



Autorità per l'energia elettrica e il gas

ANNUAL REPORT ON THE STATE OF SERVICES AND REGULATORY ACTIVITIES

*Introduction by the President
Alessandro Ortis*

Rome, 10 July 2008

The Italian Regulatory Authority for Electricity & Gas

Alessandro Ortis *President*
Tullio Fanelli *Member*

Distinguished Authorities, Ladies and Gentlemen,

This presentation of the *Annual Report on the State of Services and Regulatory Activities* occurs within a context and time which is undoubtedly critical, more difficult and more challenging than a year ago. An *oil-tsunami* is overwhelming energy consumption everywhere in general and in our country in particular. In the absence of nuclear energy, with a scarce use of coal, with a limited contribution from competitive renewable resources, Italy is still heavily exposed to hydrocarbon imports (almost 80% of the energy requirement compared to the European average of less than 50%) and its electricity generation is currently based almost 60% (vs. the European average of 20%) on natural gas (a fuel whose prices are still too anchored to those of crude oil). Thus, the *oil price rally* is dealing a heavy blow to the energy costs and energy bills of all consumers: the barrel is already up by approximately 110% in Euro terms since January 2007 and by more than 35% in just the first six months of this year.

Thus, the debate on the prevalence of the various causes has been re-ignited: market fundamentals, supply control strategies or financial speculation; which in any case, are all present.

All of this creates concern; it worries all of us, as users of energy, as those of us who are called, for various reasons, to protect consumers, and who are now losing influence in a global system where it is the producing countries, the traders, the supply chain industries and financial brokers who are prospering; this is due more to the lack of a real market, than to the failure of what is not yet a market; as a matter of fact, what is missing is a well regulated, transparent platform to guarantee trading of abundant physical product rather than of risky *barrels of paper*.

However, being concerned does not mean giving in; on the contrary, it means reacting and getting involved, now more than ever, in order to achieve a supply mix that is less oil-dependent and more competitive; to make the markets more real and more efficient; to benefit from strong and healthy competition; to have an adequate infrastructural capacity; to improve energy efficiency; to encourage the European Union to provide the hoped-for *single voice*, the bargaining power of five-hundred million consumers, in its dealings with the oil and gas producing countries; it is a power that neither Italy nor any other Member

State could have on its own over the international hydrocarbon market.

Like a *tsunami*, the *oil price rally* and the *gas price rally* have submerged and thus clouded the first, undeniable and inalienable advantages acquired with the early opening of the markets to competition and with the reduction in infrastructure tariffs.

Without these initial advantages, which, incidentally, could be improved with a complete liberalisation on the supply side; the price escalation which, unfortunately, we recently had to suffer and announce would have certainly been even larger.

Dramatic initiatives are thus needed in order to break out of the *status quo*, but such initiatives require complex solutions and cannot provide immediate relief.

THE HYDROCARBON PROBLEM

Looking at the international scenario, it seems clear that the *oil issue* is, for our country and for Europe, complex and crucial. Such is the case and will continue to be, at least in the short and medium term, also for *natural gas*. Being a raw material, the latter alone accounts for a whopping 60% of our families' total bills (electricity and gas bills), net of taxes.

The value of traded futures corresponds to over 2 billion barrels/day, while physical oil production is 25 times less. According to a recent survey conducted by the United States Congress, 71% of trades related to oil stocks were typically of a financial nature; in 2000, this percentage did not exceed 37%. However, speculation could never have developed to this extent if there had not been imbalances between the fundamentals of supply and demand.

The global spare capacity of oil (difference between demand and available supply) has shrunk to less than an extremely modest 3%. This makes any possible incident or problem (of a political, productive, logistical, commercial nature) even more influential, with volatility of values that certainly attract speculative activity as well.

Both supply and demand contributed to this scarce spare capacity. The decrease in the needs of the OECD countries (which began in 2005) was more than offset by the increase in those of the non-OECD countries; thus, the average daily demand in 2007 rose from 85 to 86 million barrels/day. On the supply side, the contraction in OECD production was basically offset by Russia, and by other former USSR and African countries, which stepped up their production from 26.9 to 27.8 million barrels/day. On the contrary, the daily production of the OPEC countries decreased from 36.3 million barrels in 2006 to 35.5 million in 2007; this was despite an estimated unused capacity of

roughly 2.2 million barrels/day.

In essence, the OPEC countries are not touching their unused capacity and are not investing in new capacity due to fears of margin contractions. As a matter of fact, this same fear holds back investments from other countries, especially those that have substantial oil fields but which can only be exploited at higher production costs and which are crowded out by those who already have much cheaper extraction activities.

As for European initiatives that can influence the oil market (giving some certainty about prices and returns on investments in the long-term), we have taken the liberty of making a proposal that aims to have an impact on the currently too modest global spare capacity and on the related speculation, launching a *real* European oil exchange that is regulated, open to selected operators, and where long or extremely long-term (even 20 or 30 years) standardised products can be traded, physically delivered in Europe and guaranteed by an extremely reliable European central counterpart (for example, the EIB or similar institutions).

For natural gas, the problem is made even more complex, if this were at all possible, by logistic and infrastructure problems being added on top of those related to supply. A European role must thus be played, aimed at promoting and strengthening: institutional framework agreements in the context of which entrepreneurial initiatives and collaborations can be facilitated (also in the producing countries); diversification of suppliers and of access; a proactive reinforcement of infrastructural capacity (pipelines, re-gasification plants, storage facilities, liquefaction) that is open to all users without discrimination or limitations.

EUROPEAN AND NATIONAL ENERGY SYSTEMS

The problems that the European Union has to face (in terms of supply security and price, and of the functioning of the internal energy system) also correctly involve aspects such as *sustainable development* and the need for additional, strong boosts in order to accelerate progress toward a real, open, efficient and integrated energy market.

As regards the first aspect, *sustainable development*, the EU is taking action with initiatives that should achieve very ambitious goals, to be reached by 2020, such as a reduction in CO₂ emission; an increase in generation from renewable sources, and energy saving.

Greenhouse Gas Emissions

The European Union is moving down a particularly challenging road which, however, should also be evaluated in terms of effectiveness with respect to the global objective to reduce emissions.

