

LIBERALISING THE NATURAL GAS MARKET IN ITALY

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FOREWORD

The slides which follow have been prepared under the responsibility of the author. Their original aim was to present the natural gas market of Italy and its prospects to an audience of international investors. So all texts are in English and some contingent problems and roadblocks might be overlooked or not properly addressed.

We all know however, that markets structures do not follow a single model. Rather, competition and freedom of choice are the result of a learning process requiring shared effort and understanding by all the stakeholders.



OUTLINE

- A. **GAS MARKET BACKGROUND AND KEY ISSUES**
- B. **REGULATING THE GAS MARKET**
- C. **REGULATOR'S CHALLENGES AND NEXT STEPS**

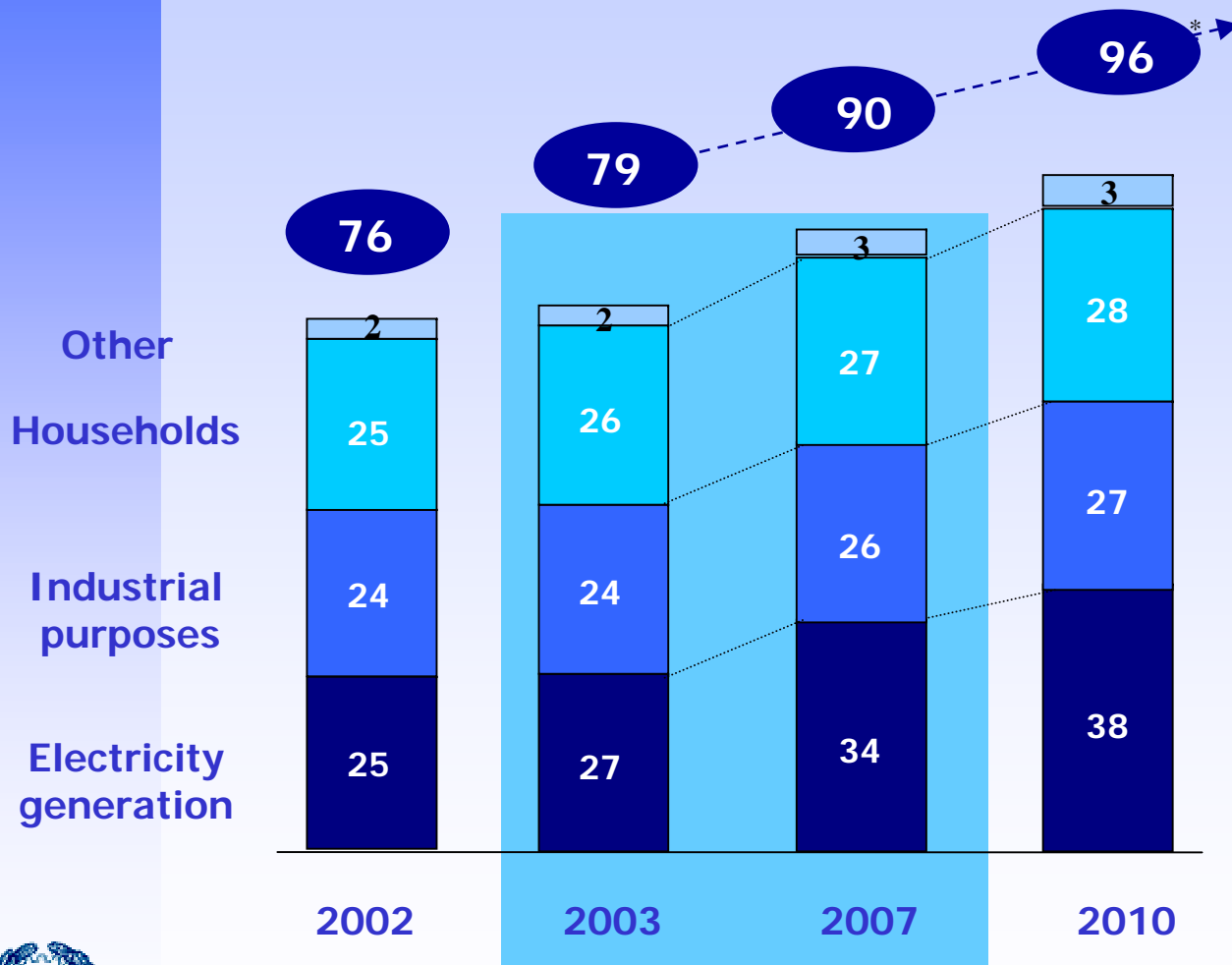


A.

