



The Italian Regulatory Authority for Electricity and Gas

ANNUAL REPORT ON THE STATUS OF SERVICES AND REGULATORY ACTIVITIES

Introduction by the President

Alessandro Ortis

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The Italian Regulatory Authority for Electricity & Gas

Alessandro Ortis *President*

Tullio Fanelli *Member*

Excellencies, Ladies and Gentlemen

The Regulatory Authority for Electricity and Gas, whose mission is to promote competition and protect consumers, was also founded with a view to the liberation of energy markets which, from the 1st of this month, approaches completion.

This appointment is held at a time which should have seen the conclusion of a protracted liberalisation process in Europe. Across the EU, five days ago, the second *package* of Energy Directives became active; this decrees full freedom of choice for all consumers, including residential users, and is intended to promote economy and safety in electricity and gas supplies, through the creation of a single, efficient, competitive market, in a *sustainable development* process. An ambitious yet clear objective, based on the choice of an instrument, competition, which is a total innovation in many European nations. In reality, as the European Commission recently reported, over 16 years after the first *Transit Directives* there still remain evident criticalities in implementing the liberalisation process: asymmetries between nations in the timing and thorough application of the Directives; lingering fragmentation of the continental market; cross border congestion and poor coordination between grid operators; concentration of supply and persistent privileges for the former national incumbents.

These criticalities, together with significant differences between the energy-environment policies and regulations of the member states, are still delaying progress towards that common continental context sought to guarantee equal competitive conditions to operators, to favour investments and offer benefits to all citizens of the Union, also in terms of security, economy and quality of energy services.

Against this background, there should be an acceleration towards harmonisation of systems and opening the markets, rather than an effective slow down of progress towards liberalisation, or worse a retreat to anachronistic protectionism and national barriers: an inversion with respect to a decision solemnly taken some time ago in support of the integration, more than ever necessary, of energy systems. Urgent integration and cooperation,

given that a tree in a Swiss forest (September 2003) or a ship on a German river (November 2006) can cause a power cut in Apulia; given that far off political tension (Ukraine – Russia, January 2006) can directly cause a gas supply crisis in Italy.

In some EU nations there is still an idea that, beyond the statement in principle of support for a common energy policy (the hoped for *single voice*), the solution to global security of supply problems is to rely solely on bilateral agreements between nations and companies.

This idea, which is not coherent with the *action plan* signed just a year ago at the St Petersburg G8, facilitates strategic and political use of energy resources; it generates mistrust among the non privileged operators vis-à-vis the market; it consequently leads to insufficient investment; all in all it brings to a weakening of the EU with respect to non European energy raw materials producer nations.

Overall, it appears that we are delayed, swaying between a past, ante liberalisation era, with closed national energy markets, assigned to public monopoly operators, and progress towards the single market; this state of stall compounds the costs of both systems, without allowing rapid delivery all the benefits of full, extended competition in favour of consumers.

At this point, Europe must choose: turn back or go forward, as we hope in the direction of liberalisation and integration, along a path which has already given good fruit and which saw energy at the very foundation of the Union, with Italy always on the front line. Between the two World Wars, power lines crossing the alpine borders had already been built to share power stations and provide for better security and lower costs; ECSC and Euratom contributed to the Treaty of Rome; during the hardest times of the *Iron Curtain* cables and tubes continued to cross this boundary, carrying energy and maintaining a link between East and West.

Along with these concerns, there are also encouraging signs: the latest proposals from the Commission; the position of a number of Member states, Italy included; the recent vote in the ITRE Committee of the European Parliament in favour of liberalisation, harmonisation, ownership *unbundling*, strengthening in all States of the role of the Regulators and of market instruments.

Regarding competition, though this is still insufficiently developed, the results obtained thus far are worthy of note. In the Italian electricity sector, for example, the market induced an imposing programme of investments in production which allows avoiding the supply deficits of 2003; as regards prices, although the trend is severely overshadowed by the sharp rise in oil and natural gas prices (hydrocarbons on which our nation continues to rely excessively), efficiency savings which can be estimated at over € 4 billion per year, have translated into benefits for both companies and consumers. Though significant we consider this result to be still partial and insufficient and thus not adequately perceived; it can and must be improved further to fill the *gap* which still separates us from other large European nations, which can draw advantage from a more competitive generation structure.

Persistent negative results in the gas sector are just as evident, where, due to the absence of effective competition, investments have been delayed, leaving the nation in grave conditions of supply deficit, as evidenced by two winter crises between 2004 to 2006.

In the last Winter, thanks to the exceptional climatic conditions, there were no supply problems; however, as little has been done to improve infrastructures, we must hope for a repetition of favourable seasonal conditions. As to prices, despite our intense commitment to limit anomalous profits unjustified in the absence of competition (a commitment that frequently has to struggle with legal challenges), consumers have borne almost all the rise in international prices; paradoxically, this negative effect was not fully perceived, being common to other major European nations.

In Italy and Europe as a whole, small consumers are facing the market openly for the first time; it is therefore fitting to ensure that this new liberty represent a real opportunity and that the absence of an adequate level of competition does not impair their role as essential and proactive elements of the market. This concern is shared by the Antitrust Authority and the Bank of Italy.

Parliamentary proceedings for the conversion of Legislative decree no. 73 of June 18th 2007, dealing with the liberalisation of the electricity market, have just started. It is my hope that our Parliament, which in past times has proved among the most determined in Europe in support of market efficiency, may now bring the process of energy sector liberalisation to fulfilment through the

conversion into law of this decree and a rapid conclusion of the legislative process for adopting the *energy draft law* implementing the Directives, currently under examination by the Senate.

