



Autorità per l'energia elettrica e il gas

ANNUAL REPORT ON THE STATE OF THE SERVICES AND THE ACTIVITY CARRIED OUT

Introduction

by the President of the Authority

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Autorità per l'energia elettrica e il gas

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Presidents of the Senate and the Chamber of Deputies,
Ministers, Authorities, Ladies and Gentlemen,

The Authority for Electricity and Gas today presents its fifth Annual Report on the state of the services and the activity carried out.

The context in which the liberalisation of the electricity and gas markets is taking place is very different today from one year ago. We need to evaluate two elements of change and draw the necessary conclusions if we are to maintain and increase the effectiveness of our public activity.

Two events, both of them dramatic, albeit in different ways, have stamped their mark on the last year. Terrorist acts of unprecedented gravity and their political and military consequences have forced us to focus our attention much more sharply on the security of energy supplies. The financial collapse of a large company specialising in energy trading on a global scale and the serious difficulties in which other, similar companies have found themselves have generated a wave of insecurity that is affecting the development of trading in the markets for energy products and their financial derivatives.

The issues of security of supply and the credibility and transparency of economic transactions today pose a challenge to the progress of the European Union, and of Italy, along the path to a single, liberalised energy services market: the institutions,

laws and rules governing the liberalisation process need to provide a satisfactory response to the worrying questions that have arisen. Otherwise, the entire transformation process will appear less credible and the difficulties of implementing it will increase. The crisis in California, in which the focus has shifted to the new evidence that has emerged regarding the speculative mechanisms that were allowed to operate, is a cautionary signal of the need for clear and consistent rules and authoritative institutions with clearly defined tasks and responsibilities, acting in co-operation and free from any influence by private interests or the pursuit of easy and immediate consensus.

Accelerating market liberalisation

The time for action is short. One of the results of the recession that was a defining feature of the world economy in 2001 and the first part of 2002 has been a smaller increase in energy consumption. The effect of this in Italy has been to lessen the pressure to set up new electricity generating capacity, and on electricity and gas imports. But the scenarios pointing to a dangerous reduction in security margins require an adequate and appropriate response.

The process of European liberalisation was set back by the European Council in Stockholm in April 2001, when the discussion of the Commission's proposals was postponed. It seemed at that time that the prevailing mood was to extend the timescale for the opening of the national markets and their integration in the internal market.

An indication of governments' renewed confidence in the liberalisation process arrived on 16 March 2002, with the conclusions of the Barcelona European Council. On that occasion the Member States confirmed their intention to adopt legislative instruments, including a new Directive that would introduce a sure and relatively short timescale for the extension to all customers of freedom of choice of supplier, make it obligatory to provide regulated and non-negotiated access to networks, and extend to all Member States the requirement to set up an independent regulatory body.

On 7 June, the European Commission presented a proposal for a new Directive on the internal market for electricity and natural gas and a proposed regulation on the conditions governing network access for cross-border electricity exchanges. The proposals include amendments approved by the European Parliament and take into account the opinion expressed by the Economic and Social Committee. The co-decision process is therefore working and the prospects that it will soon produce some effective and significant decisions are promising.

An important advance has been made over the past year: as the result of a lengthy effort by the European Commission, governments and national regulatory authorities and by the association representing the companies operating the electricity transportation networks, agreement has been reached on the elimination of the tariffs for the transit of electricity on networks other than those of the countries of origin and destination. As things now stand, in each Member State the national transportation tariff system is applied without discrimination to supplies from national and international sources and the crossing of a number of borders does not result

in additional costs. Some further improvements are to be made to the agreement for 2003. However, other problems remain to be solved if electricity exchanges are to be truly free throughout the European Union, and with the countries bordering it.

If the confidence of operators is to be maintained and strengthened and the results of liberalisation are to be made clearly evident to consumers, each national government will need to adopt the necessary measures to remove any difficulties and delays that have emerged in their respective countries. These include access to networks under equitable and non-discriminatory conditions; the possibility for companies to enter the market; the availability of information for all interested parties, without any privileged conditions for the dominant operator; and transparency in prices and conditions of supply for final customers. These conditions have by no means been achieved, although progress towards them has been made. If any obstacles were to emerge, however, this positive tendency could easily be reversed and transformed into a lack of confidence and a refusal to invest.

An acceleration of the liberalisation process is particularly necessary in a market like the Italian one, characterised as it is by high electricity and gas prices and therefore attractive to new investors on condition that they feel sure of being able to operate on a non-discriminatory basis. If operators have reason to believe from the rules and institutions currently in place that the liberalisation process will continue according to schedule and at a reasonably rapid pace, they will be willing to invest in costly operations that will only be profitable in the long-term; their decisions will help lend greater credibility to the

liberalisation process in the eyes of other operators and thus set in motion a virtuous circle of expectations and achievements and provide a better service under more favourable conditions.

