Comments to the preliminary report issued by the DG COMP regarding the energy sector investigation process

(electricity sector only)

The European Commission's General Directorate for Competition has issued a preliminary report with the first conclusions about the inquiry process open to the gas and electricity markets. This procedure is based on article 17 of the Regulation Standards 1/2003 regarding the application of competition norms, its aim being to know the competition conditions where the gas and electricity energy markets operate, and particularly, to examine any possible barriers that are holding back the development of a completely liberalized and open competition market before next 1st. July 2007.

These preliminary findings were presented at a public hearing last 16th. February in Brussels, a period having been open for comments from the parts implied. Once this process is concluded, the Commission, taking into consideration the final conclusions, shall propose structural, regulatory and competition-related remedies in the final report that it has planned to issue at the end of 2006.

This current document includes the opinions of the UNESA associated companies, regarding the conclusions of the preliminary report from the specific circumstances of the Spanish electrcity market.

The first thing that perhaps should be pointed out is not specially critic with the Spanish market, and in some cases it is even placed among the ones that have taken more advanced measures to avoid some of the barriers to liberalisation, clearly stated in the report.

The report analyses the degree of competition in the different national markets, taking into account the answers received, and it concludes that the five main barriers that are holding back a complete operation of the market are the following:

1. Market concentration

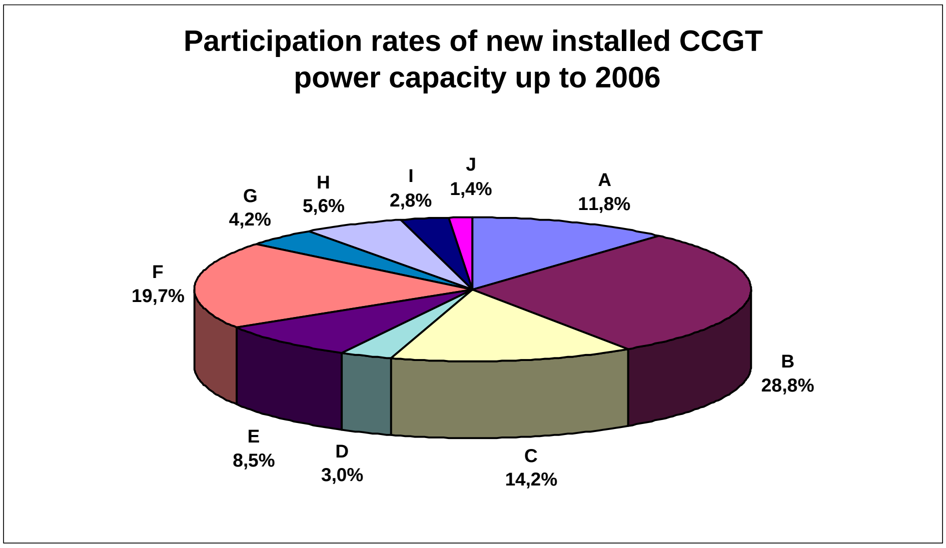
Most wholesale markets remain national in scope with high levels of concentration in generation, which gives scope for exercising market power. However, the report recognizes that it is necessary to go into more depth in order to determine whether the operators have used such a possibility of unduly increasing the prices.

Perhaps this aspect of the report, more critical with the Spanish market, using it as an example of a market where certain agents are in a position to apply market power. However, this circumstance relates to all the markets with a high negotiation in the “spot”, GME, OMEL and Nordpool market. However, the results of tables/charts 20 and 21 regarding the rate of applying power capacity in the market, place our market in a much lower position compared to the other markets aforementioned.

It is clear that the degree of transparency in the Spanish "spot" market, made evident by the report, where over 80% of the energy is negotiated, allows obtaining a knowledge of it which is difficult to obtain from the markets that where the negotiation percentage in the wholesale markets is at levels below 20%, the rest of the energy negotiated being mostly by means of bilateral agreements.

When analysing the concentration of the daily markets, as recognised in the report, the energy volume it represents should be published. It is not the same that the volume of negotiated energy, through organized markets, overcomes 80% of the country's demand -the case of Spain- where the negotiation volume is roughly above 10% of the demand.

On the other hand, if we want to compare, in homogeneous terms, the level of concentration, participation of the agents in marginal technologies should be analysed. It is clear that the entry of new agents into the market is taking place by means of the incorporation of plants belonging to the mentioned marginal technologies.



If we analyse the participation by agents in the new installed power capacity under the 'Régimen Ordinario' up to the end of this current year 2006 (see previous figure) for gas combined cycle plants which amounts up to slightly over 14,000 MW, if we take into account that over 40% of this new capacity corresponds to 6 new agents that have arrived to the market less than four years ago, and that for this current year a 20% participation is foreseen for covering the demand of this marginal technology, we can conclude that few markets in the EU sphere will have gone so far in their liberalisation as the Spanish market. It is clear hat it is necessary to continue making progress, but it is also fair to recognise that few markets can show a progression towards real liberalisation of their wholesale market as the Spanish one.