Parliament is also examining the *draft law for the reorganisation of the Independent Authorities*, on which we have already expressed a largely positive opinion before the Constitutional Affairs Commission of the Senate; this proposes strengthening and integration of the instruments available to us, these being likewise necessary and urgent for us to effectively pursue the mandate assigned by the law establishing the Authority.

THE INTERNATIONAL SCENARIO AND THE EUROPEAN CONTEXT

Prices

During 2006, oil prices continued to be under pressure with the average price increasing by some 20%, as an annual average (Brent from 54.4 dollars per barrel in 2005 to 65.3 dollars in 2006).

At the beginning of 2007, with unusually mild winter temperatures, the price of crude saw a significant drop, without ever falling below 50 dollars a barrel however; subsequently, the marked fall in oil and petrol stocks (obtaining in the spring months especially in the USA), continually growing demand and a returning tight international market once again drove price levels in excess of 70 dollars a barrel.

In the course of 2006 the price of natural gas was subject to divergent trends in different geographical markets. In the USA, where the gas market is fully liberalised and wholesale prices are formed at the nation's principal exchange (*Henry Hub*), the price fell by 24.2% over the year as a whole compared to 2005. This reflected both the full recovery of supplies after the reduction caused by the 2005 hurricanes, and by the mild weather which distinguished the latter part of 2006. In Europe, on the contrary, as long term contract prices are largely indexed to the values of crude and derivatives, dollar prices rose on average by 34% (2006 against 2005 average), even exceeding the oil price dynamics. The amplification of the effects of price

rises is the result of a type of vicious circle: with, on the one hand an oil market which is prevalently *spot* in nature, on the other a gas market based on long term contracts indexed to products influenced by *spot* oil prices. Inadequate infrastructures, conditioning supply potentials have also contributed to this situation.

Thus, as also testified to Parliament, it seems appropriate to seek, also at the EU level, to arrange for long term contracts to be flanked by *spot* components, in order to induce some decoupling of gas from oil prices. To achieve this it is necessary though not sufficient to expand, in parallel to storage capacity, also Italian import infrastructures through the prompt implementation of re-gasification plants, enabling diversification of supplies and increasing delivery potential to levels meeting current requirements with greater security.

Market liberalisation and integration

During 2006 and early 2007, international geopolitical tension, the strategic use of energy resources by producer nations and new evidence of *climatic change* restored priority to energy issues on the international political agenda. Currently the European debate centres on the inadequacy of the regulatory and normative framework for the completion of the internal market, on a par with environmental sustainability of energy choices, and the need for a *third package* of measures giving substance to a more incisive common energy policy.

In effect, the 2003 Directives are far from fully implemented (in December 2006 the Commission opened 26 infraction procedures against 16 member states) and, as evidenced by the recent enquiry of the Commission, these already seem insufficient to guarantee operation of the internal market. The principal obstacles to competition are: poor integration of wholesale markets, characterised by a low grade of liquidity and their persistent national dimensions; lack of interconnections and congestion of the infrastructures; scarce transparency in price formation mechanisms; insufficient competition in retail markets; inadequate functioning of balancing markets.

The Commission consequently presented proposals (the recent *Energy Package*) for a new European energy policy, already under examination by the Council and the European Parliament. The Commission proposed, on the one hand, massive investments in new technologies, energy efficiency and infrastructures; on the other, a further effort towards the creation of a truly competitive internal energy market, with effective unbundling of networks, strengthening and harmonisation of regulatory powers, a common external energy policy and a low carbon content economy. To this end, four ambitious quantitative objectives were also outlined for 2020: a 20% reduction in CO₂ emissions with respect to 1990 levels; a 20% contribution from renewable resources; 20% *savings* with respect to current consumption; 10% share of bio-fuels in transport consumption.

The Authority's International Collaboration

In this context and with reference to these commitments, the Authority is assuring its contribution through the CEER (*Council of European Energy Regulators*), the ERGEG (*European Regulators Group for Electricity and Gas*), the Florence and Madrid *Fora*, the *regional initiatives*, where it has been assigned responsibility for the Centre South Region.

In parallel, the Authority also continues its dedicated and significant commitment to the areas bordering the EU, of particular interest to our nation: East and South-East Europe (including the important *energy hub* of Turkey) and the Mediterranean. We contributed to the constitution of the *Energy Community Regulatory Board* (ECRB), an organism foreseen by the *Energy Community Treaty*, regarding the area of the Balkans, which came into force in July 2006.

At the same time, it promoted the establishment with headquarters in Rome of MEDREG (the *Mediterranean Working Group on Electricity and Natural Gas Regulation*); this is a body which unites the regulators of all the Mediterranean nations and which is intended to: facilitate cooperation relations between the regulators of the member countries; harmonise the regulatory frameworks in the area with that of the EU; contribute to facilitating energy exchanges, infrastructure development, industrial

collaboration and the integration of markets across the Mediterranean basin.

Moreover, contributing to the promotion of cooperation and investment, the Authority has signed a Partnership agreement with the Albanian regulator and is leader of a Twinning project, financed by the EU, with the Ukrainian Regulatory Authority - NERC (*National Electricity Regulatory Commission*).

Our internal commitments also include participation in the activities at the *Florence School of Regulation* and in the development of IERN, a global IT platform for regulators, designed by us to facilitate an exchange of experience, data, studies and to share information and/or training processes, also extended to operators and consumers.

