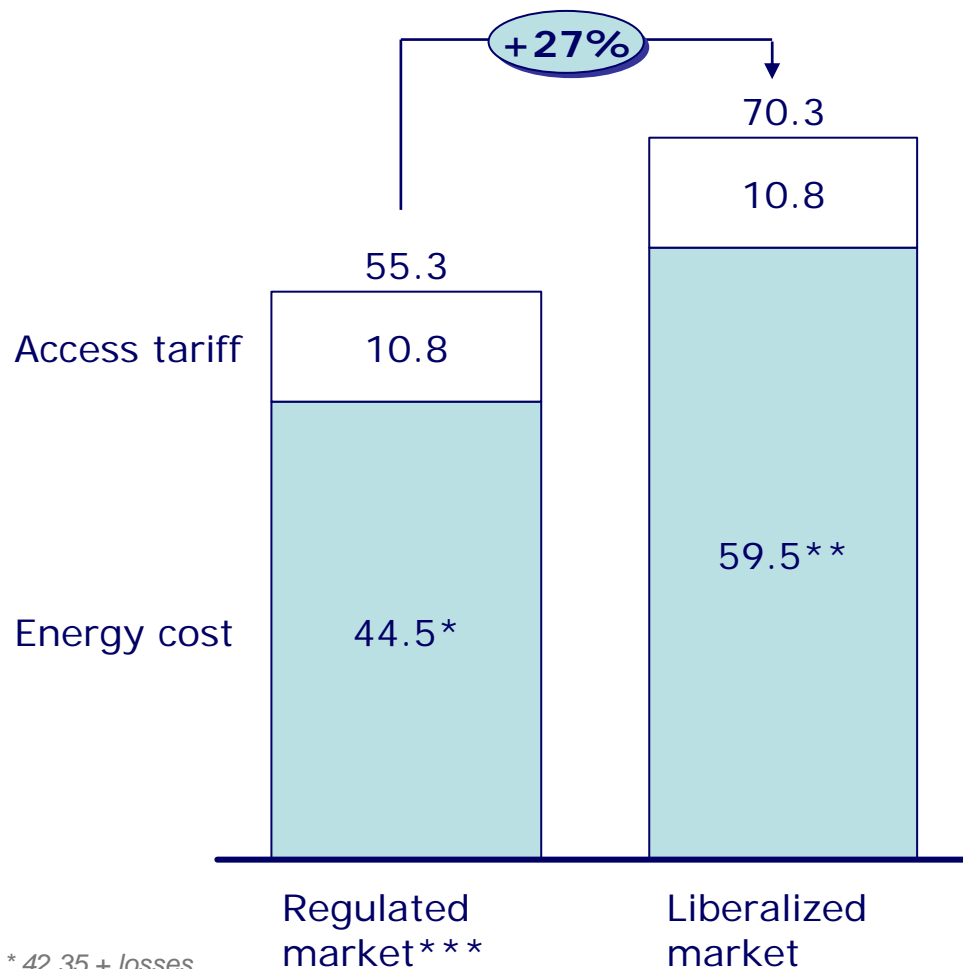


Tariffs did not correspond to energy costs

Customer segment example: 4,000 kW; 24,000 MWh
Euros/MWh. 2006



- Tariffs have been well below the cost to serve the energy
- This situation did not allow suppliers to participate in the market