The new capacity of CCGT plants, planned to install in Spain in the 2004-2008 period represents more than 50% of the total capacity planned for the whole of Europe, which evidences the entry possibilities the Spanish market is offering.

Finally, as an explanation, we would like to point out our surprise regarding the results included in figure 43. Possibly some misunderstanding has taken place as a result of the concepts and data used. From what this graph includes, the main generator agent has had an effective market generation rate of 48.3%. With the data issued by OMEL, the Spanish generator with the highest participation rate in the Spanish offers market (OMEL) in 2005 has a 39% rate. This rate rises up to 40% if we take into account participation only in the so called 'Régimen Ordinario', that is, without including renewables or cogeneration, it decreases to 37% if we take into account its generation compared to the total amount of energy generated in the country, and drops down to

34% if we only consider its participation in peninsular Generation. As can be seen, in no case does it reach the 48.3% figure shown in the DG COMP report.

2. Vertical integration

The high degree of integration between generation and retail as well as the long term PPA between independent producers/generators and incumbents, and to the inadequate unbundling of the grid operators, actually imply an entry barrier by reducing market liquidity.

The first thing to point out is the non-existence -in the Spanish case- of long term contracts between incumbents and producers.

On the other hand, vertical integration, mainly between generation and supply seems to be more a consequence than a cause. As the report itself recognises, in many cases, the lack of market liquidity forces the agents to operate at both sides by jointly managing generation and supply. So, once again what is needed here is a step ahead from regulators and politicians in order to set the basis for the development of all the possible tools for negotiating, allowing the agents to reach agreements of any type thus increasing the liquidity of the markets.

In this sense, the Spanish market up to present date has shown a high negotiation volume in the daily market without manifesting a lack of liquidity that has held back participation of independent commercializers.

However, it is clear that the conditions for developing other possibilities of negotiation have not been developed suitably. Both forward markets as of bilateral contracts, which were possible from a legal point of view but were penalised, as they did not have the right to charge the capacity payment for the energy thus negotiated.

In any case, the possible lack of liquidity of the markets is not corrected by applying new penalizing measures to the existing agents, forcing in an unnatural way the entry of new operators, but by developing the liquid wholesales markets, and above all by eliminating regulatory barriers (maintaining supply tariffs that do not respond to market mechanisms) that difficult competition and possible operation of the agents under the same conditions.

Concerning unbundling between network and competitive businesses, DG Competition mentions the possibility of introducing further regulatory requirements. Yet, the priority on this issue should be the implementation of the rules that already exist in the Directives. Many Member States do not yet comply with those obligations and it is therefore too soon to say that they are insufficient and should be reinforced.

3. Integration of the markets

The low level of cross-border trade is insufficient to exert pressure on (dominant) generators in national markets. Integration is hampered by insufficient interconnector capacity and long-term capacity reservations predating the liberalisation.

The ultimate target top achieve is the creation of a single European electricity market, and in this sense, the latest European summits have evidenced the need of extending the scope of operation of the national markets by at least two basic measures, on the one hand the increase of interconnection capacity, on the other by applying management procedures for such interconnections according to the market rules.

As far as the two measures is concerned, it is clear that progress is being made. The recent implementation of a coordinated procedure based on auctions in the interconnection between France and Spain proves it. It is also true that the increase of the interconnection capacity between these two countries- thus ending the insular status of the Iberian Peninsula- seems to become more and more distant. If we observe the export capacity from Spain to France, it not only does not increase but becomes more and more reduced. It seems clear that if we want to reduce the degree of markets concentration the best path to do so is to increase their sizes, and for this it is necessary to increase the interconnection capacities.

The operator companies are seriously damaged by the lack of development of interconnections as their possibility for accessing the European markets is significantly limited.

This being the case, the measures recently adopted by the Spanish regulators that forbid the possibility of importing the so called dominants operators does not imply any type of progress in correct management of interconnection nor in the necessary integration of the markets, but a restriction which is difficult to justify in a market.

It is clear that the solution to this situation must proceed from the governments of Spain and France and that the European Commission must enhance the development of interconnections and care for the compliance with the commitments reached at the Barcelona summit.

It is really necessary for a political impulse from all the public institutions that considers the effective and considerable increase of interconnection capacity part as a priority, that applies market rules to the management and that eliminates any measure that discriminates certain agents.

4. Lack of transparency

The report concludes that there is a serious lack of transparency in the wholesale markets that is clearly recognised by the sector.

