

Mr. Claudio Scajola  
Minister  
Ministero dello Sviluppo Economico /  
Italian Ministry of Economic Development  
Via Veneto, 33  
00187 Roma  
ITALY

2 February 2009

Dear Sir,

**Re: New governmental decree will hamper the Italian electricity market**

On November 29, 2008 the Italian government issued a decree (no. 185/08) which has been approved by the Senate as Law no. 2 "Misure urgenti per il sostegno a famiglie, lavoro, occupazione e impresa e per ridisegnare in funzione anti-crisi il quadro strategico nazionale" on January 28, 2009.

- A new pricing mechanism on the day ahead market. A "pay as bid" price mechanism will be introduced instead of the existing one, which is based on a system marginal price.

We believe that it will fundamentally impact the Italian electricity market and create potential incompatibilities with European electricity market mechanisms. Our **major concerns** are:

- 1- that the introduction of a "pay as bid system" will reduce the liquidity on the power exchange and the OTC market, and
- 2- a "pay as bid" mechanism would also severely damage the prospect for successfully linking the Italian power market to its neighbours through implicit auctions.

## **Disadvantages for the Italian market arising from the decree**

### **1. Efficient operation of power plants endangered; risk of volatility and non-cost reflectivity in the wholesale market**

The remuneration of power plants at pay as bid will create a high degree of uncertainty among operators, distort market results and lead to inefficient outcomes. Moreover, it is theoretically unclear whether such a remuneration mechanism will actually lead to more efficient price discovery.

On the contrary, it can be expected that generators, looking for the same level of individual revenues, will make their own bids based on their expectations of the market clearing price which will not necessarily imply that this price will be lower compared to the current system.

Also, due to increased uncertainty as to where prices will outturn, the new bidding system will also lead to more volatile prices. For this reason, the proposed bidding system could lead, particularly in the short-run, to an inefficient mix of power plants and the associated unnecessary carbon emissions which is likely to damage the achievement of Italy's environmental goals.

We call upon Italian politicians to consider the advantages of a market clearing pricing mechanism (i.e. marginal pricing). The existing marginal pricing mechanism, which remunerates generators according to the price of the last accepted merit ordered bid, sets a clear incentive that generators bid based on their variable costs of generation. If a specific plant operates at low variable costs it would make no sense to bid significantly higher than its pure variable costs because the risk of being out of the merit order would increase. To bid below variable cost is not sensible anyway. The same applies for a more expensive plant which will not be operated if its costs are above the market clearing price. This mechanism ensures that the most efficient power plants are operated and the costs of production are minimized.

### **2. Changing the reference price disrupts liquidity and competition**

The "pay as bid" system would not allow the PUN (i.e., the national unified price) to be determined. At the very best, any new national "average" bid price would have to be derived on a very different basis to the PUN. To the extent that the PUN is used as a reference price in bilateral agreements and in derivatives traded on IDEX, the change in the reference price is likely to disrupt and potentially frustrate the fulfilment of existing contractual obligations. This will disrupt wholesale market liquidity now, but perhaps more importantly creates the ongoing and damaging perception that reference prices are likely to be the subject of poorly signalled, capricious, unforeseen and ad hoc changes in the future. This will continue to undermine the development of wholesale market liquidity and competition in Italy far into the future.

Certainly the analogous continuous trading arrangements between sellers and purchasers in the current British wholesale electricity trading scheme suggest that liquidity will not be optimised.

### **3. Disincentive to invest in Italy**

The Italian market has been dependant on imports for many years, so any investment in new generation is therefore to be welcomed. However, if the Italian government intervenes into market mechanisms as proposed it would create a strong negative signal and deter new investors. This effect will be amplified as more volatile prices will make forecasting cash flows more difficult, investors will anticipate further interventions and other countries will be competing to attract new investors.

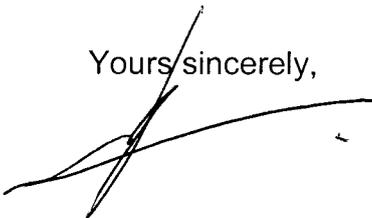
### **Pay as bid will hamper the integration of the Italian electricity market into Europe**

The proposed remuneration scheme is currently unique in Europe, and will create a broad range of problems and make the integration of Italy into a European market impossible. Therefore we see the overall objective to create a single European energy market at risk.

With the aim of optimising cross border capacity allocation and contributing to price convergence across Europe, the introduction of market coupling is planned within the next couple of years. Also within the CSE region, to which Italy belongs, discussions on the introduction of market coupling have begun. Under this system, TSOs announce the available interconnection capacities, traders bid at their national power exchanges in Italy and e.g. France and an auction office as a special trader of last resort places additional bids to guarantee maximum use of the available capacities. This mechanism is highly regarded by market participants, regulators and the European Commission. However, it only works properly if imports and exports are remunerated at the market clearing price. The move to "pay as bid" therefore will form an obstacle to coupling the Italian market with other markets, which will mean that Italy, as a high price country, will not see the benefit of maximum imports at lower prices. This has to be highlighted, as significant import volumes have a price decreasing effect, which is the fundamental aim of the decree.

Finally, EFET would like to highlight, that cross-border issues need to be addressed when defining further details of the Economical Development Minister's decrees.

Yours sincerely,



Jan van Aken  
Secretary General



Cc:

Ms. Ana-Arana Antelo, Head of Unit, Unit Electricity & Gas, DG TREN, European Commission

Mr. Massimo Maraziti, Unit Electricity & Gas, DG TREN, European Commission

Ms. Fay Geitona, Secretary General, ERGEG

Ing. Alessandro Ortis, Presidente, Autorità per l'energia elettrica e il gas

Dott.sa Emma Marcegaglia, Presidente, Confindustria