**GAS MARKET
BACKGROUND AND KEY
ISSUES**



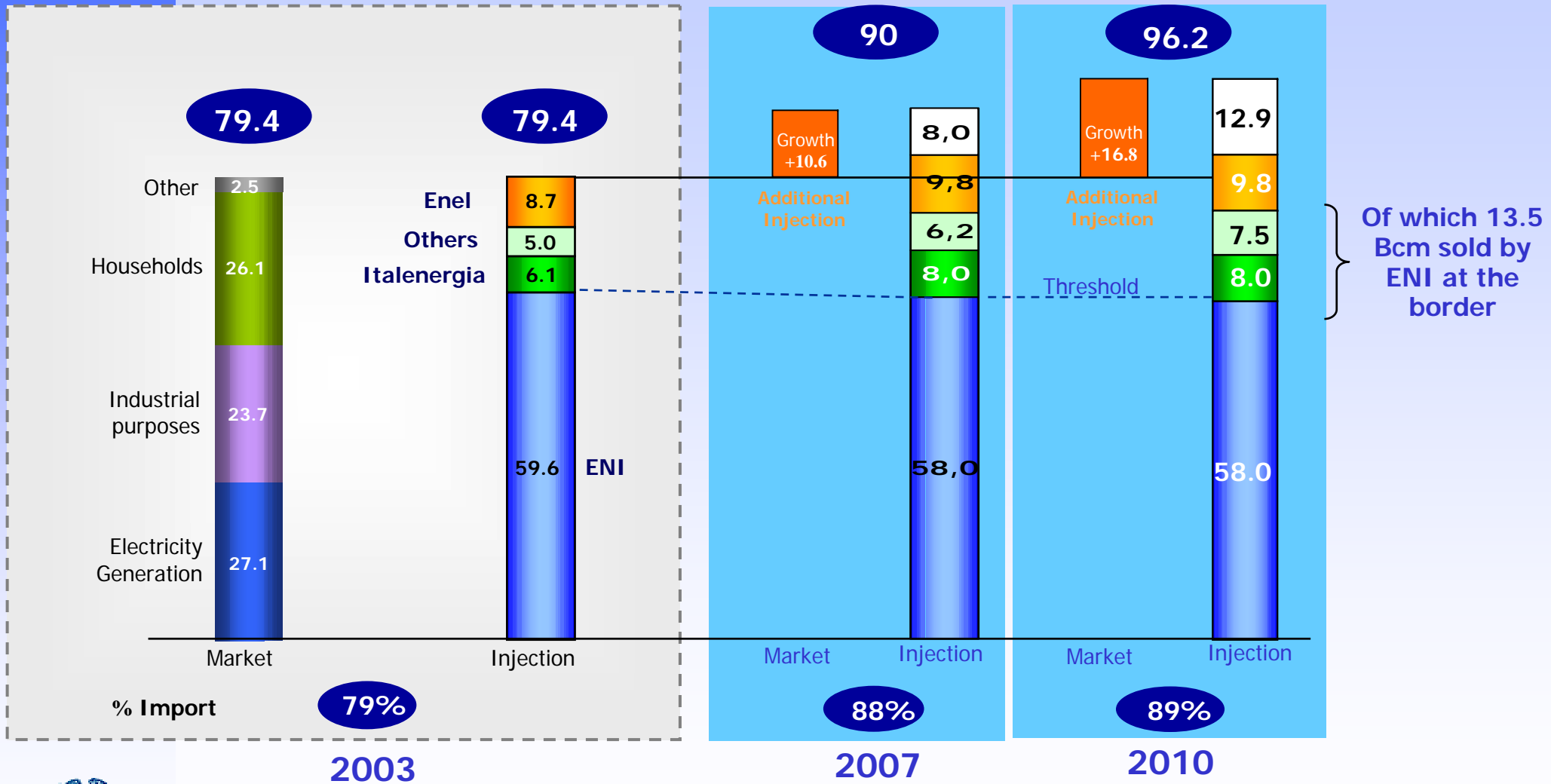
A1. THE NATURAL GAS MARKET: GAS DEMAND IN ITALY(I)



Total growth up to 2010:
~ 17 BCM



A1. THE NATURAL GAS MARKET: THE PLAYERS (II)



A2. THE NATURAL GAS MARKET OF ITALY: STRUCTURAL PROBLEM AREAS

1. Level of prices and tariffs (before taxes)

High compared with EU leading markets

2. Supply organisation and security

Lack of competition in gas primary supply; domestic production 18%, LNG terminals 4% (Nigeria), pipeline imports 78% (Algeria, The Netherlands, Norway, Russia)

