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THE ENERGY  
REGULATION  
AND MARKETS  
REVIEW

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EDITOR  
DAVID L SCHWARTZ

LAW BUSINESS RESEARCH

# THE ENERGY REGULATION AND MARKETS REVIEW

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LAW BUSINESS RESEARCH LTD

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# EDITOR'S PREFACE

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Safe and reliable delivery of electricity and natural gas has been the hallmark of energy policy and regulation in the industrialised world for the past 75 years. More recently, regulators, policymakers and the industry began to focus their attention on ways to improve economic efficiency, increase productivity and reduce costs through a seemingly endless series of reforms.

In some countries, utilities were encouraged to enhance transmission and interconnection facilities with neighbouring systems in order to pool energy resources. More recently, utilities have been encouraged to participate in regional organisations to buy and sell power, and to administer transmission, dispatch and scheduling of a variety of energy products. Certain countries have encouraged utility efficiency through a variety of performance-based incentives.

Policymakers have tried to reduce the barriers to entry by requiring non-discriminatory treatment among transmission users, and prohibiting affiliate abuse. Utilities were encouraged to unbundle certain utility services; in some cases, regulators required the divestiture of generation or transmission facilities. Utilities have even been encouraged to provide retail wheeling services to facilitate competition for delivery service customers.

Many markets have developed competitive bid-based electricity auctions to set energy and capacity prices, which often take into consideration the cost of transmission congestion. These markets tend to be administered by independent or governmental entities that do not have a market position bias. Clearing prices set in these markets are intended to send price signals to maximise short-term efficiency (scheduling, dispatching and selling energy), as well as long-term efficiency (building new or retiring old generation and transmission facilities).

In certain countries, lawmakers and policymakers have encouraged developers to build and finance new renewable resources and to develop more effective means of conserving energy, through a variety of 'carrots' and 'sticks'. These measures have included subsidies such as feed-in tariffs and renewable energy credits, as well as utility

requirements through renewable portfolio standards. In certain competitive markets, conserving electricity has been converted into a demand-side product ('negawatts') with near or equal value to supply-side generation (megawatts). New 'smartgrid' technologies have been created to increase the efficiency of transmission, generation, distribution and individual consumers' energy use.

Now, however, the myriad of efficiency mechanisms faces new and unprecedented challenges. Transmission and distribution systems are ageing and desperately need upgrading. Severe new environmental requirements are leading to mass retirements of baseload coal-generation resources. Fuel prices are volatile, adding long-term uncertainty to energy prices. Spikes in the price of raw materials are making the development of new infrastructure all the more expensive. Cyber-security threats are exposing the vulnerabilities of our energy networks. And the global economy continues to threaten our ability to obtain the necessary credit to build and finance energy infrastructure.

This is the sobering backdrop for this inaugural edition of *The Energy Regulation and Markets Review*. I would like to thank all of the authors for their thoughtful consideration of these difficult challenges. As can be seen in these chapters, we have much to consider and resolve before we can achieve the kinds of energy security and efficiency that we have been pursuing.

**David L Schwartz**

Latham & Watkins LLP

Washington, DC

June 2012

## Chapter 21

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# SPAIN

*Antonio Morales<sup>1</sup>*

### I OVERVIEW

The energy sector is highly regulated (being a key sector), its strategic and technical importance requiring a strong regulatory framework to ensure a constant supply at the lowest possible cost and respecting environmental requirements.

This regulation has undergone significant change in recent years, mainly imposed by European legislation, with introduction of market directives for the internal electricity market in 1996 and 2009 (2009/72 of 13 July) and for the gas market in 1998 and 2009 (2009/72 of 13 July).

### II REGULATION

#### i The regulators

The framework for power distribution between the state and the autonomous regions is directly established in Articles 149(1)(22) and (25) of the Spanish Constitution. The former reserves the 'authorisation of electrical installations when their use affects another region or the transport of energy out of its territorial scope' to the state's exclusive jurisdiction. The latter provides that the state has the jurisdiction over establishing the basis of the energy regime. According to this framework, facilities within each region are also authorised, and the legal bases of the energy sector develop.

