

# **ANNUAL REPORT ON THE STATE OF THE SERVICES AND THE ACTIVITY CARRIED OUT BY THE AUTHORITY**

## **The President's introduction**

Rome, 4 July 2000

President of the Chamber of Deputies, Minister, Authorities, Ladies and Gentlemen

The country is going through a difficult transition period. The restoration of sound financial conditions is now well under way, and inflation has been reined in, but economic development is now being held back by the slow-down in accumulation and by the insufficient competitiveness of the production system. The discipline imposed by Italy's participation in European Monetary Union does not allow us to offset the loss of competitiveness through the depreciation of the exchange rate). Rather, it requires structural reforms and firm action to restore efficiency and provide an impetus for new investment and entrepreneurial initiatives.

The progressive widening of the competitive gap between Italy and the other developed economies is a cause for concern, with the risk of delocalisation of production and resulting job losses. The weakening of our capacity to compete, which affects both the business sector and the performance of the institutional framework, also involves the energy sector and the services regulated by the Authority.

The energy sectors contribute about 9% to gross domestic product formation, they employ more than 180,000 people, and they account for annual investments in the order of 18,000 billion lire, the equivalent of almost 5% of total investment throughout the economy. But the importance of the electricity and gas sectors in conditioning development and the competitiveness of the entire economy does not lie primarily in their size and economic weight. It lies far more in the fact that they are both essential and far-reaching, and in the opportunities they provide, or fail to provide, for the development of other sectors and the birth of the firms of the new economy.

In any comparison with the other major European countries the two sectors compare unfavourably with respect to prices, some aspects of service quality, and the capacity of the companies operating in the sector to innovate and develop an international dimension, not least through alliances involving all stages of the production cycle.

The competitive gap is tending to grow as a result of the rapid development of the European context, into which new players are flooding, each with a strong degree of dynamism and flexibility.

As they proceed in the construction of the internal energy market, the countries of Europe are enhancing, and drawing advantage from, their strength. Reduced service costs foster economic growth. Freedom of choice increases consumers' prosperity. Alliances between companies and the creation of new players are re-drawing the map of the energy industry.

For the Italian energy sector the past eighteen months mark a historic turning point, one which opens up great potential. The decline in competitiveness can be reversed by making a firm, decisive push in the direction of liberalisation. The decisions adopted thus far have prepared the way for the economic recovery to gain in strength.

The legislation implementing the European Directives and liberalisation has been adopted: for electricity, Decree no. 79 of 16 March 1999; for natural gas, Decree no. 164 of 23 May 2000. In this way Italy has respected her commitment with the Union to implement the two European Directives designed to establish common rules for the

internal market: these are, respectively, Directive 96/92/EC of 16 December 1996 and Directive 98/30/EC of 22 June 1998.

In the same period the Authority for Electricity and Gas has approved important decisions regarding tariffs and quality of service. A significant part of the tasks set out in law no. 481 of 14 November 1995, which set up the Authority, has therefore been accomplished. These tasks include the reform of the tariff structures to bring them more closely into line with costs, and the construction of a system of rules aimed at guaranteeing consumer protection and service quality during the liberalisation process.

The route we have embarked upon should be followed in the full knowledge of the implications and importance of the decisions we have taken: it must be clear that the task of achieving our objectives has only just begun.

## **LIBERALISATION AND ENERGY PRICES**

1999 and the early months of 2000 were characterised by an exceptional upwards pressure on energy prices, the like of which had not been seen for twenty years. The international price of crude oil, to which natural gas supply contracts and the prices of a large part of the fuels used in electricity generation are indexed, increased from 11 dollars per barrel in January 1999 to over 30 dollars in June 2000. Owing to the depreciation of the Euro lira prices have more than tripled.

In July 1999, the last date for which official comparable data are available, the average prices of Italian electricity exceeded, net of taxes, the European average. The price differential borne by Italian consumers was in the order of 20% for average households, although the Italian tariffs for low consumption categories are lower than the corresponding average European tariffs. For supply to businesses, the Italian tariffs were about 30% higher than the European average. And for the gas service the Italian prices, again net of tax, were about 7% higher than average European prices, both for families and for businesses. The gaps increased if the comparisons were made gross of tax.

The gap between Italian electricity prices and average European prices does not appear to have changed over the 1996-1999 period, during which both experienced a downward trend. However, in the last eighteen months the upward pressure produced by the hike in the oil price has hit the European economies, and the Italian economy in particular, given the greater sensitivity of Italian prices to the oil price.

The indexation mechanisms for electricity and gas tariffs that the Authority has put in place over the last few years have made it possible to keep the transfer of supply costs to final prices within reasonable limits and to spread their effect over time, thus avoiding abrupt rises. In particular, during the period between early 1999 and June 2000, in the face of an increase of about 250% in the lira price of crude oil, the indexed components of the electricity and gas tariffs increased by 90% and 140% respectively.