The results achieved thus far provide an encouraging start, but one that is still fraught with uncertainties. The on-going process needs to be constantly monitored and reviewed in the light of the experience we gain along the way.

The work of the Chamber of Deputies Committee on Productive Activities is one step in this direction: the report they have produced is a highly important basis and guide for future action. The urgent measures to ensure the security of the national electricity system and the announced Government bill on the reorganisation of the energy system confirm this commitment in pursuit of shared objectives.

This Authority considers four issues, around which we have built our Report, to be of particular importance: the promotion of competitive supply; public service guarantees for citizens; non-discriminatory network access and the development of networks according to needs; and a clear, stable institutional framework.

Promoting competitive supply

When the liberalisation process was launched in Europe great attention was paid to the demand side: liberalisation is measured by the degree of market opening, defined as the percentage of total consumption accounted for by customers who are free to choose their supplier. The supply side has been somewhat neglected thus far, in the belief that the transition

from fifteen national markets to one single, larger European market would be sufficient in itself to eliminate market power.

This is not the case. The move towards a competitive European market has come up against two obstacles.

The first is the headlong process of industrial concentration, which is creating companies capable of exercising power over significant portions of the European market, thanks not least to their vertical integration, which has barely been affected by the separations imposed on them. A European electricity oligopoly is taking shape, made up of five principal companies; these include Enel, which has less of a presence outside its own national territory than the others. These companies are protected to varying degrees against predatory raids and enjoy a significant degree of protection within their respective national systems; this is especially so in the case of France. The situation is not dissimilar in the case of natural gas, where Eni has a strong international dimension. The convergence of the two sectors still has the potential to produce significant readjustments and also to accentuate this oligopolistic stamp.

The other obstacle is the continuing existence of physical, legislative and commercial barriers to free circulation on the European networks. It is still necessary in many cases to refer to national and regional markets rather than the single EU or continental market. The elimination of these barriers often requires the collaboration of the very same operators whose market power is reinforced by them.

The European Commission's Competition Directorate General took action over the acquisition by Electricité de France of

companies in Germany and, indirectly, in Spain, by imposing solutions designed to facilitate competition in some segments of the European market. Actions of this type might be needed again in the case of acquisitions by companies enjoying significant market power or exercising a monopolistic power in their market of origin.

In Italy the gas market is firmly in the hands of a single operator and it seems that it will be slow and difficult for competitors to gain ground. In the electricity market the gradual re-scaling of the dominant operator, as imposed by law, has not as things stand at present prevented this operator from exercising a decisive influence on price formation in the liberalised market.

This state of affairs needs to be viewed in conjunction with the problem of the presence, as shareholder of the third Italian energy company (second in the electricity market), of the French state-owned company that is the dominant operator in that market. This presence is subject to limitations in voting rights that are clearly transitory in nature; their elimination should be dependent upon significant progress being made towards the realisation of conditions of symmetry and substantial reciprocity in Europe. For such conditions to develop, the markets need to be opened in very real terms and according to a reliable timetable, with the degree of market opening also being measured in terms of true independence in the management of the networks and equality in the opportunities for gaining access to them. Companies will also need to be provided with a framework where they can compete without discrimination not just in the sale of products and services, but also in obtaining capital.

The Italian legislator has tended to focus on concentration on the supply side, envisaging obligatory divestment of electricity generating plants and ceilings on market shares for gas. This focus has been justified by the fact that the Italian electricity and gas markets are to some extent cut off from the other European markets: in the case of electricity, by insufficient interconnection capacity, and in that of gas, by the fact that interconnections are controlled by just one company. For the time being it is the national market, not the European one, that we need to consider for the purpose of measuring and controlling market power. The setting of limits on the dominant company is not therefore an unjust penalisation of Italian firms only, but an instrument that the situation itself calls for. Both consumers and the incumbents share the same interest in proceeding apace with the integration of the Italian market into the European one, so that the latter can be referred to in the calculation of market shares and any resulting measures: but progress on this is slow.

A sufficiently large number of actual and potential vendors is an essential condition for the desired reduction in energy costs. This condition has not been satisfied thus far. While processes that might achieve it need to be launched and taken forward, there is a need in the meantime for extraordinary transitional regulatory instruments that provide adequate guarantees against the risk of anti-competitive conduct.

The Authority considers this task to be an integral part of its mandate.

The work of fostering competition sees the full engagement of this Authority and the Anti-Trust Authority, each with their

own functions and instruments, in a shared spirit which the experience of recent years has amply tested and confirmed. We intend to go on working towards the realisation of a truly competitive market in a spirit of full and continuing collaboration with the Ministry for Productive Activities and the Ministry for the Economy and Finance.