LIBERALISATION, THE MARKET AND COMPETITION IN ITALY

Infrastructure Development

In the electricity sector, the development of generation and transport infrastructures is a continuing process.

Production capacity has now reached a discrete margin of reserve, which is however still insufficient to guarantee full security and competition due to uneven geographical distribution in the location of power stations and insufficient grid connections. Terna, now independent owner of almost the entire transmission network, is undertaking an important expansion programme, which the Authority promotes with appropriate tariff incentives; this has already delivered some results (as an example I may cite the completion of the Matera-Santa Sofia line, a historic problem on the southern grid) and should progressively reduce system congestion and criticalities which contribute to causing disservices such as those recently suffered in Sicily, and with regard to which an enquiry is underway.

Meanwhile, on request by the Ministry of Economic Development, the Authority has consolidated the regulation of *interruptibility services* which, despite its high costs, can contribute to better handling of criticalities.

In the gas sector, investments in supply and storage projects are still highly problematic: the capacity of supply infrastructures is largely below that necessary to create a competitive market; it is even below that necessary to guarantee an acceptable level of security.

The few investments started (such as the regassification plant at Rovigo, the upgrading of the gas pipeline from Austria and a few STOGIT storage reservoirs) are all delayed for different reasons; others, such as the regassification plant at Brindisi, seem once again to be in question.

A number of projects, including several regassification plants and two important new natural gas pipes from Algeria via Sardinia (GALSI) and from Turkey via Greece (IGI), are still far from coming on line, despite several steps forward of procedural or administrative nature.

The recent agreement between ENI and Gazprom, to start the technical-economic feasibility study of a new natural gas pipe connecting Russia and Europe (*South Stream*), may be a significant contribution to security of supply, particularly considering the strong growth forecast in EU consumption, but only on condition that it does not become an obstacle to other competing projects providing diversification of supplies.

With reference to management of national infrastructures, the Authority has recently passed a consolidated ruling on functional and accounting *unbundling* for companies operating in the electricity and gas sectors, though it considers ownership unbundling urgent and necessary, at least for certain activities (gas transport and storage). The ruling includes provisions for: i) strengthening the neutrality of infrastructure operations, essential to achieve market liberalisation (transmission, distribution and metering in the electricity sector; transport, distribution, metering, storage and regassification, in the gas sector); ii) improving cost transparency; iii) increasing the information required for performing regulatory activities and customer protection.

Wholesale Markets

In the wholesale electricity market, two very significant developments are currently under way. The first is reduction in the market power of certain key

operators, both as a consequence of new capacity coming on line and as a result of regulatory Intervention; this year, for the first time, also thanks to the combined action of the Authority and the Antitrust, ENEL sold electricity on the market as *Virtual Power Plant* generation, a mechanism which, without prejudice to the seller, contributes to making the market more competitive. The effects on prices are already visible.

The second is ownership restructuring of generating companies; as a result of rearrangement and concentration of property of national companies, but also as a consequence of mergers and acquisition of foreign companies which impact on the national setting (for example, the recent acquisition of Endesa by ENEL, destined to change the ownership pattern of energy companies also in Italy). If, on the one hand, internationalisation with the expansion of national companies into the wider European context can be viewed favourably, in that it broadens the market, reduces concentration and promotes Italian consumers, on the other, it is necessary to assess the effects on the Italian market in the light of these dynamics.

The Regulator's assessment of the wholesale market needs to be constantly updated for the effects of these new equilibria and the emerging cross ownership of generating companies. In recent months the Authority has reported behavioural anomalies in the wholesale market to the Antitrust Authority which suggest changes in the functioning of markets: we are moving from a situation in which a single company (ENEL) was capable of exercising market power undisturbed throughout the country to a pattern in which forms of even tacit collaboration by a certain number of generators could condition market outcomes.

Certain practices, such as withholding of production capacity for speculative purposes, that is to increase electricity prices to the benefit of all producers, must be prevented with determination. In this sense, it would be particularly useful to impose certain market productivity standards on generators, specifically to avoid companies disguising speculative actions as the result of poor reliability or technical unavailability of plant. In certain mature European markets it is already mandatory for generators to make their independent offers net of the effects of periods of plant *down time* or maintenance; a similar provision could also be imposed by the Italian Government and we

hope that it will be applied in the near future.

In the gas sector, albeit under extremely difficult conditions for the development of a competitive wholesale market, the Authority has already implemented a series of rulings promoting the efficient functioning of the regulated infrastructures: the codes for storage, transport, distribution and regassification. The objective is to provide the best protection for market entrants and to promote efficient use of infrastructures by maximising their availability and optimising their utilisation.

It must be emphasised, once again, that ENI plays a dominant role in each phase of the gas chain, including cross border supply through international infrastructures. It thus maintains the power to significantly influence prices, the propensity of new operators to enter the market and the development of competition. We have already notified these criticalities to Parliament and to the Government and suggested possible solutions.

More in general, the adoption of derivative financial instruments may contribute to improving the efficiency of the wholesale electricity and gas markets. With the Implementation of the Directives on financial instruments markets (MIFID) before the end of the year, risk management products may be introduced and developed also in Italy bringing benefits to consumers by guaranteeing full interplay between the *Power Exchange* and the derivatives markets. In the future we hope in the promotion of developments of this kind also in the gas sector, though this does not seem feasible in the absence of a platform and neutral dispatching.