3. Pipeline infrastructure and quality

About 70% grid outreach through the Country; new power plants driving further expansion

4. Distribution (and retail) organisation

Fragmented distribution with over 700 (local) companies; 30% demand increase by year 2010



A3. THE LEGAL FRAMEWORK: EUROPE (I)

- Directive 98/30/CE of the European Parliament and of the Council of 22 June 1998 concerning common rules for the market in natural gas
- Consolidated proposal for a Directive of the European Parliament of 27 November 2002 and of the Council concerning rules for the internal market in natural gas and repealing Directive 98/30/CE
- Communication COM (2001) 775 final from the Commission to the Council and the European Parliament on European energy infrastructure, December 2001



A3. THE LEGAL FRAMEWORK: ITALY

(II)

- Legislative decree no. 164 of May 24, 2000 enacting Directive 98/30/CE
- Ministerial decree of March 27, 2001 defining criteria for the authorisation of natural gas imports from non-EU Member States
- Ministerial decree of June 24, 2002 defining criteria for the authorisation of natural gas retail to final customers
- Article 35 reforming local public services as from Law no. 448 of December 28, 2001
- Draft Law presented on October 22, 2001 for the re-organisation of the natural energy system



A4. THE LEGISLATIVE DECREE NO. 164 OF MAY 23, 2000 (I)

- **Liberalised activities:**
 - Transport pipeline ownership, operation, maintenance and development (subject to permits)
 - Import-export, Shipping, Measurement
- **Activities subject to licensing (or authorisation):**
 - Domestic production
 - Gas storage ownership, operation, maintenance and development
 - LNG terminal ownership, operation, maintenance and development
 - Distribution pipeline ownership, operation, maintenance and development
 - Retail to final customers



A4. THE LEGISLATIVE DECREE NO. 164 OF MAY 23, 2000 (II)

- **Regulatory approach:**
 - Conduct and structural regulation
 - Regulated third-party access (TPA) and use of essential facilities
- **Minimum unbundling requirements:**
 - Domestic production (legal unbundling or separate ownership)
 - Transport and dispatching (legal unbundling towards separate ownership)
 - Gas storage, LNG terminals (legal unbundling)
 - Distribution (legal unbundling towards separate ownership)
 - Shipping and Retail, Measurement (managerial unbundling)
- **Tariff and price structure (all customers eligible by January 1, 2003):**
 - Benchmark prices for final customers and tariffs for transport, distribution, use of storage and LNG terminals