Supply in the electricity market

The price at generation, or wholesale price, of electricity for the captive market in Italy is still set by administrative provisions issued by the Authority, a situation that will need to be kept in place until the price is being set in an organised power exchange. In the last twelve months the price has oscillated, in close relation to international fuel price trends, around a level that is still considerably higher than the average prices recorded in electricity exchanges in Europe.

The administered generation price serves as a reference level for transactions on the free market, which at present take the form of bilateral contracts.

Imports have a part to play in keeping wholesale electricity prices down, especially for industries that are major consumers and whose competitiveness is most strongly affected by energy costs. Many of the big electricity consumers in Italy have been able to meet part of their needs from abroad, using the interconnection transit capacity allocated by the Authority in proportion to the imports requested. By raising the minimum threshold with respect to 2001 it has been possible to avoid a

situation arising where capacity is allocated that is too limited to be used in a rational way.

For the first time, the interconnection capacity on the French border has been allocated through a single procedure common to the two countries, which was agreed by the two regulatory authorities and carried out by the Italian network operator with the collaboration of its French counterpart. The capacity was allocated through an open procedure in which all applications that were above the set size threshold were granted proportionately.

The goals achieved in 2002 should be consolidated in 2003, with significant progress in the prevention of possible collusive conduct. The area of open and agreed allocations should be extended. The entry into operation of the bidding market will provide a useful opportunity for the annual allocations, which in quantitative terms are almost identical for all the hours of the year, to be continually adjusted in line with variations in actual take-up, and for occasional batches to be handled. The system will gain from this new approach in terms of both flexibility and efficiency.

The allocation of electricity produced by plants fed by renewable and assimilated sources, incentivised in accordance with provision no. 6/1992 of the Interministerial Committee on Prices, has also played a part in keeping energy prices down for large-scale consumers. The allocations were carried out through auction procedures drawn up by the Authority in implementation of decrees issued by the Minister for Productive Activities. The differences in price were added to the already high general system costs charged to users as a whole:

incentives for renewable and assimilated sources alone account for about €0.01 for each kWh consumed.

Large companies that agreed to sign contracts with interruptibility clauses were compensated by a further reduction in the cost of electricity in the form of reserved shares of import capacity and reserved auctions for the allocation of incentivised electricity.

An urgent need still remains to bring electricity prices in general, and not just specific segments of demand, onto a stronger downwards trend.

If Italian prices for final customers are to be brought closer into line with the generally lower prices applied in the rest of Europe, then this will require a renewal of the country's generating plant in order to provide increased efficiency and make more use of less costly primary sources. On average, the energy efficiency of the generating system is the same as it was five years ago. More streamlined authorisation procedures for the construction of new power stations and the modernisation of existing ones, as the government has provided for in a recent law, will help improve this situation. It would also be timely for the sites divested by the dominant operator to be made available to investors through an auction procedure.

The pressure created by a competitive context is essential if these results are to be achieved. Progress towards such a context needs to be made in the next few months, in step with the two significant changes currently on the horizon: the extension of the free market and the launch of the electricity exchange.

In 2003 the free market will grow from its current size of about one third of the total market to a potential two thirds: it is essential for this market to become more transparent and flexible and to loosen its linkage with the administered price.

The electricity exchange will be launched over the next few months. The Electricity Market Operator reports that the IT structure is in place and is currently being tested. The market regulations have been published and the related instructions are being drawn up: these two documents reflect the in-depth consultations that took place between the institutions and operators involved, during which the Authority provided detailed observations and proposals. During the same period the Single Buyer will become operational, with the task of purchasing, on the wholesale market, electricity intended for the captive market.

The launch of the electricity exchange will bring with it a system of clearly defined daily and hourly electricity prices. Price transparency and freedom of access to negotiations will mark a significant advance in the development of a free market and the diffusion of rational consumption models. The exchange will also provide operators with a place where they can trade products other than electricity, such as green certificates and energy efficiency certificates.

In addition to these transactions on the electricity exchange, bilateral electricity contracts are also envisaged to provide operators with freedom to choose the most suitable form of contract, with transparent conditions that also extend to the duration of the supply agreement.

The structural conditions for the development of competition are not yet in place. Even after the divestments envisaged by Legislative Decree 79 of 16 March 1999 have been completed, Enel will continue to hold a dominant position in the supply of electricity, with about 55 percent of the installed production capacity in Italy and about 50 percent of production, net of self-production. In 2001 the Enel group accounted for around 59 percent of the electricity actually available on the market, including electricity produced and purchased through imports and through auctions of incentivised electricity. These market shares will not be able to fall, indeed could even undergo a temporary rise, until the reconversion programme for the thermoelectric capacity of the three generating companies that have been, or are in the process of being, divested is complete. According to the industrial plan approved in the Prime Minister's Decree of 4 August 1999, this is scheduled for the end of 2008.