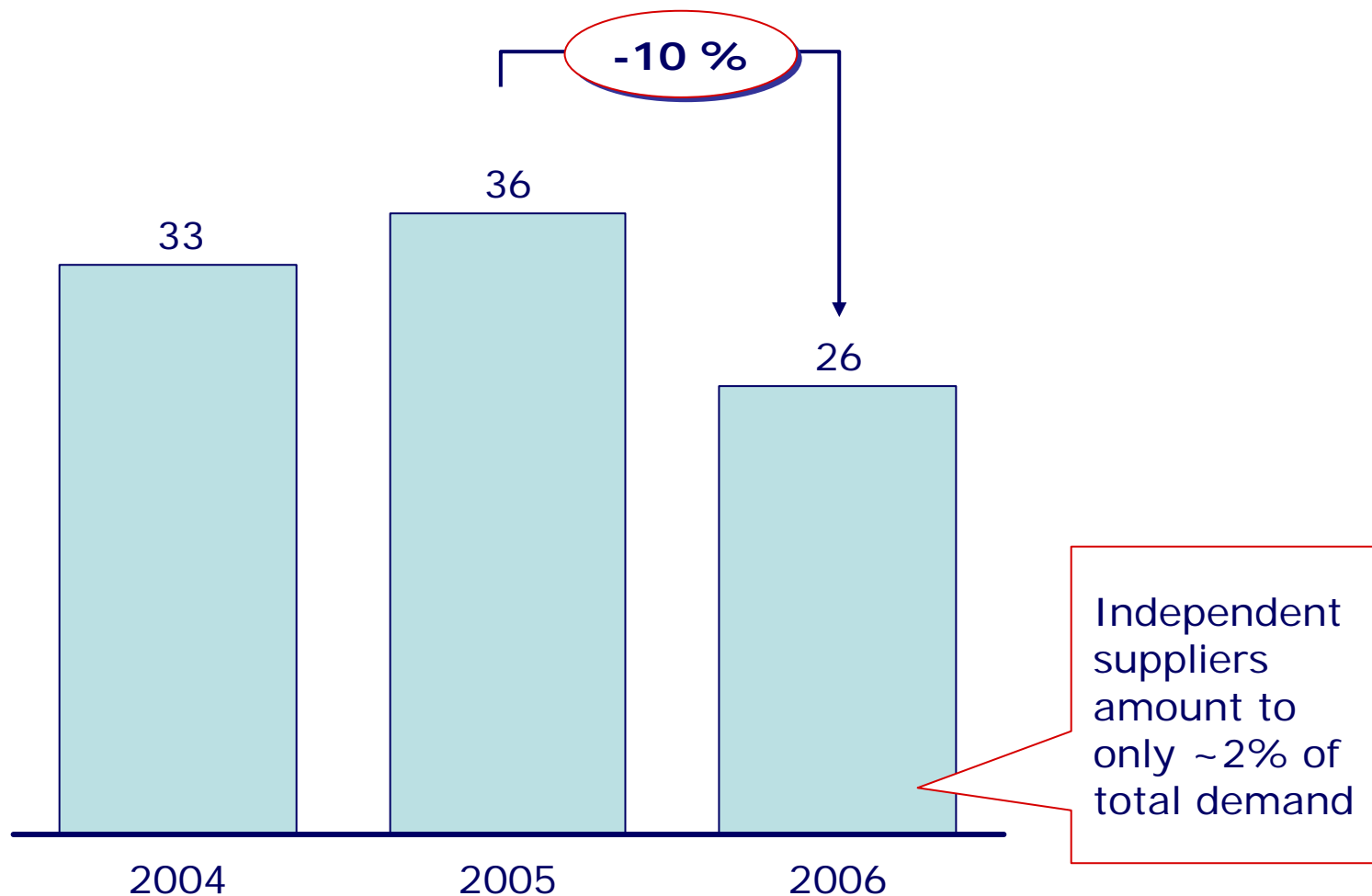
* 42.35 + losses

** 56.70 + losses

*** The distributors are the suppliers to the regulated market

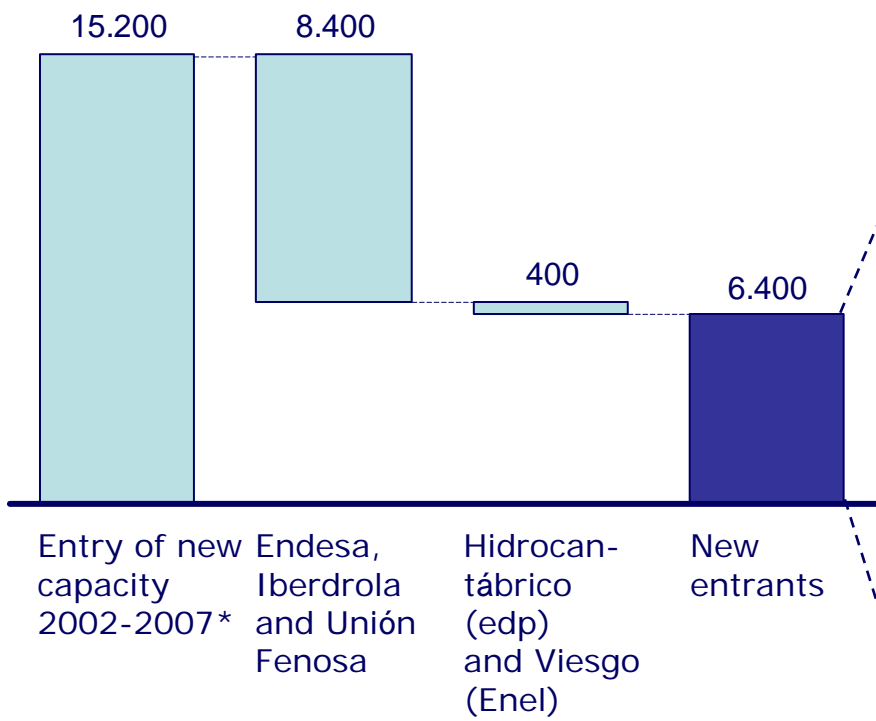
The liberalized market has experienced a significant push back