The state's wide jurisdiction in this area is reflected in the basic state legislation, which establishes the sector's regulatory framework: the Electrical Sector Law 54/1997 and the Hydrocarbon Law 34/1998. Since these two laws are very comprehensive and wide-ranging, there is little space in practice for the autonomous regions to regulate.

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<sup>1</sup> Antonio Morales is a partner at Latham & Watkins LLP.

The National Energy Commission ('the CNE') is the energy markets regulator. Law 34/1998 establishes the CNE as the 'performance regulator of energy systems, being designed to ensure effective competition in the same as well as the objectivity and transparency of its operation, beneficial to all consumers and those who operate these systems'.

## ii Regulated activities

Royal Decree 1955/2000 states that construction, expansion, modification and operation of production facilities, transportation and distribution requires certain permissions.

An administrative authorisation is needed for the draft technical installation document that is processed in conjunction with the environmental study. An application is filed with the Directorate-General for Energy Policy and Mining, which is then forwarded with the required documentation to the Ministry of Industry, which makes the decision. If the resolution is positive it will indicate the time in which the application must be submitted for project implementation approval, which – once approved – allows the owner to construct or establish the installation. The application must be submitted with the industry and energy sub-office where the facility is located. A resolution must be arrived at within three months by the Directorate-General for Energy Policy and Mining, specifying a deadline for the construction of the facility.

Once a project is duly implemented, an operating authorisation allows energy to be transmitted to the facilities for commercial exploitation. The application for operating must be submitted to the industry and energy sub-office and should be accompanied by the final certificate of work.

Some autonomous regions have specific regulations for electrical installations; they follow basically the same administrative procedure as established by the foregoing state regulations.

## iii Ownership and market access restrictions

Electricity network operation (transmission and distribution) is subject to significant economies of scale, which gives them an element of natural monopoly, as it is inefficient to introduce competition into these activities. Law 54/1997 establishes an obligation to separate legal and accounting matters within regulated electric utilities (transmission and distribution), which are provided under a financial regime. Deregulated activities (generation and supply) are carried out by operators in free competition, their remuneration being governed by the laws of supply and demand.

Directive 2009/72/CE and its subsequent incorporation into Spanish law go into greater detail on this aspect and imposes an obligation on vertically integrated groups to functionally separate their activities to ensure the autonomy of management and decisions of those responsible for the transmission and distribution networks. In addition, it purports to preserve the confidentiality of commercially sensitive information available to those responsible so as not to compromise competition in deregulated activities.

Law 54/1997 and subsequent legislative developments established and defined the role of different participants in the electricity sector:

- a* Power producers are individuals or legal entities that have the function of generating electricity, as well as building, operating and maintaining generating

plants. Depending on the generation technology used, producers are divided into ordinary producers and regime producers.

- b* Electricity transporters are companies that have the function of transporting electricity and construction, maintenance and transportation transformer facilities.
- c* Distributors are those companies that have the function of distributing power, and build, maintain and operate distribution facilities designed to establish energy consumption points.
- d* Sellers are legal persons who, by accessing transmission or distribution, have the function of selling electricity to consumers. Among them are 'last resort sellers', appointed by the regulator, which are functionally and legally separate from other companies operating in the sector, which are responsible for providing energy to consumers benefiting from the 'tariff of last resort' set by the government.
- e* Consumers are individuals or corporations who buy energy for their own consumption. The consumer who purchases energy directly in the production market is referred to as a 'direct consumer to market'.
- f* The market operator (OMEL) is the company that assumes the management of the bids for and sale of electricity in the daily power market in exchange for a regulated fixed fee.
- g* The system operator (Red Eléctrica de España) is the company whose main function is to perform activities associated with the technical operation of the electricity system, ensuring continuity and security of electricity supply and proper coordination of production and transportation systems.

