Call for clarity

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It is a waiting game for Italy's power players. With the liberalisation of Italy's electricity market in full swing and the opening of a nationwide pool market only a year or so away, foreign and local power companies and banks are jostling for position to ensure they get a piece of the action. The question for asset hungry foreign sponsors is whether to enter the generating market through acquisition, takeover or to start from scratch with a greenfield project.

Those on the acquisition trail having been circling Enel, the Italian state-run electricity giant that until recently held a monopoly on the country's electricity generating, supply and delivery assets. But with EU regulation and a government decree pushing for liberalisation, Enel has begun carving itself up. In the past few months all eyes have focused on its generation business with 15,000MW split across three newly created generating companies (gencos) ? Elettrogen (5,438MW), Eurogen (7,008MW), and Interpower (2,611MW) ? up for sale.

At the end of July Spain's Endesa, BSCH and Asm Brescia won Elettrogen with a bid of Eu2.63 billion, pipping the Edison-Sondel consortium at the post. Next off the block is Eurogen, the second biggest Italian electricity generator in the country after Enel Produzione. Enel says all three deals should be complete by the beginning of next year.

According to Anne Walter at BNP Paribas in Milan, foreign and local players see these acquisitions as a way of entering the Italian power market without the complications of operating as a greenfield developer. This is particularly relevant as gaining permission from local authorities for a greenfield project can be difficult and lengthy, with some deals taking anything up to four years to obtain approval.

Says Walter: ?This is part of the reason why newcomers want to buy in to Italy. They think they will also gain a higher position in the merit order when the new pool market is introduced.?

Daniela Katsiamakis, an analyst at Standard & Poor's in London, says: ?With few significant players in the market, the risk is higher for smaller price-taking participants. Until the spot market is developed, generation companies may continue to influence purchase prices and enjoy higher prices while electricity retailers may need to juggle higher purchase costs against competitive or capped consumer prices.?

But to compete effectively in the new pool market, these gencos will have to be more efficient. According to a source at Enel, before the sell-off the three gencos were earmarked for L10 trillion worth of investment for modernisation. Enel has traditionally built dual or tri-fuelled generation plans that could operate on coal, oil or gas, enabling the company to pick the cheapest fuel option. These plants are less efficient and create more pollution than modern combined-cycle plants. However, electricity producers will have to switch to combined cycle plants once the pool market launches if they are to compete effectively. More upgrades will mean more financing.

Meanwhile, foreign participants have been pushing up the stakes in an effort to grab a piece of the Italian power market in other parts of Italy. At the end of July, Fiat's bold alliance with France's Electricite de France paid off when their Italenergia consortium succeeded in taking over Montedison, the Italian industrial group and its subsidiaries Sondel and Edison. The takeover not only pushes Mediobanca, for years a strategic player on the Montedison board, to one side but it has opened the door for EdF which had been struggling for a politically acceptable route into the Italian market.

However, on August 28 the European Commission approved the deal, ending speculation that there would be a fourmonth investigation into the deal but it warned the case would be re-examined should EdF try to gain joint control of Montedison.

Mario Monti, European Competition Commissioner, said: ?The acquisition of sole control by Fiat of Montedison does not raise any competition concerns on the Italian electricity market, which is still dominated by Enel. However, the Commission would have to carry out a new competitive assessment of the case if EdF were to gain a controlling position in Italenergia/Montedison in the future.?

EdF has limited its voting rights in Italenergia to 2% in response to an Italian decree limiting the rights of foreign state-owned companies whose markets are not fully open to competition.

Sergio Pininfarina, chairman of Italenergia, said the Commission's decision ?allows our company to move immediately to the operating phase, to define an industrial plan from which the second producer in Italy's energy market will be created.?

So far, officials at Fiat and EdF have kept their cards close to their chest while they waited for the European Commission to decide whether the Montedison takeover was permitted. However Fiat previously made it clear that it would use its existing industrial sites to further EdF's power ambitions.

Says a source at Fiat: ?We have some assets linked to power production not only for factories but for public networks and the idea is to develop these brownfield sites. We would merge our brownfield sites, EdF's power knowledge and the financing capabilities of our three banks.?

Together with the Sondel and Edison sites, Fiat now has 5,700MW of power capacity in Italy but says ?if we develop power generation at these brownfield sites we could reach 14,000MW?. Initial funding is likely to come from the other consortium participants, the three Italian banks ? Banca di Roma, Sanpaolo IMI and IntesaBCI that own a combined 20% of Italenergia. They have said they consider their stakes to be financial investments.

But Enel's breakup, Montedison's takeover and the launch of the Italian power pool is providing just as much uncertainty as it is opportunity.

Paolo Bozzolo, associate director at Mediocredito Centrale in Rome, says sophisticated sponsors and lenders will factor in electricity pricing uncertainties associated to the yet to be implemented power exchange as they proceed with their greenfield/brownfield IPP development plans in Italy.

Financing for the big gencos has to be in place when the consortia are bidding and consequently these deals are being financed with semi permanent corporate finance bridging facilities. However, all of them are likely to need refinancing at a later date. While upgrades to existing brownfields sites through the Montedison vehicle could provide other financing opportunities.

One financier says that because of the size of the acquisitions Italian banks will not have the capabilities or knowledge to take the deals on alone. Knowledge of non-recourse structures could be important for individual upgrades but there is room for innovation while the acquisitions are likely to be financed using bridging facilities with longer-term corporate loan or bond structures replacing them.