Regarding this issue there is not much to say from the Spanish perspective, because as the report states, Spain comes second place after the United Kingdom regarding informative transparency. Perhaps what should be pointed out is the enormous divergence among the different countries meaning that an effort for homogenising is required.

5. Prices formation

For the DG COMP prices formation is complex, and many consumers have limited trust in the price formation mechanisms. The report concludes that the increase of the gas price has a determining role in the recent evolution of prices but not in the evolution of the coal prices, which have remained stable. Another relevant fact is related to the emissions trade, although its real incidence cannot be determined. In the third place, the coexistence of regulated tariffs and market prices have negative effects on the evolution of the markets.

From 1st. January 2003, all the Spanish electricity consumers have the status of qualified and can thereby freely choose their supplier. Also, regulated tariffs system has been maintained (integral tariff) in such a way that the consumer can choose to go to the liberalized market to purchase electricity or to maintain his supply contract with the zone distributor at a regulated tariff. Obviously the fact that the consumer has opted for one or the other possibility has been related to his regulated tariff being higher or lower than the price that he can obtain in the market plus the corresponding access tariff.

The integral tariff - among many others - has a major problem it dos not respond to the 'additivity' principle, that is, it is not the result of considering the Access Tariff applicable to one type of client and then adding to it a price of energy set according to its real price in the market. The tariffs structure does not reflect the costs of serving each type of customer, which generates different margins by client segment, and crossed subsidies between them, up to such an extent that its makes it difficult to liberalize customers whose Integral Tariff does not leave enough margin or is even negative, as shown next.

This problem has been evidenced not only by the majority of agents operating in the market, but also by the National Energy Commission (Comisión Nacional de la Energía) and by the European Commission, who has recently recognised as one of the problems for liberalisation the persistence of regulated prices specially in the benefit of the so-called qualified clients, who block out the incorporation of new actors".

If we compare the margins by segments, as a result of subtracting, by voltage levels to the Integrated Tariffs, their corresponding Access Tariff plus an energy market price, we come across the following:

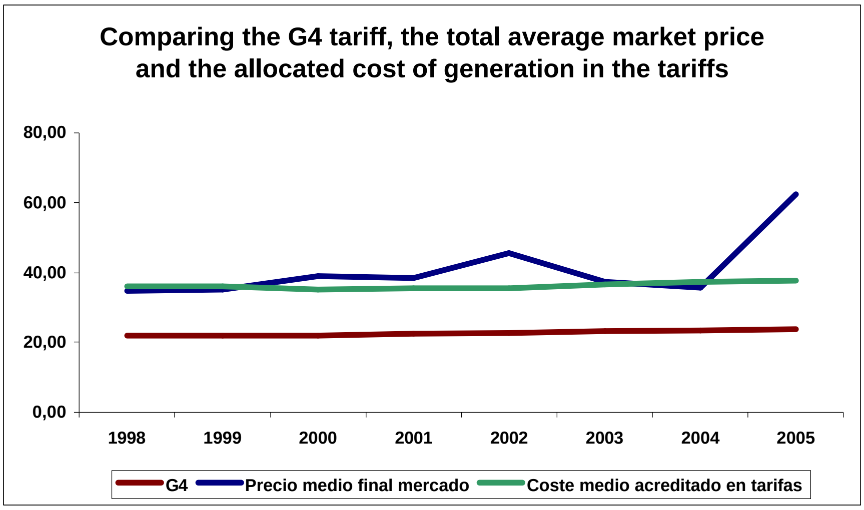
Segment	TI (1)	TA+PM (2)	Margin (1)-(2)	% Consumption to market
Low voltage				
- Residential	100*	104	-4	3%
- Non residential	99	90	9	19%
High Voltage				
- Between 1 and 36 kV	70	58	12	82%
- Between 36 and 72.5	55	44	11	79%
- Between 72.5 and 145	54	51	3	37%
- Higher than 145 kV	50	47	3	71%
- Other	28	38	-10	12%

*Figures on base 100
IT = Integral Tariff; AT = Access Tariff; MP = Market Price

Information contained in the previous table has been made with data of year 2004. If we consider the price of the market in 2005, the situation gets worse.

The problem of the apparently slow liberalisation in not a matter of lack of competition but rather that suppliers have to compete - with reduced chances of success - with the Integral Tariff, which for some segments, as we have already mentioned, is considered as an undervaluing of real costs, and also once it has been set for a year it has absolutely no sensitivity to market fluctuations.

The Report from the Commission now being commented includes in figure 68 a comparison between the market price evolution and the integral tariff paid by large consumers under the G4 tariff. The comparison refers to the period between June 2004 and May 2005. As in such a period the prices have significantly risen in the energy wholesales markets, it could be reasoned by such large consumers that their tariff shows costs whilst the rising evolution of the prices in the wholesales market is not a reflection of it but of its “marginalist” model.



