THE IBERIAN MARKET – EASIER SAID THAN DONE
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In broad terms the integration plan signed by Spain and Portugal in November 2001 looks encouraging. Under this plan:

- An Iberian market operator owned by stakeholders from both countries would be established by 1 January 2003. The market operator would administer access to the Spain-Portugal interconnectors.

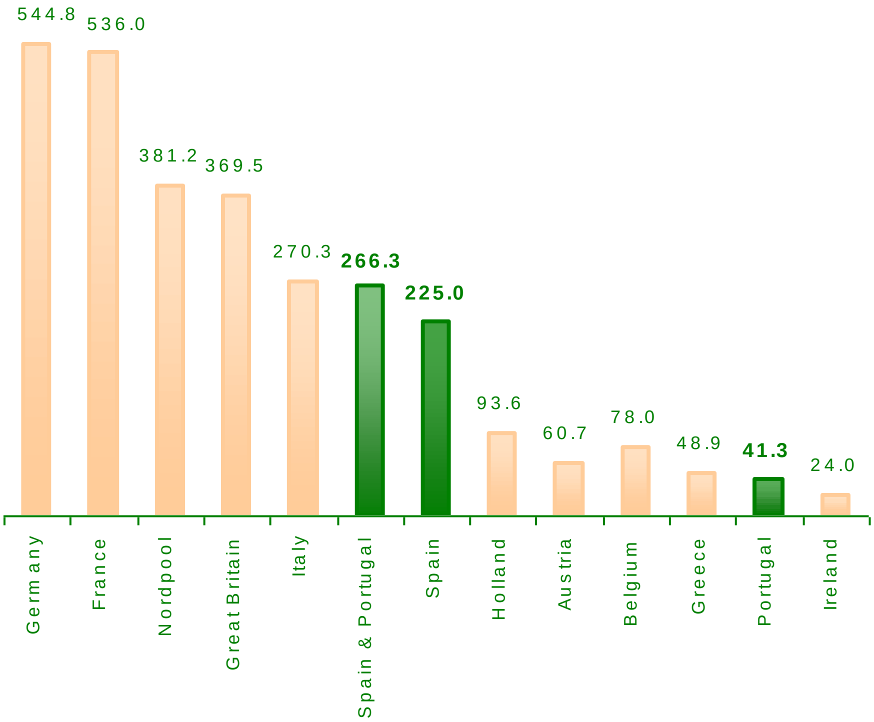
- The governing market principles are competition, transparency and efficiency.

- Transmission planning will be co-ordinated and interconnector capacity will be increased. Two new lines will be built, with one completed in 2004 and the second in 2006.

- Convergence of Iberian gas markets will also be reviewed.

Under this plan, Iberia will, in theory, be a very attractive market. Spain is western Europe's fifth largest power market, behind Italy, and Portugal is fourteenth. Together, they would form a market almost as big as Italy's **(See Figure 1)**. And if high Iberian consumption growth continues, the region will need lots of new investment to keep up with rising demand.

Figure 1 – Iberian Market – Relative Size



2002 Production (TWh)

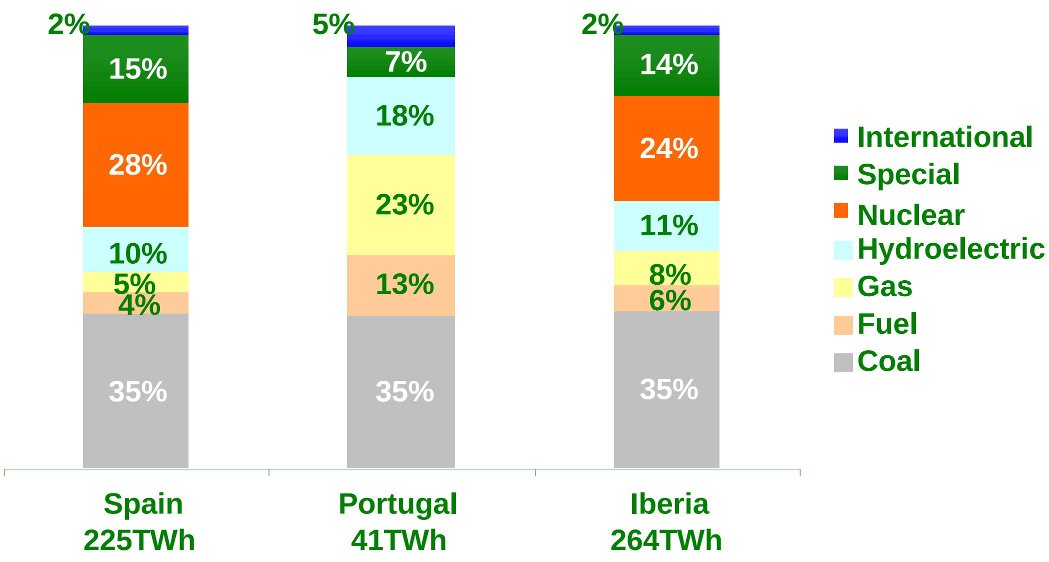
Source: Iberdrola

Unfortunately, MIBEL is still moving slowly. On 20 January 2004 a new agreement was signed in Lisbon between the Spanish and Portuguese governments to start MIBEL operations by 20 April 2004. The two market operators, OMEL (Spain) and OMIP (Portugal), have already exchanged 10% of their shares, but the Portuguese stranded costs recovery framework has not been approved yet and the development and harmonisation of the necessary regulation in both countries is still pending.

