THE IBERIAN MARKET – INTEGRATION AND INVESTMENT PROSPECTS
Mr Juan Carlos Garcia Centeno, Country Head – Spain and Portugal, Royal Bank of Scotland

Introduction

The Iberian power market will be subject to a number of significant changes over the next two years. These will aim to improve the long-term investment climate, increase competition and help meet Kyoto targets. This is welcomed, but may add to short-term risk and uncertainty potentially constraining investment. The changes include the start of the Single Iberian Power Market (MIBEL), the launch of emission trading, and the recent approval of the new regulation for renewable energy.

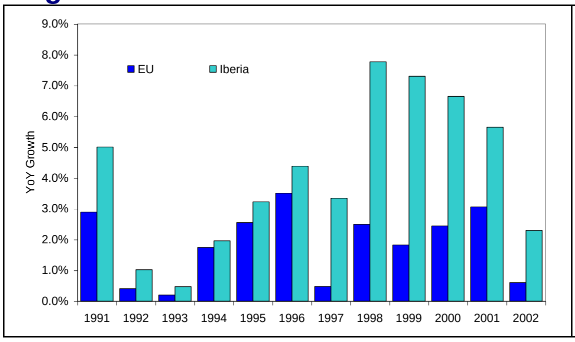
These changes will introduce a set of risks and uncertainties and it is not yet clear who will be the overall winners and losers. However, they will only have a limited effect on addressing the fundamental short-term issue in Iberian power – low levels of capacity margin and limited interconnection with the core European market.

Energy sources and market structure

Access to secure and competitive energy supplies is a key requirement for economic growth. Spain and Portugal have limited natural energy resources and for these reasons it is essential that both have a competitive and well supplied power market to realise their full economic potential.

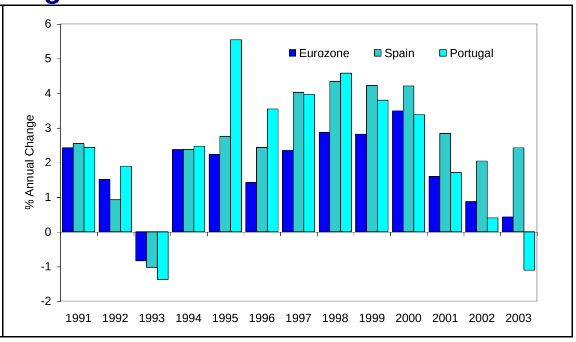
Spain and Portugal accounted for 10.8% of EU generation capacity in 2002. This share has grown from 8.5% in 1991 (Figure 1), an increase driven by economic growth rates that were higher than the rest of Europe during this period (Figure 2). Iberian capacity margins remain tight, despite this. The core European electricity market has little influence over Spain and Portugal, as interconnection with France and Italy is limited.

Figure 1 Growth in Power Generation



Source: OEF

Figure 2 Relative GDP Growth



Source: BP

Hydro and renewables are important to both the Spanish and Portuguese markets, accounting for 30% and 18% of total capacity, respectively. However, hydro is unreliable, which means that both countries require a high level of coal-fired capacity as back up, making Kyoto compliance difficult. Current development plans imply that capacity margins will remain tight over the next three-five years. CCGT is key to the future of Iberian base-load generation. Hydro and wind power are only part of the solution to Spain and Portugal's energy needs, given their unreliability. CCGT meanwhile, is low cost, relatively quick to develop, low emission and Spain and Portugal can access piped gas from North Africa and Norway.

Spain generates 84% of Iberian power and is the fifth largest power generator in Europe. Its generation capacity is expected to grow by up to 30% by 2010. Interconnection with Portugal is limited. Maximum interconnection on winter peak demand is currently around 2%. This is projected to double by 1st January 2006, under the creation of the Single Iberian Power Market (MIBEL). MIBEL was instigated following the August 2001 Agreement, which envisaged the completion of the single market by 2003. This has now been delayed until 2006. The extent to which 4-5% interconnection will stimulate competition is not yet clear. However, it is lower than the EU's objective of 10% interconnection for Europe's six satellite markets, seen as necessary to achieve the full benefits of market liberalisation.

The issues of the limited separation of transport and distribution activities in Portugal and differing pricing regimes between the two countries will not be fully resolved through the creation of the single market. This may act to destabilise the short-term investment climate, when combined with the launch of emission trading. MIBEL will start on a preliminary basis on 20th April 2004, with full implementation envisaged by 1st January 2006. In practice, increasing consumer choice will have greatest impact on Portugal and incumbent operator Electricidade De Portugal (EDP). Spanish generators are already operating in a large fully open market. EDP's long-term power purchase agreements will be renegotiated to cover 'stranded costs', and the regulatory framework for the two countries will be harmonised. A new tariff scheme will be introduced this summer for 2005-2008. However, reserve margins will remain low – limiting the impact of competition on Spanish and Portuguese operators. The new pricing regime will also have to send sufficient positive signals to encourage new investment.

Market competition

Large incumbent integrated power companies generally have significant advantages over new market entrants, particularly in retail markets where levels of switching are low. There are, however, a number of uncertainties in Spain and Portugal that will impact on the competitiveness of individual operators. These are:

- **Emissions trading** – Spain and Portugal have ambitious carbon dioxide reduction targets under Kyoto. The Spanish National Allocation Plan has been delayed beyond its planned date of 30th March. Our expectation is that coal generators (Endesa and Union Fenosa) will be most affected. However, the absolute impact will not be clear until plans are formalised.

- **Renewables –** The new PSOE Administration has introduced ambitious renewable targets. This should favour Enagas and REE. However, power supply constraints combined with the PSOE's lack of an absolute majority in the Spanish Parliament will limit the short-term impact of these targets.

- **Natural gas –** Access to competitive natural gas supplies is central to overall competitiveness. This favours businesses that own infrastructure and have strong contract positions.

- **Regulation** – The integration of the Portuguese and Spanish electricity markets will see the development of a new regulatory framework. Effective regulation is critical to the performance of electricity markets. The key themes of the new regulatory framework will most likely be increasing transparency to increase competition, supporting renewables and supporting security of supply. This will require a stable and attractive financing environment.

The development of the single market for electricity in Spain and Portugal will be an incremental process. The changes introduced through MIBEL will not be sufficient in themselves to address the fundamental issue, which is access to secure long-term energy supplies. However, the creation of a single pooled pricing regime with a single regulator will act to provide long-term investment stability. However, this needs to be balanced against regulatory threats and the uncertainty surrounding the introduction of emissions trading.

We do not expect to see significant falls in Spanish wholesale or retail prices resulting from these changes. Spain dominates supply and both markets have supply constraints at present. However, the introduction of pooled pricing and additional competition will put downward pressure on retail prices in Portugal, although this impact will be limited by interconnection constraints.

The long-term performance of the Iberian electricity market will be determined by a number of factors that will include the creation of the single market. These are the new regulation for renewable energy, the impact of emissions trading, future regulatory changes and the ongoing ability of Spain and Portugal to access natural gas and crude oil supplies on a secure and competitive basis.

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