

The Spanish quest for a national champion

The Spanish government is trying to improve Spain's vulnerable position in relation to energy by creating a national champion. Whether it will succeed in doing so is far from certain.

| by Steven Adolf

Spain is anxiously waiting to see what will happen with Iberdrola, Spain's second largest power company. The expectation is that it will either enter into a merger or be taken over. The company's future is considered pivotal to the energy policy of the Zapatero government, appointed in April. The government has expressed a preference for the formation of a strong national power company by allowing a merger between Iberdrola and the Catalan company Gas Natural. Gas Natural is by far the largest gas company and holds 80% of the Spanish market. The plan is for a group of big shareholders to form a stable nucleus to safeguard Spain's national energy interests.

But there is a lot of uncertainty. The Spanish government can push for a merger but it cannot force it. The shareholders have different and often conflicting interests. The board of Iberdrola has already announced that it will put the future of its own company first. The European Commission, which

prefers large European energy companies to national champions, is keeping a close eye on developments, to make sure that EU policies and rules are being followed. And then there is Endesa, Spain's largest electricity supplier. The recent takeover battle surrounding the former state-owned company is definitely casting a shadow on Iberdrola. 'The result of the Endesa takeover was something nobody wanted. Everybody wants to prevent the same thing from happening to Iberdrola,'

turns on a daily basis. The takeover, which commenced in September 2005 and dragged on for eighteen months, was a fight between banks and entrepreneurs, between the political interests of the left-wing government and the right-wing opposition, between various regional interests and between Spain and the EU. It left a trail of court cases and political interventions in the Spanish energy scene and the result ended up pleasing almost no one.

'The result of the Endesa takeover was something nobody wanted.'

says Paul Isbell, energy expert of Spanish think tank Real Instituto Elcano.

The battle for Endesa has been compared to a *culebrón*: a type of Latin American daytime drama in which the storyline undergoes unexpected new twists and

It was initially Gas Natural that launched a hostile takeover bid for privatised Endesa. The socialist Zapatero government was in favour of this: the new combination would have created an energy giant with a capital of €31 billion and 30 million customers. However, Gas Natural was beaten by a bid



President of the Spanish power company Iberdrola, Jose Ignacio Sanchez Galan. Photo: Rafa Rivas/AFP/Getty Images

by German Eon, which was 30% higher. European competition commissioner Neelie Kroes had a clear preference for Eon. The Spanish government in its turn tried to put as many legal obstacles in the way of Eon as possible.

In the midst of these proceedings, Spanish company Acciona seized the opportunity by acquiring a significant share in Endesa. Acciona is Spain's frontrunner in wind farms and there was some logic to combining these activities with Endesa. Acciona eventually managed to take over Endesa together with Italian Enel last year. What resulted was neither a national energy champion nor a large European energy company. Losing bidder Eon managed to take over power plants from Endesa in Spain, France, Italy and Turkey by way of an agreement with the successful bidders. New shareholders Acciona and Enel argue over control and the future direction of their new acquisition. Arturo Rojas, energy analyst with Spanish consulting group Analistas Financieros Internacionales, says, 'Right

from the start, the whole course of events surrounding Endesa was a matter in which politicians exerted their influence very obliquely.'

National course |

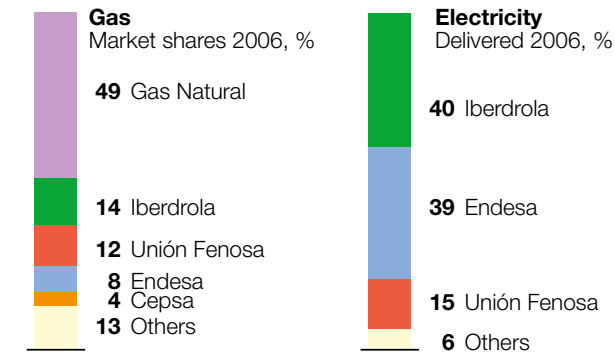
A repetition of the chaotic government interventions is now threatening Iberdrola. This is characteristic for a country which is struggling with the heritage of an isolated energy market controlled by the state and a financial community that is strongly enmeshed with politics. 'Spain is stuck between globalisation and liberalisation of the markets and its old nationalistic instincts,' says Isbell. The country has traditionally been a loyal supporter of the EU and an open European market. In practice, however, there is strong political and social pressure to stay the national course. Also at play are the interests of Spain's financial sector, where the government only has limited control.