The European efforts have already provided a substantial and costly contribution to the current global emission trading scheme, with 70% in terms of volume (2 billion tons of CO₂) and 78% in terms of value. On the other hand, according to the latest forecasts of the International Energy Agency, the United States, China, Russia and India could end up producing two-thirds of the increase in CO₂ emissions related to the energy sector.

In this circumstance, we have to acknowledge that the commitments made until today in unilateral terms have turned out to be ineffective. Within the context of globalisation, these efforts have indeed favoured the process of delocalising production to countries that have avoided limitations and restrictions, such as China and India. From an environmental standpoint, this turned out to be a negative result, caused by the lower efficiency of these countries in the production of goods that are consumed by Europe and the United States.

In China, which by now is the country with the highest emissions in the world, higher than those of all of European countries combined, domestic consumption accounts for just over one-third of the GDP: this means that Chinese emissions are largely those induced by European and American consumption. It is thus clear that the model adopted until now to deal with the climate change challenges has not worked and risks becoming counterproductive.

Unfortunately, the choices which the European Union has, do not seem to take the situation fully into account and continue to privilege the unilateral cap and trade instrument, based on the emissions in the territories of the single countries.

Last January, when the proposed revision of the Directive for the emission trading scheme (ETS) was published, the European Union basically confirmed the direction taken previously.

As regards climate change, the global challenge for the next few years instead requires a solution that is just as global and which involves all the continents, all the technological advances, all the industrial sectors (not just energy) and all the exchange mechanisms.

In this sense, we have for some time now been advancing proposals for an integrated approach (at the international level) of environmental and commercial policies, that discourage forms of environmental dumping and which, through agreements at WTO level, also look at the CO₂ content of the marketed products, while also introducing border tax ad-

justment mechanisms.

Rational Use of Energy

The most virtuous (even though virtual) *energy source* is the rational use of energy sources. In this regard, the international interest and the concrete results which characterise the market mechanism introduced in our country are significant. I am referring to those *white certificates* that have reached their third year of implementation and are achieving better than expected results. At present, the Authority, with the co-operation of Enea, to which we owe heartfelt thanks, verified approximately 3,200 interventions, certifying savings of over 2 million tons of oil equivalent (toe).

This savings exceeds the 2005-2007 target of approximately 1.1 million toe. The energy savings achieved are equivalent to the annual domestic consumption of a city with more than two and a half million inhabitants, to the annual electricity generation of three medium sized thermoelectric plants (a total of over 1,100 MWe), and enabled some 5.3 million tons of carbon dioxide emissions to be avoided.

Even in economic terms, the advantage obtained by all consumers significantly outweighs (in a ratio of roughly 1 to 8) the tariff contribution that is already in the bill, backing the energy savings.

The *mechanism* has also led to the introduction and development of the supply of energy conservation services by a growing number of entrepreneurs, as well as the launch of new consumer information and awareness initiatives.

Energy consumption control (based on new individual or social behaviour, technological innovation and efficient and effective mechanisms) will have to play a fundamental role in the efforts made by our country in order to contribute to the reduction of greenhouse gas emissions, to indirectly expand the portion of supplies obtained from renewable sources, to improve the security of supply and reduce costs for consumers.

The *white certificates* mechanism has thus proven to be able to provide a substantial contribution and it is therefore hoped that it will be extended, coherently with the time span of the European efforts, and consolidated, in order to give investors certainty and guarantee the development of interventions of a more structural nature.

Renewable Energy Sources

In order to move toward an economy with a *low carbon content* and a less hydrocarbon-dependent mix, the development of renewable sources is being closely examined as well. The European institutions have set a very challenging target: to cover 20% of consumption with renewable sources by 2020.

Italy has been asked to contribute to the achievement of this goal with a portion of renewable sources of 17% (without prejudice to the 10% biofuel limit on national consumption for transport). This target, if not modified, will lead to a substantial commitment of resources for Italy as well as intense regulatory and control measures.

The Authority, insofar as it is responsible, has already taken action aimed at reorganising and completing the regulatory framework in order to facilitate the access of the energy produced from renewable sources to both the networks and to the market. However, it should be pointed out that certain problems need to be overcome in relation to the required authorisations which, more and more frequently, represent an obstacle in the way of development.

The Authority has also constantly monitored the trend of costs to consumers for the promotion of renewable sources. For example, the Authority intervened in order to adjust the recognised prices to the renewable and assimilated energy plants that enjoy the so-called CIP 6 incentives. This intervention, which passed the scrutiny of the State Council last March, enabled the costs transferred to electricity bills to be lowered by some 600 million Euro per year.

The new incentives for renewable sources, launched in the past few years, and most of all the new quantitative targets already mentioned, can however lead to rather large costs to the national system: if fully reached, they could lead to a cost for electricity users (the A3 component of the bill) of approximately 200 billion Euro for the period spanning from now until 2035, with an annual peak of 11 billion by around 2020.

This is a substantial commitment that could be partially justified not only by the need to diversify the energy supply mix, but also by important impacts on technological and industrial development. In this sense, an in-depth costs/benefits analysis seems advisable, taking into account the specificity of each technology or source, given that the renewable sources are very different from one another. This could allow for a gradually more

targeted and efficient configuration of the incentive system, which must nevertheless be subjected to tight monitoring.

Opening and Integration of the Markets

Considering the obsolescence of the previous European Directives, which, incidentally, are far from being fully implemented everywhere, a number of proposals are of great topical interest, in the debate underway at the EU institutional level, aimed at *crossing the ford* that exists between a pre-liberalised past, with closed national energy markets, entrusted to public, monopolistic operators, and progress toward the *single market*; prolonging this stalemate means summing all the costs of the two systems, without rapidly reaping the benefits of a full and extended competition in favor of consumers.

The new European initiatives originate from national indications and from surveys conducted by the Commission, which we participated in along with our European colleagues. These highlight the primary obstacles standing in the way of integration, stepping up market and competition efficiency: scarce integration and low liquidity of the wholesale markets, still predominantly of a national size; the lack of interconnections and congestion of the infrastructures; the lack of transparency in the price formation mechanisms; insufficient level of competition in the retail market; inadequate functioning of the balancing markets.

The energy sector liberalisation process in the EU, as also in Italy, has not yet reached full realisation. In many countries, the main player (often the former national monopolist) still benefits from a high market power. The obligation of legal and functional separation between free activities and those of natural monopoly, as provided for by the current EU legislation, has not stopped the vertically integrated companies from obstructing competitors' access to the market.