Retail Markets

In retail markets it is essential to assist consumers to make free, informed and convenient choices. This requires: the availability of correct and complete information, the customer's ability to compare offers, to be informed of his rights and opportunities on the market; the reliability of sellers; the simplicity and security of switching from one supplier to another.

This quite simply requires applying regulation to increase the consumer's contractual powers thereby reducing the gap which still exists today between the negotiating capacity of customers and sellers. Otherwise, certain consumer categories would be unable to draw the maximum possible benefit from liberalisation.

The reduction of the *gap*, in terms of negotiating power, is a slow phenomenon and in Italy we are today still in the very early stages. We have undertaken a number of surveys of the retail markets for electricity and natural gas, reaching the conclusion that, as things currently stand, certain consumer/client categories are, as yet, unable – on average – to exploit liberalisation adequately. These are evidently the smaller consumers, above all families: it is thus still necessary to maintain a system of customer protection, albeit transitory.

The EU Directives allow member states to adopt non mandatory *protective schemes* (with entrance and exit at the discretion of the individuals concerned), within which electricity and gas are supplied on the basis of standardised and predefined price and quality conditions.

In this regard, while awaiting the effective application of the Directives (foreseen in the Draft *Energy Law*), it is worthwhile mentioning the recent Legislative Decree which establishes minimum accompanying measures in the transition towards a national energy market that is more competitive and more compliant with the EU directives.

The Legislative Decree certainly attenuates, while not totally eliminating, the doubts we expressed with a notification sent to Parliament and to the Government on May 15 last; it suitably confirms the possibility of defining

supply conditions, respecting market mechanisms and without interfering with other segments of the liberalised market.

In the case of electricity, for example, the so called *greater protection service* provides domestic consumers and small businesses with the right, if they so wish, to receive standard supplies guaranteed by sales companies buying energy from the Single Buyer; with the elimination of the *captive* market the latter plays a role in guaranteeing small consumers and households for a transitory period. Furthermore, a so called *safeguard service* is introduced which foresees a *supplier of last resort* for all those clients who for any reason are abandoned by their existing supplier. This service will be awarded based on competitive market mechanisms applied by geographical area; meanwhile, to avoid discontinuities, even over short periods, the *safeguard service* will be assured by the sales arms of the distribution companies.

PRICES AND TARIFFS

Electricity

Besides taxes, the price of electricity to final consumers includes three fundamental components: the *wholesale price*, *tariff services* and *general charges*. Wholesale prices reflect the costs linked to the generation mix as well as the efficiency of the markets; in Italy, in the absence of nuclear power and with only a modest contribution from coal, electricity prices are strongly influenced by those of gas; the share of the latter in total electricity production has risen considerably in recent years, marked by high and increasing prices (from 35% in 2002 to 50% in 2006. This has certainly contributed to raising costs for producers and the *bill* for consumers.

Nevertheless, analysis of price trends on the Italian *Power Exchange* (IPEX) confirms that the Italian electricity price changes has not been strictly linked to that of oil. In part, this is due to the Single Buyer's procurement strategy, in agreement with certain of our indications directed at reducing wholesale price volatility (by delaying the impact of fuel cost increases) and, in part, on the increased level of competition which is to some extent beginning to bite into the still high profit margins of generators.

In the first half of 2007, prices fell compared to the corresponding period of 2006, characterised by similar oil price levels, but also by significant peaks triggered by tight natural gas supply conditions. There are still strong differences with the major European nations; in this regard it should be noted that an increasing, even if still marginal, contribution to these differences comes from the renewable energy obligation on generators (*green certificates*) and *emission trading*: it can be estimated that their overall contribution to prices is approximately € 1/MWh, foreseen to increase to over € 5/MWh, that is to some 7% of the current average wholesale price.

Tariff services (transport, distribution and measurement) are delivered under natural monopoly conditions against levels of remuneration set by the Authority, with a view to improving productivity while maintaining precise quality obligations. In ten years of regulation, the tariff has fallen by 15% in nominal terms and by 31% in real terms.

General charges, represent a non negligible, rising fraction of final prices: a total cost of some € 5 billion a year, 13% of the average final price to households. These include costs of diverse nature, in some cases not directly related to the electricity system, which, over time, have been and continue to be added, by primary norms and government intervention, to the already high price of electricity; these weigh significantly on the comparability of Italian prices in the European context and, unfortunately, the prospects are not encouraging.

The largest among the *general charges* paid for by consumers is that required to promote renewable and like resource generation (A3), according to the so called CIP (Inter-ministerial Pricing Committee) ruling no. 6/92; this amounted to some € 3.5 billion in 2006. As is known, one of the elements defining the *CIP 6* prices, the so called *Avoided Fuel Cost* (AFC), was indexed to the SNAM/Unapace agreement of 1998, until 2006. Following the expiry of that contract, the Authority defined a new criterion (Resolution No. 249/06) to update the 2007 AFC component. This new criterion is expected to lead to a reduction of some € 600 million in favour of consumers already in 2007.

The ruling was recently annulled by the Lombardy Regional Administrative Court; we are awaiting the motives for the sentence, also to permit us to

define our appeal to the Council of State. On the other hand, this initiative in support of fairer cost determination, with significant benefits for consumers, received the support of two Parliamentary motions: the first presented in the Senate on March 15 and already approved unanimously; the second, presented to the Chamber of Deputies on March 21 and awaiting debate. Both commit the Government to support our resolution at all levels, eventually also with *ad adiuvandum* interventions.

The overall cost forecast for CIP 6, through to 2020, is some € 25 billion; this would fall to € 20 billion, if the Authority's ruling is confirmed.