Complementary Generation

In generation, the Spanish and Portuguese markets are reasonably complementary **(See Figure 2)**. Integration will enhance competitiveness in both countries. The Spanish market is at present more diversified, since it includes nuclear energy.

Figure 2 – Generation Mix for 2002



Source: Iberdrola

The Spanish government anticipates growth in annual demand of 3.3% until 2011, which would be met from CCGT and renewables. For Portugal a 3.7% annual growth is expected, also to be met from new CCGT and, to a lesser extent, renewables.

Competitive Imbalance

However, the degree of competition varies significantly:

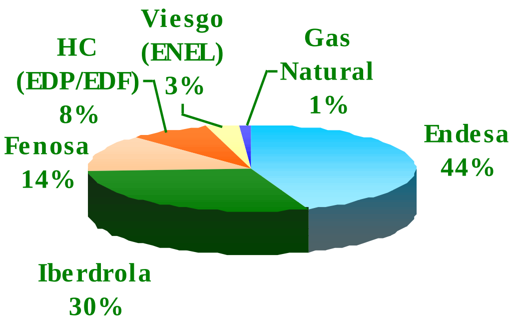
- The Spanish generation market is effectively liberalised, with at least six significant producers, four of which are large national companies and two are companies controlled by large European utilities **(See Figure 3)**. Another four or five companies are joining the market with well advanced CCGT projects.

  Interconnections with Morocco, France and Portugal allow producers to operate on equal terms in the market via pool purchases and/or sales.

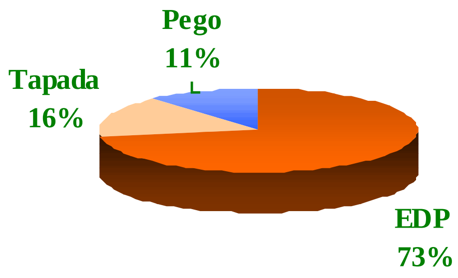
- On the other hand, the Portuguese market is dominated by EDP, which has a 73% share.

Figure 3 – Power Generation – Market Shares (2002)

Spain



Portugal



Source: Iberdrola

Next new entrants in the Spanish market:

- **Electrabel**
- **Repsol**
- **ESB**
- **RWE**
- **AES**

Obstacles to Harmonisation

Nevertheless, even if there was a total and immediate liberalisation of the Portuguese market, there would still be other issues left to solve to make the single market an effective reality:

- The limited capacity of the present interconnections between Spain and Portugal results in saturation for most of the year. It will be impossible to secure price harmonisation until the totality of the envisaged interconnections is built.

- Although the recent construction of the second Cartelle – Lindoso interconnector is a step in the right direction and will allow an increase of energy exchanges between both countries, this increase in capacity will not be enough to solve the problem.

Electricity and Gas Distribution

The distribution of electricity is a regulated activity in both countries. This is also the case with gas distribution.

In Spain the presence of five distributors gives the Regulator a frame of reference to indirectly encourage efficiency by comparison. In contrast, there is only one company in Portugal (EDP) **(See Figure 4)**.

Gas distribution is similar in both countries. In Spain there is one company (Gas Natural) with a market share of 80%, and the second company is controlled by Hidrocantábrico-EDP.

In Portugal, once the intended reorganisation is concluded, EDP could control more than 90% of gas distribution in addition to its control of 100% of electricity distribution.