#### **iv Transfers of control and assignments**

Royal Decree 1955/2000 also establishes the authorisation for the transfer of installations. The request for authorisation for facilities transfer needs to be sent to the Directorate-General for Energy Policy and Mining, enclosing supporting documentation about the applicants. A decision must be rendered by this department within three months (failure to respond positively within three months means the application is deemed rejected), prior to the report of the National Energy Commission. The applicant then has six months to confirm the transfer.

### **III TRANSMISSION/TRANSPORTATION AND DISTRIBUTION SERVICES**

#### **i Vertical integration and unbundling**

Energy (electricity or natural gas) is transported from the point where it is generated to the point of consumption by large industrial consumers who are directly connected to the transmission system and to the point of intersection with the distribution networks (substations) through which power is carried to the remaining consumers.

The electricity transmission network is made up of lines, transformers and other elements of voltage equal to or greater than 220kV. There are also international interconnection facilities connecting Spain with other Spanish territories, which have a voltage transport function lower than 220kV.

Transport networks are developed when new investment is periodically approved by the Ministry of Industry. The construction of network sections included in this planning is regulated, and remuneration is calculated by the regulator in accordance with the approved methodology in the regulations. Law 17/2007 established the single-carrier model with Red Eléctrica de España as the owner of the entire transportation network. As a system operator, it must comply with the relevant instructions by filing its investment plans for the future years.

## **ii Transmission/transportation and distribution access**

Power distribution brings the energy from the output of transport networks (electricity or gas) to the final consumer. Electrical distribution facilities with voltage lines lower than 220kV, which are not considered part of the transport network, and all other elements (communications, protection, control, etc.), need to be performing properly and at a level of quality required by the regulations.

Prior to June 2009, distribution companies were also responsible for servicing a regulated tariff supply to consumers. Since then, regulated supply has disappeared, creating a 'last resort supply', which will be managed by 'suppliers of last resort', who must supply electricity at a price no higher than that fixed by the government.

Distributors must build, maintain and operate power grids linking transport to consumption centres. For the proper development of these functions, distributors have the obligation to expand distribution facilities when needed to meet new demands for electricity, at all times ensuring an adequate service quality level, and differentiating by type of consumption and area. Furthermore, distributors are responsible for supply measurement, applying consumer's tolls or access fees.

Distributors are required to keep a points of supply database, always maintaining confidentiality. They must send the required customer information to the Supplier Exchange Office and provide reports to the transporter about their network incidence and maintenance plans to ensure certainty of supply.

Finally, distribution companies must also provide information to clients, the Ministry of Industry, Tourism and Trade, autonomous communities, Office for the Change of Supplier and the system operator; they must also submit their investments plans annually. Distribution companies, by the exercise of their activities, are entitled to payment by the administration.

Notwithstanding the foregoing, prior to the approval of Royal Decree 222/2008, laying down the emoluments of electricity distribution activity, electricity distributors with fewer than 100,000 customers were covered by a special regulation (established in Transitional Provision 11 of Law 54/1997) with a different financial and regulatory regime to other distributors. Approval of Royal Decree 222/2008 meant that all distribution companies would be subject to the same remuneration and policy, therefore removing the previous size differentiation.

## **iii Rates**

Remuneration for transportation is administratively established in response to investment costs, operation and maintenance, and network management, according to a calculation

model defined by the regulator by Royal Decree and in accordance with provisions established in Law 54/1997.

This remuneration methodology aims to cover all costs of transportation providing (including capital invested remuneration) and in turn encouraging effective management. It is calculated every year as the sum of the following individual parts linked to: the current value of investments, recovery of operation and maintenance costs, and incentives for the availability and efficiency of facilities.

The fixed value of assets is calculated on the basis of reference unit costs approved by the regulator. Annual remuneration of capital invested in these assets is calculated as the sum of annual depreciation (value of assets divided by useful life) plus a return of invested and recovered capital.