Component A3 of general charges already includes incentives for solar power and will do so increasingly in the future. The overall cost of these charges is forecast to reach up to € 10 billion by 2020.

Among the other *general charges* the *nuclear decommissioning* component (A2) is particularly significant. Although SOGIN now seems to be managing its activities more in line the objectives assigned to it by the law, there remains much concern over the lasting uncertainties of *decommissioning*, mainly due to the unresolved issue of identifying a location for the storage of radioactive materials. This implies burdening electricity consumers with very significant costs, to which must be added transfers in favour of the Municipalities which host the deactivated nuclear plants and even in favour of the State finances. With reference to the latter, the Authority has sent a notification to Parliament and to the Government proposing the termination of these fiscal and fiscal like appropriations, introduced by the 2005 and 2006 Finance Bills.

In the same report to Parliament and to the Government, again on the issue of *general charges*, the Authority also proposed to terminate the improper application of VAT on fiscal and fiscal like charges.

With reference to other *general charges*, such as those for facilitated financing to certain large companies (for example, Ferrovie dello Stato), a reflection on their allocation to the electricity system rather than to general fiscal accounts would appear urgent.

Regarding the comparison between electricity prices in the different member States, the situation is still highly variegated, with respect to both level and Incidence of the fiscal component. Prices net of taxes paid by residential

customers with 3.500 kWh/year consumption, show deviations greater than 40% from the European average; the share of taxes in the overall final price ranges between 5% (UK, Portugal) and 55% (Denmark). Variations in electricity prices to industrial consumers with respect to European averages are only slightly more contained. The fiscal burden for an industrial customer with an annual consumption of 2,000 MWh varies between 1% in Sweden and 41% in Denmark.

The January 2007 data confirm the Italian anomaly, caused by a progressive tariff structure for residential clients: net of taxes, the prices paid by Italian users with the lowest consumption levels are lower than those prevalent in Europe while those applied to higher consumption groups are higher than the values registered in the major European nations. Net of taxes, Italian companies pay lower prices than German companies at lower levels of consumption and similar or slightly higher prices for higher levels (more than 2 GWh per year). Italian businesses are penalised with respect to all types of French, Spanish and English industries. In this regard, we trust in a swift harmonisation at the Community level of facilitations and subsidies currently applied with significant asymmetries to energy intensive industries in the different EU Member States.

Concerning the appointment of July 1st, the Authority prepared a *temporary tariff reform* for the residential sector, allowing families to benefit sooner and better from the full liberalisation of the market. The current transitional reform preserves the previous overall price levels but eliminates the cross subsidies present in the energy component; this immediately eliminates any form of discrimination between residential users in the liberalised market.

Going beyond this transient reform to more closely reflect real costs requires the definition by the Government of norms applicable to disadvantaged customers in need of particular forms of protection (for example, poverty stricken families and individuals requiring energy intensive health treatment). The Authority has already issued two consultation documents proposing different approaches to the problem and is collaborating actively with the competent ministries to reach a solution as rapidly as possible.

Natural Gas

A comparison of European prices also evidences significant asymmetries. Final prices net of taxes to residential customers consuming some 2,200 cubic metres of gas a year present deviations greater than 25% with respect to the European average. The share of taxes in the overall final price for this level of consumption, ranges from 5% in the UK and Portugal to 56% in Denmark (in Italy it is 36%). The differences are just as marked for industrial consumer prices. Here the share of taxes for customers with annual consumption of just over a million cubic metres ranges from a minimum of 5% in Portugal to over 30% in Austria (it is 14% in Italy).

Comparison with the major European nations indicates that prices to residential customers net of taxes, as of January 1st 2007, are lower in Italy than in Germany and higher than in England for all levels of consumption; by contrast, they are lower than in France and Spain for small consumers, comparable for intermediate consumers and slightly higher for the largest consumers.

As regards industrial consumers, Italian prices net of taxes are always higher than French and Spanish prices and almost always lower than German and English prices, with the exception of the lowest consumption class (11,000 m²/year).

SERVICE QUALITY

In 2006 the commitment to service quality improvement continued. In the electricity sector, Italy is now in the group of EU Member States with the best performance in terms of service continuity. In the natural gas sector, regulatory activities focussed on such issues as heating value and safety, with incentive/penalty mechanisms intended to favour safety improvements in local distribution networks through reduced leakage and stricter monitoring of the degree of *odourisation* of the gas supplied.

Technical Quality

The regulatory approach introduced by the Authority (based on incentives

and penalties) to which the companies have responded quite positively, resulted in a further reduction of power cuts without forewarning (exceeding 3 minutes), both as regards the number (falling on average to 2.39 power cuts per client, a 37% improvement over 1999), and the overall duration (falling to 64 minutes per client, a 20% improvement over 2005 and 67% over 1999). The continuing reduction in the gap initially existing between Northern and Central-Southern areas of the country (net of the consequences due to exceptional climatic events) confirms the validity of the adopted approach.

New standards for the maximum number of *interruptions for medium voltage clients* introduced in 2006 are among the most stringent in Europe.

Moreover, a consultation process introducing new regulations to encourage improvements in the quality of high voltage transmission has been launched and proposals to define voltage quality regulation are under study.

With reference to safety in gas distribution service, the provisions introduced by the Authority have brought about strong growth in the portion of the distribution mains inspected annually, helping to identify possible leaks: this fraction has now reached over 45% as an annual average.

