



Autorità per l'energia elettrica e il gas

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1 FOREWORD

In Italy reform of the electricity and gas sectors undertaken since 1999 went considerably further than mandated by European directives 96/92/EC and 98/30/EC, generally encompassing the requirements of the subsequent directives 03/54/EC and 03/55/EC and in some instances going significantly beyond. The implementing decrees redesigned the electricity and gas sectors in their entirety. They eliminated exclusive rights and ordered open access to all essential infrastructures; drastically reduced the market share of the incumbents, while providing the stimulus for their development in an EU wide competitive market; organised wholesale markets and established a broad concept of market opening and guarantees for customer protection in the transition to a fully liberalised and competitive market. The following provides a background summary of the implementation of the EU directives in Italy, highlighting the major developments over the last year or so.

2 MAIN FEATURES OF THE IMPLEMENTATION OF THE ENERGY DIRECTIVES IN ITALY

In the power sector, Government decree n. 79/99, implementing EU directive 96/92/EC, broke ENEL assets into separate companies for generation, transmission, distribution and sales. It established an independent system operator (GRTN) for the coordinated management of transmission assets belonging to ENEL and to other companies; a single buyer (AU) to manage power purchases and sales for the captive market; a power exchange for the wholesale market. It defined access to transmission facilities on the basis of regulated tariffs and non discriminatory rules. The decree set a ceiling of 50 % of total final supplies on production and imports of any one company and to this end ordered the divestment of 15 GW of the incumbent's generating capacity, which was completed by the beginning of 2003 with the creation of three new generating companies (GENCOs). It also rationalised distribution concessions by merging network assets in municipalities with more than one distributor and obliged all large distributors to create a separate company for network management and sales to the captive market. The decree accelerated market opening by extending eligibility status to consortia of small and medium size commercial and industrial consumers and by reducing the threshold to 0,1 GWh/year in the Spring of 2003.

In the gas sector, Government decree n. 164/00, implementing EU directive 98/30/EC, mandated legal separation of transport and distribution activities from

sales and of storage from all activities except transport in which case it imposed unbundled accounts. It defined access to transport, distribution and storage facilities on the basis of regulated tariffs and non discriminatory rules. It established a licensing framework for suppliers meeting strict security of supply criteria. It introduced ceilings on gas supplies and final sales of any one company, beyond those quantities required for own consumption, and mandated competitive bidding for gas distribution concessions in local networks once every 12 years. The decree also opened the market to all final consumers independently of their size from January 1 2003.

Government decrees n. 79/99 and 164/00 implemented most of the conditions established in the subsequent directives 03/54/EC and 03/55/EC. Eligibility was extended to all non domestic electricity consumers beginning on July 1 2004. With specific reference to the regulator required by these directives, the Italian electricity and gas authority (AEEG) had been established by law n. 481/95. It began to function in 1997 and contributed broadly to the liberalisation and re-regulation process. The establishing law endows the AEEG with full autonomy and independence of judgement, subject to EU norms and general policy directives issued by the Government. Its mandate stretches from issuing directives for accounting and administrative transparency and guaranteeing access to networks under competitive conditions, to ensuring customer protection and quality of services, to settling controversies and providing advice to Government and Parliament. In the pursuit of its functions the AEEG has full responsibility for setting tariffs and penalties, subject only to general criteria such as the application of price caps on tariffs and a minimum regulatory period of three years.

Numerous laws, decrees and other administrative measures have complemented the original implementing decrees over the last 5 years. Most recently law n. 239/04 is concerned primarily with clarifying relations within the energy sector; improving coordination between central and local governments; simplifying authorising procedures, with specific reference to power and gas infrastructures; stimulating investments in upstream oil and gas development, in renewable resources, distributed generation and clean coal technologies.

3 THE CURRENT STATUS OF COMPETITION AND LIBERALISATION IN ITALY

Despite some delays and transitional problems, the changes implemented in the Italian electricity and gas sectors over the past few years have been marked with a reasonable degree of success, stimulating competition and efficiency among suppliers and transforming the perception and concept of energy markets among consumers.

The liberalisation process was accompanied by a strong trend in the privatisation of the largely publicly owned energy industry. Both the State and local governments drew advantage from the new energy environment by selling their shares in energy companies while maintaining majority control. Privatisation of ENI and ENEL started, respectively, in 1995 and 1999. Direct and indirect interests of the State in these companies are now reduced to 30 %. Municipal energy companies began privatising in 1996 and most of the larger concerns are now at least partly privatised. Mergers and acquisitions have also increasingly characterised the Italian electricity and gas sectors, leading to consolidation of what is still a highly fragmented industry structure, despite the overwhelming dominance of ENI and ENEL. In this respect, the Italian energy sector has proved to be comparatively open to energy companies from both EU and non EU countries, which now own a significant fraction of the assets and contribute increasingly to electricity and gas supplies.