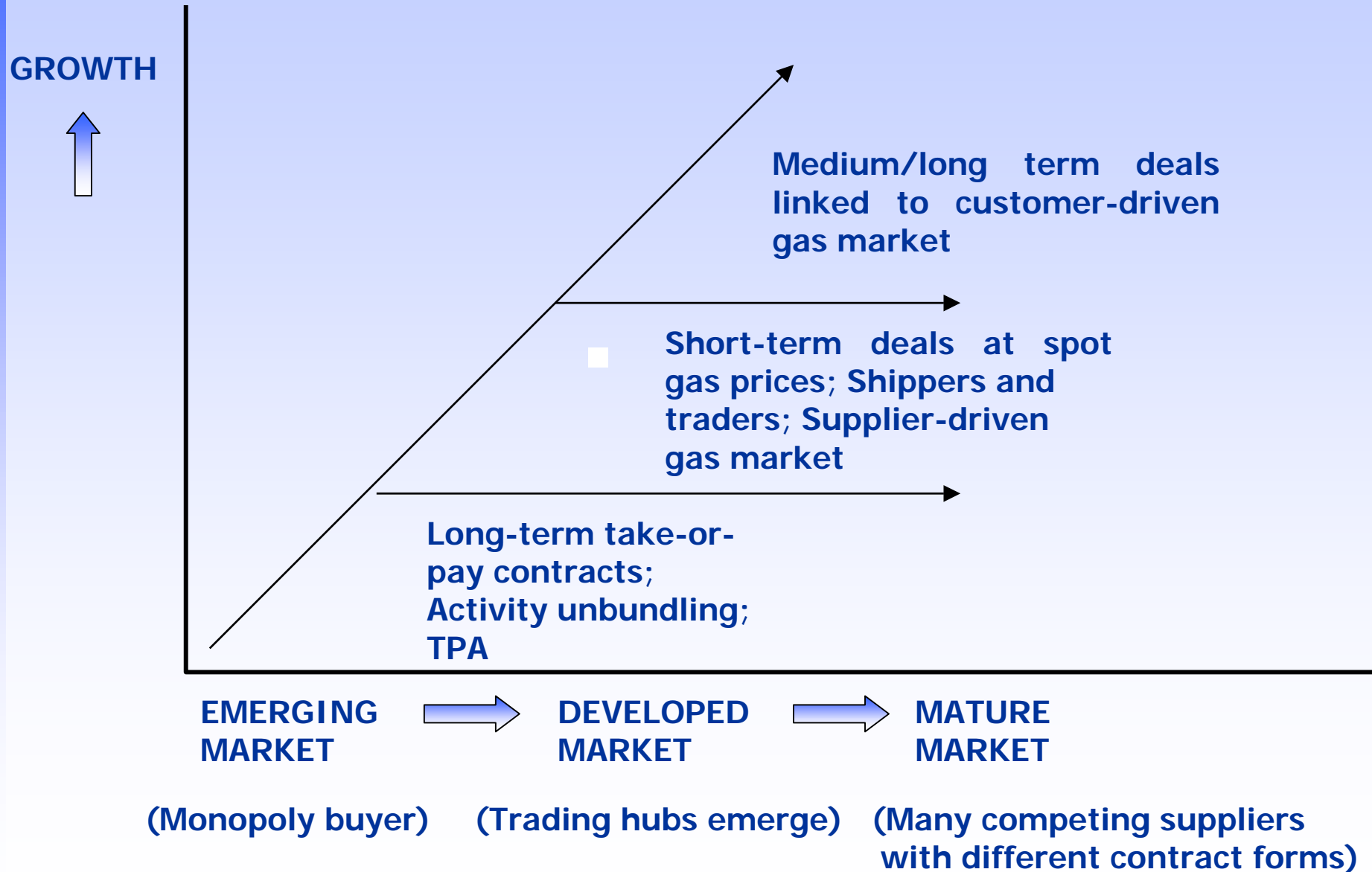


A4. THE LEGISLATIVE DECREE NO. 164 OF MAY 23, 2000 (III)

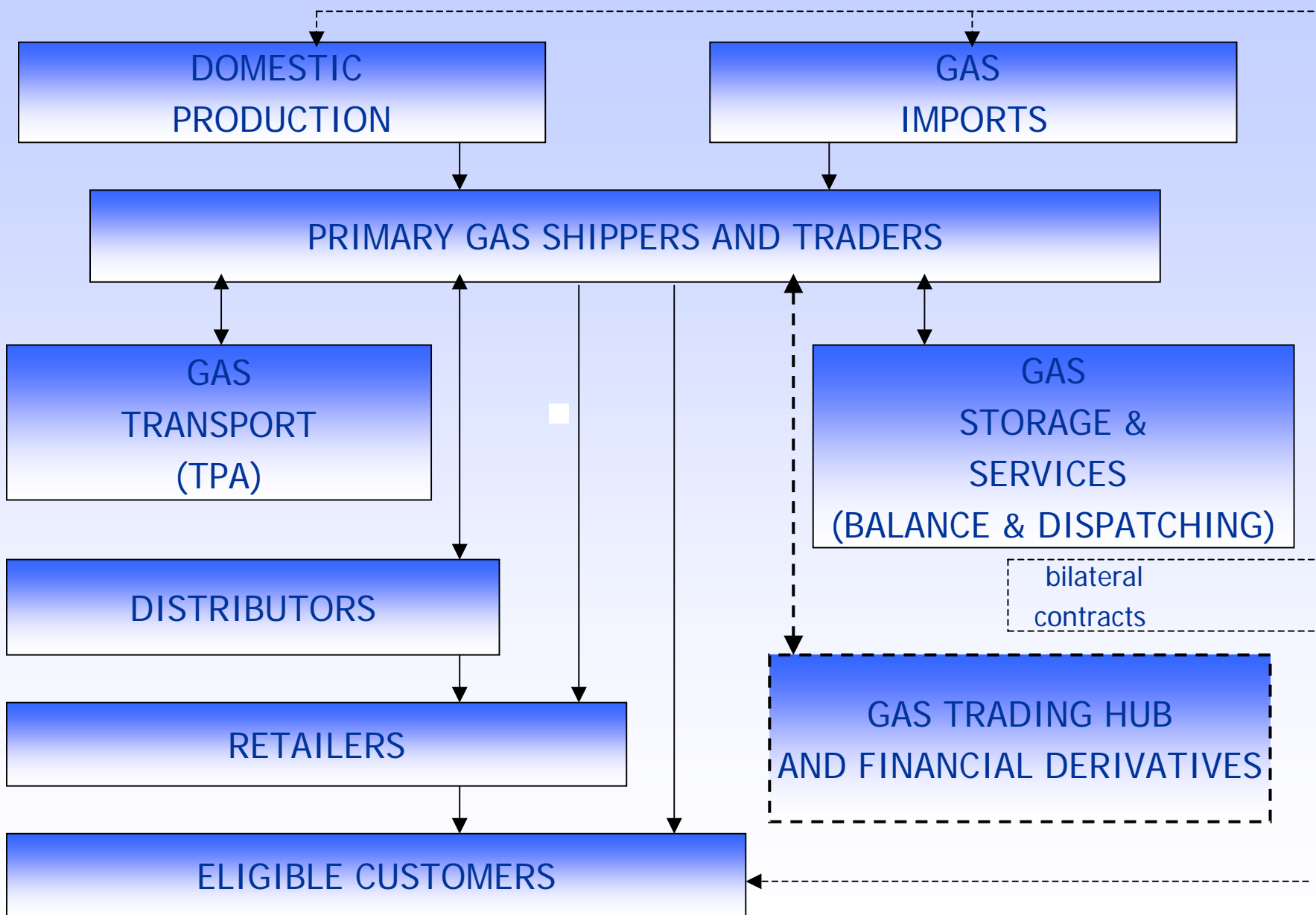
- **Containing market power of the incumbent:**
 - 50% ceiling on national gas retail to final customers and 75% ceiling on gas national primary supply (to decrease to 61%) for State-controlled Eni Spa
- **Gas trading:**
 - Bilateral contracts and self-organised gas trading hub
- **General obligations:**
 - Strategic gas storage, physical safety of gas pipelines and appliances, promoting DSM, special measures for regions of Southern Italy, safeguarding existing long-term take-or-pay contracts