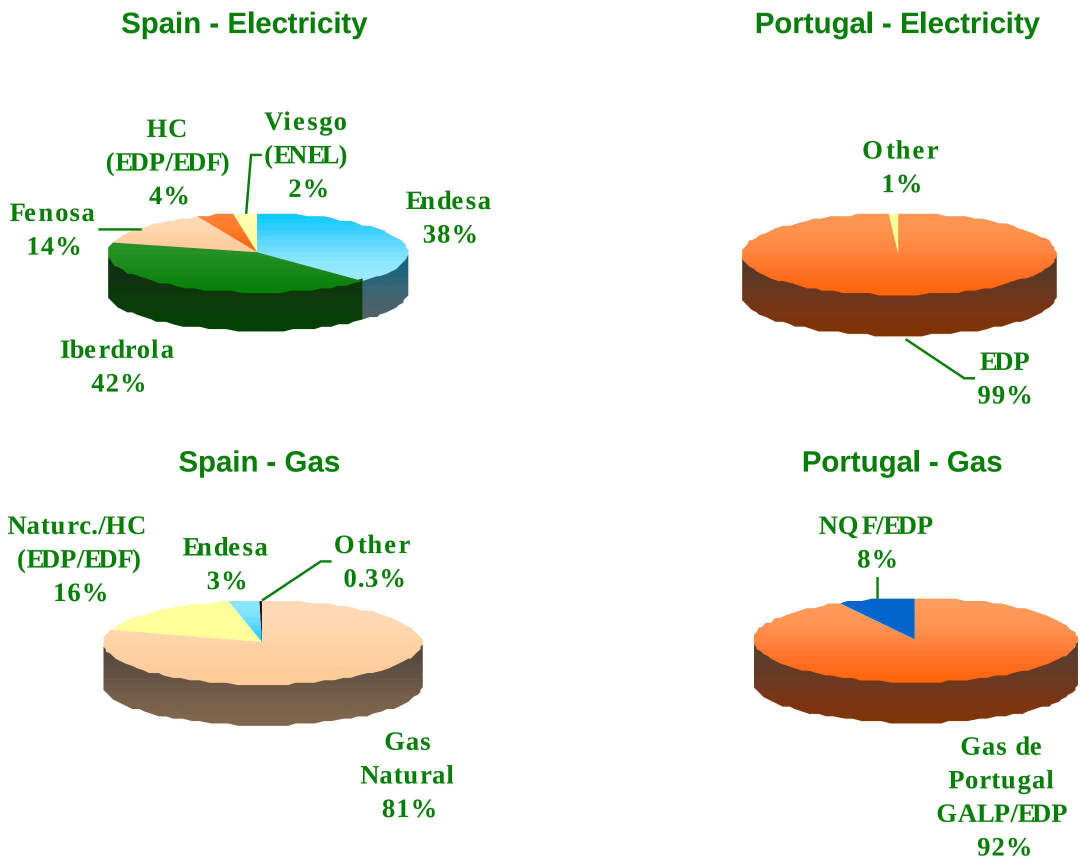
Theoretically, because distribution is regulated, it could be argued that such domination of distribution is not a problem. However:

- A number of national institutions in charge of competition control, including Spain's, argue that one must not underestimate internal barriers created to new entrants by the presence of companies undertaking electricity and gas distribution, and have ruled against simultaneous control of both activities in a determined area or set limits to the total distribution quota.

- Having 100% of the distribution in a country, plus ownership of other unregulated activities, contributes to inefficiencies and encourages the introduction of cross-subsidies.

The agreement signed on 13 February 2004 between the Portuguese government and Iberdrola, which allows the latter to gain control of two small gas distribution companies is an important step in the right direction.

Figure 4 – Electricity and Gas Distribution – Market Shares (2002)



Source: Iberdrola

Electricity and Gas Supply

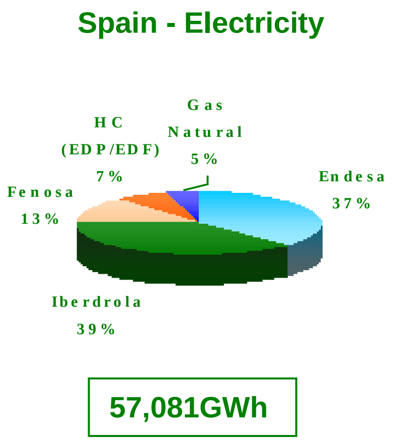
Electricity and gas supply are at different stages in the liberalisation process **(See Figure 5)**.

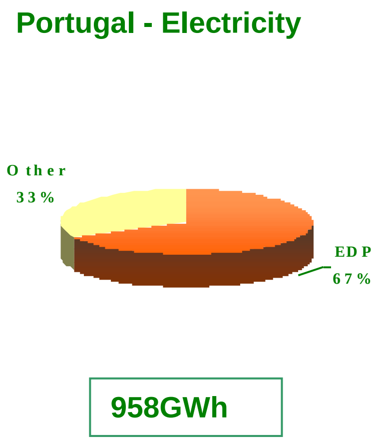
In Spain, since 1 January 2003, all customers are able to freely choose their provider, in gas as well as electricity. As a result, 23 million electricity customers and 5 million gas customers have full freedom of choice. Approximately 31% of electricity is supplied through the liberalised market. Advances in the gas market are significantly greater: 67% of the total supply is effectively liberalised and this is expected to reach 75% by the end of 2003.

