

Comments to the “Draft Preliminary Report on the Energy Sector Enquiry” conducted by COMPETITION DG Electricity Sector

Following further analysis of the data gathered in the Energy Sector Enquiry, on the 16th February 2006, Competition DG published a preliminary report confirming the initial findings presented in the Issues Paper (November 2005).

On the document mentioned, “**Draft Preliminary Report on the Energy Sector Enquiry**”, before 1st May 2006 comments were solicited on the problems identified, in order to publish a final report at the end of 2006.

Next are Endesa’s comments and further considerations to the document, as far as the Spanish electricity sector is concerned:

1 Market Concentration

The Draft Report indicates that “when analysing who determines the market price at certain power exchanges it appears that there is scope to influence prices for operators in Italy, Spain and Denmark.”

In the case of Spain, the document points to the possibility that companies with a limited share in generation might have market power at certain moments, depending on the generation mix operated, which may be more relevant than the generation capacity share, when analysing market power. Specifically, the document says:

“...in Spain, the second largest operator has almost the same size of installed capacity as the largest one (and both of them represent one third of total capacity respectively). However, the second largest one accounts only for a quarter of the effective output of the largest operator (while the two of them represent three quarters of the total production). This is because the main operator predominantly operates base load plants (essentially nuclear and coal), whilst the second largest operator is likely to serve more peak load demand (especially with hydro plants).”

The Draft Report also explains in a theoretical way this fact and ends up saying:

“It is however important to underline that having scope for influencing prices does not automatically mean that market power was abused in an anticompetitive manner, as many market participants claim.”

Endesa would like to put more emphasis on the fact that one of the most used indexes to measure market power by power regulators is the so called “Pivotal Supplier Index” (PSI), which could be defined as the number of hours during which the supplier becomes indispensable to fully meet demand.

Besides, in the Issues Paper published in November 2005 by Competition DG, it is already stated that: *“it needs to be assessed in more detail, which company can be considered to have market power by setting prices at different levels of demand.”*

According to calculations made by Endesa based on real data as of year 2004 provided by the Spanish market operator, OMEL: the second largest Spanish operator, Iberdrola, was indispensable during 4802 hours, whereas the first largest Spanish operator only during 1737 hours.

The fact that Iberdrola's generation mix allows it to set prices is even more evident when it comes to assessing its behaviour on the balancing markets:

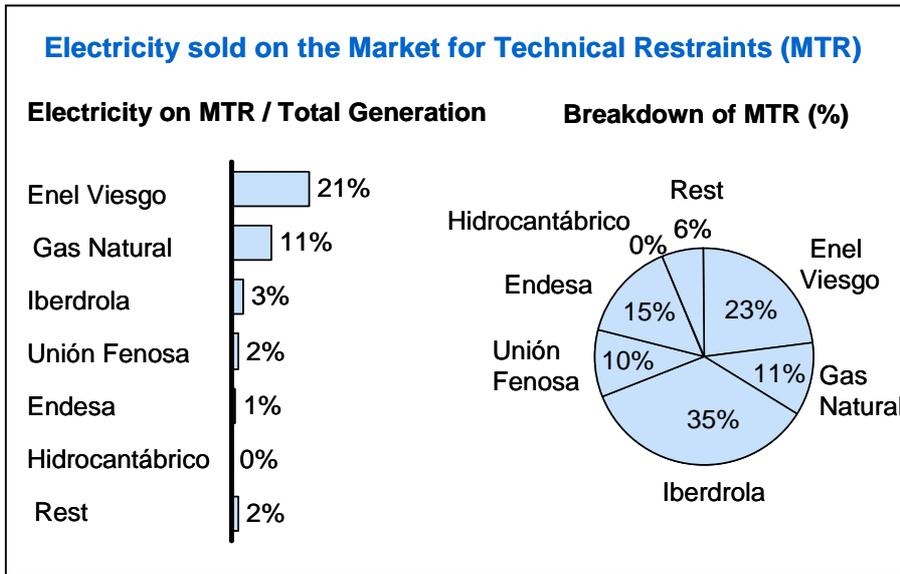
The Draft Report mainly concentrates on wholesale issues and does not systematically deal with balancing regimes, "even if it is generally accepted that these markets are vulnerable to the exercise of market power". The final report will analyse in more detail the balancing markets.

With the aim of helping Competition DG carry out its analysis on the balancing markets, Endesa would like to point out that there are other market-based mechanisms, conceptually related to the balancing markets, that are also affected by competition problems. This is the case of the mechanism for solving transmission constraints.

This mechanism is used to solve transmission constraints that affect the schedule of generation facilities (see Annexes I and II); the process applied to solve technical restraints in any markets by definition is problematic from the competition point of view, in the sense that technical restraints arise locally and it is highly foreseeable which plants will help solving them.

In practice, many operators have plants which will most probably be present on the transmission constraints market, and therefore bid those plants at a price higher than their real marginal costs, being confident that they will be paid as high as bid since otherwise the system will not be operated properly. Despite the apparently small size of this market, its economic volume is quite substantial and, particularly, it affects the bidding behaviour of generators in the day-ahead market: generators who know that they are going to be dispatched in the transmission constraint mechanism will bid high prices in the day ahead market so that they are not dispatched and their capacity remains available for the more lucrative transmission constraints scheme. This obviously affects prices in the day ahead market.

