

# IBERDROLA'S COMMENTS ON THE ENERGY SECTOR INQUIRY'S DRAFT PRELIMINARY REPORT

April 28<sup>th</sup>, 2006

## 1. Object

On February 16<sup>th</sup> 2006, the EC's DG COMP published a draft preliminary report on the inquiry on the operation of EU gas and electricity markets.

After this publication, DG COMP has opened up a consultation period to allow all interested parties to send comments on these preliminary conclusions. With the comments received and following further assessment of data, DG COMP expects to publish the final report on this inquiry towards the end of 2006.

This note reflects the opinion of IBERDROLA concerning the five barriers that DG COMP has considered as the main reasons for the non satisfactory operation of EU's electricity and gas markets.

At the end of this note, we include specific proposals of modification on some of the most important issues, so that concrete changes can be easily identified and implemented in the draft report.

Our comments are focused on the Spanish market, in particular in the electricity sector.

## 2. General Comments to the report of DG COMP on the electricity market.

### 2.1. Market concentration.

Regarding the preliminary conclusions of the report, we would like to highlight the following issues:

- **The Spanish market is not a particularly concentrated market**, in comparison with other European electricity markets. Hence, we do not understand the special emphasis given in the report to this aspect of the Spanish market. We have also observed inconsistencies in some of the data reported. For instance, in the graph "2004 Effective Generation" on page 118, the amount of energy is *less* than that considered in the graph of "Omel –Shares of spot sales in 2004" on page 125. For this reason, the "Effective Production" shares for the generators are distorted (they are

higher than the true shares). Obviously, it is not possible for the spot market to have *more* energy than the quantity generated in the country as a whole (this can happen in forward markets, but not in spot markets). We suspect that the figures in the first graphic are distorted because they include only the generation remunerated under the “Ordinary Regime”, while the second graphic correctly includes generation in the “Special Regime”. The graph “2004 Effective Generation” on page 118 should therefore be corrected so that it also includes generation under the Special Regime.

- **There are no entry barriers in the Spanish Market.** For market power problems to exist, there is a *necessary* condition (though not a *sufficient* one) that there are barriers to the entry of new agents. Indeed, in competition policy analyses, it is considered that the threat of entry places the incumbents under competitive pressure, and prevents any abuse of market power. In markets where barriers of entry do not exist, the concerns about use of market power are therefore mere theoretical possibilities, regardless of the level of concentration, and totally irrelevant from a practical perspective. In that sense, it is worth noting that over the past few years, some 14.000 MW of new CCGTs have been connected to the Spanish system, of which *40% belonged to new entrants* in the electricity sector, and there are plans for the construction of an additional 24.000 MW over the next five years, where *more than 50% are promoted by non incumbents*. This proves, beyond any doubt, that there are no barriers of entry in Spain and that, therefore, market power concerns are totally misplaced.
- **Even though Iberdrola has a larger share of peaking plants than other agents in the same market, it cannot charge high prices at peak times.** Unlike the rest of EU countries, in Spain there is a capacity payment to generators that guarantees the existence of a substantial reserve margin.<sup>1</sup> This means that there is always excess capacity in the Spanish system, even at peak, and that there are always other agents competing to sell their energy, even in peak hours. As a consequence, IBERDROLA cannot freely set the prices at peak, as suggested by the text. Indeed, IBERDROLA has never been in a position where it was the only company with idle capacity at peak, and has always had to compete with other agents who are ready to place their energy in peak hours.<sup>2</sup>
- **The operation of the Spanish electricity market is subject to continuous supervision by the Competition authorities and the specific Sector Regulator.** Potential problems only exist in theoretical market models, but not in practice. To conclude that the Spanish electricity

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<sup>1</sup> It is worth mentioning that the Draft Conclusions (footnote 190 in page 112) states that “In Spain only electricity traded via OMEL is entitled to receive capacity payments.” This information is obsolete. Currently all energy is paid the same amount as capacity payment.

<sup>2</sup> Note also that the statement “the second largest one accounts only for a quarter of the effective output of the largest operator” (paragraph 381 on page 119) is incorrect. The second largest one (Iberdrola) is in fact more than half the largest (Endesa). This can easily be seen in Figure 43, page 118.

market has problems of market power on the basis of theoretical models, ignoring that the corresponding competition authorities in Spain have not ever found signs of abuse would only obstruct the liberalizing impulse in a situation where there is a strong pressure for the effective re-regulation of the sector.<sup>3</sup>

Due to the above reasons, we cannot understand why the report dedicates so much attention to explain with a high level of detail the theoretical possibilities that the two biggest Spanish agents have to manipulate prices, while there are very few references to other European markets with higher concentration, almost no entry of new agents, and less transparency than in the Spanish market.

