

COMMENTS BY IBERDROLA ON THE IMPACT OF THE ELECTRICITY DIRECTIVE

July 31, 2005

1. Object

Last 13th of May, the European Commission opened a period of public consultation, to last through July 31, to allow all interested associations and companies to send their assessment of the impact of both the Electricity and Gas Directives, with a view to the report that the Commission must present to the European Parliament and the Council before the end of this year. The publication of these reports, on a yearly basis, is a requirement of both the Electricity and the Gas Directives, (Art. 28.1) and (Art. 31.1), respectively.

The subjects to be covered in these reports are very diverse, including for both sectors the experience in creating the markets and the obstacles that remain, fair and non-discriminatory access to the networks, economic, environmental and social consequences of the opening of the markets, system capacity levels and security of supply, measures to cover peak demand, relations with third countries or the harmonisation of other aspects not considered in the Directives.

The Commission has specifically mentioned in its open invitation three subjects to be assessed by the different stakeholders interested in this consultation:

- Current and likely future development of the gas and electricity markets.
- Aspects to improve both at Community and national level.
- Measures to reinforce the protection of the interest of customers.

IBERDROLA has contributed through UNESA to the position paper that, about the situation of the Internal Electricity Market and for this same consultation, has been produced by EURELECTRIC. At the same time, it has also contributed to the opinion that UNESA produced in its turn for both the electricity and gas sectors.

In the particular case of electricity, there are however several additional comments that IBERDROLA would like to send to the Commission concerning both the Community and the Spanish market.

2. Electricity Market

2.1. General Considerations.

IBERDROLA considers that the single energy market, and in particular, the internal electricity market are essential requirements to achieve the objectives of the Lisbon strategy, as they will result in greater efficiency in the operation and the

development of the European energy sector that will be translated necessarily into lower final energy costs to customers and more competitiveness for European industry.

In the electricity market, and in particular in those activities opened to competition, as generation and supply, all agents must be able to operate under equal terms, conditions and opportunities (level playing field), and as freely as possible, complying obviously with the technical and competition regulations that may apply, and meeting Public Service Obligations (PSOs) imposed regarding universal service, environmental protection, security of supply and so forth.

On the other hand, all regulation related to those activities that remain regulated, such as Transmission and Distribution, must be aimed, in terms of access, pricing and development, at facilitating the proper performance of the generation and supply markets, contributing to the global efficiency of the system and to its security and continuity of supply.

When analysing the situation of markets in Europe and their possible improvements, it must be taken into account that these markets are still in a transitional stage. The basic community legislation for the internal electricity market is the Directive 2003/54/EC on common rules for the internal market in electricity, and the Regulation 1228/2003/CE on access to networks for cross-border trade. Although this legislation was published and the transposition date was due more than a year ago (in the case of the Directive), not all provisions of this legislation may currently be enforceable. As an example, the total opening of the retail market included in the Directive is not required till July 2007, and in the case of the Regulation, the guidelines needed for its development have not yet been published.

This transitional situation regarding community legislation does not prevent, however, drawing some initial conclusions or recommendations about the performance of the individual markets and their eventual integration in a single market.

The concrete aspects that we are going to analyse at community level are:

- Wholesale markets
- Transmission and Cross Border Trade
- Retail markets

For each one of these issues, we analyse briefly the current situation and areas for improvement. We also include two additional comments about measures to reinforce customer protection and about ways to integrate renewable sources into the market. Some global comments about the Spanish market are also included in the final section of the paper.

3. Community framework

3.1. Current and future situation

As it has been mentioned in the previous section, the internal electricity market is still at a transitional stage, both from the point of view of legislative development and, in general, of application in the different Member States. Regarding legislative development, it must be remembered that besides the basic legislation of the Directive and Regulation, there is or there will be, other important legislation that will also affect the internal electricity market. Some legislation, such as the Directive on renewables, the one on Large Combustion Plants, the IPPC or the recent one on Emission Trading with impact on the energy sector are already being applied. There are others, however, not yet being applied, such as, for example, the Directive on Security of Electricity Supply and investment in infrastructures, whose legislative development has recently finished, but it is still pending final publication, or even the Directive on Energy End-use Efficiency and Energy Services, still in the legislative process in the Council and the Parliament.

3.1.1. Wholesale Markets

The degree of development of the wholesale markets in different Member States is very diverse. In general, there exist in most countries, OTC markets where bilateral long-term transactions can be carried out, along with organised and marginalistic markets for the day ahead. In more mature markets, all energy can be traded. In others, however, an important part of the generation does not yet participate in the markets, with its operation and financial conditions still under PPA contracts.