Isbell thinks that the political preference for national champions mainly arises

from the need to safeguard energy supply. Spain is an isolated island in terms of its energy supply: the country is dependent on oil and gas for 70% of its energy requirements, compared to the European average of 50%. Connections with grids for electricity and gas on the other side of the Pyrenees are almost negligible. The current account deficit, the Spanish treasury and inflation are particularly dependent on the prices of energy. In addition, energy requirements have exponentially increased over the past fifteen years as a result of continuing economic growth. Energy consumption has roughly doubled since the middle of the seventies. 'Our reliance on foreign hydrocarbons means our energy policy plays an important role in the government's foreign policy,' says Vicente Palacio of the think-tank Fundación Alternativas.

While this reliance may be obvious, the solutions are much less so. With the arrival of alternative sources of energy, the dependence on oil is being reduced

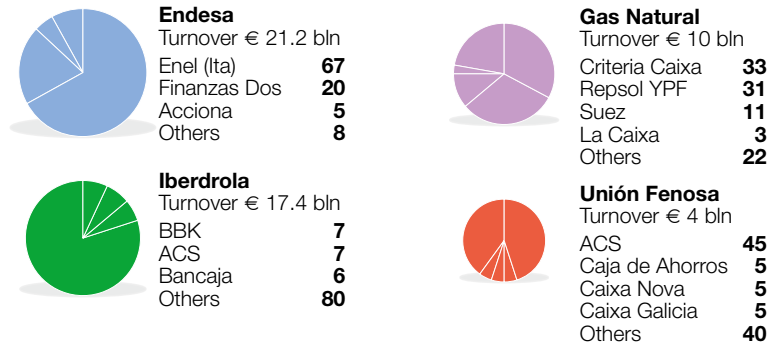
The markets in Spain



X&Y Graphics

The big four

Shareholders in power companies



but in absolute terms oil consumption is growing unabated. Industry and the big industrial energy consumers in particular are pushing hard for the development of nuclear energy. However, this meets with a lot of resistance from society at large. In fact, the existing nuclear plants, which are sufficient for one-tenth of the energy supply, appear to be dying a slow death due to the lack of active political support. The Spanish government prefers to subsidise renewable sources of energy. This has strengthened the position of wind power producers in particular. Iberdrola Renovables, the sustainable energy subsidiary of Iberdrola is global market leader with a capacity of 8,000 MW, more than half of which is produced in Spain.

Gas supply |

It is no coincidence that government intervention is concentrated in the area of gas and electricity companies. Replacing traditional coal-fired thermal plants with gas has turned Spain into one of the strongest growing gas markets in the world. The logical development is a further integration of gas and electricity companies. Spain's gas consumption was 33.4 billion cubic metres (bcm) in 2006, more than 3.5 times as much as in 1996. Spain's isolated position has led to a diversification of gas imports and investment into LNG facilities. After Japan and South Korea, Spain is the third largest LNG importer with a processing capacity larger than that of the US. An importance source for LNG is Nigeria.

In the south, the Maghreb-Europe pipeline connects Spain by way of Morocco with the Algerian Hassi R'mel gas field. This pipeline, also known as the Pedro Duran Farell, has a capacity of 11 bcm per year. A second pipeline under the Mediterranean with a provisional capacity of almost 8 bcm, the Medgaz, is being laid by a consortium of Cepsa (Spain) and Sonatrach (Algeria).

Isbell thinks that the combination of LNG from Nigeria and gas imports from Algeria offers Spain the potential of developing



Gas Natural Group Headquarters.
Photo: Jose Fuste Raga/Corbis

into a strategic transit country for gas. 'That could be an option for the European market in answer to the political risks of Russian gas.' The problem is connecting through to the north. 'Connecting grids involves large investments,' says independent energy adviser Walter van Rosmalen.

The energy isolation also applies to electricity. Spain and France have agreed to build a new interconnection on the eastern side of the Pyrenees. The main

aim of the connection is to guarantee local energy supply in the north-eastern part of Spain. 'The Spaniards would like a connection to the European electricity grid but in this case it is the French who are not cooperating. They do not want an integrated electricity market with all the consequences in terms of privatisation and unbundling,' says Isbell. He believes France would rather cross the Pyrenees to take over Spanish utilities. EDF has shown an interest in taking over Iberdrola.