The concentration of supply can play an even more significant role in price formation in the hours and days of high demand, when most of the production capacity available in the system is already taken up and high prices cannot attract further supply into the market. The mid-merit plants that have a decisive role to play in price formation are at present almost entirely in the hands of the Enel group.

Supply is even more concentrated in some geographical areas defined by network transportation constraints. This geographical division will become clearly evident when merit order despatching is applied.

We should therefore be looking to a further significant reduction of Enel's market power that enables a sufficient degree of competition to be introduced to negotiations on the free market, both through bilateral contracts and the opening of the exchange. This reduction in market power can be achieved through further divestment of plants, and mid-merit plants in particular.

In order to ensure that Enel remains sufficiently large to face up to competition in the future European single market, measures can be contemplated that, while effectively limiting its market power in the immediate term, do not require plants to be divested on a permanent basis. The instruments that might be used to achieve this are currently under study by the Authority and the Ministry for Productive Activities, each according to their respective competencies. Possible arrangements could be the temporary divestment of plants on a rental basis, or divestments in the form of auctions of quotas of annual electricity production to be traded using the "virtual generator" formula already applied in a number of countries.

While the main company is being obliged to slim down to a size that will enable the free play of competition, a limit needs to be set on the growth of the other operators. The experience of liberalised electricity markets teaches us that we should avoid situations where any one company accounts for more than 20 percent of the market, not least to ensure that agreements that could constitute a "collective dominant position" do not become too easy and attractive a possibility. This measure should be used as a benchmark for the protection of competition in the European electricity market, and also at the national level.

Even with the prospect of further divestment of mid-merit plants and temporary divestment of production capacity by the dominant operator, there is still a real possibility that for a considerable period of time prices on the exchange will be influenced to a significant degree by the decisions of just one operator. The protection provided by the powers of intervention of the Anti-Trust Authority in cases involving restriction of competition cannot be the only line of defence. Preventive measures need to be introduced to limit the risk that the existence of a dominant position poses to operators trading in the exchange, and consequently to final customers in general. This Authority is drawing up suitable measures, to be adopted after consultation with the Ministry for Productive Activities and the Anti-Trust Authority.

Supply in the natural gas market

Starting on 1 January 2003, companies selling natural gas, which are now separate from distribution companies, will be able to compete over the entire range of customers, whatever their size. The Authority intends to take steps to ensure that tariff protection remains in place for smaller customers, but in a form that respects the liberalisation process and is also able to ensure that this brings benefits to consumers with less contractual power.

There can be no effective liberalisation without the development of competitive supply in the wholesale market and

in the market for imported gas. The saturation of the existing import pipelines could create a barrier to the entry of new operators, Italian or foreign. The Authority is keeping watch on the situation to ensure that access is not refused unless this is justified by the need to respect long-term contracts entered into before 1998 and therefore explicitly protected by European Directive 98/30/EC. Where pipeline capacity is not sufficient and the necessary expansion work is not being done by the company managing the network, the applicant may contribute to the financing of the work, as envisaged by the same Directive.

The capacity of a given pipeline may be fully taken up by contracts entered into by the principal operator. Competitors with access to the network can take over the supply to some customers without altering the overall quantity of gas imported. If the principal operator needs to honour long-term import contracts that include take-or-pay clauses that make the loss of market share particularly burdensome, one possible course of action is to expand its sales abroad. For this to happen, clauses restricting supply to any particular country need to be removed, where these exist. This question, which has been raised by this Authority, is currently being examined by the European Commission. An initiative by European companies to obtain agreement by suppliers to eliminate these clauses, without waiting for provisions to be issued by the institutions, would be a positive contribution to the liberalisation process.

Companies in the principal supplier countries, Russia and Algeria, exert what amounts almost to monopoly power on the European markets. The biggest importing companies, with Eni in

the front line, have negotiated their conditions of supply, thus defending their balance sheets and to some extent the interests of consumers also. The participation of other operators in negotiations is sometimes feared as potentially weakening the demand side to the benefit of supply. But this risk can be avoided if the integration of the European market introduces competition between primary suppliers and if new supplies are introduced to the market through new pipelines and new liquefied natural gas terminals.

Guaranteeing the public service in the liberalised market

In some countries, the liberalisation of the market and the elimination of the traditional privileges granted to the public operator are coming up against a substantial obstacle in the form of a fear that this will undermine the traditional guarantees regarding service quality and the public service obligations imposed on operators.