Suppliers' share on total demand



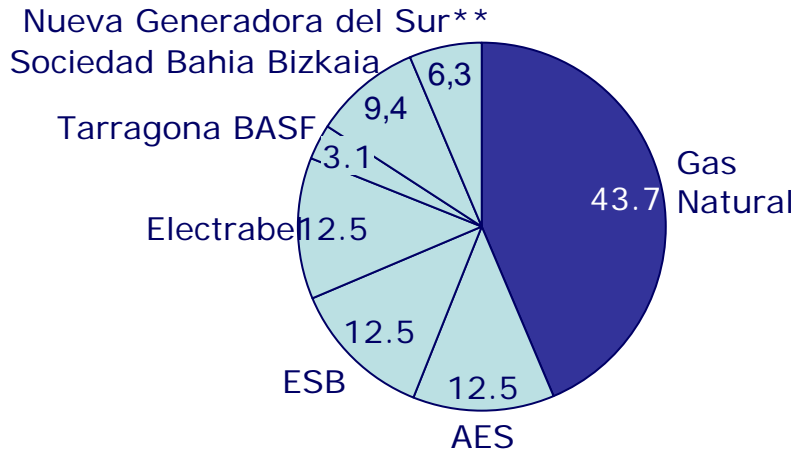


There are no entry barriers for new entrants, that have installed 40% of the new capacity
 New capacity installed 2002-2007*. MW



EdP and Enel have entered the Spanish markets

Distribution of new capacity among new players
 Percentage



7 "pure" new entrants – "green field" – each with a significant market share

* Capacity currently in operation
 ** 50% Unión Fenosa and 50% by Cepsa

The new regulated tariff recognizes the real energy cost

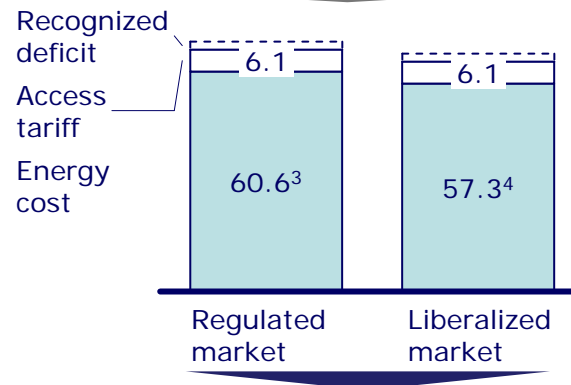
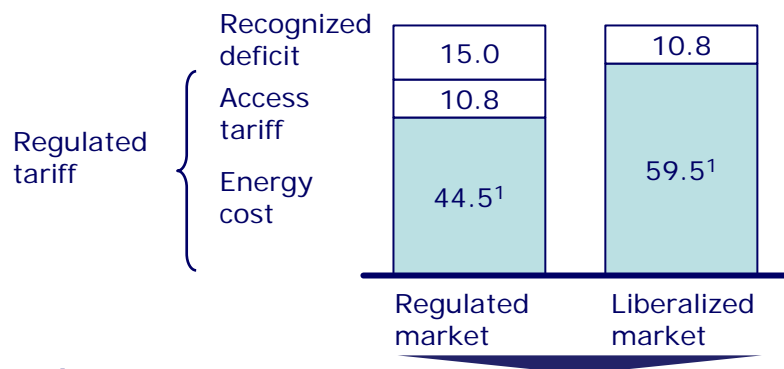
Customer segment example: 4,000 kW; 24,000 MWh
Euros/MWh. 2006

From ...

Until 2006 tariff was updated annually and did not reflect changes in the real cost-of-service

To ...

After Dec. 2006 tariff will be updated quarterly based on real market cost obtained from an auction



Key elements

Deficit calculation

- Ex-post

vs.

- Ex-ante

Recognized cost of energy

- Closing variable ("politically acceptable" tariff – Cost of regulated activities)

vs.

- Real cost defined by the market

Access tariff

(to cover other costs)

- Full coverage of regulated costs

vs.

- Closing variable ("Politically acceptable" tariff – Energy cost)

Tariff update

- Mechanism
- Frequency

- Regulators decision
- Annually

vs.