For the time being, either because of a lack of interconnection capacity among countries or insufficient homogeneity in the corresponding arrangements, most markets are purely national. The regional market appears then to be a necessary and intermediate step in order to complete the internal electricity market.

Both levels of generation reserve capacity and construction of new capacity are decreasing in most European regions in a worrying way. Some reserve shortfall situations have occurred, which in some cases were resolved with temporary measures not totally compatible with the operation of energy markets. We must realise that prior to liberalisation, the generation reserve was, in general, generous. The regulatory insecurity that the introduction of liberalisation has brought about and the increase in demand due to reduction (or artificial contention in some case) of final prices to customers have absorbed most of these margins. In addition to these general problems, some Member States have announced the progressive decommissioning of nuclear plants, something that may also aggravate the capacity shortfall situation, increase our energy dependency and make it even more difficult to comply with European commitments to reduction of CO₂ emissions.

There is no common practice across Europe regarding how to guarantee the existence of sufficient generation capacity to meet demand. There is a consensus

that the signals of the energy market (and the corresponding to ancillary services market) are not only the basis for short-term decisions of production and consumption, but also for the new investment or final closure of generation plants at longer term. The introduction of additional revenues to maintain an appropriate capacity margin, limit scarcity periods or avoid price increases during long periods is seen by some stakeholders as an element of distortion in the markets. The Directive on Security of Electricity Supply requires monitoring capacity margins and allows the adoption of measures (including demand management) that would make possible the existence of sufficient generation capacity to meet demand. In this regard, it is positive that several organisations (IEA, UCTE or ETSO) are producing reports warning of the likely evolution of margins in different regions of Europe and the need to commit new capacity.

Another issue of concern at the community level is the degree of market concentration. In some cases, all recent price increases in the wholesale markets are being attributed to this concentration, forgetting all other aspects that may have a larger influence on prices, such as fuel or allowances costs, tax increases, or even the reduction of capacity margins. The integration of national markets in larger regional markets may in reality contribute to the reduction of players' shares of relevant markets, increasing the confidence of both customers and regulators in the markets' results.

3.1.2. Transmission and Cross-Border Trade

In each Member State, one or more TSOs exists, with greater or lesser independence from other activities, and with responsibility for Transmission Management. TSOs are also responsible for the management of Cross-Border Trade and for Transmission development (including both the internal network and interconnectors).

As in the generation business, legislation concerning the activity of Transmission must be aimed at guaranteeing efficiency not only in the short-term or operation stage, but also in the long-term or development stage. Construction of new Transmission infrastructure, in particular interconnectors, is also slowing down, as this sort of infrastructure is increasingly being contested based on pseudo-environmental grounds.

Agreements among TSOs for the compensation for Transits of Cross Border Trade have eliminated some of the artificial barriers that prevented this kind of trade. However, there are many interconnections where no agreement has been reached so far for the implementation of a market-based method for the assignment of available capacity.

Insufficient progress has been made in harmonisation of Transmission charges to generators. However, in most markets, in particular in the south of Europe, generators are not charged for Transmission Infrastructure (except for dedicated transmission lines and regular connection fees), easing efficient competition among generators.

3.1.3. Retail Markets

The situation of retail markets is of enormous importance to achieve a consolidated performance of the national markets. The situation of opening of retail markets is really diverse. There are markets that have been totally opened for several years, while in other cases, market opening will follow strictly the minimum required by the Directive, that is, the opening of the domestic sector in July 2007.

The safeguard of the regulated tariff still remains in some markets. The existence of this regulated tariff hampers, in some cases, development of the supply business, in particular if this tariff is set independently of the results of the market and at levels so low that it is impossible for suppliers' offers to beat it.

With the exception of large customers, who will renew, generally on a yearly basis, their supply contract, rates of change of supplier are relatively low. There are several reasons for this. First of all, some customers, in particular the domestic ones, are new to this market (in some countries they will not be in the market till 2007). Besides, in many cases, customers are reasonably happy with their current supplier and, although they may change their contractual conditions, they see no reason to change supplier. There are even some instances where the regulation to switch supplier is not appropriate or is not sufficiently developed. Finally, and as it has been mentioned previously and as stated in the Commission's last benchmarking report, very low levels of the regulated tariff prevent in many cases the real possibility of changing supplier.

A significant share of energy is being billed to customers with no hourly differentiation. Although, it is possible nowadays to install hourly meters at reasonable prices, many customers do not find it interesting to modulate their consumption based on hourly energy prices.