#### **iv Security and technology restrictions**

Security in relation to transportation facilities of electrical energy is relevant from the perspectives of both industrial safety and security of supply.

Industrial safety is dealt with by Law 21/1996 of 16 July and Law 54/1997, understood as safety aimed at risks prevention and control, as well as protection against accidents and disasters capable of causing harm to the population or damage to flora, fauna, property or the environment. Security of supply is dealt with under the electric sector regulations. Law 54/1997 states in this regard that 'few basic rules are established techniques and needed to ensure the reliability of electricity supply and installations of transport network'.

## **IV ENERGY MARKETS**

### **i Development of energy markets**

According to Law 54/1997, electricity production takes place in the electrical power production market in a free competition regime. The electricity production market is composed of all business transactions of purchase and sale of energy and other services related to the supply of electricity. It includes forward markets, a daily market, intraday market, the resolution of technical constraints of the system, ancillary services, and the management of deviations.

The Spanish electricity market has historically competitive prices for end users compared with other European markets. The Iberian Electricity Market was started in 2007, and the results of this integration into the market have been obvious: while in the second half of 2007 the average price differential between the Portuguese and Spanish electricity systems was €10 per MWh, this difference fell to €0.3 per MWh by 2010, with identical rates on both sides of the border for a majority of the time.

The operation of the wholesale market at any given time is determined by the mix of generation structure, import capacity, the imperfect meshing of the network, the inelasticity of demand and the system reserve margin. The market design rules can make this operation more or less efficient, but cannot make up for significant deviations in these factors.

From the opening to competition of the market generation in January 1998 until until 2005, almost all of the transactions in wholesale energy were carried out in

the pool. Forward markets and bilateral contracts have been developed gradually with the evolution of the regulations. Thus, in recent years, the energy involved in the daily market run by OMIE (the Iberian Electricity Market Operator) has ranged between 45 and 55 per cent of demand, with the remainder opting for bilateral transactions.

Despite the reduction in the quantities traded in the daily market, its price still represents the main visible energy price reference and the underlying settlement of bilateral contracts, the over-the-counter ('OTC') market and forward markets organised by OMIP (Iberian Market Operator Portugal).

In this context the significant increase in OTC negotiations on the financial market should also be noted. The volume of energy traded in this market went from 6 per cent of domestic demand in 2007 to 10 per cent in 2010.

The low prices in the Spanish wholesale market compared with their European counterparts have reflected the influence of generation technology's price takers. As an illustrative example, in December 2009 to March 2010 period the market price showed a very substantial fall even below fuel price, reaching an average of €19.6 per MWh in March 2010, reflecting, *inter alia*, prices of €0 per MWh for almost 300 hours. One of the main causes of this was a 1.91 per cent reduction in demand, along with growth in wind production coinciding with intense rainfall.

## ii Energy market rules and regulation

Since 1998 the Spanish electricity sector has undergone a major transformation as a result of regulation changes resulting from the adoption of Directive 96/92/EC, the main objective of which was to create an internal market for electricity in the EU by liberalising electricity generation and sale.

The electricity markets are regulated by:

- a* a market operator, responsible for the preparation of the daily operation of the system, matching offers and demands, supervised by a committee of representatives of producers, distributors, traders and qualified consumers;
- b* a system operator, ensuring continuity and security of supply (Red Eléctrica de España);
- c* the Electricity System Commission, which protects consumer interests and ensures the transparency of the whole system; the Industry and Energy Ministry must supervise the correct operation of production activities and consumption of electricity;
- d* autonomous communities, which also have direct responsibilities in regulating their electrical systems; and
- e* the European Union, which establishes the general framework of the electrical system in all countries of the Union through directives and legal regulations.

Royal Decree 949/2001, which regulates third-party access to gas infrastructure and establishes an integrated economic system of the natural gas for regulated activities paid under rates, tolls, and regulated fees, also sets out the basic criteria for remuneration of regulated activities, setting tariffs and fees to be paid by individuals for the use of gas installations.