Specially worrying for us are the references to the second operator that, although not specifically mentioned, it is obviously IBERDROLA, as well as to the possibilities it has to manipulate prices, that, as we previously mentioned, we consider groundless.

Even though the report mentions that the possibility of manipulating prices does not necessarily mean that such abuse is actually taking place, the discussion in the report can lead to the wrong conclusion that pricing manipulation in the electricity Spanish market is a common practice.

We consider that the high transparency of the Spanish market has allowed DG COMP to access all the information needed to make such detailed analysis and that these analysis were not done in other markets because they did not have the transparency and the public information needed for the analysis. But the transparency of a market is harmed if, as it is done in the report, it is used to show it as an example of theoretical anticompetitive practices, whereas references to other markets less transparent are avoided since information is not available.

As a conclusion, the Spanish market does not show a special concentration. In our opinion, the report of DG COMP should be focused preferably in those countries that might show unequivocal symptoms of bad functioning.

## 2.2 Vertical Integration

Below, we distinguish between the integration of generation-retail and then the integration of distribution-retail.

In relation to the integration of generation-retail, we understand that the concern of the European Commission is the risk that an integrated operator with generation and retail could prevent access to the system to new independent generators and/on retailers (i.e. close the market to new entrants). The Commission should clarify that those anti-competitive strategies can only be put in practice in those systems mainly based on physical bilateral trading.

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<sup>3</sup> The cases brought to the competition authorities are about anomalous bids motivated for distortions on the regulations reported by Iberdrola that have occurred in just half a dozen hours at year and referred to a sub-segment of the market (the management of technical restrictions) whose impact over the overall consumers is practically null.

It is evident that this market closure strategy cannot take place in the Spanish pool, because the Spanish pool is a marginal-price market in which most of the energy is traded through the spot market and any new generator or retailer can buy or sell energy in the spot market without having to be present in other activities.

In fact, given the existence of a spot market, vertical integration in Spain does not only prevent market closure, but it also discourages the exercise of market power (because the generator is also a buyer, which reduces its profits when the spot price increases) and therefore reinforces the credibility of the resulting spot market prices. Thus, vertical integration is anti-competitive in systems based on physical bilateral trading but pro-competitive in systems where trading occurs through a central marginal-price pool such as the Spanish one.

In relation to the integration of distribution-retail, we agree that a proper level of unbundling between distribution and retail is necessary for the proper operation of the retail market. However, that level of unbundling already exists in Spain. The low rate of change of supplier in Spain is not due to insufficient unbundling, but to the existence of regulated tariffs that in many cases are lower than the market price of energy. In addition, Spain has decided to create a “switching office” to make it possible for competitive retailers to obtain data from eligible consumers without involving distributors, as well as to manage the process for the change of retailer. This should eliminate any potential problems related to the integration of distribution-retail.

In these circumstances, we think that it is better to wait for the progressive elimination of the regulated tariff and the approval and implementation of the “switching office” mechanism, before attempting to impose additional separation measures, because unnecessarily and more strict separation requirements would only introduce inefficiencies that would translate into higher costs of supply for consumers.

## 2.3 Market Integration

We agree with the fundamental analysis of DG COMP about the need to have greater market integration.

The lack of integration is largely due to the limited capacity of existing interconnections. We believe that it should be a priority for the European Commission to adopt all possible initiatives so that the minimum of 10% of interconnection capacity among Member States, as established in the European Summit of Barcelona, is achieved. Once this level is reached, the development of new interconnections should be based on economic criteria. In other words, they must be constructed where the price differences between markets justify the investment. In certain cases some facilities could also be justified for reasons which may not be strictly economic, such as the improvement of security of supply or greater market integration. In any case, the remuneration of investment in interconnections, and in general in transmission, should always be regulated.

We consider essential to ensure the best use of the current existing capacity. For this reason, it is necessary to reinforce the coordination between TSOs in order to increase the use of common tools and information so that the true level of capacity is known. It is also important to develop all the necessary guidelines for the effective application of the Regulation 1228/2003 on Cross Border exchanges.