3.1 Electricity

The past year has seen numerous important developments in the Italian power sector including the opening of the Italian power exchange (IPEX), the introduction of energy efficiency certificates, the development of firm capacity rights in relation to congestions in both imports and internal transmission, etc. The following summary aims at providing a description of the major features of the ongoing liberalisation process.

Industry structure

Despite the drastic reshaping and reduction, the incumbent has emerged unscathed and even benefited from the process of liberalisation. As established in decree n. 79/99, competing generating companies have captured over 50 % of the market, though ENEL still greatly dominates generation and there may be evidence of oligopoly control. The major contribution to new supplies comes from the three GENCO's emerging from the sale of ENEL assets. Many new suppliers have emerged out of industrial companies that previously produced electricity for their own requirements and found it convenient to enter the generation market. Moreover, legislation issued in 2003 to simplify the authorisation process has attracted new investments and there are now some 20 GW of generating capacity in various stages of implementation. A major feature of the redesign of the electricity market is the growth of wholesale companies. Wholesale dealers run into the hundreds though barely two dozen account for over 60 % of the liberalised market and the ENEL group for just 16 %. Most operate on the basis of bilateral contracts with only 30 wholesalers currently participating actively in the IPEX.

Access to networks

The separation of management activities (undertaken by State controlled GRTN) from ownership of the assets (TERNA belonging to ENEL) has enabled non discriminatory access to the transmission network, but sufficiently complicated the

maintenance of and investment in new power lines as to call for a merger between the two entities, which Parliament has mandated must be completed within October 2005. Limits on the share of the stock of the new transmission company (RTN) and on voting rights held by the generating companies (including ENEL) are expected to guarantee continuing non discriminatory access, even after the merger.

A primary task of the RTN is to improve interconnections to reduce congestions between different parts of the internal network which currently enhance the incumbent's market power. To support the required effort, the rate of return established by AEEG as a basis for the transmission tariff applied in the second regulatory period (2004 - 07) was increased to 6,7 % real pre-tax for past investments and to 8,7 % for new investments (from 5,6 % in the first period).

A significant fraction of the transmission and distribution tariffs (increasing from about 10 % for small customers to almost 50 % for large consumers in July 2005) is accounted for by regulatory charges of general interest. These charges are levied to meet the costs of items including: nuclear decommissioning; renewable energy and energy efficiency incentives; power systems R&D; stranded costs and other transitional subsidies to energy producers, distributors and consumers; rewards for improvements in quality of service; compensations between high and low cost service areas, etc.

Historically a large fraction (around 15 %) of electricity demand has been satisfied through imports. With market liberalisation the demand for scarce import capacity increased dramatically and its allocation among numerous potential buyers has in the past been largely undertaken on the basis of non market rules. Beginning with 2005, following EC Regulation n. 1228/2003, the allocation is undertaken on the basis of implicit auctions, as in the case of congestion management within the Italian network.

Market liberalisation

During the first few years of market opening, larger customers responded quickly to the relatively strong price reductions offered by new suppliers. Members of consortia and other eligible consumer groups followed with only a short delay and by the end of 2003 over 70 % of eligible clients (consuming over 0,1 GWh/year) had changed supplier at least once. More recently, supply limitations, increases in the prices of oil and gas inputs to generation and the higher costs borne by suppliers catering to the requirements of increasingly smaller customers all conspired to reduce discounts from the franchised tariffs defined by AEEG and the convenience of switching supplier. At the end of 2004, after market opening to all non domestic consumers, sales in the liberalised market had declined to 60 % of the overall potential; moreover, only 3 % of the energy consumed by customers recognised as eligible after July 1 2004 were acquired on the liberalised market. On this basis, extension of eligibility to the domestic sector on July 1 2007, mandated by law n. 239/04, seems unlikely to contribute significantly to market liberalisation in the short term.

Wholesale markets

After a three year delay, the Italian power exchange was finally launched in April 2004. A significant departure from the semi-mandatory pool conceived in decree n. 79/99, the IPEX provides more fluid management of power demand and supply and a measure of transparency which was absent in the previous liberalised market, based entirely on bilateral contracts and administered balancing mechanism. However, the large fraction of mid merit plants, hydropower and peaking plants belonging to ENEL and its practically exclusive pumped storage capability provide the incumbent with price setting powers in most of the internal market areas defined by limited interconnection capacities. Increasing evidence of price distortion over the past year has led the AEEG to introduce close monitoring procedures to keep the exercise of market power under control. Prices have been showing a declining trend but remain consistently much higher compared to other EU exchanges.

Customer protection

The results of electricity sector liberalisation are not generally accepted as favourable by domestic and other small consumers and their associations who have seen only price increases in nominal terms. Reductions have been masked by the effects of increasing oil and gas prices on international markets and by perverse fiscal mechanisms. In real terms electricity prices in the captive market actually declined by 1,5 % between 1999 and 2004.