In Portugal, since January 2002, all mid-voltage (1kV) customers are eligible to switch suppliers, which represents some 20,500 clients equating to approximately 54% of total consumption. As of 31 December 2002, this status of qualified consumer had been granted to 1,331 clients, with a yearly consumption of 5,700GWh which represents 29% of the potential market. Of these, only 493 (958GWh approximately) have abandoned the regulated tariff. Starting 1 July 2004 all customers will be eligible to switch suppliers.

Regarding gas supply, there is no liberalisation as such. Service to residential and commercial customers is done through several distribution companies, mostly owned by Gas de Portugal. Gas supply to major users is provided by Transgas with the possibility to negotiate the tariff if yearly consumption exceeds 68GWh.

Figure 5 – Gas and Electricity Supply – Market Shares (2002)





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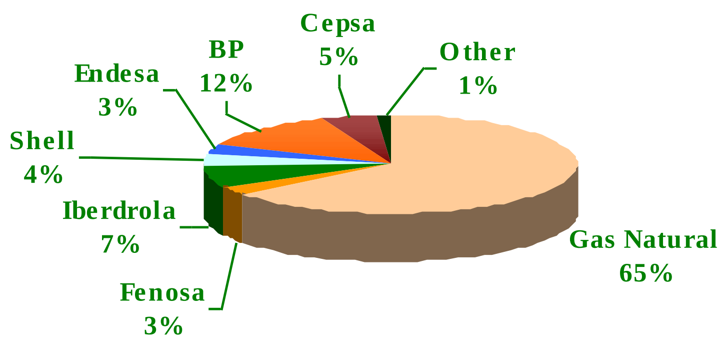
Spain - Gas

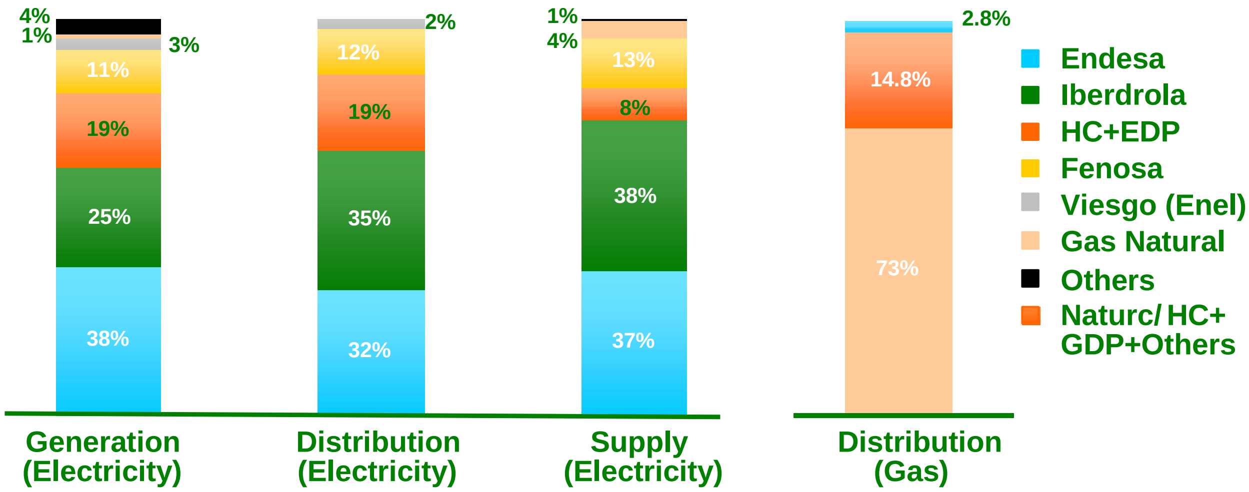


Source: Iberdrola

Some Conclusions and Proposals

The full integration of both markets would result in an Iberian Market of approximately 270TWh **(See Figure 6)**.

Figure 6 – Electricity and Gas – Integrated Market Shares (2002)



Source: Iberdrola

There are a number of issues that need to be addressed if the Iberian market is to achieve full integration. Most of these revolve around the need to further open up markets:

- Speeding up the building of new interconnectors and avoiding possible delays. As long as this is not done, room for manoeuvre for competitive companies will remain limited.

- It would be a positive move if the Portuguese government undertook the necessary actions to speed up the approval of new CCGT projects, now being proposed by new entrants.

- The Portuguese and Spanish governments should adjust their respective stranded costs recovery frameworks in order to eliminate the possibility of disturbances in market price formation.

- The present reorganisation of the Portuguese market should be completed by opening the electricity distribution activity to one or several new entrants, in order to introduce some competition by comparison.

- Territories where a participant could simultaneously distribute electricity and gas should be reduced to the minimum in both countries.

- The Spanish government has recently allowed EDP to exercise its rights in Hidrocantábrico. To reciprocate, the Portuguese government could clear the way for Spanish and other foreign companies to be able to gain control of some additional generation and distribution of electricity and gas.

April 2004