Liberalisation can, however, be governed in such a way as to lay this fear to rest. Due attention to the constant improvement of the quality and supply of the service in conditions of security is an integral part of the regulation of a liberalised market.

Companies, whether private or public, are equally responsible for the quality and security of the service for which the regulatory Authority acts as guarantor through timely rules, regulations and supervisory actions. Constraints can and must be placed on activities that for technical and/or economic reasons remain monopolistic in nature. All these activities are

subject to rules designed to achieve through externally imposed obligations those objectives that were previously assigned directly to the body or public company carrying out the service.

The Authority has introduced a wide range of regulations to guarantee service quality: the most demanding task now is to oversee their application.

Provisions are in force that define various aspects of the service, such as speed of connection and responses to calls, deposits, the handling of arrears, the provision of information and the handling of complaints.

Uniform national specific and general quality standards have been introduced. If services to customers are not provided within the timescale envisaged by the specific standards, customers are refunded automatically through their bills. In 2001 over 24,000 automatic refunds were paid to customers of the electricity and gas services.

Some gas companies were obliged to change the billing arrangements for estimated consumption and others received fines for failing to provide sufficient billing information.

In applying the rules on interruptions in the electricity service, the first step was to impose uniform arrangements for the measurement and publication of data, followed by an obligation to gradually reduce the number and average duration of interruptions. These measures were accompanied by a system of fines and incentives. The first effects of these measures can already be seen.

Taking the country as a whole, with the exception of Campania, Calabria and Sicily, between 1999 and 2001 there was a 21 percent reduction in the duration of interruptions; if we

measure only interruptions for which distributors were responsible, net of exceptional events, the improvement amounts to 33 percent. In Campania, Calabria and Sicily the figures recorded for the base years, 1998 and 1999, turned out not to be reliable; after a series of interventions, including fines imposed by the Authority, the duration of interruptions in these regions fell by 20 percent in just one year.

The gas distribution networks are now subject to obligatory periodic safety checks. In the case of gas distributors, obligations regarding the safety of plants inside users' homes are also being drawn up with the help of wide consultation; the new arrangements will not undermine competition between the various installation and repair companies.

The Authority is working to implement the energy efficiency regulations introduced by two ministerial decrees issued in April 2001. These regulations include an obligation on electricity and gas distribution companies, partly covered by the tariff, to introduce programmes designed to improve customers' energy efficiency, and in so doing benefit the environment. These obligations, which for each distributor are proportionate to the volume of energy distributed, can be met in part through the purchase of energy efficiency certificates, which represent similar programmes introduced by other distributors over and above the obligations they are required to meet, or are put in place by other companies specialising in this activity. The system has been designed in such a way as to reduce the demand for energy, at minimal cost and with operational flexibility. The wide consultation carried out in recent months has allowed interested parties to provide an input to the final version of the provisions.

The tariff systems for final users who still have captive customer status are nearing the end of the transition phase. Any differences between categories of customers that are not justified by objective cost-related factors are gradually being phased out.

From 1997 to the first semester of 2002 the average tariff for natural gas, net of taxes, increased by €0.025, or 5.1 percent, as the result of the €0.037 increase in the element covering fuel costs, which depend on international trends, and a reduction of €0.012 in the element covering fixed transportation, storage and distribution costs.

In compliance with the ruling of the Regional Administrative Court (TAR) of Lombardy, the Authority introduced new criteria to the gas distribution tariffs for the determination of the cost of invested capital for firms holding certified balance sheets for at least ten years. This provision, which leaves the parametric evaluation system in place for all other companies, means that many of the tariff options presented and approved for the thermal year 2001-2002 can be considered valid.

The transition stage for the electricity tariff system came to an end in 2001; this had produced an additional cost to consumers as a result of the gradual nature of the reduction in electricity companies' tariff revenues, as requested by the government in 1999.

Between 1997 and the first semester of 2002 the average electricity tariff increased by €0.008 per kWh, or 9.3 percent, as a result of three variations: an increase of €0.017 in the fuel cost element, brought about by fluctuations in the international prices of hydrocarbons and the euro exchange rate; an increase of €0.002 in the part covering general system costs, caused

mainly by legislative provisions; and a reduction of €0.011 in the element covering production, transportation, distribution and sales costs.

As far as tariffs for non-domestic customers are concerned, 2003 will see the completion of the transition towards a structure that is more closely matched to costs, with a reduction for small users and an increase for bigger ones, who will also be able to go over to the free market. In 2003 the tariff structure for domestic customers will be simplified and brought more closely into line with the cost profile; a consultation process is also being opened to introduce special arrangements to protect economically disadvantaged customers. The Authority intends to follow the government's social policy recommendations in this respect.

International price comparisons are made difficult by the structural transformation currently under way, which can reduce the relevance of the traditional surveys. Electricity and gas prices are higher in Italy than in the other Member States of the European Union, but the gap is beginning to shrink.

