:** The sustained successful achievement of the objectives of this licence condition.

In addition to the above, the Guidance Note also specifies a fourth factor that will be used when considering whether to add or remove Schedule B of the licence condition:

- iv. **Changes to supply market share:** Any significant and sustained changes in the domestic supply market share or volume supplied of a party, taking into account its relative domestic market share and overall size.

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<sup>5</sup> Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition [https://www.ofgem.gov.uk/sites/default/files/docs/2013/06/liquidity-final-proposals-120613\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2013/06/liquidity-final-proposals-120613_0.pdf)

<sup>6</sup> Liquidity in the Wholesale Electricity Market (Special Condition AA of the electricity generation licence): Guidance. <https://www.ofgem.gov.uk/ofgem-publications/86717/liquidityinthewholesaleelectricitymarketspecialconditionaaoftheelectricitygenerationlicence-guidance-pdf>

Taken together (i) and (iv), are intended to reflect circumstances where there is a fundamental change in the structure of a business, which may impact upon the ability of a licensee to meet the requirements of the licence condition. One of the grounds for Ofgem placing the Market Making Obligation (MMO) on parties was for them to have a substantial presence in both generation and domestic supply markets.

## **Supporting evidence and our assessment**

The following paragraphs contain RWE's evidence to justify the removal of Schedule B from their Electricity Generation Licence, and our assessment of RWE's request in accordance with the Guidance Note.

### *Changes to RWE's strategy and structure*

On 12 March 2018, RWE and E.ON announced an asset swap transaction that would see RWE focus on upstream generation activities and E.ON on downstream activities in networks and retail. This asset swap is taking place in three stages:

1. The first stage of this transaction completed on 18 September 2019. Through this, E.ON acquired RWE's 76.8% stake in Innogy SE and RWE acquired a 16.67% stake in E.ON. RWE's share in E.ON has subsequently reduced to 15%.
2. On 30 September, a further stage of transactions completed with RWE acquiring E.ON's interests in Gundremmingen and Emsland nuclear power plants in Germany.
3. In early 2020, further stages of the transaction will see the transfer of Innogy SE's renewables business and storage activities, as well as its stake in Austrian Legal, to RWE.

RWE applied for the removal of Schedule B on 19 September 2019 on the grounds that later stages of the transactions have no bearing on UK retail.

### *RWE's justification*

RWE are applying for Schedule B to cease to have effect in their Generation Licence under criteria (iv) "changes to supply market share". RWE argue that the sale of its share in Innogy SE to E.ON on 18 September further separated RWE Generation plc from npower's licenced UK retail business. RWE argue there is no longer an integrated relationship between RWE Generation plc and npower's UK supply business and, as such, RWE does not have a domestic supply business. RWE state that this change is intended to be permanently sustained, i.e. it does not represent a gradual change in size or market share. RWE argue that they will have no influence over npower, with the commercial interests of RWE and E.ON separated into upstream and downstream activities. As such, npower will no longer have any continuous option to source energy from RWE as an affiliate.

In assessing this request, we have sought evidence to enable us to determine:

- Whether the operations for RWE Generation plc are clearly and demonstrably separate from npower's retail operations under E.ON's ownership; and
- Whether the nature of RWE's shareholding in E.ON means that they could be considered an affiliate<sup>7</sup>, in which case Schedule B would continue to apply.

Having assessed evidence provided by RWE in accordance with the Guidance Note, our overall assessment is that it is no longer appropriate for Schedule B of Special Condition AA to have effect in RWE's Generation Licence. This decision reflects consideration of criteria (iv) "changes to supply market share".

Evidence provided by RWE demonstrates that the company's retail market share has significantly reduced following the completion of the 18 September 2019 asset swap with E.ON. We agree that structural changes to RWE's business, specifically the replacement of RWE's majority financial stake in npower's former holding company (Innogy SE) by a minority financial holding in E.ON as the new owners of npower, means that RWE can no longer be considered to be vertically integrated with a domestic supply business.

This impacts RWE's ability to meet the requirements of Schedule B. As noted, parties subject to the MMO should have a substantial presence in both generation and domestic

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<sup>7</sup> As defined in Standard Generation Licence Condition 1.

supply markets. This is consistent with our decision on E.ON/Uniper in November 2016, Centrica in 2018 and ScottishPower in January 2019.

**Our decision**

For the reasons outlined in this letter, we consent to RWE's request for Schedule B of Special Condition AA to no longer have effect in their Electricity Generation Licence. We have today published a Direction to give effect to this decision.

Yours faithfully,

**Chris Thackeray**

**Head of GB Wholesale Markets**