In line with decree n. 79/99, the AU began operating with the opening of the IPEX. In the interim up to April 2004, the role of the AU in procuring energy for the franchised market was undertaken by ENEL using its own resources and those of the three GENCOs. During this period, the wholesale price was established by the AEEG based on a fixed cost component determined from nation wide generating costs and a variable component updated every three months from a basket of oil product prices. Fixed generating costs were determined (much as transmission costs) based on the capital asset pricing model and weighted average cost of capital using a 7,9 % rate of return and updated with the price cap mechanism.

Starting from April 1 2005, the AU procures energy from a variety of sources including the IPEX, import contracts inherited from ENEL, the GRTN (for subsidised energy supplies), bilateral contracts and contracts for differences with producers and wholesalers. The energy is transferred to the distributors companies which proceed to invoice the final customers. The price billed to the franchise customers is administered by AEEG and covers refunds to the AU for power purchases and despatching costs, transmission and distribution fees and general charges.

As part of its mandate AEEG has dedicated considerable effort to improving the quality of service. Soon after it started operation it introduced a system of fines and rewards which resulted in improvements in quality of service across the board. The

duration of low voltage power interruptions per customer declined from 192 to 91 minutes/year for Italy as a whole between 1999 and 2004, most of which was attributable to improvements in the Southern regions. Likewise, dramatic progress in the quality of service and customer relations were secured through the application and yearly updating of minimum standards to the time required to deliver specific services. More recently the AEEG introduced a commercial code of conduct for sales agents.

3.2 Gas

Major events in the Italian gas sector in the past year are related to ENI abuse of dominant position, highlighted also in the joint analysis of the gas market undertaken by the AEEG together with the Competition Authority (AGCM) and published in early 2004. ENI accepted to release 9,2 billion m³ of gas each year over four years, with the first batch of 2,3 billion m³ auctioned in October of 2004. As part of the reparation ENI is also boosting import capacity on the interconnectors carrying Russian and Algerian gas. Likewise AEEG obliged the national network company Snam Rete Gas (SRG) to improve access on its regasification terminal. The following provides a brief description of the major features of developments in the gas sector.

Industry structure

As in the case of electricity, the drastic limitations imposed on the incumbent by decree n. 164/00 do not seem to have negatively affected its performance. The ceilings on supplies (75 % of the total on January 1 2002, declining to 61 % by December 31 2010) were comfortably eluded by transferring the gas it could not itself import to Italy, together with the related transport rights, to four competing companies. The ceiling on gas sales in final Italian markets (50 % from January 1 2003 to December 31 2010) were met by converting old oil generating plants located in its refineries and petrochemical facilities to gas fired combined cycles. ENI further reduced its risk on take-or-pay obligations for imported gas by cutting investments in upstream activities in Italy, thus reducing domestic reserves and production. According to law n. 290/03, ENI must reduce its share in the ownership of the transport company SRG from the current 50 % to no more than 20 % by July 1 2007. ENI is moving away from regulated activities (in the transport, distribution and storage sectors) into its core business of upstream development and marketing of oil and gas where it is now a major world player.

Though decree n. 164/00 has had as yet little success in reducing the incumbent's power, it has nevertheless provided competitors with apprenticeship in the liberalised market. Companies importing gas to Italy have increased from a mere handful in 2000 to more than 25 in 2004, though almost 75 % of the non ENI imports was imported by just four companies. The mandated separation of distribution from sales activities with the dramatic reduction of the duration of concessions (from an average of over 30 to 12 years) has triggered a wave of

mergers and acquisitions which has already reduced the number of local distributors and their sales agents by 40 % (from about 750 in 2000). To maintain their sales licence the latter must negotiate gas supplies from importers, producers, wholesalers and/or other sales agents and flexibility arrangements with the storage companies suitable to serve final customers over the entire heating year. Commercial activities especially in the household and small commercial sector are being concentrated to reduce overheads, as evidenced by the merger of the sales branch of ITALGAS into ENI as of January 2005. There are also indications of a trend towards vertical integration with former distribution company holdings buying into production and storage interests.

Access to networks

The legal separation of SRG from the merchant interests of ENI has been largely successful from a regulatory standpoint although the risk of discrimination in access conditions will always be present as long as ENI maintains a controlling share in the company and the 20 % limit currently foreseen for 2007 has been the subject of political debate with appeals for reducing the maximum to 5 %. Non discriminatory access is facilitated by the network code which governs SRG operations and by the transparent structure of the transport tariff which consists of entry-exit, postage stamp and point-to-point components, depending on the entry and exit locations with respect to the national and regional networks.