The reductions the Authority has applied, following a careful study of costs, to the parts of the tariff intended to cover the industrial costs of gas transport, and the generation, transport and distribution of electricity, have made it possible to balance the effects of the rise in the international price of crude oil and the depreciation in the value of the Euro, and thus to contain their overall effect on the tariff paid by consumers. In June 2000 the average electricity tariff was about 3% higher than in late 1998, and that of gas, about 20% higher.

The fall in the final prices of electricity in the countries of Europe which has been under way for some years, is the result of the greater efficiency produced by competition, whether existing or expected. The reductions have been particularly marked in the countries where liberalisation has been most intense or most recent, such as the United

Kingdom, Spain and the Nordic countries. In Germany, where competition between electricity providers has become livelier as liberalisation has progressed, reductions of around 30% in the prices paid by large clients have been recorded.

In Italy the first evidence relating to contracts on the free market points to significant price reductions, the result also of the liberalisation of imports under transparent conditions, defined by the Authority, for the allocation of interconnection capacity. The price reductions have, in some cases, been considerable, in the order of 15 to 25%, depending on the conditions for the use of capacity. In many cases the lack of competing supply has allowed prices to be kept only slightly lower than the franchised market tariffs.

The convergence of energy service prices in the European area will only proceed if exchanges are extended and competition is consolidated. Obstacles to competition and the reduction of prices include limited interconnection capacity and the persisting concentration of electricity generating and gas supply capacity in the hands of firms occupying a dominant position.

The Italian energy system needs investment if growing demand is to be met at satisfactory conditions of cost, security, reliability and environmental compatibility. Energy sector investment as a share of GDP, which amounted to 1.4% at the beginning of the 1990s, fell below 1.1% in 1999; it needs to recover its historic value. New electricity generating plants are needed, new infrastructures for the transport of electricity and gas, new sites for the storage of gas and regasification terminals for liquefied natural gas. Competition should encourage the entry of new operators and speed up investment initiatives.

The uncertainty of the operational frameworks, which has accompanied the early stages of a liberalisation process that is still incomplete, has also played a part in hindering the decisions that need to be taken if the infrastructures are to be modernised and improved. This phase must be completed quickly, with the implementation of the measures envisaged by the Legislative Decrees implementing the European Directives.

In each European country liberalisation proceeds at three, equally essential, levels: the recognition for customers of freedom of choice of supplier; the development of competition in supply; and the availability of network access and utilisation of the networks under fair and equitable conditions. The speed and intensity of liberalisation vary from one country to another, for each of the three levels. Some European governments are studying indicators, which have also been proposed to the European Commission, which could be jointly used to measure the degree of liberalisation and identify the need for intervention.

Comparisons between the degrees of liberalisation of single national markets must not be expressed, as is usually the case, by a single indicator, such as the extent of eligibility. To be effective, liberalisation on the demand side requires a corresponding evolution of supply, towards competition among different, numerous and mutually independent operators, each with a low degree of market power. In countries like Italy, in which liberalisation is taking over from legal or *de facto* monopolies, the route is an arduous one. Significant established interests, connected to some degree with the dominant companies, oppose the changes. The very development of these companies, which is of great importance for the national economy, appears at times to be in conflict with the objectives of liberalisation. If we extend our gaze beyond purely short-term considerations and take a close look at the characteristics and trends of economic globalisation, we can see that not only is liberalisation vital to the general interest, but that it also plays a positive role in the development strategies of the same formerly monopolistic firms. The country's rules and institutions, which include the Authority itself, have the task of steering the process of liberalisation, and a responsibility to

guarantee that the general objectives are respected. In first place among these are the protection of consumers and the environment, and the efficient use of resources, in harmony with the financial equilibrium of the companies themselves.

## THE ELECTRICITY MARKET

A key feature of 1999 was the approval of Legislative Decree no. 79/99, which paved the way for the liberalisation of the electricity sector. The activities of generation and supply to clients on the free market were opened up to competition, while distribution and transmission over the national network retained their monopoly structures. In the months following the approval of the Decree, the integrated electricity companies embarked on the unbundling process, which involved either setting up separate companies or implementing an administrative and accounting unbundling, as required by the implementing Decree. The accounting and administrative unbundling regulations laid down by the Authority were also taken into account.

The reorganisation of the Italian electricity system has been characterised by the sequence of regulation – liberalisation – privatisation, which seems appropriate for a sector in which segments operating in natural monopoly conditions co-exist with segments operating in conditions of open competition. The institutional transformation was launched in 1995 with the law setting up the Authority, and proceeded in 1999 with the implementation of the European Directive. The consolidation of a context firmly oriented towards liberalisation has made possible the initial public offering of Enel Spa shares (amounting to 35.5% of the capital) and of quotas of important local electricity companies.

Problems, sometimes serious, can arise when an activity still operating in monopoly conditions is placed in private hands or moves towards privatistic modes of conduct. They can also arise when the interest of the Government, as shareholder, in increasing the value of a firm engaged in the privatisation process comes up against the requirements of the ordered and impartial regulation of tariffs and of the liberalisation process. Up until now problems of this sort have been, if not avoided, then at least kept within acceptable limits. It is necessary to operate with balance and courage so that they do not crop up again in the near future, on the occasion of the sale, as already announced, of a further *tranche* of Enel's shares.