A5. EMERGING GAS MARKETS: POSSIBLE EVOLUTION OF GAS CONTRACTS



A6. THE NEW GAS MARKET IN ITALY (I)



A6. LIBERALISING THE GAS MARKET: RE-SHAPING THE STATE-CONTROLLED MONOPOLY (II)

January 1, 2000

January 1, 2004
(development prospects)

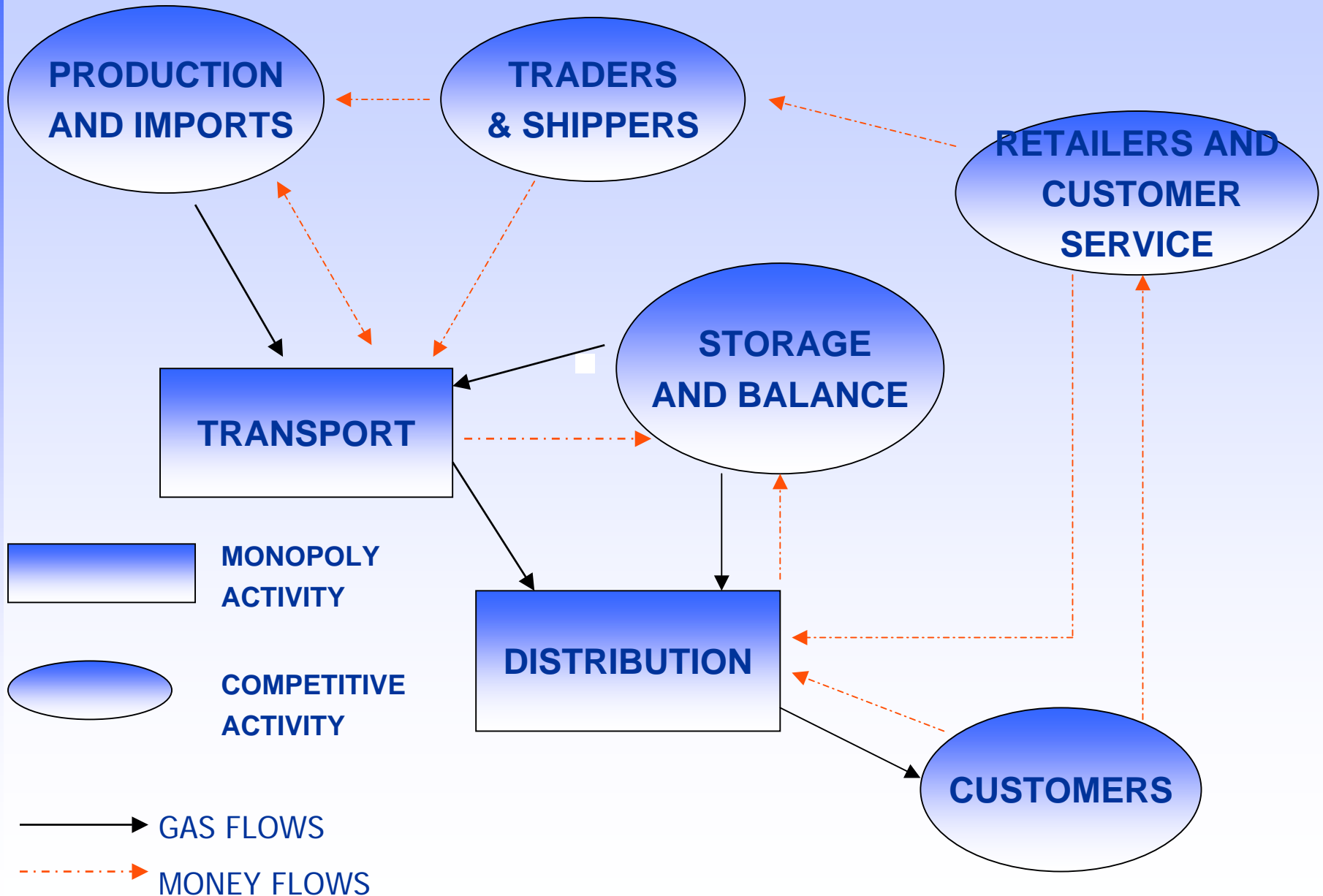
ENI-SNAM MONOLITHIC (35% State-owned)		COMPETITORS		ENI HOLDING (70% private ?)		COMPETITORS	
• Imports	90%	• Enel and others	10%	• Snam Gas (Import and Shipping) Division	~ 60%	• Others (and Gas release)	~ 40%
• Domestic production	95%	• Others	5%	• Agip (Hydrocarbon Production) Division	~ 90%	• Others	~ 10%
• Storage	100%		—	• Stoccaggi Gas Italia Co	~ 90%	• Others	~ 10%
• Transport	98%	• Others	2%	• Snam Rete Gas Co	~ 90%	• Others	~ 10%
• Distribution and Retail (Italgas Co)	~65%	• Enel & Municipalities	~ 35%	• Distribution (Italgas It Co) and Retail (Italgas Più Co)	< 50%	• Distributors and Retailers	> 50%