**iii Contracts for sale of energy**

Participants on the energy market may freely agree the terms of contracts for the sale of electricity to subscribe, subject to the terms and minimum content under Law 54/1997 and its implementing regulations.

Electricity traded through daily and intraday markets is remunerated on the basis of the prices resulting from the balance between supply and demand of electricity offered. Electricity traded through bilateral contracts or the physical or term market is remunerated on the basis of the price of the firm contracted operations in those markets.

**iv Market developments**

Historically, the energy market has functioned properly, but in recent years a technology-driven influx of price takers has distorted its proper functioning. This has caused a reduction in the wholesale market price, which, together with a reduction in the thermal gap, is not sending the right economic signals to garner investment in new capacity.

This situation will only deteriorate in the future, as the progressive decarbonisation production mix forecasts a greater presence of non-renewables, relegating thermal technologies' main role as backup power with only a residual role as contributor energy, jeopardising the recovery of investment. Incentives for investment and the availability of service, recently established in Order ITC/3127/2011, have not sent sufficient economic signals to encourage investment in new backup power in the vicinity of 500 hours per year, which highlights the need to revise that target.

In particular, a procedure to assist supply security was introduced in 2011 with the aim of ensuring a level of domestic coal consumption according to the provisions of the National Coal Plan (which justifies the operation of these plants for security of supply and capacity for each state to give priority to indigenous sources for up to 15 per cent of production). This regulatory change involves the generation of coal that is paid (10 plants totalling 4,700MW) at a regulated price, while production in the process of withdrawal of the production-demand balance (imported coal and combined cycle) does not receive any compensation.

**V RENEWABLE ENERGY AND CONSERVATION**

**i Development of renewable energy**

Special regime installations, which include renewable energy sources, are not subsidised in the state budget. Instead, they are included in electricity rates, causing a 'tariff deficit'; however, not only do renewable energy premiums generate a tariff deficit, so do other items such as regulated tariff billing. In fact, the special regime premiums cause only a third of the tariff deficit. In this context, however, the purpose of Royal Decree-Law 1/2012 is to limit the impact of renewable premiums in the tariff deficit, thus reducing costs.

Royal Decree 6/2009, dated 30 April, had previously attempted to limit the increase of the aforementioned general tariff deficit, however, it was not sufficient, given that only a year later further steps needed to be taken by the government: a new Royal Decree Law 14/2010 was passed, for the same purpose.

While the government is planning a reform in the electricity industry to avoid tariff deficits, it has decided to suspend financial incentives to build new energy projects on a temporary basis. This situation has been brought about both by the global economic crisis and by financial difficulties being experienced by the electricity industry. Measures taken to date have not been effective in reducing this deficit, thereby making overall sector development more difficult, and hindering the continuation of policies promoting electric power from renewable energy sources. Royal Decree-Law 1/2012 will be part of a large group of other regulatory measures that will probably need to be passed in the future to change and improve the fortunes of the energy sector.

The government is maintaining its commitment towards keeping renewable energy as an essential part of Spain's energy mix. In 2011, 33 per cent of electricity demand was derived from renewable installed power, making Spain a leader in this type of energy; however, the current payment system is not sustainable, given the reduction in demand caused by the financial crisis. Until the system is reformed, the current payment system has been suspended.

## ii Energy efficiency and conservation

Objectives and actions on energy efficiency in Spain are part of the policy objectives and progress set by the regions' institutions. Also, in addition to the objectives approved in the European Council in spring 2007 of reducing greenhouse gas emissions and increasing renewable energy, a target was included of improving energy efficiency by 20 per cent in 2020 in the EU compared with the baseline scenario (the target block is commonly called 20-20-20 targets). Unlike the target for 20 per cent renewables and 20 per cent reduction of CO<sub>2</sub> emissions, the efficiency target is not binding and has been distributed by Member States.