The initial public offering of Enel's shares was considerably larger than was the case for other privatisations that had taken place previously. Revenue in the order of 35,000 billion lire was generated, raising the capitalisation of the Italian stock market, in relation to gross domestic product, by about 1.6 percentage points. More than 4 million private shareholders now hold interests that are distinct from those of the users of the service. This leads to a conflict in the distribution of the value generated by the companies between consumers and shareholders, and between service effectiveness and company profitability. The balance between different stakeholders' interests is safeguarded by competition and regulation.

The new tariff structure for the supply of electricity to the clients of the franchised market, started up by the Authority in June 1997, completed with the decisions of December 1999 and today in the process of gradual implementation, is based on the principle that tariffs should correspond to costs and to service quality. The reform reduces the number of user classes from fifty-two to nine, and eliminates differentiation between different types of use.

An important element of flexibility lies in the possibility for operators to offer tariff options, basic and special, that respond more closely to users' requirements. The tariff options must be offered in a non-discriminatory and transparent way to all the clients in

question, in full respect of a Commercial Code of Conduct. Constraints on tariff revenue have been introduced in order to prevent supply side flexibility from developing into the exploitation of dominant positions by one or a very limited number of operators, to the detriment of consumers' interests. These constraints are applied uniformly throughout the country, in accordance with the dictates of the law. Cost differences resulting from the different characteristics prevailing in different parts of the country, and which cannot be attributed to differences in efficiency levels between one operator and another, will be adjusted using compensation mechanisms on which consultation is currently taking place with the operators and with the other parties involved (employers associations, trade unions, consumers' organisations).

During the reform process the tariffs have been subjected to a significant internal re-balancing process, as a result of the elimination of the old cross subsidies between different user classes. On average, the tariffs are following a downward trend, notwithstanding the contrasting but transitory effect of higher oil prices. Their level is affected by surcharges to finance the general system costs. These include the costs of dismantling nuclear power stations and the disposal of irradiated fuel and waste, support for system research, and support for renewable and assimilated sources through guaranteed high prices for electricity sold under the onerous measures laid down in provision no. 6 of April 1992 of the Interministerial Pricing Committee (*Comitato Interministeriale Prezzi, or CIP*) which, in view of specific legal restrictions, the Authority has been able to rationalise only to a very limited degree. The need to reduce the average tariff level only gradually, as the Government recommended in the Economic and Financial Planning Document (*Documento di Programmazione Economico-finanziaria, or DPEF*) for the years 2000-2003, places an additional burden on users over the 2000-2001 period.

The costs that emerge in the transition from the monopolistic to the competitive structure, known as stranded costs, will also weigh on consumers' expenditure. These are costs deriving from energy generation investments, or from contractual obligations, dating from before 19 February 1997, when the European single market Directive came into force. It now appears that these costs, justified at the time by service responsibilities linked to the sole concession regime, are not fully recoverable following the opening up to competition. The criteria for defining them were laid down by the Decree of 26 January 2000, issued by the Minister of Industry and the Minister of the Treasury, following a proposal by the Authority. The stranded costs to be recovered in the tariff will be quantified by the Authority in each end-year balance.

The transition to competition involves the formation of a single market price for electricity, independently of its origin, and the elimination of the current regime of differentiated compensation, which includes a contribution to fuel costs borne for thermoelectric generation.

This regime was introduced in far-off 1975 to lessen the impact of oil costs. The single price produces a substantial benefit for electricity producers with hydroelectric plants. This benefit, which is symmetrical to the aforementioned costs of the transition to competition, is subject to partial and transitory compensation, through an increase in network access fees. The revenue to the system will play a part in reducing costs for consumers.

The process of incorporating the costs of the transition to competition in the tariff is overseen by the European Commission. The format followed and the rigour of the procedures adopted lead us to believe that the cost that will actually fall to consumers will be kept well below the ceiling of 15,000 billion lire indicated in the Legislative Decree.

The Authority has taken decisions aimed at guaranteeing the effective opening up of the market, regulating in the first place the network access arrangements. As Decree no. 79/99 was issued, the technical and economic conditions for the wheeling of energy on the networks were being laid down. The wheeling tariffs, based on the principle that they should correspond to costs, are set in such a way that distance becomes almost irrelevant: the result is a situation of parity between the different regions of the country. The tariffs incorporate incentives for the removal of network congestion.

On a provisional basis, until the market is fully operational, the prices for the sale of electricity by producers to distributors have been re-defined. The reduction of the scope of administered prices at the generation stage should not leave space for the exercise of market power.

In implementing the liberalisation Decree the Authority has recognised the import capacity available in 2000, and in assigning it to the market of free customers has followed procedures that have allowed a large number of companies to gain access. Where previously only Enel operated, today 24 subjects, holders of 44 contracts, are active. Competitive procedures will be introduced for 2001.

The development of international electricity exchanges requires a European agreement on the rules and tariffs of trans-border transport, which must be compatible and non-discriminatory.