It is hoped that, in relation to the current European institutional debate, already oriented to new parliamentary readings, and in the event of a final conciliation amongst the institutions (Parliament, Council, Commission), sufficient consideration can be given to the positions originally expressed by the Commission, those adopted by the BEUC (*Bureau Européen des Unions de Consommateurs* – The European Consumers' Organization), those also expressed by the EESC (European Economic and Social Committee) and by the CEER (Council of European Energy Regulators), according to laws and regulatory solutions already adopted by our Country. These positions can be summarised as followings: i) for the national regulatory

authorities, harmonisation to reach more advanced levels of powers and duties, autonomy, independence and accountability; ii) establishment of an independent European Agency composed by the same national Regulators, in order to better regulate and supervise international trade, the security of the continental networks and the relative cross-border flows; iii) separation of ownership of monopolies (for example, transport or transmission) from the contestable activities (production, supplying, trading and sales); this type of separation has already been recognised as the first best option, also by the majority of the delegations of the Energy Ministers in the European Council and by the Commission.

As regards this last issue, the type of unbundling to be adopted, an excessive flexibility in favour of various national options such as ISO (Independent System Operator) or ITO (Independent Transmission Operator), backed by some industrial groups interested in maintaining monopolistic privileges through control of the network infrastructures, would risk fuelling, instead of attenuating, the persistent imbalances in the EU and due to inefficiencies and a lower level of security.

Ownership separation has already been successfully tested in the EU and has been adopted by 13 Countries for the electricity grid and by 6 Countries for the gas network. On the other hand, solutions other than full separation of the dominant operators have already been tested and proven unsuccessful in Europe, also in relation to security.

Here are a few examples: the blackout of 2003 (originated by a vertically integrated Swiss group that developed in Italy, in the presence, at the time, of an ISO system for the electricity grid, GRTN and Terna); the blackout of 2006 (originated in Germany by a vertically integrated German group); the gas emergencies in the winters of 2004-2006 (in Italy, with gas network and storage vertically integrated in the ENI group).

At the same time, the *separation of ownership* solution, already legally provided for in Italy by law no. 290 of 2003, favours a less *invasive* regulation and is suitable for: promoting competition and infrastructure development; *securing* advisable national control of the strategic networks (definitively making their neutrality not exposed to the control or power of an operator, belonging to the EU or not, dominant either upstream or downstream in the sector supply chain); allowing the promotion of a *gas exchange*, the results of which are implemented (by way of the dispatching service) by an independent party, without any fear of partiality; supporting the competitive projections of *national champions* in the international arena, so that they can prove to be real *international champions*. In this regard and in relation to the feared weakening of *national champions*

due to the disposal (even though compensated) of the grid, it should be kept in mind that: the turnover for services rendered by the transport networks and storage (deriving from tariffs which are already in the *bill*) is entirely marginal for the large, vertically integrated groups (for example, Snam Rete Gas and Stogit respectively account for roughly 2.1% and 0.4% of ENI's turnover); the most well-known international champions (Exxon, Total, Chevron-Texaco, Shell, BP, BG, etc.) do not have control over the respective national grids and they do not complain that the absence thereof represents a weakness in their negotiating powers.

We therefore hope that, in line with our previous reports and with the bipartisan proposal made by the Xth Commission of Chamber of Deputies in February 2006, what has already been opportunely done for the electricity sector (Terna transaction), is promptly undertaken also in our country's gas sector as well (through the related implementation decree already provided for by the already mentioned law 290/03). This sector lags behind other industries, in terms of the level of market efficiency and of infrastructure development (pipelines, storage facilities and re-gasification plants); development is needed, to improve security and help promote competition in a national gas market that is still heavily dominated and controlled by Eni in every part of the supply chain.

The completion, in Italy and in Europe, of the path toward a real (not only functional) *separation* of the network monopolies in the gas sector as well, would immediately be beneficial to the single national systems (without having to wait for the actions of others) and, even more important, would help to induce other countries (EU or non-EU) that are still bent on obsolete solutions, toward more open and efficient structures. This would also provide the necessary and best premise for looking forward to a future integrated European transport system, made up of national networks that are well coordinated amongst each other or by an integrated, equally third party network. As a matter of fact, the transport networks and storage facilities, which all the upstream or downstream operators that are in competition with one another must compulsorily use, would have to have ownership and control structures able to guarantee full *impartiality* and neutrality: management systems and developments that are beyond any danger or simple suspicion of discrimination against all existent or new users. Therefore, these infrastructures cannot be left in the hands of just one or a few competitors in the arena, especially if they are dominant on their respective markets.

EUROPEAN AND INTERNATIONAL REGULATORY FRAMEWORK

The network systems, flows and energy exchanges oblige Italy to develop its international dealings at all levels and thus also in terms of sector regulation and the relevant controls, as a matter of necessity but also of opportunity. Therefore, in order to duly contribute to the national institutional and those of the EU, through the promotion of regulatory frameworks and provisions that are clearer, more stable and harmonised (supporting the international development of our entrepreneurs, security and at accessible prices), we have also intensified our commitment in relation to: *CEER/ERGEG* (Council of European Energy Regulators) and Board of Regulators of South East Europe (established by the Athens Treaty for the Balkan region).

Mention should also be made of the activities dedicated to FSR (Florence School of Regulation), and its related IERN (International Energy Regulation Network); to the *Forums* of Florence, Madrid and Athens (respectively for electricity, gas and the electricity market of South East Europe); to the *Regional Initiatives* (gas and electricity), promoted by CEER and supported by the Governments and by the Commission, to realise market integration at the regional level and aimed at facilitating further integration on the continental level (for the *Regional Initiatives* that include Italy, the Italian Authority is responsible for presiding and coordinating them).

Moreover, we are managing a *twining* project with our Ukrainian colleagues (entirely financed by the EU) and we have promoted and preside over MEDREG, the Mediterranean Working Group on Electricity and Natural Gas Regulation, which aims at harmonising the regulatory framework of the region, in order to facilitate network and market integration and create conditions of stability that encourage investments, also for the national companies.

MARKETS AND COMPETITION IN ITALY

Infrastructure Development

Infrastructure development is still underway in the electricity sector, in particular as regards generation and transmission, which are essential for the consolidation of the wholesale market.