We disagree with the criticisms to the “explicit auctions” for the allocation of existing capacity. Although we agree that under certain theoretical conditions the best option is “market splitting”, auctioning capacity is an allocation method based on market criteria very simple to implement, and probably the best option to apply in the current phase of market integration, when liquid spot markets do not exist in all systems.

Explicit and implicit auctions (market splitting) are not mutually exclusive and can be applied simultaneously in different and sequential horizons. While implicit auctions can be used simultaneously and with the same horizon (daily) as the spot market horizon, explicit ones can be conducted in advance and with longer horizons (months or years).

“Market splitting” requires the existence of sufficiently liquid markets at both sides of the interconnection, something that happens in the Spanish market, but not in the neighbouring countries. It also requires a high degree of coordination in the design of the markets, something that does not currently exist. On the other hand, explicit auctions are easy to implement and allow generators located in a market to submit offers for physical supply to consumers located in neighbouring systems, even when a liquid spot market does not exist in those systems.

Nevertheless, we think that the lack of interconnection capacity or its incorrect management is not the only cause for the lack of market integration. The existing differences among the different regulatory regimes prevent, in many cases, market integration: the different degrees of market opening (theoretical and real), the difficulties for accessing the networks, the licensing for the construction of infrastructures of generations and transmission. The application of the Directives, not only in their letter but also in their spirit, and the above-mentioned Regulation for the access to the transmission network for cross-border trade, will contribute to the creation of a level playing field in which all agents will be able to operate in equal terms and conditions, and therefore to a greater and more efficient integration of the national markets.

We also consider it necessary to have a common approach for security of supply across Member States. Indeed, according to the Draft Conclusions (p. 102), “EU Energy policy also aims at maintaining a high level of supply security.” If this common framework does not exist, the integration of markets will allow countries that do not have mechanisms to guarantee the supply of electricity to take advantage of the security provided of the countries that, like Spain, do have them. This implies that Spanish consumers would subsidise the security of supply in neighbouring countries (who would “free-ride” on Spanish consumers), which the EC should not allow.

## 2.4 Transparency

We agree that transparency is necessary for the development of the market. We value very positively the initiatives that have been taken recently in the “**Florence Regulatory Forum**” to progress in this area. In our opinion, it is necessary to develop guidelines with the information that should be public at a minimum in each market. In this sense, we consider that the level of transparency existing in Spain is a good reference.

As it has been a subject of discussion in some forums, we would like to clarify that, in our opinion, it is necessary that all agents have information about the availability of all important generation and transmission facilities, so that all agents compete on a level playing field and competition increases.

Another aspect to consider include the tariffs and conditions for the access to transmission and distribution networks. Although there has been some progress in the methodology to calculate them, they are still very dependent on the criteria of the particular Regulator. There should be a greater transparency in the methodologies used to calculate the access tariffs.

## 2.5 Prices

In Spain, one of the greatest problems for the effective liberalization of the electricity market is that eligible customers still maintain the option to be supplied under the regulated full-service (integral) tariffs. Recently, the European Commission has considered that this practice is an obstacle to the entry of new agents in the market.

We share this Commission interpretation and support the prompt elimination of these tariffs, scheduled for the beginning of 2011 in the current proposal of modification of the Spanish Law for the transposition of the Electricity Directive. In addition, in the case of Spain these tariffs are not additive, and in many cases do not reflect the true cost of supply. For this reason, final consumers prefer in many cases the regulated tariff alternative to the option of obtaining their supply on the free market. As a result, the Spanish free retail market is shrinking, as consumers return to the regulated tariff.

In our opinion, and as has been mentioned before, this is the main reason why changes of supplier are barely taking place in Spain.

The problem is much worse in the case of big customers, because as reflected in the DG COMP report, the prices for supply under the regulated tariffs are in some cases even lower than the energy-only prices of the wholesale market. We consider, as the European Commission states in its recent Green Book on Energy Policy, that it is necessary to study "what is the best way to accommodate the legitimate needs of energy intensive industry whilst, at the same time, respecting competition rules.". The High Level Group that the European Commission has recently created on Competitiveness, Energy and the Environment, may help find answers to this problem.



