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Date: 30 November 2016

Dear Colleague,

REQUEST FOR MODIFICATION OF SPECIAL CONDITION AA OF E.ON'S AND UNIPER'S ELECTRICITY GENERATION LICENCES

On 12 September 2016 the E.ON SE corporate group completed the spin-off of a majority shareholding in its subsidiary company Uniper, thereby creating a new corporate entity known as Uniper SE. As a result of the spin-off E.ON UK plc has written to us to requesting changes to its and Uniper UK Ltd's Electricity Generation licences.

E.ON UK considers that, as a consequence of the spin-off, the Electricity Generation Licences held by the E.ON SE corporate group should no longer be subject to Special Condition AA: Liquidity in the Wholesale Electricity Market, and that the Electricity Generation Licence held by Uniper UK Ltd should no longer be subject to Schedule B of the Special Condition.

This letter sets out the background to the request and explains our reasons for consenting to it. To give effect to the changes, pursuant to Paragraph AA.1 of the Special Condition, we have published today two Directions – one covering the Electricity Generation Licensees in the E.ON SE corporate group, and one for Uniper UK Ltd. We have considered our statutory duties and in particular our principal objective in making this decision.

Background

Special Condition AA: Liquidity in the Wholesale Electricity Market came into force on 21 March 2014. The condition is designed to tackle relatively low levels of GB electricity wholesale market liquidity, identified as potentially detrimental to retail competition as far back as our Energy Supply Probe in 2008.

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 by requiring the 'Big Six' vertically integrated generation and supply companies to simultaneously post bids and offers to buy and sell certain 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.

E.ON's divestment of Uniper

In November 2014 the E.ON SE Group decided to separate its fossil fuel generation and energy trading business from its energy supply, networks and renewable generation business. This entailed the combination of the former into a distinct group of companies under the name of Uniper and the latter remaining part of the E.ON SE Group.

Since 1 January 2016, Uniper has been operationally active within the E.ON SE Group as a wholly-owned group of E.ON SE. However, on 8 June 2016, E.ON's shareholders agreed the proposed spin-off of a majority shareholding in Uniper. The spin-off was implemented on 12 September 2016 by the creation of a new corporate entity known as Uniper SE, the allocation of 53.5% of Uniper SE's shares to E.ON SE shareholders, and the admission of shares in Uniper SE to trading on the Frankfurt Stock Exchange. Following the spin-off the E.ON SE Group no longer has a controlling interest in the Uniper SE Group.

Uniper UK Ltd owns all of what was previously E.ON's conventional generation and global energy trading business and, as a result of the spin-off, E.ON can no longer be considered to have a significant GB generation market share. Consequently E.ON considers it should no longer have to meet any of the provisions of Special Condition AA. Further, because Uniper SE does not have an electricity supply business, E.ON believes the market making obligations of Schedule B should be removed from Uniper's generation licence. E.ON considers that Schedule A (Supplier Market Access rules) should still apply to Uniper as it will retain a significant GB generation market share.

E.ON UK formally wrote to us concerning this matter in advance of the spin-off. Following the spin-off both E.ON UK and Uniper UK have confirmed to us independently that they would like us to publish a direction to introduce the licence changes outlined above.

Our assessment

In assessing E.ON's request we refer in particular to two documents. The first is our June 2013 Final Proposals document[1] on wholesale electricity market liquidity in which we set out our rationale for applying the condition. The second is our January 2014 Guidance document[2] in which we set out, amongst other things, the factors that we would take into account when enforcing the licence condition.

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[1] 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

[2] Liquidity in the Wholesale Electricity Market (Special Condition AA of the electricity generation licence): Guidance

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Criteria for Schedule A - Supplier Market Access (SMA) Rules

Our Final Proposals document indicates the main purpose of the SMA rules is to ensure that suppliers can get access to power in the wholesale market and that the firms in the market best placed to provide this power are the larger generators. It is for this reason that we proposed that the eight largest GB electricity market generators should face the SMA rules.

Our Guidance document specifies that any decision to remove, or add, Schedules A, B or C of the licence condition will be based on a combination of the following, non-exhaustive, list of factors:

i. 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. An indication that an existing 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. The sustained successful achievement of the objectives of this licence condition.