Electricity generation capacity, thanks also to the economic signals received from the market since it was launched, has increased substantially with respect to the early 2000s, enabling healthy national margins of adequacy and operating reserve to be achieved.

However, there are still considerable difficulties in some areas of the country (for example, the main islands), with inevitable repercussions in terms of both security of supply and zonal prices.

The efficiency of the generating plants is making substantial progress, and this is also proven by electricity exports to important foreign markets, especially in times of tight markets. The balance is nonetheless still in favour of the latter's exports to Italy, given that they are characterised by a more balanced and competitive supply mix.

In this regard, the provision contained in the recent decree no. 112/08 is certainly important; it assigns priority to the “*measures needed to achieve, with also through market mechanisms, a diversification of resources and of their geographic location*”.

In line with that trend, the Authority recently started a procedure to define the trading of long-term hedging instruments; this is in order to create a favourable context for investments in generating plants characterised by a high share of fixed costs; leaving these plants off line could in the long-term, be detrimental to the system and hinder diversification towards a competitive generating mix.

Development of electricity transmission infrastructures certainly received a boost from the unification (GRTN-Terna) and *ownership unbundling* of Terna. However, primarily as a result of some delays in or opposition against the authorisation of new lines, there is still some network congestion in both the North and South of the country. This is standing in the way of transition toward an efficient market integration and of spreading throughout the country the positive effects of competition between producers. In order to facilitate this process, the Authority has introduced mechanisms to promote the development of *transmission* lines, giving priority to new infrastructures entering into operation .

A similar incentive program has already been activated also for the gas transport infrastructure and storage system, although this is not yet under separate ownership.

Considering the late progress made in strengthening the natural gas import infrastructures (re-gasification plants included), our country is still far from that ideal situation where the supply of capacity exceeds, always and proactively, the mounting demand. The availability of *abundant* infrastructure capacity is a necessary though not sufficient condition for a real market to exist and guarantee security of supply; *security* and *competition* go hand in hand and currently, for the national gas system, both are short of the desired levels.

In order to deal with the next winter, we have to rely on an additional capacity of only some 30 million cubic meters/day, from the expansion of the existing pipeline capacities (connections with Libya, Tunisia-Algeria, Austria-Russia). As a matter of fact, complete strengthening of the TAG (10 million cubic meters/day in the Austria-Russia connection) has been postponed to October 2009, the Rovigo re-gasification plant (25 million cubic meters/day) will now not be operative until the beginning of 2009 and storage capacity (held over 94% by Eni) has remained basically unchanged. In relation to the latter, we are in the process of conducting, in conjunction with the Antitrust Authority, a fact-finding investigation.

The current gas infrastructure situation thus confirms the need to support all actions that could speed up the development projects, out of the many that have been initiated or simply proposed, such as pipelines, re-gasification plants (particularly important for the diversification of supply) and storage facilities.

We will have to reignite the *ambition* to overcome the current shortcomings (which once again force us to hope for a mild winter and with no international supply crises) in order to be able to make our country a candidate to be a future hub of Southern Europe, which would be convenient for supply prices and for consumers.

Wholesale Markets

Two important phenomena are occurring on the wholesale electricity market: positive expansion and diversification of markets over differentiated time horizons, for forward trading and management of the associated risks; a reorganisation of the ownership of generation assets in an expanded international environment.

As regards the second phenomenon, there is an interesting expansion of Italian concerns (for example, the former monopolist Enel, strengthened also by the alienation of Terna) beyond the national borders and a reciprocal arrival of new companies on the Italian market, benefiting both Italy and Europe in increasing the level of competition.

As for diversification, we will see the co-existence of forward markets with physical delivery (proposed by the electricity market operator) and markets for electricity *derivatives* (managed by Borsa Italiana) that will soon be launched; the combination will provide for a better management of the risks related to trading, which will obviously continue to be monitored by the Authority and, as far as the *derivatives* are concerned, they will be monitored in conjunction with CONSOB (the public authority responsible

for regulating the Italian securities market) and in execution of the MIFID Directive.

Moreover, the Authority is preparing (through consultations with the companies) a revision of the *Balancing Market* (MSD) in order to help lower the costs deriving from this market. However, we must also deal with the issue of decreasing the market power held by some electricity producers, which can still play a pivotal role in certain hours and areas. In relation to this and the dispatching issue, the current update of the 2005 electricity market investigation that we are conducting with the Antitrust Authority will be extremely useful.

As far as the gas wholesale market is concerned and in light of what has already been said on the infrastructure situation, there are more than a few difficulties in promoting the launch of a real *gas exchange*. However, through a recent consultation, which we hope will enjoy a fruitful participation, we are trying to verify the state of the existent trading instruments, based solely on OTC (over the counter) trades, typical of immature markets, and provide a draft for an organised platform for centralised trading.

Such a system is also following last year's legislation providing for mandatory sales on the market of the government proceeds from the extraction of domestic gas (royalties), and of quotas of new gas imports.

At the same time, we recently put into consultation an innovation of the current *natural gas dispatching* procedures, also undertaken by Snam Rete Gas; this is in order to switch to a dispatching system in which the resources for system balancing (mainly storage, flexible imports, withdrawals from gas power plants and interruptibility of industrial gas supplies) are priced on the basis of market bids as compensation for the concerns holding these resources with the objective of introducing cost minimisation by the dispatching operator. Dispatching based on economic merits would also provide price signals to re-gasification plants and storage facilities which are under construction or feasibility evaluation. With this new dispatching set up they could, indeed, be sized and remunerated on the basis of the additional flexibility that they would make available for balancing.

The problematic factor that needs to be underscored in this context is once again the fact that the dispatching operator is *not a third party*, given that Snam Rete Gas is still controlled by the incumbent ENI. In any case, and waiting for the hoped-for separation, we are pursuing any possible improvement in the current situation.

Generally speaking, we can see that in the wholesale markets, there are clear-cut asymmetries in terms of market efficiency and competition levels between the gas and the electricity sectors. Unlike what has already been done for the electricity market, in the gas sector the supply ceilings

are less strict, can be eluded and will soon come to an end with the by now imminent 2010. The former monopolist has not disposed of national production capacity or of transmission networks. Consequently, it is still difficult to imagine a real *gas exchange*.

Retail Markets

The retail electricity market has been fully free for one year now and, with the *captive market* having been eliminated (law no. 125/2007), the Authority created the *greater protection* and *safeguarded* markets; the latter is of a transitory nature in order to assist smaller consumers during the gradual shift from the old to the liberalised system.