Another point to take into account, and that has not been mentioned in the report, is the impact of the so-called "stranded costs" (known as CTCs in Spain) on the wholesale prices. In the case of Spain (the problem was already described in our answers to the initial questionnaire), the fact that revenues from CTCs decrease when the spot market revenues increase can create perverse incentives in generators' behaviour in the spot market. The Spanish government has showed its intention to give a solution to this CTC problem. Nevertheless, the existence of stranded cost payments in other countries can negatively condition the performance of those markets and discourage new entrants. For this reason, the Commission should make sure that the recovery of stranded costs does not distort the development of competition, especially when revenues from stranded costs schemes can incentivise incumbents to set predatory prices (i.e. prices below costs).

### 3. Comments to the report of DG COMP on the gas market.

IBERDROLA shares DG COMP's opinion on gas markets in the sense that a high concentration of market does exist and that incumbents play still a big role in the value chain of this sector. In this framework, the lack of information and of transparent and balanced rules for all agents certainly hampers the development of a competitive gas market.

This general opinion cannot be applied, however, to the situation in Spain, where a competitive market has developed quickly thanks to good regulation and also to the specific characteristics of the Spanish sector, with a high volume of supply through LNG.

Although in general terms, the assessment of the Spanish gas market is positive, there still exist important improvements that have not been properly identified in the report.

First, the continued existence of regulated full-service supply tariffs that eligible customers can sign for is still a problem, especially when those regulated prices do not reflect the real cost of supply. However, the proposals to change the Law to implement the Gas Directive include the elimination of these tariffs at the beginning of 2008.

Second, it is necessary, to increase the independence of the Transmission Operator, because currently it is still responsible for gas procurement to supply the regulated market.

### 4. Modification proposals

This section includes the changes needed to reflect the above mentioned comments and also to include recent regulatory changes, which in our opinion, should be reflected

Pag. 112, note 190: Remove the sentence “In Spain only electricity traded via OMEL is entitled to receive capacity payments.” This information is obsolete.

Pag. 118, figure 43: Correct the graph to include all generation (not only the generation from “Regimen Ordinario”, but also generation in the “Regimen Especial”)

Pag. 119, point 381: Remove the reference to Spain.

Pag. 125, point 397: Remove the sentence “This situation does not reduce the concerns that there is scope for market power.”

Pag. 125, conclusions: Remove the reference to Spain or at least replace by a sentence stating that Spain is a country that needs to be studied deeper. Replace the text: “at certain power exchanges it appears that there is scope to influence prices for operators in Italy, Spain and Denmark. The situation on the French, Dutch and German exchanges will be further assessed.” by: “at certain power exchanges it appears that there is scope to influence prices for operators in Italy and Denmark. The situation on the French, Dutch, German and Spanish exchanges will be further assessed.” Reflect the same change in page 183 where the sentence is repeated.

Page 135, point 421: Clarify the fact that these problems only appear with physical bilateral contracts, and not when energy is negotiated on the pool. Add the change underlined: “Exclusive long term physical contracts may also result in vertical foreclosure.”

Page 135, point 422: Idem. Add the change underlined: “Vertical integration of generation and retail within the same group together with physical bilateral contracts reduces, all other things being equal, the need to trade on wholesale markets.”

Page 140, point 435. Add the sentence “Vertical integration reduces the incentives to abuse market power.”

Page 147, point 462: Add reference to the creation of a “Switching Office” in Spain.

Page 149, conclusions: Add the change underlined: “Vertical integration of generation and retail reduces the incentives to exercise market power. However, vertical integration of generation and retail together with physical bilateral contracts reduces the incentives to trade on wholesale markets.” Reflect the same change in page 184 where the sentence is repeated.

Page 162, chart 28: There have been changes regarding the allocation of capacity on the France-Spain interconnection. First, dominant operators in the Iberian market can no longer import energy through this interconnection. Second, this allocation is made through auctions on the French side and through OMEL on the Spanish one. Work is in progress to develop a common allocation

Page 165, point 511: Modify as follows: “The result of the above analyses illustrates that explicit auctioning is theoretically an efficient mechanism assuming perfect foresight and that it is in practice compatible with Regulation 1228/2003. The absence of perfect foresight causes efficiency losses in explicit auctioning



compared to implicit auctioning if there are no adjustment mechanisms to use idle interconnection capacity. However, explicit auctions are the only option when there are no liquid markets on both sides of the interconnection. Thus, explicit auctions facilitate cross-border sales by operators and contribute to the integration and development of a single energy market.”

Page 169, point 527: Modify it as follows “Other things being equal, the markets in which most information is published (e.g. NordPool, Spain and the UK) will tend to be more competitive than those where little information is published.”