The free market is beginning to take real shape, at least on the demand side. A fundamental aspect of this process has been granting eligible clients the option of withdrawing from the habitual supplier. The Authority has guaranteed this from the outset of the liberalisation process by imposing a time limit to the period of notice required for withdrawal from the contract. The lowering of the eligibility thresholds has been accompanied by a continual growth in the number of eligible customers who, are about 800 players with 3,500 withdrawal nodes), accounted for 30% of demand in May 2000.

With an amendment inserted in bill no 4339, annexed to the Financial Law (budget) for the current year, the Government set itself the goal of lowering still further the eligibility threshold, following a more rapid time scale than the one envisaged by Legislative Decree no. 79/99, subject to the sale of production capacity by Enel. This acceleration of the liberalisation process, with a series of interventions made possible by the satisfactory progress of the initial stages, reflects the experience of many other countries. In this very period the Spanish government has extended eligibility to all customers as of 2003, and at the same time has introduced measures to limit the expansion of the main electricity operator.

An extension of freedom of choice for small consumers seems particularly desirable in co-ordinating the liberalisation of the electricity market with that of the gas market. Companies operating in one of the two sectors, which transform themselves into multi-utility firms, can rapidly provide the necessary range of supply options to consumers by extending operational capacity to the other sector. The process would be helped along if the deadlines for the two liberalisations were brought closer.

The management of the national transmission network has been entrusted to a new company, which started operating independently in April 2000. Its relations with the companies owning the networks, of which the company belonging to Enel plays a major role, are currently being defined.

This experiment in managing the transport and despatch activities separately from the ownership of the network, in the presence of a highly concentrated ownership structure, is unique in global terms and presents a challenge that is far from easy.

The objectives of this challenge are: the orderly functioning of the system in the delicate market start-up stage, a rapid start to the necessary strengthening of interconnections,

the interventions required to deal with congestion and reduce duplications, and the development and recovery requirements posed by the problem of electromagnetic fields. It is appropriate that the organisational review of local distribution should be consistent with the reduction of the eligibility threshold. The renewal of the licences should only involve distribution activity, in recognition of the liberalisation of supply activity.

If the free market is to become fully effective two other steps are needed: the establishment of the power exchange and the creation of truly competitive generating conditions.

The electricity power exchange should become operational at the beginning of 2001. It must be both liquid and transparent; the liquidity of the positions might be aided by the development of a derived financial contracts market. Wholesalers, the Single Buyer, and, where permitted, distributors, will also have to operate on the power exchange, if they are to be able to serve their final customers at competitive prices. Bilateral contracts must become the exception.

The creation of competitive conditions for power generation could derive both from the entry of new operators, and from a re-balancing of existing ones. The dominant operator must be prevented from increasing its degree of market power. Agreements with other companies or with public administrations, even where they include desirable rationalisation aspects, must be fully subject to this condition.

For the purpose of creating competitive supply, Decree 79/99 limits to 50% the energy that, with effect from 1 January 2003, each single operator can produce or import. Critical aspects here are the timing and conditions of sale of the generating plants. Decree 79/99 envisages that by the end of 2002 generating plants owned by Enel and accounting for a total of 15,000 MW will be sold to third parties. The conditions for the divestment were decided by the Decree of the President of the Council of Ministers of 4 August 1999 and the Decree of 25 January 2000, issued by the Minister of the Treasury and the Minister for Industry. The Industry Minister has announced that the first divestment will take place by the end of this year and that the divestments will be completed next year, earlier than initially envisaged.

This acceleration in the divestment schedule is highly desirable, not least to allow a re-launch of investments, which should lead to a lowering of the high average age of the generating plants, currently about 25 years. In particular, the re-conversion of old plants to new combined cycle systems will make it possible to improve the efficiency of power generation plants, today held back by modest yields of about 38%. This is considerably lower than the yields that can be obtained using more advanced technologies, which are nearer to 60%.

The renewal of the plants will also take us a good way to meeting the objective of containing greenhouse gas emissions, as laid down by Decision no. 137 of 19 November 1998 of the Inter-ministerial Committee for Economic Planning (*Comitato Interministeriale Programmazione Economica, or CIPE*). This was adopted in the wake of the Kyoto protocol commitments signed up to by Italy and the European Union.

New investments are necessary because the Italian electricity system continues to be distinguished by highly visible weak points. The high dependence on oil sources makes it vulnerable to the variability of crude oil prices. A higher recourse to less costly, and more abundant, resources, such as coal, is desirable if costs are to be contained and security of supply increased: this can be taken into consideration only if it is matched by significant progress in modernising the existing generating stock, so that that the complex of polluting emissions follows a downward trend compatible with the commitments Italy has signed up to in international quarters.

The revamping of power generation plants has been held back until now by the lack of competitive stimuli and the complexity of the authorisation procedures. Decree 79/99 includes measures to simplify these, which have still to take effect.

The sale of the Enel power stations must be conducted in such a way as to contribute as fully as possible to achieving the objective for which it was decided, the formation of a competitive electricity market. The procedure for the sale must keep this purpose in sight.