Emergency interventions in response to telephone calls continued to be delivered promptly (on average emergency calls in 2006 were resolved in just over 35 minutes), while controls by distributors on levels of *odourisation* increased significantly, thanks also to the incentive mechanism introduced by the Authority (in 2006 there were over 34,000 controls compared to 25,000 in the previous year); as already mentioned, these are of fundamental importance for the identification of possible leaks.

In 2006, over 20 local gas distribution companies, mostly large scale, declared having attained sufficiently high levels of safety to apply for the foreseen incentives; these will be granted only after verification of the notified data and on the basis of random company inspections.

Commercial Quality

The application of quality standards uniformly on a nation wide scale (maximum time for connections and disconnections, cost estimations,

execution of works, etc.) with automatic settlements in favour of consumers, confirmed its' validity: in 2006 over 100,000 compensations were awarded for failure to respect the standards, corresponding to a total of over € 4 million for electricity service clients and € 3 million for gas service clients.

Although service performance times remained well below the maximum permitted also in 2006, the Authority has started to review commercial quality regulation in the electricity sector by launching a consultation with all interested parties and a public opinion survey aiming at verifying the degree of satisfaction of consumers and at identifying expectations for further improvements in the service.

Consumer Safeguards

In view of full opening of the electricity market, the Authority introduced new consumer safeguards, intended to make their free choices increasingly informed and convenient.

Transparency in electricity bills. *Electricity bills* are in the process of being restructured to make them easier to read, more intelligible and complete. The new format, already being circulated, is to all intents and purposes the principal channel for communicating with consumers; the consumption and cost data providing an essential information base for comparing alternative offers on the market.

Commercial conduct codes and evaluation forms. The Commercial conduct codes for the electricity and gas sectors were introduced in 2006 and establish correctness and transparency rules which suppliers are required to respect during marketing and definition or modification of contractual arrangements. In collaboration with the consumer associations, the Authority is watching over compliance with the Codes, also in relation to *dual fuel* (combined electricity and gas) commercial proposals which can now be formulated. To complete the Commercial conduct code for the electricity sector, we have drawn out *summary templates* outlining the costs foreseen by the offer, which must be provided to the client before contract finalisation. The form summarises the cost of service, detailing all cost items and foreseen discounts or bonuses; in particular, for residential customers, the

form permits calculating the annual savings which representative clients in different consumption categories, would obtain by accepting the proposal, with respect to the Authority's reference price applying at the time of proposal.

Right of withdrawal. The procedures regulating the right to withdraw from supply contracts were promptly redefined. In the case of residential customers and small businesses supplied at low voltage; these were designed to simplify and guarantee switching to new suppliers.

Reconciliation procedures. To facilitate the settlement of disputes which may arise in the new liberalised market, the Authority is promoting a training programme for professional careers in reconciliation procedures, within the framework of agreement between commercial concerns and consumer associations.

Call centres. After extensive consultation, and following agreements with the Authority for Personal Data Protection, we introduced new provisions regulating the quality of commercial *call centres*. These establish service obligations (such as minimum working hours and clarity of the programmed call options); mandatory standards for accessibility and performance; publication of the comparative scores assigned to the quality of the *call centres* based on customer satisfaction surveys and other means.

Further, with a view to contributing to the general understanding of the set up and function of the new liberalised market, the Authority has prompted the opening of a call centre serving all interested citizens at the Single Buyer.

ENVIRONMENTAL CHALLENGES

Concern over the impact of human activities on the climate are widely shared today and we also consider a responsible, proactive attitude in favour of environmental protection and sustainable development of foremost importance.

The real challenge, we underscored during a recent hearing at the Environment Commission of the Chamber of Deputies, is to tackle the problem at its root, by applying fractional approaches to the climate issue,

inducing responses that are ultimately inadequate to the dimension of the problem: what is required is a global approach with global solutions, involving all production sectors (not just energy), all the technologies, all market mechanisms and behaviour, and all the continents.

The risk is that the development paths of emerging and less developed nations prevail over the energy efficiency and savings choices adopted by the industrialised nations. There is an evident risk of delocalisation of industrial sectors with higher climate altering emissions from the more *virtuous* nations, in terms of environmental regulation and technology, towards the more tolerant nations. The risk is that international trade could translate this into a form of environmental *dumping*, with precisely the opposite environmental outcome to that pursued. We must focus our attention on these risks, both to better coordinate environmental policies at the international level and to prevent developing nations from resorting to *lax* environmental legislation in order to attract business to propel their economic growth. On this issue the European Commission has recently begun consultation on the use of economic tools (taxes, subsidies, tradable permits) for the protection of the environment and proposed further debate on the introduction of *fiscal border adjustment* mechanisms intended to encourage EU business partners to apply measures to restrain their greenhouse gas emissions.

The European Emission Trading Scheme

The first two years of application of the Directive governing the emission trading system did not produce satisfactory results: excess allocation of the quotas at the EU level in 2005 - 06 determined a collapse in the price of CO₂ from some € 30/ton CO₂ (April 2006) to the current € 0.50, with potential negative implications in terms of price signals for new investments in low environmental impact technologies.

Moreover, a number of criticalities have emerged in the competitive position of companies and single nations. In particular, inequalities regard relations between: existing plants and new entrants within a member state; plants belonging to different sectors within a member state (more specifically between power plants and other plants subject to the Directive or not); plants

in the same sector but sited in different member states.

To overcome these difficulties, in 2006 the Commission initiated a review process to define changes coming into force in 2013. We consider that particular attention must be paid to the need to harmonise the *national allocation programmes*, or even better, to replace these ultimately with a single upper limit at the European level.