Greater protection market

In our country, as in other countries in an advanced stage of liberalisation (such as the United Kingdom), a service with greater protection is provided to families and small companies.

This service has three purposes:

a) to guarantee at least one offer (out of all the others that can be freely proposed by the competing suppliers) at conditions set by the Authority; this is based on market supply mechanisms that enable reasonable prices and quality to be set, as provided for by the relevant European Directive;

b) to guarantee a last resort service for those customers who, while being entitled to greater protection, opted for the free market but who find themselves faced with the risk of an interruption of service (for example, bankruptcy of the supplier);

c) to nonetheless leave ample space for competition on the free market, in terms of both price and quality; this is because the greater protection service is regulated based on market criteria, which transfer the costs of the electricity commodity, purchased on the wholesale market by the Single Buyer, with transparent and generally foreseeable methods by the suppliers on the free market.

The Authority feels that the structure outlined by Law 125/07 for the retail electricity market could be improved even further by introducing sharper competition amongst suppliers and less dominated by integrated groups (for example, the former monopolist Enel and the former local monopolists).

Regulation of the *greater protection* and of the *retail free market* is developing and will follow two guidelines:

a) eliminate barriers and conflicts that condition free consumer choice, in order to ensure that competition takes place as much as possible in a context of regulated equal access amongst suppliers;

b) promote choices that are more informed, freer and convenient for consumers.

In this sense, adequate solutions have been identified for non payment and the switching process (change of supplier); a *list of suppliers* who participate voluntarily has been prepared, and is controlled by the Authority and published on its website.

For consumers with new electronic meters (the installation of which, already at a very advanced stage, must be completed by 2010), diversified prices are gradually becoming available; they will be more in line with costs and aim to shift off-peak utilisation to less expensive hours. As a matter of fact, within a year and a half all customers, including families, will have prices that are differentiated between peak and off-peak hours, and between periods of high and low season.

Free Market

The process of transition toward the *free market* has already involved, in just one year, approximately 1.8 million customers, over 5% of the starting base (34 million customers). This also takes into account the return of customers from the *free market* to the *greater protected markets*. This rate is coherent with the switching percentages of the countries which are historically more advanced in terms of liberalisation (for example, England, with the opening of its retail market).

As regards the Italian geographic distribution of switching percentages, that of the Centre-North is higher for non-domestic customers, while for families it is higher in the South.

Particular focus ought to be placed on switching from old distribution companies to new suppliers associated with them. While 80% of domestic customers chose a supplier with the same brand as their historic distributor-supplier, 35% of small companies (low voltage) chose an entirely different supplier. The latter figure is indicative of how dynamic the retail market is.

There are very few cases of customers that have already switched, at least once, to the free market, and gone back to *greater protection*: one small company out of 10 and one family out of 100. The Authority intends to continue to monitor this trend also in order to make regulatory adjustments that could be needed in order to promote competition even further.

Safeguarding Service

The *safeguarding service* (established by law no. 125/07) is a *last resort* service reserved for customers who, although in the free market, find themselves faced with the risk (for example, due to bankruptcy of the supplier) of service interruption. This service was assigned through a tendering process at the beginning of this year and was already active on the 1st May, 2008. It was the first time in our country, that an assignment of energy ser-

vices (the so-called *competition for the market*) was made to operators bidding for groups of final customers to provide continuity of service, based on reasonable conditions, until the consumer freely chooses a new supplier.

The initial indications of the results of this initiative are encouraging.

As a matter of fact, a) there was a healthy participation of large and medium sized operators (9 in total) in the tenders; b) in the South, for example, the prices charged to customers for the new *safeguarding service* were lowered by a good 10 Euro/MWh, with respect to the rate previously applied to the same customer; c) there were no problems of a contractual or procedural nature in the *automatic switching* of some 180,000-200,000 withdrawal points; d) the switching of customers from the *safeguarding service* to the *free market* is taking place at encouraging rates.

Gas market

In the gas sector as well, law no. 125/07 provided protection mechanisms for domestic customers, designed to protect *small* consumers, which typically have limited negotiating power and are thus more easily exposed to unilateral price increases by suppliers. The law basically confirmed the *protection* structure, in relation to the economic conditions for the supply of natural gas, defined by the Authority since 2003.

Also In the gas sector regulatory activity has aimed at promoting a context of equal access for suppliers competing against one another and at making consumer choices more informed and knowledgeable.

In 2007, the tenders for the selection of *provider of last resort*, aimed at guaranteeing continuity of service to end customers who find themselves temporarily without a supplier, as In the electricity sector, were also a great success.

PRICES AND TARIFFS

Until now the Authority has sought to mitigate the substantial increases in the costs of energy inputs by combating market inefficiencies and through the most fitting determination of the general charges that enter the tariff system.

The results, especially in the electricity sector, are evident and significant despite the overall picture of marked and painful price increases essentially due to the *oil price rally*.

In addition to those tasks, entrusted to the Authority by its establishing law, the recent act no. 112/2008 assigns to the Authority the responsibility for monitoring that the tax in-

crease applied by said act to energy sector operators is not transferred to electricity, gas and oil product prices. It is a difficult task, but one that we have already duly got started on.

There is no doubt that, in the absence of a strong and immediate engagement, companies would have no trouble at all in transferring said tax increase to prices. This is particularly true in the gas sector and for oil products, whose markets are more than imperfect in terms of level of competition.

On the back of the above, and in order to promptly respond to the urgency of the decree law, we have already published an initial ruling that outlines our monitoring process and procedures and we have asked the operators to provide the Authority with the required information. The abovementioned decree law extends the Authority's 's duties to the oil sector as well: we will thus request the traditional and helpful collaboration of *Guardia di Finanza* (the Italian Tax Police), as well as that of the other institutional entities that are involved.

Electricity

In the last 18 months, despite the tremendous escalation in the price of Brent (around +150% in dollars, +110% in Euro), the increase in the price of electricity for families was much more limited: 14.7% for *greater protection* consumers (from 15.60 cents of Euro/kWh in the first quarter of 2007 to 17.9 cents of Euro/kWh on July 1, 2008). This is also thanks to the complete liberalisation of the market as of July 2007 and to the continuing improvement in the efficiency of generating plant and network activities.