The steps that have been taken so far are the grouping of the Enel plants into three companies and the choice of the negotiated tender for the sale. The regrouping holds smaller players back from participating in the purchasing procedure. The negotiated tender method, which underlines the importance of elements of preference other than price, needs careful handling if the requirements of transparency and equality of opportunity for all potential participants are to be respected. The selection, which hinges on the evaluation of elements of preference such as the quality of the business plan and its contribution to the competitive development of the sector, should if possible be carried out by a player other than the transferring party, which cannot be considered as free of direct interests in the matter. The Decree makes this possible, by providing that the operations be supervised and co-ordinated by the Treasury and Industry Ministers. The same Decree also provides for a public offering for the larger company although as a second option: this would be a significant improvement in terms of both transparency and the promotion of competition.

The freedom for the purchaser to develop the plants and gain competitiveness is particularly important. The imposition of restrictions regarding fuel supply and the renewal and possible re-powering of plants, additional to those contained in the sell-off plan which are already considerable, must be avoided.

The rapid completion of the sales is of fundamental importance in encouraging competition in the supply of electricity in the delicate start-up phase of the electricity market.

It is advisable that decisions regarding the supply on the market of electricity produced by plants in the process of being sold should be taken, from the outset, by new players, who have no reason to co-ordinate their decisions with those of Enel. While there can be no questioning the need to ensure that the market is opened up within the established deadlines, if by then the sale had not been completed the risk of an exercise of market power on the supply side would have to be satisfactorily dealt with. Recourse to administrative control can be avoided by preventive measures, which must be put in place in good time.

With regard to the rationalisation of the distribution networks and the integration of the local network services, the principle of the promotion of competition must hold good: the market power of the dominant subject must not therefore be increased by new agreements between companies.

## **THE GAS MARKET**

The approval of Legislative Decree no. 164 of 23 May 2000, implementing European Directive 98/30/ECE, is a prime opportunity for the development and strengthening of our country's natural gas sector. The liberalisations of the two markets, gas and electricity, are mutually supportive and complementary, by reason of the increasing synergism between the two sectors. The Decree comes into play against a background of expected strong expansion in gas consumption over the next few years, due first and foremost to the use of gas in electricity generation. This expansion will facilitate competition between a range of companies.

Key aspects of the liberalisation of the gas market are the quotas on supply inputs and sales by a single operator. Effective competitive conditions can only gain a foothold if the upstream stages of the system are progressively opened up. The importance of supply from abroad for Italy's consumption and the concentration of the sources of origin makes the availability of gas imported by a plurality of operators a crucial factor for competition and security of supply.

In this respect the proposals for the sale of nationally produced gas or of imported gas at the frontier are useful, but not sufficient in themselves. Supply infrastructures should be developed, at the same time ensuring that the current dominant position does not end up being reinforced by this process. In the near future new regasification terminals for liquefied natural gas will have to be built: initiatives in this respect have been initiated in one case, aired in others. Equally desirable and deserving of support are the initiatives for the construction of new gas pipelines for supply from abroad.

Non-discriminatory access to existing infrastructures must be guaranteed, including through arrangements co-ordinated at the European level, with guaranteed network inter-operability. The European Commission is investigating some clauses contained in the natural gas importation contracts which, by restricting importers' selling activity, tend to segment the final market and obstruct competition. The removal of these clauses should make a significant contribution to liberalisation.

Access to and use of the transport and distribution networks, storage facilities and regasification terminals have been regulated: the actual availability of the structures to those players intending to offer gas on the market will emerge as being better guaranteed, with greater credibility for liberalisation and better prospects for new investments by existing and new operators. Regulation, in addition to defining tariffs, envisages the definition of impartial access criteria, on the basis of which the operators will adopt their own network and storage codes of conduct which will include adequate recourse to competition mechanisms.

One measure of great importance in the liberalisation Decree is the unbundling of high pressure transport, storage, despatch and secondary distribution from other activities of the sector; in particular, the unbundling of the national transmission network, albeit under the control of Eni Spa, is envisaged. The Authority is in the process of defining the rules for accounting and administrative unbundling.

The recent announcement of the quotation of the company owning the national gas transport network, with the possibility of selling the majority shareholding, confirms that the format inspired by the promotion of competition and the general interest is matched by a new strategy within the company involved. The aim of this is to build up its strategic activities for a competitive repositioning on the open market. This is an important example, which could exert a positive influence on the development of the natural gas market in Europe. It could also provide a benchmark for the regulation of the electricity sector in Italy. Italy now occupies one of the most advanced positions in gas liberalisation in Europe, preceded by the United Kingdom and recently followed by Spain.

Conditions of full reciprocity must be guaranteed vis-à-vis other countries, especially those that are still lagging behind.

The Legislative Decree recognises immediate eligibility for customers with consumption of more than 200,000 cubic metres per year, and for all users from 2003. The free market will therefore expand rapidly on the demand side; this will require a consistent, rapid and effective opening up on the supply side.

Small consumers could find themselves having difficulty coping with the free market. They must be protected by regulatory initiatives, which include the transparency and comparability of supply options, and by the vigilance of the Authority against a possible

exercise of market power, which would presumably remain in the hands of some players operating on the supply side.