In this respect, it is remarkable the fact that some generators' output on the balancing market represents a great share of their total energy output, as is shown on the following table, with data as of year 2004:



According to the data, some agents, namely Gas Natural, Iberdrola y Enel Viesgo have plants which operate very much in the balancing markets.

Additionally, twin plants such as CCGTs San Roque 1 (Gas Natural) and San Roque 2 (Endesa) are bid very differently on the balancing markets, which denotes an abusive behaviour, given that by twin plants it is meant the following: both plants are placed on the same location, work on the same technology, the same pipe supplies gas to them and thru the same wire is evacuated the electricity they both produce, therefore it is quite unjustified the fact that their participation on the Market for Technical Restraints (MTR) is so different: In year 2004, San Roque 1 placed 462 GWh on the MTR whereas San Roque 2 placed only 181 Gwh

These abusive practices have been denounced in the past on behalf of Endesa Generación, S.A., both before the Spanish Energy Commission (CNE) and the Spanish Competition Watchdog (SDC) and submitted to Competition DG on August 2005 included in Endesa's response to the Sector Enquiry.

Since the abusive behaviour has persisted , the Spanish Cabinet has established specific regulation in order to tackle the problem; the solution has consisted in having a balancing market independent from the wholesale market. Unfortunately, the regulation has not taken effect on the agents behaving anti-competitively and as detailed proof of this are enclosed documents in the Annex III to the present document.

2 Vertical Foreclosure

According to the Draft Report, vertical foreclosure in generation and commercialization activities is more a consequence than a cause. As the very Report admits, in many cases, lack of liquidity on the markets forces agents to operate on both sides by jointly managing generation and suplpy. Therefore, what is really needed from Regulatory

Authorities is to give a boost to the development of all possible trading tools, allowing agents to close all kind of agreement, therefore increasing liquidity in the market.

In that respect, the Spanish market features a high volume of energy traded on the daily wholesale market, given the lack of provisions for the development of other choices to trade, both future organised markets and bilateral contracts, which, although feasible from a legal point of view, were penalised since the energy traded under a physical bilateral contract was not entitled to receiving the capacity payment.

The solution to such lack of liquidity does not lie in applying new penalising measures to the existing agents, thereby unnaturally forcing the entrance of new agents, but in developing liquid wholesale markets,

3 Lack of market integration

With the aim of creating an Internal Energy Market, the European Commission has identified two essential measures: increasing the interconnection capacity and applying market based methods to manage the interconnections.

Concerning the second measure, an evident progress has been made: the recent coming into force of a coordinated procedure based on auctions for the French-Spanish interconnection is a proof of it. Concerning the first measure, there still is a long way to go, for the commercial exporting capacity between Spain and France keeps diminishing, and amounts to approximately only 1% of the peak demand.

In view of this situation, the Spanish Regulatory Authority has merely established measures forbidding power imports thru the interconnection only for the so called dominant agents.

It is obvious to say that, in order to solve the previous problems, it is necessary to effectively and considerably increase the interconnection capacity (by giving a real boost which allows to overcome basically the environmental reticences), as well as to avoid the introduction of measures which discriminate certain agents in their use of the interconnection under a market mechanism.

4 Lack of transparency

In contrast with the Spanish gas sector, where quite a few comments are made on this respect of lack of transparency, the Spanish electricity sector is ranked as the second more transparent after UK, therefore no further comments need to be made.

5 Price formation

The Draft Document warns that the coexistence of tariffs alongside with liberalised prices may allow some Member States to fix tariffs under the market prices, especially in periods with high prices.

This may have very negative effects, and harms not only new suppliers without own generation, as indicates the report. In order to build an efficient electricity market it is essential that all consumers pay the same real market price.

The example of Spain and France is picked out: to this respect Endesa would like to state, as it did earlier before TREN DG, that this fact negatively affects the liberalization process of the power markets and establishes subsidies for the Spanish large power consumers (steel, cement, aluminium), which can advantageously compete with the rest of their European peers.

As a summary of the current problems undergone by the Spanish electricity prices described in this document (see Annex II for a more detailed description), here are the main conclusions:

- The problem of the supposedly slow liberalisation in Spain is not a matter of a lack of competition among the suppliers, which actually exists and is quite aggressive.
- It is neither a matter of dominant positions nor of privileged situations amongst agents belonging to the same corporation group, since the distributor actions are subject to a great number of audits and controls by the Regulatory Authorities and clear advances have been made as far as transparency is concerned, existing no discrimination whatsoever in this sense.
- The actual problem in Spain is that suppliers must compete, sometimes with no possibility of succeeding, with the Integral Tariff, which represents an undervaluation of the real costs for some segments and also once it has been set for a year is absolutely insensitive to any market fluctuations.

In any case, the existence of an Integral tariff that reflects costs which are under the actual costs allows the clients to carry out an arbitration between the regulated tariff and the liberalised market, which makes the electricity companies continue to serve their clients under negative margins, whilst the rest of the clients tend to go to the open market. This also generates a deficit of revenues to the system.

6 Other recent issues in Spain

In the beginning of year 2006, it has entered into force a new regulation intended to have an impact on the electricity wholesale market, namely on the aspects related to the bidding procedure and its remuneration. The Board of Ministers has processed this new regulation with urgency and without consultation from the National Energy Commission, arguing that market prices impact consumers in an immediate negative and irreversible manner.

New *Royal Decree Law 3/2006* is supposed to promote the use of Physical Bilateral Contracts as an alternative to trading in the pool. See Annex IV for a description and assessment of this regulation.