The environmental commitments already concluded in the electricity sector in Italy are a matter of concern, as there is an increasingly evident *gap* between the time necessary to develop the generating technologies and the time lag established by the Directive to achieve the emission reduction objectives.

Again with reference to the electricity sector, it is possible to estimate the mean unit price of emission permits required to cover the difference between the actual emissions and the quotas assigned in the National Allocation Plan (some 44 million tons of carbon dioxide) at some € 0.53/MWh in the period 2005 - 07.

Over the next five years, 2008 - 12, corresponding to the period of application of the Kyoto Protocol, both the mean annual shortage of quotas for the thermoelectric sector and the price of emission permits will rise significantly, with a foreseeable increase in the cost of electricity in Italy. The impact on the price of electricity will depend inversely on the efficiency and competitiveness of the electricity market. In the absence of robust competition, the effect on average prices could exceed €5/MWh on the wholesale market.

Rational use of energy

2006 was the second year of application of the *white certificates* mechanism, introduced by Ministerial Decree in July 2004, and disciplined by technical and economic regulations defined by the Authority, which has responsibility for implementation and monitoring of the results; the latter are evaluated with the active collaboration of ENEA, availing itself of a specific Convention.

Since first implementation, we have certified some 2,000 applications of the mechanism (by distributors and energy service companies) corresponding to a savings of some 900,000 tons of oil equivalent (toe); the target for 2005 - 06

(468,000 toe) was thus amply exceeded. The total savings achieved to date, equivalent to the annual consumption of the residential sector of a city with over 1.2 million inhabitants or to the annual electricity production of a power station of some 510 MW, have permitted avoiding emissions of some 2.4 million tons of carbon dioxide.

The avoided energy costs on the part of consumers receiving the energy savings applications, was far greater (from six to ten times) than both the average price of *white certificates* traded on the market and the value of the tariff contribution granted by the Authority for each toe saved.

Considering these results and the economic - environmental benefits which the mechanism may provide also in the future, we believe it should be boosted through the extension of the obligation to small distributors and the establishment of more challenging objectives for the coming years; this also with a view to providing investors with greater certainty and to promoting investments of a more structural nature.

Further, it is essential that the mechanism preserve its ability to pursue Government objectives, through the market promoting those applications which present the best cost effectiveness and which generate energy savings which are truly *additional* to those which would be produced anyway, as a result of other normative obligations, technological progress and market development. From this point of view, it is important to ensure strong coordination between the various instruments employed in the promotion of energy savings in final uses, in order to avoid excessive or unbalanced incentives which could work against the diffusion of applications assuring large savings at relatively lower costs.

All this will also be essential to guarantee that the *white certificates* mechanism provide an adequate contribution to meeting the European energy saving targets.

Renewable energy resources

There can be no doubt about the need to develop renewable energy resources with determination, because of their relevance for security of

supply, energy diversification and environmental protection.

This development must however be pursued with clear awareness of the present and future costs of the different choices. Renewable energy resources are not all equivalent in terms of added cost and impact on Italian industry, with greatly differentiated results on energy prices and on the national economy.

The *green certificates* system, aptly based on market criteria right from the start, has repeatedly been misused and perverted; in order to raise its efficiency and reliability, it is now necessary to restore the original competitive mechanism.

It is, therefore indispensable that clear and coordinated choices are soon adopted in regard to the objectives, the energy sources and incentive mechanisms to be used; in any case, these must be based on market instruments to minimise the costs for given objectives.

From this point of view, paragraph 5 of the recent Decree Law No. 73 of June 18, establishing that sales companies provide information on their generating *mix* in their billing and promotional material, in line with Community recommendations, is particularly appreciated. This norm could facilitate the development of renewable energy demand and a more better allocation of costs.

CONTROLS, INSPECTIONS AND SANCTIONS

Controls and inspections at companies, their plants, on processes and services provided have been intensifying, in relation to quality of service, safety, access to grids, tariff determination and use of incentives.

In the period April 1 2006 - March 31 2007, 123 inspections were undertaken, of which 35 in collaboration with the Electricity Compensation Fund (CCSE) and 88 with the Guardia di Finanza (Finance Police). In 52 of these, undertaken together with the officers of the *Special Market Protection Unit*, the inspections benefited also from the participation of the *Fuels Experimentation Station*.

The inspections undertaken with the Guardia di Finanza rose significantly

(from 58 in 2004 to 88 in 2006). The Guardia di Finanza is, thus, due our gratitude for its' growing commitment and for the highly appreciated professional skills dedicated to our activities.

The certifications undertaken with the CCSE on generating plants receiving incentives (based on renewable energy sources, equated fossil sources and cogeneration), regarded a total of 4,600 MW and resulted in the recovery of some €77 million.

Over and above this recovery, the certification campaign allowed: detecting a significant effect of *moral persuasion* (controls induce a greater propensity for self verification and compliance with the norms); improving the regulatory framework, particularly with regard to implementation and to particularly complex cases; stabilising operating arrangements with the CCSE, through the establishment of an expert committee and selected inspection units and the involvement of universities and sector experts; the achievement of a reduction, also in the years to come, of the *general system charges*.

Sanctioning procedures were also strengthened. Mature regulation is accompanied by the need to intervene to guarantee effective compliance of subject companies with the norms.

The workload handled in 2006 (including both initiated and completed procedures) rose to 96 (from 89 in 2005) while the strengthening of the sanctioning function is underscored by the number of procedures completed (56 against 30 in 2005).