The Authority's initiatives in the gas sector have concentrated on the launch of the tariff reform and the safeguarding of the technical and commercial quality of the service

The launch of the tariff reform was preceded by two interventions. In April 1999 the mechanisms indexing tariffs to raw material prices were redefined. In December 1999 the allowed costs for the transportation of gas on high pressure networks, which an analysis of the available data suggested were excessive, were reduced. These two interventions resulted directly in a reduction of the tariffs for the final uses of gas distributed over urban networks, through the allowed price of the raw material, and indirectly in a review of the prices negotiated with thermoelectric and industrial users.

In spite of this, the tariffs and prices of gas have increased considerably in the last year as a consequence of the rise in oil prices. To allow for a gradual loosening of the close link between gas and oil prices, the development of organised gas markets, as in the case of North America, should also be encouraged in continental Europe, with negotiations concentrated in hubs in which these markets might acquire autonomy and substance.

The task of monitoring the tariffs and tariff adjustments applied by distribution companies to users, carried out in 1999, enabled errors to be identified in more than 150 cases. Action by the Authority led to tariff reductions from which over 60,000 users benefited, in part through the refunding of erroneous payment demands.

The new tariff regime which the Authority is putting out to consultation takes into account the new structure of the sector outlined by Decree no. 164/00. The proposed arrangements distinguish between services destined to remain under technical monopoly conditions and services that could potentially be provided under competitive conditions, so as to encourage their liberalisation. Distinct tariffs are envisaged for the services of high-pressure transmission, storage, distribution (i.e. transmission at the local level), and for ancillary services, as well as tariffs for franchise customers, with the appropriate adjustments. In keeping with the measures set out in Law 481/95 the tariff system should, being based on predefined criteria, be transparent and stable, protect the interests of consumers through the promotion of competition and efficiency, and ensure the diffusion of the service at suitable quality levels, while taking into account the economic-financial equilibrium of the operators. The costs that can be allowed, since they correspond to acceptable levels of efficiency, will be defined partly through comparisons between companies, taking into consideration their respective operating conditions. Efficiency is encouraged in operators, while respecting the restrictions aimed at promoting the quality of the service and limiting crossed subsidies between user categories. The tariffs will be set by the operators within the framework of constraints defined by the Authority, as in the case of electricity, and under its control. The transition to the new arrangements will be gradual and will follow set deadlines.

There is a link between gas market liberalisation and the reorganisation of the local public services that concerns in particular the distribution of natural gas for civil use. The implications of this link are grasped in the Legislative Decree, which proposes solutions that also appear in draft bill no. 7042, which is currently being examined by the Chamber of Deputies. The legislation reforming the local public services aims at unifying the wide range of organisational and management solutions, often a product of their strong roots in local community affairs.

It is desirable that the transition to appropriate tender-based forms of market competition be encouraged. In this perspective, the Authority is preparing to tackle the tasks entrusted to it by the Legislative Decree, and is drawing up an outline contract for the service and defining the conditions for the re-evaluation of any investments not

amortised by the out-going operator. These are essential instruments for the transparency of tenders that have a part to play in interventions for the reorganisation of the services by the local authorities. They also have a role in promoting the aggregation of the distribution service on the basis on efficient supply areas, in such a way that the exclusive nature of the licence does not create an obstacle to competition and the development of the service.

## **QUALITY OF THE SERVICES AND CONSUMER PROTECTION**

The introduction of competition to the public utilities changes the terms of reference of the concept of public service. From a set of obligations, sometimes inappropriate and excessively rigid, applied to the licensee, we are now moving to restrictions of a more general order which the subjects operating the service are required to respect to protect the interests of users and consumers and encourage the diffusion of the service. In the case of the essential public utilities this aspect of protection requires that adequate contractual conditions of supply, and minimum standards of security and reliability of the service, be guaranteed.

In order to improve service quality, customer relations, and the supply of additional services, the operators are currently working on technological and organisational innovation, growth, and expansion into adjacent sectors. The dynamism thus demonstrated benefits the development of the production system and is also beneficial to consumers, if expressed within a context of competition. Customers are an economic asset for companies: they must not become an opportunity for rent seeking.

As laid down in its constitutive law, the Authority regulates the quality of the service through the tariff lever; it also defines incentives for quality improvements and penalties for operators who diverge significantly from predefined levels.

The third annual survey on the quality of the electricity and gas services has been completed. The survey responds to the task of monitoring service supply arrangements and provides the framework of information that is needed to implement more decisive initiatives than was the case under the previous regulatory system, which was voluntary in nature and based on Citizens' Charters.

For both the electricity and the gas sectors the Authority has introduced ceilings to the time required to provide the services to users. These are uniform throughout the country and mandatory for all operators, and include provisions for automatic refunds to users whenever they are not respected. In the electricity sector uniform criteria for measuring service outages have been introduced and a new system has been set up to regulate continuity of service. The objective of the Authority's initiative is to reduce, in a relatively short time, the gap that currently exists between Italy and the principal European countries. The gap can be summed up emblematically in terms of the average number of supply outages per user in 1998, which was 4.1 in Italy, 1.3 in France, and 0.9 in Great Britain, and their average annual duration, in terms of minutes lost per user, which for the above three cases was, respectively, 196, 63 and 81 minutes.