Assessment for Schedule A- Supplier Market Access (SMA) Rules

Following the spin-off of Uniper, the E.ON SE Group has four GB Electricity Generation Licensees. However, of E.ON's four Generation Licensees, E.ON UK plc and Citigen London Limited will not at any time provide electrical power from any one generating station of more than 50MW, and all of the generating stations will have a declared net capacity of less than 100MW. Both companies would therefore qualify as small generators for exemption from requiring a generation licence, if they were not already generation licensees.

E.ON's two other Generation Licensees, E.ON Climate & Renewables UK Humber Wind Limited and Rampion Offshore Wind Limited, are both operators of wind powered generating stations. As operators only of wind powered generating stations, neither company has the ability to schedule generation output to reflect normal wholesale market price signals.

Based on wholesale market indicators published on our data portal[3], we estimate that the share of the GB electricity generation market made up by E.ON SE's Electricity Generation Licensees was approximately 6% in 2015. From the information submitted to us by E.ON as part of its Special Condition request, we understand that excluding Uniper UK Ltd from this calcualtion (i.e. including only those licensee listed above) would reduce this market share to around 1%.

In our view this represents a significant and, on the basis of the spin-off, sustained reduction in market share. We further consider that, as a consequence of this reduction and lack of schedulable generation capacity, E.ON SE would face disproportionate costs and risks in meeting the SMA rules. For these reasons, although E.ON SE still owns GB Electricity Generation licensees, we consider it would no longer be appropriate for these firms to face the SMA rules.

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https://www.ofgem.gov.uk/sites/default/files/docs/2014/03/liquidity_in_the_wholesale_electricity_market_special_condition_aa_of_the_electricity_generation_licence_-_guidance.pdf

[3] https://www.ofgem.gov.uk/data-portal/overview

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Uniper SE has not requested the removal of Schedule A of the Special Condition from Uniper UK Ltd's electricity generation licence. However we note that, on the basis of 2015 market shares, Uniper UK Ltd will have slightly less than a 5% GB generation market share as a result of the spin-off, all of which will be schedulable generation. In our view, the nature and size of this market share is commensurate with continuing to face the SMA rules.

Criteria for Schedule B – Market Making Obligation

In our Final Proposals document we set out our rationale for applying the Market Making Obligation to the 'Big Six' vertically integrated electricity generation and supply businesses as follows:

- **The domestic supply market –** at the time, the firms we proposed to subject to the market making obligation, controlled around 98 per cent of the domestic supply market, and held broadly stable shares of this market. In our view this market structure may have been reducing supplier's incentives to trade in the wholesale market.

- **Vertical Integration** - the firms we proposed to subject to the obligation had a substantial presence in both generation and domestic supply markets. Vertical integration provides an alternative to wholesale market trading that is not available to independent players. While the proposed licensees did participate in the wholesale market, we considered they had an ongoing option to source energy from their affiliate business as an alternative.

- **Trading capabilities –** Because of their size and vertical integration, the firms we proposed to subject to the obligation regularly took both long and short positions and had the capabilities to take a sophisticated view of market prices. In our view this meant that the costs they were likely to face in meeting the obligation would be small in comparison to their existing businesses.

- **Effectiveness of the intervention –** We considered the market making intervention could be delivered successfully with the licensees we had identified. The benefit of additional market makers might be limited, but the costs would be higher. We considered our proposed list of licensees provided the best balance of costs and benefits to consumers.

The three factors from our Guidance document listed in the section above as relevant to the consideration of the removal of Schedule A are also relevant to the consideration of Schedule B. In addition, the Guidance document lists a fourth criterion applicable exclusively to Schedule B:

iv. 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.

Assessment for Schedule B – Market Making Obligation

On the basis of the retail indicators published on our data portal, we estimate E.ON had approximately 15% GB domestic supply market share as of Q2 2016. As Uniper SE will not hold a GB electricity supply licence, the spin-off will have no direct impact on E.ON's domestic supply market share.

By contrast, because of the significant and sustained reduction in E.ON SE's GB generation market share, the spin-off can be said to directly impact the extent of its vertical

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integration. E.ON no longer has schedulable GB generation capacity capable of meeting a significant proportion of the electricity demand from its domestic supply business.