In 2001, average European electricity tariffs for domestic customers increased slightly, compared with a fall in Italy. Gas tariffs for domestic users rose everywhere, but in Italy less than the European average. Regulation played a decisive part in this, especially indexation to the international prices of oil and derivatives, which provides guarantees for companies and at the same time limits the quantitative impact and distributes over time the transfer to the tariff of international price variations.

Electricity tariffs for industrial users fell in 2001, whether we take the European average or the Italian tariffs into consideration. The prices recorded on the principal electricity

exchanges indicate lower levels than those applied to retail tariffs, even taking distribution costs into account. In Germany, where there was a substantial and highly publicised reduction in prices for major consumers, the tariffs for domestic customers are still nearly 20 percent above the European average and, with the Italian tariffs, the highest in Europe.

Taken as an average, gas prices increased everywhere in 2001, but in Italy the increases were lower than the European average.

In addition to the setting of tariffs and the regulations governing service quality, other measures to protect consumers included freedom of choice of supplier, which is progressively being extended and brings with it the benefits produced by competition among suppliers, both on prices and on quality. On 1 January 2003 all gas consumers will be free to choose their supplier; three months after the divestment by Enel of the third generation company this freedom will also be extended to electricity customers consuming more than 100,000 kWh per year, which means that most of the electricity market will in effect be open to competition.

The granting of eligibility to freely choose their supplier should be an opportunity for consumers, not a loss of security. Protective measures that are compatible with the liberalised market will remain in place, including the obligation to provide a supply of last resort service, following the best international practice.

In the Authority's view a reliable and rapid timescale needs to be drawn up for the granting of eligible customer status to all final customers in the electricity market, in order to impart certainty to the liberalisation process and encourage the

formation of companies in a competitive framework. The economies deriving from the joint supply of electricity and gas cannot go on being a privilege solely for those holding a licence for the sale of electricity, but must be made available to all competing companies, so that they can be translated into a benefit for consumers. The date for the attribution of eligible customer status to all final customers in the electricity market could be 1 January 2004: by that time the power exchange should be fully operational and the Authority will have put in place the instruments to protect final customers and control the conditions for the provision of the services that are necessary for the retail electricity market to function properly.

Ensuring the independence and development of the networks

In the electricity and gas sectors, which are characterised by the presence of networks that are unlikely to be duplicated or multiplied, the opening of the market is measured essentially in terms of accessibility to these same networks. If the principal network, which provides long-distance transportation and is therefore essential for the formation of a wholesale market, remains directly or indirectly in the hands of a dominant operator, then the opening of the market cannot be said to be either credible or complete.

The European Council of Barcelona announced its intention to adopt in the course of the year the proposals for the final phase of the opening of the electricity and gas markets, including the separation of transmission and distribution from production and

sales. There is only one configuration for this separation that can provide credible guarantees of independent management and impartial access: the entrusting of the network and its management to a company that is independent from the interests of the principal users and which also owns the infrastructure.

The experience of a number of other countries suggests that the total separation of the networks is an appropriate step in the liberalisation of the market and shows that the operation of an electricity or gas network can be a significant economic activity. The announced merger between the company that owns and operates the English electricity network and its counterpart in the gas sector illustrates the dynamism of companies that are still subject to strict regulation, including in tariff terms.

In Italy several more steps need to be taken.

The withdrawal of ownership of the national electricity network from the principal electricity generator and vendor and the unification of network ownership and operation in a single operator have always been seen as desirable by this Authority, which therefore considers the initiative recently taken by the government to be timely and indeed necessary. The Italian electricity system urgently needs to be up-graded, both in terms of interconnections with abroad and in points where internal congestion is a problem. The separation of activities driven by different logics and interests, such as the operation and development of the network on the one hand, and commercial activity regarding the electricity transiting on the network on the other, is conducive to this. A simplification of the decision-making process and a clear identification of the

lines of responsibility would also help ensure that actions to upgrade the network are both rapid and adequate.

The conclusions of the Barcelona Summit set the minimum level of external interconnection capacity for national electricity networks at 10 percent of installed generating capacity. Italy is still below this level, which will be reached once the projects set out in the National Network Operator's three-year plan have been completed: this needs to be achieved as soon as possible.

The interconnection capacity of the electricity network in the Alpine region increased from 5,400 to 6,000 kWh between 2000 and 2002. The power line linking Italy with Greece entered into operation recently on an experimental basis: commercial activity should be starting up shortly on the basis of the rules agreed between the Italian and Greek regulatory authorities.

Initiatives by private operators for the construction of direct lines, which have attracted a considerable degree of interest, can make a significant contribution to the efforts of the network operator. After a consultation process, the Authority is drawing up a provision that favours this development without creating problems for the operation of the national transmission network.