The new regulatory provisions for service continuity also aim to reduce the gap between different regions of the country, as represented by an average number of outages per user, per year, in the zones served by Enel, of 2.6 in the North and 5.4 in the South. These figures correspond, respectively, to an average annual duration of outages of 121 and 270 minutes lost per user.

Operators have been set improvement targets that should, overall, bring the average continuity values of the Italian electricity service more into line with European levels and reduce the gap between the average values found in the different areas of the country. This measure is a new departure for the Authority. Prior to this, there was no

obligation to reduce the number and duration of outages, the solution of the continuity issue having been left to the operators themselves.

For the gas service too, the Authority has presented its proposals on the regulation of security and continuity in a consultation document currently being examined by the interested parties. By introducing service obligations and other regulatory instruments, the Authority aims to achieve, in a short time scale and on a countrywide basis, minimum levels of security and continuity.

The task of evaluating complaints, appeals and reports from consumers has led to the opening of individual proceedings against some operators, and to the direct resolution of disputes. This activity has provided the occasion and opportunity for the issuing of directives on the subject of contractual supply conditions. These will replace the clauses previously laid down unilaterally by the operators providing the service.

The Authority has also completed its interventions on the subject of transparency of billing documents, in 1999 for the natural gas service, and in spring of this year for the electricity service. It has also been established that at least once a year customers will find in their bills a comparison between the quantity of electricity consumed in the twelve months leading up to the billing period and the quantity consumed in the previous, comparable period. Improving customers' awareness of their consumption levels, and trends, is a starting point in educating them towards a rational use of energy.

The possibility for the operators of the electricity distribution service to offer tariff options lends flexibility to the new tariff system launched by the Authority at the end of last year. To avoid disparities of treatment, the tariff options must be offered in a non-discriminatory way, with complete information provided to all the customers involved, in full respect of a Code of Commercial Conduct approved by the Authority.

Another service obligation is the protection of economically and socially disadvantaged user classes. As is the case with other public utilities, an evaluation of the efficacy and equity of social protection criteria and mechanisms is also required for electricity and gas. Traditionally, the monopolistic regimes envisaged particularly favourable economic conditions for some classes of consumer, granted according to criteria that did not reflect the beneficiaries' actual ability to pay. The Authority intends to adopt mechanisms for access to the "social tariff" that will be based on a means testing mechanism, adjusted taking into account the characteristics of the family unit. These indications have been taken on board by the Legislative Decree for the reform of the calculation mechanism of the Equivalent economic status indicator (*Indicatore della situazione economica equivalente, or ISEE*), which gives the regulatory Authorities the task of deciding how the Indicator will be applied. It is to be hoped that the Government will provide guidance on setting the threshold for access to the special terms. The Authority is ready to offer whatever assistance may be necessary.

The protection of the environment is one of the general objectives to be pursued in the new competitive context. Measures to achieve this include programmes for the management and monitoring of demand, the development of renewable resources, and technological research. The pursuit of environmental protection objectives involves costs and benefits, sometimes deferred, that must be distributed amongst the different categories of players in a clear and stable way. It must be based on economic instruments that do not run counter to the principles of competition. An example is provided by the constraints on operators' revenue, which were introduced as part of the electricity tariff reform. These restrictions are formulated in such a way as to reduce considerably the incentive to promote increased consumption that was implicit in the old tariff system: this is due to the fact that increases in customers' average consumption now involve, and rightly so, an allowance only for the variable costs of the service.

The development of renewable resources should also be encouraged by using efficient instruments that are able to keep any repercussions on supply costs to a minimum. In the current legislative framework difficulties remain, however, in linking up both with the existing regulations (such as the incentives envisaged by *CIP* decision no 6/92), and with the taxes on energy products, which correspond only in part with environmental protection objectives.

One activity receiving support is small-scale hydroelectric generation, which is protected in view of its beneficial repercussions on the territory.

Looking further ahead, the awaited market of "green certificates", which would indicate the cost of generating energy using non-polluting sources and bring out the demand to support this, could come to play a significant role.

The most advanced high yield electricity generation technologies that limit the environmental impact of energy conversion processes are favoured by the new economic climate following on from liberalisation. A more extensive use of these technologies would make it easier to fulfil the country's commitments to contain the emission of greenhouse gases and other pollutants.

A reflection is currently under way on the measures to be adopted to prevent the health risks produced by the electromagnetic fields generated by the transport of electricity along power lines. The scientific evidence on the harmful effects of exposure to low frequency fields is controversial. In the absence of definite conclusions it is advisable that any remedial interventions be spaced out over time. The point of departure should be the highest risk situations, which should be identified on a precautionary basis, to ensure that the electricity system is not burdened with costs that would be difficult to sustain, and which might compromise its competitive position in the European internal market.