In our view the impact of the spin-off on E.ON's trading capabilities and therefore the extent to which it would face disproportionate costs and risks in continuing to meet the licence condition, is more subjective. It is true that the energy trading business formerly part of the E.ON SE group now belongs to Uniper SE. However E.ON UK's need to hedge forward wholesale electricity trading positions should, if anything, increase following the spin-off, albeit its predominant interest will be in hedging buy positions, rather than than the buy and sell positions necessary for market making.

In the case of Uniper, because Uniper SE owns no GB Electricity Supply Licensees, it has 0% GB domestic supply market share and is not vertically integrated. However it does have a significant and sustained GB electricity generation market share, a need to hedge forward wholesale electricity trading positions, and a significant energy trading capability. We therefore disagree that Uniper would face disproportionate costs and risks in continuing to meet the licence condition.

Nevertheless, our overall assessment is that it would be appropriate, at this stage, to remove Schedule B from the electricity generation licensees under the ownership of both the E.ON SE group and the Uniper SE group, for the following reasons:

1. Vertical integration – One of the main reasons for introducing the market making obligation was to mitigate the potential effect that the Big Six vertically integrated generation and supply companies could be having on wholesale market liquidity. Following the spin-off, neither Uniper nor E.ON can be described as vertically integrated therefore any disincentive to trade should be significantly reduced. In making this point we note the significance of ownership separation which means that, in the case of E.ON and Uniper, risk sharing between generation and supply businesses will not be possible across the corporate group.

2. Consistency - In the case of E.ON we recognise that we have not obligated any licensees without a significant GB electricity generation market share to undertake market making activities. In the case of Uniper we have not obligated any licensees without a significant GB electricity domestic supply market share to undertake market making activities – indeed, in terms of consistency we consider that following the spin-off Uniper may be considered similar to Drax and Engie, both of whom are obligated under Schedule A of the Special Condition, but not Schedule B.

3. Effectiveness of the intervention – There are currently six corporate groups obligated to carry out market making activities under Schedule B of the Special Condition. This number was mainly a consequence of there being six vertically integrated corporate groups at the time of the policy implementation. While more market makers may be marginally more effective than less, at this stage we have no evidence to suggest that five obligated parties will be significantly less effective than six.

4. Review of the Special Condition - The Special Condition came into force on 21 March 2014. At the time we indicated our intention to leave the condition in place for at least three years before considering changes. To this end we are scheduled to carry out a review of the policy starting in Q2 2017. We consider that the review will allow us time to evaluate whether a sustained successful achievement of the objectives of the Special Condition has been achieved. As part of that review we will also have the opportunity to take a broad look again across the market at which generation licensees should face the market making obligation. With this in mind we consider it is consistent with our current rationale to remove the market making obligation from E.ON's and Uniper's GB generation licensees. We may of course seek to review this position as part of the review.

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Assessment for Schedule C - Reporting Requirements

As we consider it would be appropriate to remove both Schedule A and Schedule B of the Special Condition from E.ON's electricity generation licences at this stage, we see no reason to continue to apply Schedule C, and we therefore propose to direct that the Special Condition is in its entirety switched off for these licensees. As Uniper's GB electricity generation licence will continue to be subject to Schedule A, we consider that it is also appropriate that Schedule C applies, to ensure that Uniper continues to report its activities under the SMA rules.

Our decision and next steps

For the reasons outlined in this letter, we consent to E.ON's request to have Special Condition AA: Liquidity in the Wholesale Electricity Market removed from the GB electricity generation licences owned by the E.ON SE corporate group. Further, weconsent to Uniper UK Ltd's request to have Schedule B of Special Condition AA: Liquidity in the Wholesale Electricity Market switched off in its electricity generation licence.

To implement these changes we have today issued a licence direction to coincide with the publication of this letter. If you have any questions relating to this letter please contact Lewis Hodgart on 01413316005 or at lewis.hodgart@ofgem.gov.uk

Yours sincerely

Cathryn Scott, Partner, Energy Systems, Legal and Wholesale Market Conduct

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