In the gas market the European directive only requires the accounting separation of the network. Further measures are needed, however, even if gradual, and the major network infrastructures need to be made accessible for long and short-term sales and purchasing contracts by a number of operators.

By effect of Legislative Decree 164 of 23 March 2000 and the choices made by Eni, high-pressure gas pipelines belonging to the Eni Group, which make up 96 percent of the entire national

network, have been transferred to the Snam Rete Gas company, which is currently being separated from the group after an initial placing of 40.2 percent of its capital in December 2001. The success of the placing reflects financial operators' confidence in developments in the sector, including the transportation tariff established by the Authority to ensure an adequate return on invested capital, incentives for new investment and a cost for users that is not overly high compared with European levels and in any case decreasing over time. Now Snam Rete Gas needs to be made fully independent.

Within the framework of the provisions adopted by the Authority, the use of the network needs to be regulated by Network Codes. In order to ensure that the regulations match the real needs of the interested parties, the Authority has authorised Snam Rete Gas, the principal network operator, to adopt provisional regulations subject to consultation with users. These regulations can be contested before the Authority itself if discrimination should occur. Taking the experience of the first year as a basis the Authority is in the process of issuing the criteria for the definition of the Codes by the network operators.

The geographical structure of the natural gas networks needs to develop from the current mono-directional model, from point of extraction or importation to supply zone, to a meshed model that enables contracts to co-exist and intersect in a competitive context: a structure that enables the development of sorting and trading centres, or hubs. It is essential that the system of transactions and negotiations that emerges from this should be transparent, reliable and open to foreign operators.

To ensure transparent price-setting procedures and a reliable framework for transactions, a system of exchanges for the sale and purchase of natural gas, capacity and financial derivatives would be timely. This development would offer Italy extremely interesting opportunities to improve security of supply, as demanded by the rapid development of natural gas consumption, and become a key commercial and financial centre for the Mediterranean area.

If a large-scale natural gas system is to function properly, storage deposits are needed in order to ensure security and flexibility of supply. In Italy, storage is subject to twenty-year licences and is almost entirely in the hands of Eni, which has transferred them to a company set up for that specific purpose, Stogit. This essentially monopolistic set-up requires adequate regulation: the Authority has already set out the criteria for storage tariffs and is putting together those for the Storage Code. A separation of Stogit from the Eni Group is configurable; alternatively, it would be conceivable for the storage service to be supplied by different, competing operators, a development that would require some divestment by the Eni Group.

Natural gas consumption is estimated to increase by about 30 percent by 2010; this will require the channels of supply, international gas pipelines and terminals for liquefied natural gas (LNG) transported by ship, to be reinforced. Security considerations suggest that these structures should be developed in such a way as to obtain supplies from a variety of sources: LNG terminals lend themselves naturally to this purpose.

The construction of these terminals, which in the past has often been held back by location difficulties, requires guarantees of

profitability and availability. With this in mind, in a recent Decision adopted after wide consultation the Authority established that up to 80 percent of access to the new terminals may remain in the hands of their funder, for 20 years. This will only apparently involve constraints on freedom of access, if the new rules become a decisive factor in encouraging the construction of new terminals. These terminals will be available to different operators, who will be able to use them to compete in the provision of supplies. The remaining 20 percent will enable the development of a residual regulated market.

There is a need to develop the major gas pipelines supplying the Italian system with gas originating a long distance away. The existing pipelines bringing gas from Russia, Algeria and the North Sea could be up-graded cost-effectively. In the next few years the Libyan gas pipeline will begin operating and a new pipeline between Algeria and Sardinia is under study.

These works, which are essential to maintain a balance between supply and demand, must be carried out in line with liberalisation. Third party access, which is not sufficiently guaranteed in many EU Member States, is absent in the stretches external to the territory of the Union. The liberalisation process introduced by Directive 98/30/EC risks being undermined by this.

The planned up-grading of the pipeline from Russia provides an opportunity to introduce linkages between the Italian gas system and those of Central Europe, at the same time facilitating the entry of foreign operators to the Italian market and penetration by the principal Italian operator in the markets of existing or applicant EU Member States, all of which would foster liberalisation throughout the area.

Reinforcing the institutional framework

Liberalisation is a complex process that needs to be governed. The old monopolistic systems made it easier to coordinate the small numbers of players operating on the ground. The cost to consumers could be very high, but the relative lack of transparency made this seem tolerable. Similarly, the cost to tax payers, which took the form of reduced revenues for the state, was not perceived in full. The new liberalised system will be able to provide its full benefits once it has settled into a framework that includes regulations, institutions, companies, and forms of conduct. Until then, failures of coordination are possible, with, as we have seen in some countries, risks for service continuity.