Of the 56 procedures, 24 ascertained the responsibility of the indicted, while in the other 32 the evidence emerging during the cross examination led to termination of the case. The total value of the sanctions applied was quite high: €152 million, due to the fact that the majority of the sanctions referred to infringement of the provisions enacted to protect fundamental values such as system safety and basic information requirements of the Authority.

Regarding the nature of the procedures, these referred to infractions of: norms enacted to safeguard system safety; rulings regarding access to the grid and network services; provisions for the supply of information requested by the Authority; tariff discipline; conditions for commercial guarantees In favour of consumers.

DISPUTES

During the last year, the rulings challenged, largely by the operating companies, accounted for 14.2% of the total; the measures annulled, wholly or partially or with provisional sentences, amounted to 1.8% of the total.

With reference to the legal orientation emerging in 2006, I wish to remind you of two important sentences from the Council of State which emphasise the crucial role assigned to the Authority by the law, given its' *“power and duty to enact all measures favouring the establishment of a market with effective competition, also in the interest of the users, not only through repressive actions applied ex post, but also through ex ante obligations on company behaviour directed at anticipating and removing market distortions, to the ultimate benefit of consumers”*. (Council of State, VIth section, 5 June 2006, No. 3352 and 14 June 2006, No. 3503).

Administrative justice has furthermore underscored the full compatibility between liberalisation and energy market regulation, emphasising that the Authority's *“mandate includes the promotion of competition (Article 1, Law No. 481/05) and it is thus logical that it must watch over the correct functioning of the market [...] In order to assess the presence of anomalies and distortions”*. This pro-competitive regulatory power is obviously not unrestricted, in that it finds *physiological limits* in the need to respect underlying principles of due proportion and reasonableness.

To establish whether these limits are respected, it becomes fundamental to provide exhaustive detail of the factual evidence and legal rationale whereby the Authority exercises its' powers; for this reason the Council of State requires from the Authority a meticulously detailed deposition on the motivations behind its decisions on the observations formulated by companies during consultations (VIth section, 27 December 2006, No. 7972).

ORGANISATION AND OPERATIONS

The need to respond quickly and efficiently to the dynamic changes in market functioning and structure and to the challenges that these entail for the Regulator, advised us to expand and restructure our organisation aiming at

regulatory *convergence* and harmonisation between the electricity and gas sectors.

With reference to staffing, during 2006 the number of employees rose by 14% (to reach 134 units, below the legal maximum) and over 60% of the staff received further training and professional updating.

I and my colleague Fanelli wish to express sincere and heartfelt thanks to our personnel, to all our collaborators, for the constant commitment assured with much appreciated professional dedication.

Regarding the economic and financial situation, entrusted to the oversight of our Auditing Committee, whose cooperation is much appreciated, we worked to contain costs and investments within levels which allowed us to continue limiting the contributions due from the regulated companies (active in the electricity and gas sectors) to 0.3 per thousand of their proceeds, thus well below the one per thousand limit permitted by law; our funding does not foresee any costs borne by the State.

Regarding planning and control activities, we have continued to adopt and publish the *Three Year Plan* as the first resolution of the year. Our intention is not only to dispose of an essential instrument of management, but also to provide timely information and full transparency to all interested bodies and individuals on the objectives, programmes and internal responsibilities for all the initiatives planned over the next three years. The *Three Year Plan* is, obviously, a flexible instrument which we update annually, also on the basis of public consultations which we hold continuously and which, in line with consolidated practice, we employ in the preparation of all the most important rulings, with the application of *Regulatory Impact Analysis* in the most relevant cases.

As regards relations with other institutions, I wish to confirm our keen interest in an increasingly intense interaction with the Parliamentary Commissions, both through hearings and the contributions which we seek to offer with our notifications.

As regards the organs of the Government, fruitful relations were developed regarding energy, environmental protection and related themes, within the competences defined by the Authority's founding law.

Furthermore, 2006 has been a year of intensified and effective collaboration with the other independent Authorities, to which we address our gratitude. I wish particularly to mention the positive, ongoing relations with the Antitrust authority, with Consob (the National Commission for Companies and the Stock Exchange), the Communications Authority and the Authority for Privacy.

Our thanks, for their collaboration and kind attention, also go to the CNEL (the National Economics and Labour Council), to the Lawyer's State Counsel, to the National Consumers' Council, to ENEA (Italian National Agency for New Technologies, Energy and the Environment), and to the Cassa Conguaglio per il Settore Elettrico (Electricity Compensation Fund), an organisation with which we operate closely and whose duties were recently extended by adapting its Regulations, jointly with the Ministry of Finance.

I also wish to express our appreciation for the time and attention dedicated to us by the trade unions, the consumer associations and industry organisations.

OUTLOOK FOR FUTURE ACTION

In pursuit of the institutional mission assigned to us, we intend developing our future activities coherently with the objectives already published in the *Three Year Plan* and detailed in the *Annual Plan*: promoting the development of competitive markets; supporting the efficiency and economy of infrastructure services; promoting investment; protecting consumers and users of energy services; promoting rational energy use and contributing to environmental protection; inducing the correct application of sector norms and standards; interfacing with institutions, consumers and the other stakeholders in the system; assuring information adequate to the needs of public communication.

These are our intentions, this is our due, sincere commitment. It is but a part, our part, of a far wider, necessary mobilisation; that of the institutions, of companies, of research, culture, training, information, the labour organisations, the consumers who must accept a challenge that is unavoidable for all: rapid improvement of the security, competitiveness and sustainability of our energy system.