Therefore, with the last quarterly update and for a typical domestic consumer (consumption of 2,700 kWh/year, power 3 kW), the share of the *tariff component* for transmission, distribution and metering services decreased to 13.3% of the total *bill*, gross of taxes; the *energy portion*, on the other hand, which is heavily influenced by oil and gas prices, increased to 65.1% of the total bill; taxes to 13.7%; *general system charges* account for 7.9% and include the levies established by law that basically refer to: incentives for renewable and assimilated resources; special tariff schemes for energy intensive companies; stranded costs; charges for nuclear decommissioning and territorial compensation; compensation for smaller electricity companies; support for system research.

In relation to the *system charges* (burdened by VAT as well, despite being of a para-fiscal nature) and some tax charges in the *bill*, we wonder if the time has not come to transfer some items from said *bill* to *general taxation*, as already proposed by us in the past. This would

certainly be a fairer solution that would prevent a large family, which obviously has a higher electricity consumption, from having to contribute to the *general charges* more than a well-off single person. In regard to low-income families and individuals requiring energy intensive health treatments, a *social protection mechanism* will be activated that is coherent with the relevant government trends. The *social bonus* on electricity bills will be activated in the fourth quarter of the year. The collaboration of the municipalities is required for its application and the necessary operating procedures are being defined. The mechanism will nonetheless have a *retroactive effect*, with a *bonus*, for all of 2008. The bonus mechanism could also be extended to gas services as well, after issuance of an Interministerial decree in accordance with law no. 31/2008.

Based on the most recent international data (Eurostat second half of 2007), Italian families with an annual consumption of up to 2,500 kWh had prices that were more than 20% lower, gross of taxes, than the European average. In general, Italian companies, on the other hand, paid electricity prices that were higher than the European average for all the consumption classes during the same period of time, both gross and net of taxes. More in detail, in reference to the consumption classes of small and medium companies (500 – 20,000 MWh/year), gross Italian prices are among the highest in Europe (with peaks of over 35%), along with those of Denmark, Germany and Ireland.

In this context, it would seem appropriate to also promote harmonisation at the EU level of facilitations for energy intensive companies that are considered strategic.

Natural Gas

The abovementioned Eurostat comparison also shows that the gas bills of Italian families were in line with the European averages for the lowest class of consumption (cooking and hot water) while for the higher classes (use of gas for heating as well) they were a slightly higher than the European average, net of taxes, and 20% higher gross of taxes.

The gross prices paid by Italian companies (excluding non-energy and electricity generation) were fairly close to the European average for all the consumption classes. Compared with the main European countries Italian prices, net of taxes, for the three central consumption categories, were midway between the lowest prices of the United Kingdom and Spain, and the highest prices of Sweden and Germany.

Following the latest tariff adjustments, the reference price of gas for small consumers (less than 200,000 m³/year) rose to 77.61 Euro cents, with an increase of 12.3% with respect to that of the first quarter of 2007. In this case, the increase in the price of the raw material (gas) was softened solely by the decrease in tariffs operated by the Authority for transmis-

sion, storage and distribution services.

Considering the total expense of a typical domestic consumer (1,400 m³/year) gross of taxes, the *gas raw material* now accounts for 47.7%; taxes for 36.7%; services under tariff (transport, distribution and storage) for 15.6%. Of these, the distribution service represents approximately 10% of the *bills*.

Another improvement in efficiency could come from the hoped-for reduction in the number of distributors. In Italy there are currently some 320 distributors, compared to 6,400 concessions for 2,080 tariff areas. Therefore, as in other European countries and in order to identify more convenient company-concession sizes (based on economies of scale, efficiency and the quality of services), without having to sacrifice competition, the Authority feels that the appropriate number of national concessions can be lowered to around 50. The Authority has expressed this opinion in a document that is under consultation; the consultation will be completed very soon, so that the proposal to the Government may be issued, in accordance with law 222/07.

The *gas bill* accounts for 68% of the total annual expense for electricity and gas. Therefore, and considering that 60% of domestic electricity generation is based on gas, the *natural gas input alone* accounts for roughly 60% of the total expense (of gas and electricity) of families and certainly for a significant percentage for companies.

Consequently, the *gas issue* has become increasingly important for consumers, Italian consumers in particular. The issue regards the continuing correlation between the prices of oil and gas, security and the diversification of supplies, the available infrastructures, market competition, price levels and the behaviour of the sector operators.

QUALITY OF SERVICES

The commitment of the Authority and of the energy companies to improve the quality of services, was kept up in 2007 as well.

Technical Quality

The Authority's decision to regulate the *continuity of the electricity service* by implementing rewards and fines led to further reductions in electricity interruptions (without advance notice and for longer than 3 minutes), in terms of both the average number (down to 2.16 long

interruptions per year per customer) and in terms of total duration (down to 58 minutes of interruption per year per customer, with an improvement of 70% compared to 1999). The gradual narrowing of the gap between the Northern and the Central-Southern regions of Italy is particularly gratifying.

New regulations have been drawn up, to support the progress made, in the next four-year regulatory period (2008-2011). This is aimed at: further reducing the number of interruptions, including, for the first time in Europe, brief interruptions; expanding the group of consumers who benefit from certain types of compensation; and improving the service quality of high voltage lines. A compensation plan has even been defined for blackouts lasting a particularly long time; this will come into force in 2009 and is based on an innovative solution of joint-responsibility between the operators and a *Fund for extraordinary events*, financed in part by tariffs and in part by fines chargeable to the operators.

As far as the gas sector is concerned, security has improved over the last five years, with results that are coherent with the type of regulations and incentives adopted.

As a matter of fact, there has been a progressive reduction in the average national number of leakages (- 27%), in the calls for emergency intervention (-11%) and in the time elapsing between the call and intervention (down to 35 minutes). Moreover, the number of controls carried out by distributors on the correct odourisation of gas have increased by more than 33% from 2003 to 2007, passing from an average number of 1.38 per thousand customers in 2003 to 1.83 in 2007.

Overall, there seems to be a higher level of compliance by the operators with the obligations on the percentages of network that must be inspected, set by the Service quality code issued by the Authority.