Home-grown |

The government's preference is for a home-grown energy giant. Minister of Finance Pedro Solbes, and Minister of Industry Miguel Sebastián made this clear to the core shareholders of Iberdrola and Gas Natural in April. However, there is no obvious agreement within the group of relevant shareholders. Ignacio Sánchez Galán, chairman of the board at Iberdrola, warned that he will not cooperate in a merger or takeover if this leads to profit and cash flow per share being watered down or to a sale of assets forced by Brussels. The ACS construction company is a large shareholder of Unión Fenosa, which ranks third in the electricity market, and as such is keen to acquire divisions of Iberdrola that it will then add to Unión Fenosa. All the ingredients are there for a power struggle. 'The fight over Iberdrola is to do with a number of strong companies and personalities,' says Arturo Rojas. 'The result of the process is therefore highly uncertain.' ■

Spanish biofuel market in the doldrums

There is considerable uncertainty in the Spanish market for ethanol and biodiesel. Spain has 23 biodiesel plants and four ethanol plants. These have now either stopped production or are running at minimal capacity. The construction of new plants has been halted. This is due to the current high prices of raw materials. As a result production has become unprofitable. In many cases, producers have not even been able to obtain raw materials. Spanish farmers are not keen to enter into contracts requiring them to supply their crops against low prices.

Within the framework of EU regulations, Spain has undertaken to ensure that by 2010 almost 6% of fuel used in the transport sector will be based on biofuels. This will need to increase to 10% by 2020. However, market conditions are threatening the feasibility of this ambition. During the second Biofuel Summit which was held in Madrid recently Juan Guía García, Director General for Fuels for the Spanish Ministry of Industry, concluded that 'the production of biofuels is not a panacea for the current problems in the energy market'.



Caparroso biodiesel plant in Spain. Photo: Acciona

Last year only twenty percent of the Spanish biofuels production capacity of 840,000 metric tons (most of which is biodiesel capacity) was utilised. More than 40% of the 300,000 metric tons of biodiesel Spain consumed last year was imported from the US. Due to American export subsidies this worked out cheaper than homegrown production. This infuriated Spanish producers of biodiesel, prompting them to talk of price dumping. They have now taken the case to the European Biodiesel Board.

The mood of crisis in the Spanish biofuels market has been further inflamed by the worldwide controversy around the production of biofuels, which are being blamed for rising food prices and deforestation. The Spanish producers – companies like Biocarburantes Castilla y León, Biodiesel Caparroso, Ecocarburantes Española, Bioetanol Galicia and a host of smaller ones – are convinced that what is involved here is a

coordinated publicity offensive by the large oil producers and the food producing industry. They say data are being manipulated in order to put the production of biofuels in a bad light. 'There is a conspiracy against bio-ethanol,' said Javier Salgado, President of the Board for Spanish biofuel producer Abengoa, during a Sevilla conference recently. According to Salgado the impact of biofuel production on food prices is insignificant. He also countered by saying that Spanish companies are already producing a lot of second generation (non-edible) raw materials. However, Salgado thinks that the large producers of fossil fuels are worried about their position of power within the market. 'That is why they wish to eliminate us.'

André Baken, organiser of the Madrid conference agrees, saying 'It is a perverse situation'. According to him there is no doubt that large oil companies such as Repsol have their sights set on achieving a strong position in the biofuel market in spite of the current production crisis. 'We have now seen the first wave of wild cats originating from the agricultural sector,' he says. 'They often ran plants with a capacity ranging from 5,000 to 15,000 tons. Now the big boys are coming along and they are planning 250,000 ton plants.'

He compares the situation with that of the IT bubble: first a period of exaggerated expectations, followed by a market collapse, then a transition period, followed by a strong rebound in the long term. Baken expects the large oil companies to start using new technology for the construction of multifunctional plants able to work with a range of different raw materials. They will also be able to switch between either biodiesel or ethanol as their end product.

Christian Langaard of Euro-Latin Capital, who oversees investments in biofuels in the role of advisor and capital fund raiser, agrees that combining second generation raw materials and a considerable improvement in production efficiency will lead to strongly improved results in the future. In the corridors of the Madrid conference, he makes no bones about his frustrations in relation to the criticism levelled at the production of biofuels by big players in the food industry, such as Unilever. 'This is a new industry, so for a start the most obvious raw materials were used without considering alternatives. Moreover, the various governments have caused a disruption of the market by providing all sorts of subsidies aimed at assisting farmers.'

Manipulation or not, the only satisfied comments to be heard came from the big established fuel producers. Alvaro Mazarassa of the Spanish Association of Oil Producers AOP maintained that for the time being their hesitation in entering the biofuel market is paying off. He states: 'The issues surrounding biofuels are more complex than first thought. The reproach voiced by many politicians that we were too conservative has now been shown to be unjustified.' ■