Special regime above 200,000 cm/yr
Eligible market ~ 10%

Eligible market 100% by January 1, 2003



A7. REGULATION TOWARDS A COMPETITIVE GAS MARKET (I)



A7. REGULATION TOWARDS A COMPETITIVE GAS MARKET (II): REGULATED OR NEGOTIATED TPA?

RTPA

NTPA

“protection” of
new entrants

security

“control” of
new entrants

risk
sharing in the
short-term

financial
risk

risk
predictability
in the long-term

customer-
driven market

market
risk

supply-driven
incumbent

broad-scale
interconnections

cross-
border trade

directional
developments



B.

REGULATING THE GAS MARKET

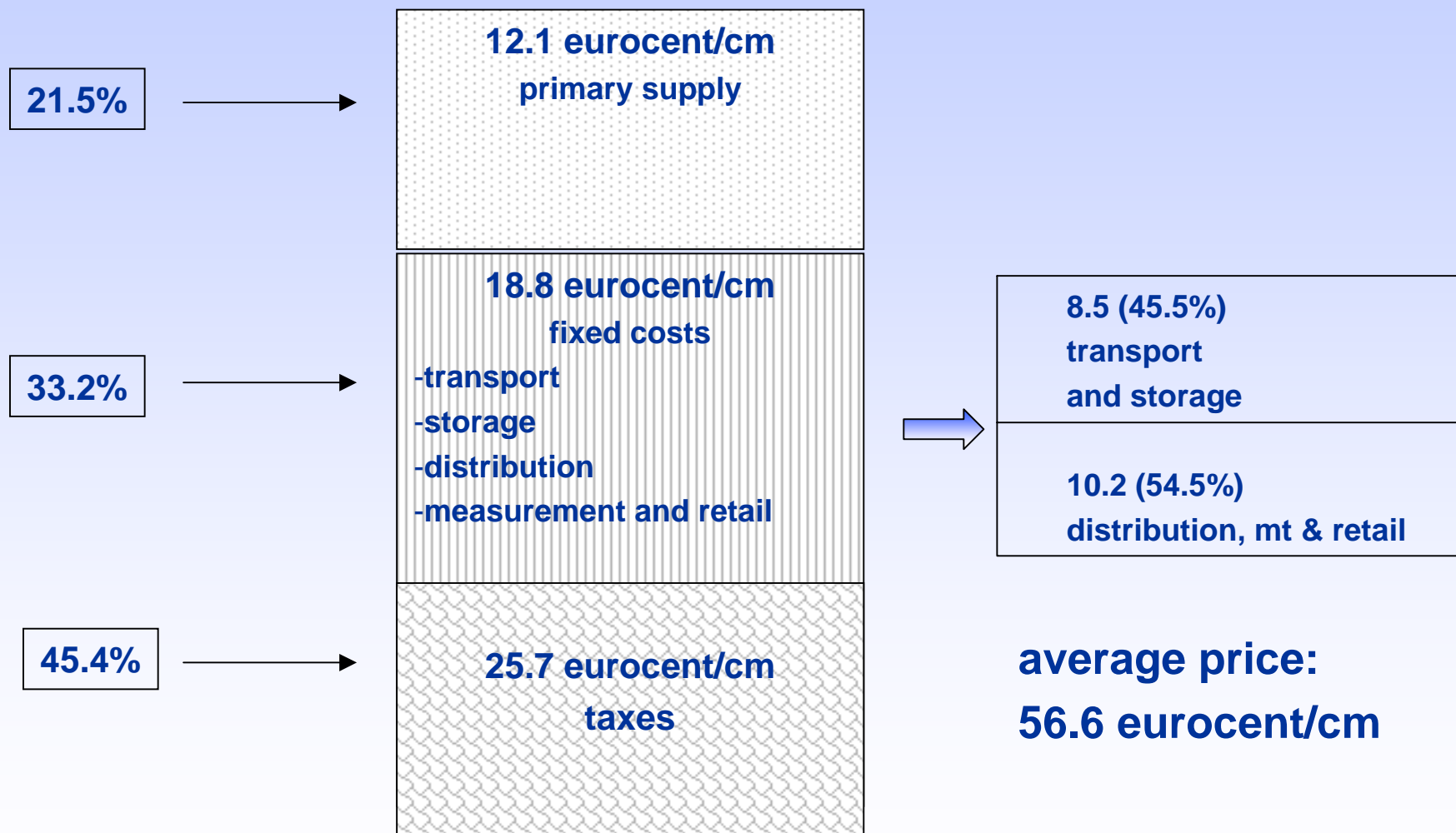


B1. REGULATORY ISSUES AND PRIORITIES 2002-2003

- **Front end: the customer**
 - protecting the customer in the retail market**
 - code of conduct for retailers
 - price benchmarks and last resort service
 - ensuring physical safety
 - new rules on DSM
- **Upstream: primary gas supply**
 - promoting competition**
 - governance codes for gas transport
 - governance codes for gas storage and LNG
 - import caps and gas release on the border
 - long-term investments (priority access and new interconnections)
- **System “core” and gas trade**
 - ensuring market operation**
 - grid access monitoring and control
 - establishing a national gas trading hub
 - governance codes for gas distribution
 - rationalising distribution structure



B2. FRONT END: AVERAGE GAS PRICE TO FRANCHISED CUSTOMERS (TARIFF PLUS TAXES, NOVEMBER 1, 2002)



B3. FRONT END: NEW FUEL INDEXATION IN GAS BENCHMARK PRICES FOR FINAL CUSTOMERS

- Law no. 238 of October 28, 2002 to cope with inflationary concerns (Regulatory Order no. 195/02 of November 29, 2002):
 - moving fuel price average 9 month period (6 months)
 - adjournment every 3 months (2 months)
 - trigger threshold $\pm 5\%$ ($\pm 5\%$)

Note: former values in brackets



B4. THE NEW GAS MARKET IN ITALY: THE TARIFF AND PRICE SYSTEM (I)

1. Import and national production

- Negotiated prices and take-or-pay contracts (monitored by the Regulatory Authority and Market Competition Authority)

2. National (and main) regional pipeline network

- Regulated TPA and transport tariff (determined by the Regulatory Authority)

3. Storage, LNG, tech services

- Regulated TPA and use tariff (determined by the Regulatory Authority)



B4. THE NEW GAS MARKET IN ITALY : THE TARIFF AND PRICE SYSTEM (II)

4. Local pipeline
distribution network

- Regulated TPA and transport tariff (determined by the Regulatory Authority)

5a. Supply to
franchised customers
(until Dec 31, 2002)

- Supply tariff (determined by the Regulatory Authority)

5b. Retail to eligible
customers and to
all former franchised
customers (since
Jan 1, 2003)

- Negotiated retail price (benchmark determined and monitored by the Regulatory Authority)



B5. TARIFF FOR GAS TRANSPORT AND DISPATCHING, AND USE OF LNG TERMINALS (I)

ORDER NO. 120/01 OF MAY 30, 2001

- **National pipeline grid (NTG) and regional pipelines (RTG) tariff based upon:**
 - capacity
 - distance
 - shipped volume
- **Tariff:**
 - set for a 4-year regulation period
 - subject to price-cap on the allowed revenue and commodity component