- Regulated demand open auctions
- Quarterly

(1) 42.35 + losses

(2) 56.70 + losses

(3) 57.70 + losses

(4) 54.60 + losses

Effects on competition derived from the transaction

Wholesale markets

Horizontal effects on midstream gas market

- Strengthening of Gas Natural's dominant position (control over 70% of the gas in the system)
- Disappearance of Endesa, one of the main *mavericks*, with a more solid position than Iberdrola and Unión Fenosa

Vertical effects

- High incentive of the New Group to raise gas prices (because it will capture extra profits in the electricity market)
- The other operators are not able, or willing to thwart this price increase

Horizontal effects on the wholesale electricity market

- Increase of the existing concentration and market power
- Disappearance of Gas Natural, the only credible *maverick*
- Unsuitability of the proposed divestments to Iberdrola

Retail markets

Horizontal and conglomerate effects in gas and electricity

- Starting point very different across regions, with very different competitive situations, conditioned by the ownership of the distribution networks and without regulatory solution
- Dramatic reduction of competition due to the overlapping networks that appear as a result of the transaction, leading to the elimination of the most credible and efficient competitor: the distributor of "the other product"

- **To sum up, the transaction generates, in addition to the "classic effects" derived from the increase in concentration, basic effects such as:**
 - Removal of the gas and electricity mavericks
 - Creation of vertical effects
 - Overlapping of distribution networks



The Spanish Cabinet has proposed the least restrictive conditions

Gas Sourcing

Auctioned gas
2007-2017. Bcm

CNE's technical report

- Assignment of SAGANE I contract to Enagás (tariff supply and surpluses)
- Sale of Endesa share in MEDGAZ as well as associated capacity reservations
- Prohibition of additional gas imports above volume imported in 2005, until market share is below 40%
- Divestment of regasification plants (Sagunto y Reganosa) and gas transmission

CNE's final report

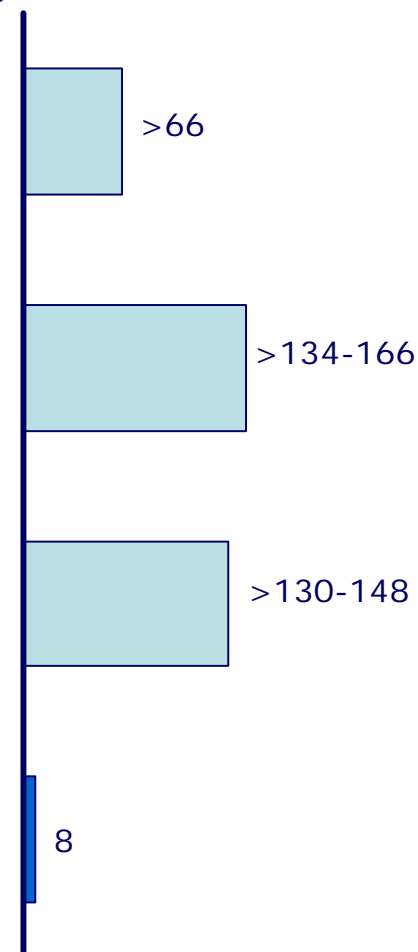
- Release of SAGANE I contract surpluses
- Release of an equivalent quantity of gas to that of Endesa's natural gas sourcing contracts
- Divestment of regasification plants (Sagunto y Reganosa) and gas transmission

TDC's minority vote

- Release of Endesa's gas sourcing contracts
- Release of 6 bcm annually for 8 years
- Prohibition of additional gas imports until market share below 50%
- Divestment of Endesa share in MEDGAZ
- Divestment of regasification plants (Sagunto y Reganosa) and gas transmission

Spanish cabinet decision

- Release of 1,8 bcm annually for **3 years**
- Release SAGANE I annual surplus up to 1 bcm (expected excess around 2,4 bcm en 2005) for a **3-year period**, starting 2007
- Divestment of regasification plants (Sagunto y Reganosa)



Final conditions much weaker: gas volumes more than 8 times lower than other conditions

The Spanish Cabinet has proposed the least restrictive conditions

Generation

Divested power MW

CNE's technical report

- 3,100 MW proposed by Gas Natural in the takeover bid offer conditions
- Additionally, 1,200 or 4,000 MW in plants in Spain (currently in operation)
- Asset sales to Iberdrola are prohibited