In line with European objectives, the only public reference in a Spanish context has been the 20 per cent target of improving energy efficiency in the government's 'Strategy for a Sustainable Economy' in December 2009, which includes a target 20 per cent reduction in energy usage by 2020 compared with the current scenario.

In at national level, the main energy efficiency measures are based on the Spanish Energy Efficiency Strategy (E4) for the period 2004–2012, which has developed in several plans: Plan of Action 2005–2007, Plan of Action 2008–2012 and Plan of Action 2011–2020.

The 2008–2012 Action Plan includes a significant number of structured activities and strategic sectors. The measures carried out are divided into the following categories:

- a* Legislative actions, in general far-reaching, and representing a complex set of recommendations, regulations, rules of functioning, constraints, and generally binding rules.
- b* Incentive measures for carrying out audits and analysis of consumption of the technologies used, and promoting investment in equipment to increase energy efficiency.
- c* Training in good practices, knowledge of available technology, advances and new techniques of management demand, consumption and, in general, the correct use of energy.

Alongside this plan, some of the key energy efficiency measures stated in the Spanish Action Plan 2011–2020 include those in the transportation, building, utilities and cogeneration sectors.

### **iii Technological developments**

Royal Decree 1565/2010, dated 19 November, which modifies some aspects of the special energy production regime in order to promote innovative investment, stated that the Ministry of Industry could grant additional compensation for solar thermoelectric projects installations with a high level of innovation by means of a tender. Through a resolution dated 24 June 2011 of the State Secretary for Energy, the tender was granted to Termosolar Alcazar SL.

## **VI THE YEAR IN REVIEW**

The Spanish government temporarily suspended pre-allocation registration as well as abolishing financial incentives for new energy production projects using cogeneration, renewable energy sources and waste, as a consequence of the complex economic and financial situation that Spain is currently undergoing. The intention is to temporarily halt a reward system that involves a substantial cost for the electricity system, which has caused the tariff deficit to continually increase. This measure does not jeopardise supply, nor the renewable energy sources targets set by the European Union.

It also passed Royal Decree-Law 13/2012, dated 30 March, by which the directives on internal markets for electricity and gas field and electronic communications were incorporated, adopting measures to correct deviations between electricity and gas costs and revenues.

## **VII CONCLUSIONS AND OUTLOOK**

Spain heavily depends on foreign energy and needs all available sources. Its system has been in constant state of revision and has created legal uncertainty for international investors, who demand safe, predictable and transparent markets. The main objectives for the government in a short term are to shore up its markets for this purpose, but it is also important to definitively outline the energy mix that is wanted for the next 20 years; once defined, this plan should be stuck to for that period of time.

## Appendix 1

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# ABOUT THE AUTHORS

### ANTONIO MORALES

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Antonio Morales is the responsible partner for the regulatory and litigation practice in the Spanish offices of Latham & Watkins, as well as being part of the environmental, land and resources practice group. Mr Morales' practice focuses on projects and transactions relating to public and administrative law, including the energy, utility, water and telecommunications sectors.

In 1997, Mr. Morales became a state attorney. During his time in the public administration, he worked at the government delegation in Madrid from 1998 to 1999 and from 1999 to 2002 at the Tribunal Superior de Justicia of Madrid. From 2002 and 2005 he served as Secretary General of the Spanish Nuclear Safety Council. Prior to joining Latham & Watkins, Mr Morales was a partner at Lovells. In 2008, Mr Morales obtained his PhD at the Universidad Autonoma de Barcelona. He currently sits on the Legal Commission of the Spanish Olympic Committee.

Mr Morales has been recognised as a leader in administrative and public law by *Chambers Global* for the past four years and in the energy sector by *Chambers Europe* from 2008 to 2010. Additionally, he has been recognised as a leading Iberian energy lawyer by *Iberian Lawyer* in June 2006. In 2007 Mr Morales also received a '40 under forty' award presented by *Iberian Lawyer*.

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