## **THE NEW REGULATORY FRAMEWORK**

The conditions which justify, in terms of economic governance and the effectiveness of public initiatives, the entrusting to a separate, autonomous body with a high degree of technical expertise, of functions previously carried out by the central administration and of functions required by the transition to a liberalised market, include procedural transparency and autonomy of evaluation, as exercised responsibly within the limits posed by the constitutive law and the general policy guidelines formulated by the Government. The same conditions include the consistency and stability over time of a set of regulations characterised by their highly technical nature and their ability, using the lever of economic advantage, to direct towards the protection of the general interest behaviours that, taken individually, are directed more to the interests of the companies themselves.

Law no 481 of 14 November 1995 set up bodies endowed with a significant degree of decision-making autonomy, indirectly but firmly linked to the political institutions. The Authority operates at all times in connection with the other institutions of the Republic. It has close relations with the Parliament, through hearings before the parliamentary Committees; with the Government, from which it receives guidelines through the *DPEF* and to which it conveys proposals, reports, and observations as laid down by the constitutive law; and with the other regulatory authorities and guarantors, in particular the Antitrust Authority (*Autorità Garante per la Concorrenza e il Mercato*.)

The Authority has also provided an input to the Constitutional Affairs Committee of the Senate of the Republic, which has carried out a survey on the independent authorities.

The experience gained by the new independent administrative authorities during the period of starting up and becoming fully operational, also in the light of the

development, at European level, of public regulatory policies, should now allow for some re-thinking. It is to be hoped that the legislator, taking into account the specific nature of the tasks involved and the variety of organisational frameworks, which is not necessarily a bad thing, will now set to work on the harmonisation of some of the legislative aspects. For example, more uniform staff grading structures might encourage the mobility of human resources between the various bodies, spreading, and injecting new life into, the regulatory culture; procedural transparency and the participation of the interested parties in decision making could be even better promoted; the simplification of the procedures for the settlement of disputes, which would cut down on their length, at present excessive and prejudicial to the reliable application of the legislation, would also be beneficial. The Authority will be happy, if asked, to provide its contribution, in terms of experience and evaluation, to the considerations currently in progress at the institutional level.

The OECD's initiative for a regulatory review, focusing on criteria and methods, is of great importance. The Authority took part in the review, with the agreement of the Government, in the knowledge that part of its mandate is to contribute to the construction of a new regulatory system through, for example, the fine tuning of its operating criteria and a comparison of its experience with that of other countries and institutions. The praise expressed by the OECD for our work is a great encouragement to us all.

Together with my colleagues Giuseppe Ammassari and Sergio Garribba, I wish on this occasion to express my heartfelt thanks to all the staff of the Authority who have accompanied us in tackling difficult challenges, in seeking practical and effective solutions, and in carrying out the tasks entrusted to the Authority with great skill, dedication and responsibility.

In 1999 no cases of violation of the Code of Conduct were discovered or reported. The Code, adopted by the Authority in 1999, contains rules of conduct, especially from the point of view of conflict of interest, that apply to all those who, in whatever role, work within the Authority.

## **FINAL REMARKS**

1999 and the first half of 2000 have been crucial for the transformation of the energy markets.

Liberalisation and competition in energy services are the instruments through which competitiveness can be restored and national companies enabled to become players in the integrated European energy market. Liberalisation, accompanied by a degree of carefully gauged regulation, can provide more efficient services, price reductions, improved quality of services, and technological innovation.

To regulate behaviours previously entrusted to the internal functioning of vertically integrated companies, and to guarantee that activities are carried out under competitive conditions using network structures that will continue to operate under a monopoly regime, requires, at least in the immediate term, more numerous and complex rules than in the past. This paradox of transition will to some extent be left behind once competition has come fully into play, when the market and co-ordination between operators can replace part of the rules today fixed by the regulator, without undermining the principle of impartiality.

The guidance provided by the European institutions for public interest services and for the functioning of the internal market is an extremely important benchmark for regulatory activity. The Authority takes an active part in the processes of periodic consultation and in joint action launched by the European Commission with the

Florence Regulation Forum for electricity, and the Madrid Forum for gas. Representatives of the governments of the member states, and of the principal industry associations, also take part in these.

The setting of tariffs consistent with the trans-border transport of electricity and the definition of suitable criteria for the management of congestion should be the first result of these meetings. Maximum network interconnection must be guaranteed, since the scope for energy exchange also depends on the absence of technical-economic barriers, especially to the inter-operability of the national systems.

In order to make a better contribution to the initiatives directed at the integration of the European energy markets, and to co-ordinate interventions in their respective spheres of responsibility, the Authority continues to work closely with the other regulators. With these ends in mind the Council of European Energy Regulators was recently set up and is already operational.

The experience, fruitful as it is, of collaboration in all these quarters confirms that without a firm lead from the Commission and the governments the process of integration will be too slow and patchy for the European energy market to become a reality.

The activity of regulation, and to an even greater degree the political initiative, will not be effective if they merely follow international market aggregation; this is something they should, rather, be anticipating and actively promoting.