The entry-exit system adopted for transport on the national network is composed of a component related to capacity nominations at entry and exit points, a commodity component related to the gas transported and a fixed component related to final delivery in the proportion of 67, 30 and 3 % of total allowed revenues, respectively. The postage stamp and point-to-point approaches are adopted on regional networks for delivery points at distances greater and, respectively, shorter than 15 km. In the first regulatory period allowed revenues were determined on the basis of a 7,9 % rate of return with incentives for new investments. The tariff is updated at the beginning of the heating season using price caps of 2 % and 4 % respectively for the capacity and commodity components. The allowed rate of return and other parameters to be applied in the second period (2005 - 09) are currently under consultation.

Other natural or de facto monopolies that are regulated by the AEEG are regasification terminals, local distribution networks and underground storage reservoirs. The regulatory approach is similar to that adopted for transport on the national and regional networks, consisting of a code of conduct, amortisation schedules for long lived assets, a fair rate of return with incentives for new investments, price caps, approval by the AEEG of the detailed tariff structure proposed by the companies. The AEEG is currently developing a generalised distribution code aiming at achieving greater uniformity required to simplify regulatory oversight of the large number of distributors.

Growing demand for gas and increasing import dependence require considerable expansion of import capacities. Though there are many plans for new import terminals only two have received the necessary authorisation and construction activities have not yet begun due to last minute opposition from local authorities. In order to promote their construction, in 2002 the AEEG introduced derogations from third party access to new terminals for a sizeable fraction (80 %) of the gas treated and for a period as long as 20 years. Similar conditions are included in directive 2003/55/CE and are implemented in law n. 293/04, reforming the energy sector.

Market liberalisation

Eligible clients of the gas sector established by decree n. 164/00 (all gas fired generators irrespective of consumption and companies with annual consumption greater than 200 thousand m³) were very quick to enter the liberalised market immediately after market opening. By the end of 2002, an estimated 93 % of the total consumption of eligible clients (excluding large generators) was being supplied on the basis of contracts with new suppliers or renegotiated contracts with the old supplier. Full market opening from January 2003 did not add significantly to participation in the liberalised market, due to limitations in new supplies and decreasing margins resulting from gas price increases and the higher costs of small customer switching. Market negotiated supplies to customers with annual consumption lower than 200 thousand m³ amounted to just 2 % of total supplies to this group in 2003 and to 6 % in 2004. As an average over all consumption excluding power generation, market negotiated supplies increased from 45 % in 2002, to 48 % in 2003 and to 51 % in 2004.

Wholesale markets

Exchanges of natural gas volumes and transport capacities between shippers with excess gas and/or capacity and shippers with shortages have been taking place since the inception of the liberalised gas market, with the separation of transport activities in SRG. The exchanges were initially confined to border trades, agreed over the telephone. They were subsequently made more efficient and flexible by introducing a virtual exchange location, the *Punto di scambio virtuale* (PSV), managed from SRG's internet site. The PSV has proved to be a useful balancing tool and transactions grew rapidly immediately after its inception in October 2003 to reach some 20 % of total exchanges in terms of volume in October 2004.

The PSV currently accounts for a little over 2 % of total supplies compared to about 10 % for border trades. The potential for continued growth are good but await regulatory approval of a standard contract (under consultation) and radical changes in design. The exchanges take the form of bilateral trades at prices negotiated between the parties so that the PSV currently lacks the anonymity of commodity exchanges. The future importance of a hub at the PSV for the creation of an efficient gas market in the EU cannot be underestimated in view of the large number and quantities of gas from different sources that are expected to converge into Italy in a 5 year perspective and the very substantial storage capacity.

Customer protection

Shortly before full market opening on January 1 2003, the AEEG introduced the concept of a reference or fall-back tariff that all suppliers must communicate to customers with annual consumption smaller than 200 thousand m³ as a regulated alternative to their market based offers. This tariff was determined following the same rules as applied prior to full market opening with the intention of providing a measure of protection to household and other small consumers in the transition period. Averaged nationwide, the tariff resulting from the application of these rules in the last update of July 2005 was 62 c€/m³. By far the largest element of the tariff is the fiscal component amounting to 44 % of the total. The gas commodity accounted for 28 % and marketing costs for 10 %. Fixed infrastructure costs contribute the remaining 18 % (12 % for distribution, 4,5 % for transport and 1,5 % for storage). In late 2004, the AEEG attempted to reduce the commodity component but was out-ruled by the competent tribunal.

As in the electricity sector, the AEEG has introduced measures to improve quality of supply through the application of commercial quality standards. It also introduced mandatory inspection of distribution networks to improve safety conditions and extended the obligatory insurance policy for accidents related to gas use applied since 1991 and expiring in 2005. A Government decree issued in early 2004 introduced a supplier of last resort for each of 17 areas in order to replace suppliers who had failed to separate sales from distribution and, more generally, to guarantee supplies in case of insolvent sales agents.