CNE's final report

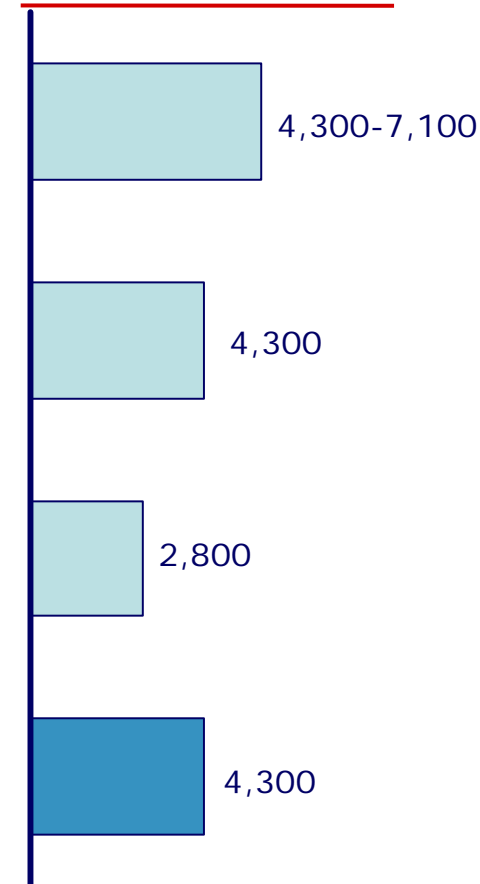
- Identical to the technical report, but limiting additional divested capacity to 1,200 MW

TDC's minority vote

- Divestment of **GN's current 7 CCGTs** in operation
- Asset sales to Iberdrola are prohibited
- CCGTs sales also includes gas supply for 2 years

Spanish cabinet decision

- 4,300 MW with at least 10 years of useful life (1200 MW or more should be CCGTs or hydro-electric power)
- No comment about asset sale to Iberdrola
- 400 MW should be located in Andalusia and 400 in Catalonia



Final conditions very similar to those of the CNE's final report but less restrictive than those of the TDC's minority report and the CNE's technical report

The Spanish Cabinet has proposed the least restrictive conditions Distribution and Supply⁽¹⁾

✓ Included
✗ Not included

	Divestment of Endesa's natural gas commercial activities	Divestment of GN's electricity commercial activities	Service points divested Million	Network overlap	Maximum market share allowed
CNE's technical report	✓	✓	1.25	Prohibited ⁽²⁾	<40% share in gas and electricity
CNE's final report	✗	✗	1.5	Allowed	<50% share in gas and electricity
TDC's minority vote	✗	✗	n.a.	Prohibited/Only allowed if overlap is below 20% of the population	Not limited
Spanish cabinet's decision	✓	✓	1.5 ⁽³⁾	Allowed	Not limited

Additionally, divestment of Naturcorp and Gas Natural de Alava is required

Unlike all the recommendations, final conditions do not limit neither network overlap nor market share

1. The CNE and the minority vote proposed several options. Only the least restricted is considered
2. Forbids supply in areas with network overlap
3. Without geographical restrictions and in two packages with, at least, 250,000 service points each

Under the wrong conditions, the TSO model can result in conflicts of interest

- **TSO Model:** Grouping into one single entity the functions of the System Operator, manager and owner of the transmission network
- **Private TSO management:** TSO as a private entity whose mission is to maximize the return on shareholder investment
- **Limited mechanisms for monitoring, supervision and creating incentives:** Lack of penalties for low quality, etc.

- **Conflicts of interest between:**
 - Transmission grid owner (goal: profitability)
 - System Operator (goal: security of supply)

The current TSO model in Spain may be the cause of several problems

- 1 **Lack of evacuation capacity** and inadequate market supply, with the resulting increase in costs due to congestions
- 2 Occurrence of very **serious incidents** related with the quality of service
- 3 Inefficient **management of disconnections** favorable to transmission
- 4 Inadequate **attribution of responsibilities** and long duration of processes

Ways to mitigate the problems of the implantation of the TSO model

Adding new elements to the TSO model ...

Penalties and incentives for quality

Mechanisms for control and supervision

Adopting characteristics from other models ...

ISO model

Description

- Incentives and penalties for:
 - Improving incidents and quality ratios
 - Reducing investment delays
- Rules and procedures to reduce asymmetries in ops.
- 3rd party control of the role and independence of the TSO

Difficulties

- Very infrequent, but very serious incidents, which make the proposed system difficult to implement
 - Requires a strong, independent regulator
 - Foreseeing all potential scenarios
 - Requires a strong, independent regulator
-
- System Operator independent from transmission
 - Focused on maintaining the system's security and a high level of service
 - Coordination with the transmission owner
 - Financial incentives to ensure the system's efficient operation