However, if we carry out this comparing from the beginning of he liberalisation process in Spain in the year 1998 and we also compare the G4 tariff not only with the market price but with the average generation cost[1] allocated in the integral tariff for this period, we can check that from the market point of view it is difficult to provide an economic justification for the G4 tariff.

It is clear that the adaptation of the large consumers to the market prices is complicated, and that as the Green Paper on energy policy has made evident it is necessary "to accommodate the legitimate needs of energy intensive industry whilst, at the same time, respecting competition rules", but the solution to this situation have been delayed regularly in the case of Spain meaning that it is necessary to find a solution by means of a transitory and at the same time final process to place this important consumption segment in the market.

Having said this, it is clear that if we want fast evolution for the retail market it is necessary, at least in the case of Spain, to establish sufficient tariffs model that establishes an objective and adding allocation of costs, that is, that it guarantees that each customer pays the real cost involved for the system.

[1] This is the cost of generation acredited to the 'Régimen Ordinario' in the market. The G4 tariff not only includes the cost of generation but also the costs of the grids and the rest of the costs of the

Also, and in compliance with the Community directive on the internal market, it is necessary to progressively eliminate the integral tariff except for all the consumers that might need to have a last resource tariff as a public service obligation.[2]. In the transition period and until final suppression of integral tariffs is implemented, to establish a periodical (less that a year) revision mechanism that incorporates possible deviations of the Integral Tariff in the following periods.

CONCLUSIONS

It is clear that the liberalisation process of the electricity markets is far from the end goal set: the creation of a single internal market. However, it is the time for taking a breath and analysing the path trodden so far, how we have reached the current point, and what are the steps to be taken from now on.

This process began significantly in the year 1996 with the approval of the first Directive on the interior market. This process was strongly enhanced with the approval of the set of norms in the year 2003 and, specifically with the approval of the second Directive that established a final calendar for liberalising supply from next 1st. July 2007. Also the Heads of State and Government summit held in Barcelona a series of targets were agreed in order enhance the process.

Both the principles established in the Directive and political agreements, have not been in many cases consequently adapted to the Member States legislation. This circumstance can in no case be attributed to a lack of will by the companies and thus any possible deficits of the process cannot be corrected with new regulatory measures that generate competition increase artificially. As the Commission has pointed out recently, it is necessary to reach a political commitment to transfer to the national regulation not only the word but the spirit of the energy regulation regarding the internal market.

The Spanish system has made significant progress in the liberalisation process its electricity market and has the support of all the agents. The system has shown to be open enough to have attracted over 50% of the new investment in generation made in the EU thus reducing the degree of participation of the established operators.

The problems the process shows currently are due to a lack of a stable and transparent regulation based on the market rules. It is necessary to adapt the methodology for setting the tariffs in such a way that they reflect the real costs of the corresponding supply for the regulated activities (basically the costs of the grids) and that the price of energy is determined by the agents based on the market mechanisms. If in any case, it is necessary to maintain a last resource tariff, this tariff must be the result of adding the regulated costs of the system and a price of energy that reflects the market price.

The main barrier for effective liberalisation of electricity supply in Spain has been the maintenance of a regulated tariff that does not respond to the real costs. This problem

[2] As set in article 3.3 of Directive 2003/54/EC regarding common rules for the interior electricty market: “all residential clients, and when the member Staes consider it appropriate, the small companies, that is companies with less than 50 employees with a turnover or overall annual balance of less than 10 Million Euro”

has become worse lately as a result of the Increase of prices of energy in the market and from not having affected it on to the end consumers, meaning that rather than a barrier to entry of independent operators it has been an "invitation" for them to exit as they have not been able to compete against the "tariff".

As part of this tariffs problem it is necessary to find a solution to the supply of large customers, as solution that has to do with making compatible the needs of this group of consumers with the market.

Creating an interior market will not be a fact until the capacity for exchange between States does not become substantially sound. However, it is necessary to make progress in establishing procedures for managing interconnections based on market mechanisms and to additionally homogenize the markets in such away that the agents can use the existing capacities to heir utmost. In any case, a real political commitment is necessary to allow increasing interconnection capacity of the Iberian Peninsula with the rest of Europe.

It is clear that the internal electricity market is not yet a reality. Although the current EU legislative framework provides an adequate general framework, it cannot work without full commitment to proper implementation by all Member States of the 2003 Electricity and Gas liberalisation package in all Member States.

There is still a need to further harmonise national regulatory frameworks across the EU, in order to avoid possibly discrimination among agents assuring a real level play field, and to ensure the full implementation, in areas as DSO unbundling and interconnection capacity management, before proceeding to introduce new regulatory modifications.