For the gas sector as well, a reinforced consultation process has already been launched (Fall of 2007) for regulating the quality of the distribution and metering service for the 2009-2012 period, which entails that a reward and penalty system be extended to all distributors in order to decrease the number of leakages and increase the number of controls over the correct odourisation of gas. The Authority has also focused its efforts on promoting investments in innovative technologies (remote network surveillance) and advancing performance in customer relations (prompt provision of main services, response to complaints and to written requests for information, disclosure obligations, etc.).

Electricity and Gas Metering

The Authority has strengthened the regulations pertaining to gas meter inspection requests made by consumers, as solicited also by the consumer associations. These provide for a free substitution of the meter if the inspection outcome is negative and establish, on one hand, new rules for the recalculation of consumption based on the outcome of the inspection and, on the other, benefits for customers should the meter subject to inspection turn out to be extremely old.

The Authority has also formulated proposals aimed at renewing the stock of gas meters, at introducing innovative functions (such as, for example, automatic conversion, in the meter, of the volumetric measurement at the standard temperature and pressure conditions; remote disconnection). In this context, concern is being raised on the possible repercussions of the very recent decree law no. 112/2008 (for example, meter calibration abroad and assignment of metering functions to the municipalities). We trust that the necessary adjustments will be made during the conversion phase.

In this regard, the Authority has already outlined some proposals and submitted them to Parliament and the Government in March of 2008.

For the electricity sector, specific deadlines have been set for the complete diffusion, already at a very advanced stage, of electronic metering and specific indicators have been introduced in order to monitor the system's performance.

Commercial Quality

In 2007 consumers were issued more than 100,000 automatic indemnities, with payment of more than 7 million Euro for inefficiencies in the electricity and gas sectors related to failure on the part of the operators to comply with the standards introduced by the Authority.

In the course of 2007 the new discipline for suppliers' call centres was introduced, with new quality standards pertaining to waiting time and call quality.

In the framework of a complete reorganisation of *commercial quality*, broken down into various aspects regarding customer-operator dealings, an integrated text of the earlier and more recent regulations will soon be published, which already exists for consumer protection, and concerning, for example: the quality of the response to complaints and response time; the accuracy of billing, promotional activities and communication; the behaviour of suppliers; the completeness of the offers and how they comply with

the standards set by the Authority; the stipulation of contracts or amendments thereof; supply continuity when switching supplier and the treatment of arrears, if any.

Consumer Desk

In order to provide more adequate responses to reports, complaints and requests for information received from individuals or consumers' associations, we have decided to develop even further the services already ensured with the *Finestra del consumatore* (Consumers' Window) section on our website and by the call centre of the Single Buyer (which I would like to thank for its valuable co-operation), launching an electricity and gas *Consumer Desk*.

Consumers, families and companies can contact the new *Desk* (via phone, fax or internet) to obtain information about the electricity and gas market, report inefficiencies and file complaints. In order to manage the *Desk*, we make use of *Cassa Conguaglio per il Settore Elettrico* (Compensation Fund for the Electricity Sector), with the co-operation of the Electricity Services Operator.

In order to ensure that the *Desk* develops a dialogue with consumers that is increasingly efficient and focused on their various needs, a *Coordination Group*, made up of representatives of the domestic consumers and business associations, also provides assistance.

Conciliation procedures

We are also still promoting the use of *conciliation procedures* between companies and consumers' associations.

These procedures are based on specific, voluntary agreement protocols signed by companies or business associations and consumer groups. To fully back this initiative, in the framework of one of these protocols in February - May of this year alone, 21 training courses were financed involving more than 450 operators in 9 different regional capitals, designated by the consumer associations.

CONTROLS, INSPECTIONS AND SANCTIONS

During the period 1 April 2007 to 31 March 2008, 114 inspections were conducted, thanks to the co-operation of the Special Units of the Italian Tax Police, of *Cassa Conguaglio per il Settore Elettrico* and of the Fuel Experimentation Station.

The Italian Tax Police is thus due our gratitude for its much appreciated, growing com-

mitment, which is also proven by an increase in the number of inspections conducted with its cooperation , growing from 58 in 2004 to 92 in 2007.

Our sincere gratitude also goes to the *Fuel Experimental Station* and to the *Cassa Conguaglio*, which also effectively supervise the delicate activities of fund management, control and evaluation, entrusted by the Authority.

In 2007, inspections were also extended to new investigation segments, such as: tariff integration for smaller electricity companies; monitoring of the information provided to customers; the correct application, by the natural gas distribution companies and suppliers, of k and M correction coefficients of the volumes read by the meters.

In relation to the incentives for electricity generation plants fuelled by renewable sources, assimilated sources and cogeneration plants (CIP6), inspections have covered 105 plants, for a total of 7,160 MW, since 2005. From these, more than 144 million Euro will be recovered as a result of incentives received without entitlement; of this amount, 31.5 million Euro has already been paid, thus helping to lower the largest *general system charge* (the A3 component) in the electricity *bill*.

In addition to the abovementioned administrative recoveries, the inspection campaign generated: a substantial moral suasion effect, creating a greater propensity for self verification and compliance with the regulations; suitable regulatory optimisation intervention; as well as control, in the forthcoming years, over the *general system charges*.

The Authority thus intends to strengthen and intensify its controls and inspections of the operators, plants, processes and public services. In this sense, we hope that the cooperation provided by the Italian Tax Police will be reinforced and that particular focus will be placed on the organisational development proposals that the Authority will make in implementing decree law no. 112 issued last June.

Energy services are becoming more and more critical for any kind of fruition; therefore, the need to control and guarantee compliance with the regulations has become even more important. Consequently, the need for sanction procedures has increased as well: from the start of 2007 to today, the Authority has completed 45 procedures and has opened 123.

A rather substantial portion of the intervention pertains to the gas measurement sector where the Authority, insofar as it is responsible and thus not including the legal measurement standards, has undertaken a massive effort to verify compliance with the regulations and an intense institutional co-operation with the Milan public prosecutors, which are also

actively involved on this front.

Thanks to a fact-finding investigation opened in 2007, several violations of the *gas meter correction coefficients* set by the Authority were discovered, and therefore 109 procedures were opened which, in the course of just a few months, resulted in the first sanctions against 9 companies (4 were acquitted), with a concomitant ruling to compensate end customers.

As regards the safety of the system, after having completed the final investigations into the so-called national *blackout* (which ascertained the responsibility of 8 generation companies and of 6 distribution or transmission companies) 4 procedures have been initiated in relation to the *post meter* safety of the gas service.