3.2. Aspects to Improve

3.2.1. Wholesale Markets

The creation of the Internal Market with regard to Wholesale Trade requires the definition and development of the 'common' model of a national market and the integration of these markets in a single market, having gone through a previous stage of regionalisation.

The greater the similarity among markets, the easier it will be to integrate them and the more efficient their joint operation will be. We will first give some ideas about how to improve the performance of individual markets, and later identify those aspects that will contribute to their integration.

IBERDROLA shares totally the opinion already stated in the corresponding document of EURELECTRIC that we have to let markets work freely so that the proper price signals are generated to produce efficient decisions of production and consumption in the short term, and of investment in the longer term.

We must then avoid either the introduction of Caps that artificially limit prices, or schemes of recovery of stranded costs that may influence the bidding strategy of generators. The improper use of these methods may produce equilibrium prices different from the true costs of generators, including environmental costs, (such as CO2 allowances).

PPA contracts should also and progressively be eliminated, since they take part of the generation out of the market, reducing its efficiency and distorting prices that result from partial markets.

A non-homogeneous application of environmental requirements applicable to various electricity production technologies derived from the Directives that limit polluting emissions, LCP, IPPC, etc..., may produce distortions in the electricity markets at both the national and community levels. A deeper harmonisation at both levels (national and among Member States) of environmental requirements applicable to electricity generation should be pursued, in particular in the case of Large Combustion Plants, and discrimination based on the type of technology or a plant's age should be avoided.

At the same time, a larger consensus shall be reached on how to guarantee the appropriate generation margins in different markets. In particular, methods incompatible with energy markets (such as tendering) shall be abandoned, considering instead 'capacity tickets' or preferably capacity payments.

Intraday and balancing markets shall be created as they facilitate the entrance of new generation.

In addition, it will be necessary to advance in the creation of regional markets, making the operating rules of national markets more homogenous and reinforcing common interconnections. Integration in regional markets will allow a more efficient sharing of available generation resources, narrowing gaps in energy prices between countries and reducing overall capacity margins. Regionalization will additionally reduce the degree of market concentration.

3.2.2. Transmission and Cross Border Trade

In order to facilitate generators' investment decisions, TSOs will publish with sufficient lead time their development plans both for their internal Transmission network and for interconnections with other countries.

The application of market-based methods, starting with explicit auctions, will be speeded in every interconnector with structural congestion. Exchange of information among TSOs will also be improved, so that assessment and allocation of available transmission capacities among different systems can be performed in an efficient way that is compatible with security criteria.

The development of studies at regional level for the identification and eventual financing of the necessary transmission reinforcements either at a national level or between countries will be encouraged.

The development of trans-European networks should not only be based on efficiency criteria, but also on cohesion criteria. According to the first ones, only

those interconnections that are justified on economic grounds, i.e. those whose benefits (including fuel costs and improvement in security of supply) are greater than the interconnection costs, should be developed. However, if peripheral countries are to benefit from the internal market, it will be necessary to integrate them through appropriate interconnection levels. The agreement adopted at the European Council of Barcelona, establishing that the level of interconnection capacity for the Member States must be equivalent to at least 10% of their installed capacity perfectly meets this cohesion criterion. This will be then the criterion to meet in the case of cohesion. Development of interconnections above this target could indeed be based on purely economic reasons.

As has been emphasized by the electricity industry, increased harmonization of transmission charges for generators is needed. Exempting generators from transmission charges for infrastructure is a practical way to achieve this objective. So far, recommendations for Harmonisation in the Guidelines developing Regulation 1228/2003/EC are a step, albeit a very timid one, in this direction.

3.2.3. Retail markets

As mentioned before, a proper performance of the retail market is absolutely essential for the overall performance of the market.

In our opinion, the two main issues that need to be improved in the case of retail markets are transparency and efficiency. In the first case, important progress has indeed been made regarding pricing information and, as it is also required by the electricity Directive, information is also being provided on the origin of the supplied energy (Fuel Mix disclosure). In view of the completion of the liberalization process for all customers, informative actions should be promoted concerning both contracting possibilities (especially if hourly tariffs are applied) and a more efficient end-use of electricity. At the same time, some sectors have misguided expectations about what can be expected from the liberalization of energy markets. Customers should be better informed that although liberalization means an improvement in efficiency and certainly reduces prices (compared with those that would prevail in a regulated framework), it does not guarantee that prices will keep falling. As in any other industry, electricity prices will fundamentally depend upon the availability and prices of raw materials (fuels) used in the production of electricity. In this sense, every available technological option for the production of electricity should be properly considered. Any limitation on the use of any of them will necessarily mean higher costs, and, as a consequence, higher prices for customers.