B5. TARIFF FOR GAS TRANSPORT AND DISPATCHING, AND USE OF LNG TERMINALS (II)

ORDER NO. 120/01 OF MAY 30, 2001

- Rate of return from Capital Asset Pricing Model
- Allowance for new investments
- NTG: entry-exit capacity tariffs with consideration of distance to smooth regional differences
- RTG: exit capacity tariff, distance-related with distance cap





B5. TARIFF FOR GAS TRANSPORT AND DISPATCHING: ENTRY-EXIT POINTS (III)



B5. TARIFF FOR GAS TRANSPORT AND DISPATCHING, AND USE OF LNG TERMINALS (IV)

ORDER NO. 120/01 OF MAY 30, 2001

- **Capacity booking regime:**
 - path-based booking to avoid capacity hoarding
 - annual or six-month booking, with tradable capacity
 - capacity linked to final customers
 - daily balancing with hourly ceiling
- **Interruptible service:**
 - reduced capacity components TE^* , TU^* , TR^*



B6. GOVERNANCE CODES FOR GAS TRANSPORT THROUGH NATIONAL PIPELINE GRID ORDER NO. 137/02 OF JULY 17, 2002

- **Rules are established for:**
 - companies (notably Snam Rete Gas Co) to prepare their **pipeline grid governance codes**
 - communication and information **transparency and non-discrimination**
 - **allocation criteria for existing capacity** at the entry points in case of congestion (ship-or-pay clause)
 - **access refusal and conditions**
 - **priority access** to new capacity for sponsors that are financing new transborder pipeline construction and upgrading during a 20-year period



B7. GOVERNANCE CODES FOR USE OF LNG TERMINALS

ORDER NO. 91/02 OF MAY 15, 2002

- **Priority access for the capacity booking regime:**
 - 80% of the access to new capacity and its use **can be reserved during a 20-year period** to LNG sponsors that are financing LNG terminal construction
 - **right to priority access is non-transferable and applicable** to new LNG terminals in operation before December 31, 2010 or before national LNG capacity is attaining 25 bcm/year
 - conditions for the priority access and use conditions **are published**
 - **use-or-lose clause** to convert priority access to regulated access and use



B8. QUALITY OF GAS DISTRIBUTION: TECHNICAL REQUIREMENTS ORDER NO. 236/00 OF DECEMBER 28, 2000

- **Continuity of service:**
 - enhancement of overall level of continuity
 - adoption of (European) benchmarks and reduction of regional gaps
 - pipeline inspections and safety
 - emergencies and accident recovery



B9. QUALITY OF GAS RETAIL TO FINAL CUSTOMERS: COMMERCIAL REQUIREMENTS ORDER NO. 221/02 OF DECEMBER 28, 2002

- **Quality of service:**
 - billing practice and payments
 - change of supply contract
 - frequency of meter readings
 - meter replacement and repair



B10. FRONT END: IMPLEMENTING THE RETAIL GAS MARKET

- **Timeline for eligible customers:**
 - all by January 1, 2003
- **Separation of distribution from measurement and retail:**
 - Decree by the Minister of Productive Activities of June 24, 2002
- **Directive for the implementation of retail prices and market:**
 - Order no. 207/02 of December 12, 2002 and Rulemaking document for consultation published by the Regulatory Authority on December 12, 2002
- **Distribution code and Commercial code for retailers:**
 - Rulemaking document published by the Regulatory Authority in Spring 2003



C.

**REGULATOR'S CHALLENGES
AND NEXT STEPS**



C1. CONCLUSION: REGULATOR'S CHALLENGES

- **Strong market power still exists in the national gas sector: the regulator must be able to recognise new exercise of market power and respond**
- **The financial health of gas industry requires stable rules and institutions so that capital markets can judge risks and invest reasonably**
- **Long-term investment in the gas market must be insured while looking at interaction with the electricity market and public service obligations**
- **Progress towards the single European electricity and gas market is setting the framework (with concern for regional market asymmetries and national energy security)**



C2. GAS MARKET: NEXT STEPS (I)

- Promoting and monitoring competition in gas import, production, storage and LNG terminals, shipping and retail market
- Defining rules to increase security of supply and cross-border interconnection, while adjusting for take-or-pay contracts
- Introducing governance codes and rules for the access and use of gas storage, LNG terminals and the distribution grid



C2. GAS MARKET: NEXT STEPS (II)

- Enacting legal separation in distribution, measurement and retail while introducing liability for physical security standards



- Insuring transparent information and opportunities for choice to all final customers