Responsibility for the satisfactory functioning of public utility services falls primarily on the public institutions as a whole. These must act in a clear, agreed fashion.

The reform introduced by Constitutional Law no. 3 of 18 October 2001 changes the framework of legislative competencies, in the electricity and gas sectors as in others, by allocating certain important tasks to ordinary legislation and to agreements between the different levels of government. The characteristics of public utility services provide useful indications for a re-allocation of responsibilities among the different institutional levels, including the European level. The function of regulation, like the protection of competition, cannot be fragmented. The responsible institution needs to guarantee the functionality of network systems, the uniformity of services and guarantees, and active participation in the process of European harmonisation.

Disagreements between the national and regional institutions which now have significant responsibilities in the network energy services sector need to be avoided: these could have disruptive consequences for liberalisation and the security of supply of the services. It is essential for the institutions all to agree on the principles informing the liberalisation process and the single European market, in primis freedom of circulation of goods and services and the respect of the duties and rights of companies providing public utility services, so that we can demand from them the conduct we expect and require in the interest of consumers. One cause for serious concern in this respect has been the recent introduction by the Regional Authority of Sicily of an environmental tax on gas pipelines, which in effect constitutes an economic barrier to the free circulation of natural gas. The Authority considers this tax to run counter to the principles inspiring the European legislation and feels that the rightful course of action is to refrain from applying it for tariff purposes, while providing assurances that if the provision were to be deemed legitimate it would be included in the tariff from the date of its entry into force, so as to avoid damaging investors' interests.

The role of the regulatory authorities is currently open to reflection and proposals for change. Even before the two European Directives for the liberalisation of the energy markets were issued, Law 481 of 14 November 1995, which the Italian Parliament approved by a very wide majority, had set up the authorities for the regulation of the public utility services, starting with this Authority, and endowed them with adequate powers. The liberalisation project drawn up by the European Directives for the electricity and gas markets requires strong and independent regulation. Experience confirms this need, as

can be seen from the enhanced provisions contained in the new draft Directive.

It is our view that the legislative context as thus defined has made it possible to provide operators with a satisfactory degree of confidence in the impartiality of the rules, even in the presence of fully or partly state-owned companies in a dominant position, and in the stability of the regulations themselves, even under different governments and parliamentary majorities.

The Authority has sent a note to the Commission set up by the Ministry for the Public Administration to put together proposals for the reorganisation of the independent authorities, setting out the results we have achieved thus far and the considerations we feel can be drawn from our first five years in operation. We appreciate the ample process of reflection, comparison and elaboration that is being taken forward in Parliament for the reorganisation of the independent authorities, including those charged with the regulation of public utility services. We are confident that the new legislation will introduce whatever rationalisation measures may be appropriate and use to better effect the contribution these bodies can make to the construction of the new system of rules and forms of conduct that the liberalisation of the markets requires.

In the name too of the other members of the Board, Prof. Giuseppe Ammassari and Prof. Sergio Garribba, I would like to thank all members of the management and staff of the Authority, who are still too low in number with respect to the workload but who have worked tirelessly and generously to carry out their tasks and ensure that the interests of users and

consumers are protected. The structure needs to be strengthened to cope with our growing tasks and responsibilities, not just in terms of drawing up regulatory provisions but also of overseeing their implementation, providing information and helping resolve disputes.

Any provisions adopted for general application were preceded by consultation processes in which all interested parties were able to participate, and were accompanied by explanatory technical reports. The Authority is considering introducing regulation impact analyses, to be applied gradually to all significant decisions.

Over the last year the Authority has intensified its international activities. The European Electricity Regulation Forum, which envisages periodic meetings between the European Commission, the regulatory authorities, ministries, and operators' associations and has met eight times in Florence over the last four years, will be convened in Rome this coming October.

As one of the founding members, the Authority is taking an active part in the activities of the Council of European Energy Regulators (CEER), which brings together the regulatory institutions of the countries of the European Union. The CEER is also developing fruitful relations with other regulatory institutions that have recently been set up in the countries of Central and Eastern Europe, including EU applicant states.

Our interest in the development of liberalisation and regulation in these countries has led the Authority to take part in several EU programmes providing technical assistance to the regulatory institutions of Eastern European countries and to collaborate with the Commission in setting up a forum dedicated to the

problems of energy regulation in the countries of South-eastern Europe.

Our mandate to work towards a suitable regulatory framework in our own country has been enhanced by the development of exchanges of views and experience and the mutual learning process with our counterparts in Europe and other countries throughout the world. Through this transfer of knowledge and technical cooperation, the Authority intends to play a role in keeping with the intellectual resources and economic weight of a country such as Italy.