Regarding efficiency, it is essential that the price signals given by wholesale markets are finally passed on to customers. Neither market (wholesale and retail) can function in isolation. One of the major mistakes made in the California electricity market was to artificially limit retail prices. This caused excessive increases on consumption, deficits for the operators and a slowing of investment in new capacity.

In addition, it will be confirmed that the regulation for switching of supplier is appropriate and does not prevent the process of changing supplier.

As proposed in the recent Green Book on Energy Efficiency, it should be encouraged that hourly price signals reach final consumers. This would reduce consumption, would make it more efficient, and would possibly reduce the requirements of installed capacity.

3.3. Reinforcement Customer Protection

Creating the internal electricity market has the double goal of improving efficiency in system performance, while maintaining the necessary consumer protection.

Customer protection, especially in the case of the residential customer, was one of the Commission's main concerns in both the first and second Directives, which even includes a specific Annex about this subject. This Annex is very much focused on the contract relationships with the Supplier, and does not mention other more general issues that also contribute to customer protection. It is too early to give an opinion about the suitability of the measures in the Annex. In any case, we feel that, in general, they are positive.

Consumer protection must not only be limited to the relationship with the supplier. Guarantee and quality of supply depend upon activities that take place before supply, such as production, transmission and distribution.

Insofar as regulation of those activities contributes, on a stable basis, to keep appropriate levels of guarantee and quality of supply, the customer protection will be reinforced. Therefore, and as mentioned above, wholesale markets should be allowed to operate freely, so that appropriate price signals can be generated, which will possibly have to be complemented with revenues for capacity in order to reach and maintain a suitable guarantee of supply. Revenues for regulated activities (Transmission and Distribution) from network tariffs should also be sufficient to allow companies involved in these activities to offset their operation costs (investment and operating costs) with the required level of quality, and develop the network according to the needs of the system.

Finally, and with the exception of the first stages of the liberalisation process, interference in the retail market should be avoided. Artificial price caps encourage inefficient energy use, create obstacles for the development of the supply business, and reduce the number of suppliers and supply choices for final customers.

3.4. Integrating renewables in the markets

As mentioned before, efficiency is not the only goal to be achieved by the introduction of the market in the European electricity sector. In order to reduce the impact on the environment of electricity production and boost our degree of self-supply, the EU has some targets for production of electricity from renewable energy sources.

Bearing in mind that, in general, production technologies that use these sources are more expensive, the Directive for renewables considered the possibility of introducing some support mechanisms to comply with national targets.

In order to make compatible market efficiency and compliance with targets for production from renewables, the following order of priorities should be taken into account:

- Schemes for support of Renewables should guarantee in the first place compliance with established national targets.
- Compliance should be achieved at a reasonable cost. In this sense, we would like to point out that ‘feed-in tariff’ methods are the most effective as well as, for the time being, the methods that imply a lower cost for the overall system.
- There should be coordination between different national schemes so that distortions can be avoided and overall compliance costs of the system can be reduced.

4. Spanish framework

As mentioned at the beginning of this document, IBERDROLA has been actively involved in the comments that the Spanish Electric Industry Association (UNESA) has submitted to the Commission concerning this survey and obviously shares the views expressed there.

As mentioned in the UNESA document, regarding the performance of the Spanish wholesale market, there is no excessive concentration in the national market, if we compare it with the situation in all other national markets in Europe. What’s more, the likely evolution of this concentration will even reduce this level.

At the same time, building of new generation capacity may be considered in the case of Spain an example to follow. Though current capacity payment could be improved in amount and distribution (to include bilateral contracts), there is no doubt that its existence is contributing, unlike what is happening in other countries in Europe, to avoiding the premature closure of generation facilities as well as encouraging the construction of new ones, maintaining an appropriate capacity margin.

There are, however, some room for improvement. In particular, it is widely acknowledged that the current mechanism to recover stranded costs produces distortions in the price formation in the wholesale market. This mechanism will be probably be changed soon in order to eliminate perverse incentives, ensuring that price formation in the market reflects more closely true generating costs. In our opinion, it is not only the current stranded costs recovery mechanism that needs to be reviewed, but the complete system, as we feel that the conditions that were once established to finalise in advance this regime, are currently being met.

Finally, and relating to the supply activity, we agree, as indicated in UNESA’s document, that the main problem for the development of the supply market in Spain are regulated tariffs, which do not respect, for many customer segments, the principle of additivity. Keeping these artificially low tariffs is also contributing to Spain sharp increases in electricity demand, boosting the country’s energy intensity, the reverse of what is happening in the rest of Europe, as it is reflected in IEA studies.