In relation to service access, an investigation was conducted into the main gas storage operator for not having adjusted its commercial conduct to the new regulatory framework.

In 2007 violations regarding failure to provide the Authority with the data and information it needs in order to perform its duties were also documented. These are particularly severe violations, especially when the market power of the operator required to make the disclosure makes the information of key importance in exercising the regulatory function. Three investigations have thus been opened in order to verify that the tariff scheme set by the Authority is being applied correctly, and two have been completed against companies that failed to provide the information required by the unbundling regulations.

There has also been an increase in the number of sanctioning procedures pertaining to consumer protection: infractions of continuity of economic supply condition obligations, also in the case of switching; infractions against the obligations concerning the reading of meters; non-compliance with the regulations on separation of bills into installments.

DISPUTES

An analysis of the rulings of the Administrative Judge in 2007 and until March 2008 confirms the solidity of the Authority's actions to jurisdictional scrutiny.

Out of 2,756 provisions adopted by the Authority since its inception, 248 have been challenged, with only 41 being fully or partially annulled; this means that 98.5% of the resolutions were recognized as being legal.

It should also be considered that fully annulled rulings have almost never concerned the general provi-

sions, with which the guidelines of the regulatory framework were drawn. In particular, the most important measures have been basically confirmed, such as resolution no. 249/06 on the avoided fuel cost and the new unbundling regulation adopted in implementation of the sector EU Directives.

These results, which confirm the stability of the regulatory framework adopted, are also the outcome of a legal system which, on the one hand, clearly defined the limits of our intervention and on the other, helped us interpret regulations often of a generic content and, most of all, apply them to very complex cases from a technical and economic point of view.

In 2007, there was a substantial decrease in the number of disputes, which was almost half that of the year before, and important rulings were delivered in relation to the extent of the Authority's 's regulatory power. I would cite, in reference to the gas market, the confirmed compatibility between sector liberalisation and competition-enhancing regulations and, in terms of tariff regulation, the positive valuation of the State Council as regards the application of the price-cap to natural gas re-gassification, transport and dispatching tariff adjustments.

INTERNAL ORGANISATION AND OPERATIONS

The year 2007 saw the consolidation of the organisational structure defined at the end of 2006, with encouraging results also in terms of the goals for the harmonisation and convergence of the electricity and gas sector activities. At the same time, the gradual workforce completion process continued (though still below the legal requirements), based on the scheduled planning; the training and updating activities involved roughly 70% of our personnel.

Remaining on the workforce issue I would like to point out, also to support the plan that will be submitted in compliance with the recent decree law no. 112/2008, that the number of staff with fixed term contracts and open-ended contracts, defined by the institutional law of thirteen years ago, has not changed in the past few years, despite the increasing and new duties or functions that we have been assigned, even recently.

These duties include: the power to resolve disputes between energy producers and network managers, based on the 2008 Budget Law; the definition of the *social tariff* with the interdepartmental decree of December 28, 2007; the system research management functions (CERSE), with a ministerial decree of June 2007; implementation of law no. 125 of August 3, 2007; supervisory activity subsequent to the abovementioned decree law no. 112/2008.

During 2007, 51 consultation documents were issued (31 in 2006) and 359 resolutions were adopted (337 in 2006). Of these, 179 were *general regulation* provisions and 66 provisions for supervisory and sanctioning activities.

The regulating activity of the Authority continues at full speed also in 2008: to date, 196 resolutions have been approved: 87 of which as *general regulations*; 59 for supervisory and sanctioning activities; and 23 consultation procedures have been initiated.

The Authority also activated a simplification process that has already allowed identifying 300 resolutions that are no longer applicable. This is in the interest of clarity, transparency, and accessibility for all the parties involved.

The simplification measures, for which a specific Group has been created, will continue with new acknowledgements and the drafting of *consolidated regulations*. All of this also aims to facilitate the research and consultation activities of the involved parties.

Looking at the work that has been accomplished and in light of the constant commitment ensured with appreciated skill and dedication, I would like to express my sincere and heartfelt thanks to all our staff, and that of my colleague Fanelli, to whom I am grateful for his precious, unwavering and professional contribution.

As for the economic-financial management, which is also subject to the constant and scrupulous scrutiny by the Board of Auditors, to whom a grateful acknowledgment is due, I should mention that the contribution due to the Authority was limited, as has been the case for years and thanks to continual efficiency enhancements, to 0.3 per thousand of the sector operators' revenues. This percentage is thus well below the one per thousand provided for by law for the funding of this Authority, which entails no costs being borne by the State.

In relation to the more generic management aspects and dialogue with all the possible parties involved, we have consolidated practices and procedures aimed at making all of our provisions public, making our actions more transparent, basing them on broad and open consultations; for provisions of a broader scope, these consultations are conducted by adopting a *regulatory impact analysis* (RIA). In keeping with the past, in July we will make this Report, which I have the honor to present today, available for public consultation along with our Three Year Plan; the latter has already been published as our first resolution of the year in order to provide all interested parties with timely information about our scheduled initiatives and enable them to make observations that are useful for our an-

nual update of the Plan.

The operating commitment and the results that I have mentioned are also the fruit of: valuable dialogue with the union representatives; the precious assistance of Government Lawyers; a constructive dialogue with the business associations and with the National Consumers' Council; an intensified collaboration with the Antitrust Authority, the CONSOB, the Communications Authority, the Authority for Privacy and the CNEL (National Economics and Labour Council); we would like to express our sincere gratitude to all of them and to the Guarantor of our Code of Conduct.

OUTLOOK FOR FUTURE ACTION

The very difficult and demanding challenges that we must face in order to promptly make up for the delays that have accumulated over the years in relation to the safety, competitiveness and sustainability of our energy system, call for a strong mobilisation and an improved collaborative effort from everyone involved: operators, social parties, consumers and institutions, including the Authority for Electricity and Gas. In this sense, we confirm our full commitment to and devoted interest in developing an increasingly intense dialogue with Parliament and the Government in order to guarantee an adequate disclosure of information for the needs of public communication and to ensure that the utmost contribution is being given toward developing the energy system and consumer protection.

For us, this also means establishing an adequate dialogue with all the stakeholders; promoting the development of competitive markets and of energy supplies; supporting the efficiency and low cost of the infrastructure services; promoting investments; favouring the rational use of electricity and environmental protection; promoting quality and security.