Meanwhile, new entrants to the IPP market face an uncertain environment. In the mid 1990s moves to kickstart the power sector with subsidised tariffs lured in foreign players. Financing for Rosen, Sarlux, Serene and API Energia, for example, were all project financed ? albeit at a high price.

Some early deals were financed at an average spread of 150 basis points over Libor. ?Spreads were high but this was the first time we had seen IPPs in Italy,? says Mr Bozzolo. ?Lack of familiarity with Italian legislation raised a series of questions in the mind of financiers regarding the potential enforcement of certain rights typically available to non-recourse lenders ? force majeure provisions, liquidated damages, etc. This translated into pricing levels generally encountered in transactions with substantially higher risk profiles in some emerging market countries. A wave of refinancings consequently followed.?

A few years on and most of these deals were being refinanced at more reasonable rates. Tractebel's Rosen project, for example, refinanced with a margin of about 80bp.

Legislation from the early 1990s allowed foreign IPPs to take advantage of CIP6 ? a subsidy which reduced the cost of the power tariff, proving a valuable incentive for foreign participants. But with government authorities claming the tariff was lining the pockets of foreign banks at the expense of Italian taxpayers, the subsidy has been removed for new projects. Despite the removal of this subsidy, some power developers still see greenfield opportunities in Italy.

International Power, the demerged overseas arm of the former National Power, has outlined plans to develop up to about 8,000MW of gas-fired power plants in Italy together with its partner Ansaldo Energia, the Italian turbine manufacturer. In April the two groups said they would build 4,000MW of gas-fired plant in southern Italy ? three near Naples and two in Calabria. This followed an agreement in March to develop 3,200MW at sites in Piedmont, Veneto and Emilia Romagna in norther Italy. There are also plans for another 1,600MW plant. Together the projects would cost about E4 billion.

International Power claims, while these deals may some way off, it would prefer to follow the IPP route than pay too much for a genco.

Paribas' Walter says that renewable energy projects will also continue to offer opportunity for private investors as EU directives and the Bersani Decree mean at least 2 per cent of power supplied in Italy must come from renewable sources from 2002. Those companies who do not meet their renewable energy target can buy green certificates from those who do. The upshot is that more deals in the model of the IVPC project in southern Italy, financed in 1998, are likely to come to market, with small startups jumping on the same bandwagon as more experienced players.

Italy's move towards an open competitive electricity pool is perhaps causing the most uncertainty. Already the launch date has been delayed and a number of key issues are still to be resolved, with doubts over the timeframe of the launch and how it will actually work dominating. Meanwhile, one project financier says that the framework for the trade of green certificates is very unclear. ?At the moment it is very difficult to see exactly how the pricing would work for green certificates.?

With so much uncertainty, sponsors of greenfield deals may want to hold back. Bozzolo says: ?You may see a couple of greenfield IPP projects coming to the market in the next six to nine months but it really depends on the timing of the implementation of the power exchange. Structures that take into consideration present uncertainties such as miniperm type deals will likely be considered.?

Without a clear indication of how the pricing environment will develop once the pool opens, sponsors that want to proceed will have to do so with very flexible structures. Says one project financier: ?If a sponsor said to me lets go ahead with the deal now, we would do it ? but at a price.?

The story so far

Enel, Italy's state run electricity company, has until now dominated power generation and distribution in the country. The electricity giant accounted for more than 90% of electricity sales to final customers and more than 70% of domestic power generation.

More recently pressure from a more competitive tariff regime and declining market share has pushed Enel to diversify. Consequently the company now also operates as a water and gas distributor as well as in the telecom sector.

Enel's monopoly over the power generation sector began to change in the 1990s with the government's introduction of CIP6 subsidy which encouraged independent power producers into the country tempted by the opportunity of a more favourably pricing environment. Power deals to emerge from this included the Rosen, Sarlux and Serene power projects ? all of which were financed on a project finance basis in the mid 1990s.

In line with European Union directives that had led to liberalisation of power markets across Europe, Italy has introduced a competitive reform policy. The Bersani Decree said Italy should open up the electricity sector to new and foreign players and dissolve Enel's powerful market position.

Implementing the decree are the Ministry of Industry and Energy and the Energy Authority, the utilities regulator. Under the terms of the Bersani Decree, by January 1 2003, these agencies must ensure industry participants in the Italy hold no more than 50 per cent of production or import sources.

Enel, with 77% of national supplies, has to divest about a quarter of its generating capacity ? equivalent to about 15,000MW. The bidding for Enel's generating companies ? Eurogen (7,008MW), Elettrogen (5,438MW) and Interpower (2,611MW) ? is underway. Spain's Endesa won the bidding for Elettrogen but the other two gencos are still to be sold with the next key date being on September 7 and the completion of all three sales expected by the beginning of 2002.

The Bersani Decree also calls for unbundling and consolidation among the smaller players. For example, in the supply business, participants serving more than 300,000 customers will be forced to isolate transmission assets, distribution networks and energy supply activities into separate businesses.

And of course all of this preparation work is designed to pave the way for opening up the electricity trading environment. Italy hopes to have 40% of its supply market open for competition by January 1 2002, with the remaining 60% liberalised once the national pool market has opened.

Meanwhile, a system operator will control 49,000km of the country's transmission grid ? 90% of which is owned by Enel. Together with the other transmission owners, the operator will compensate Enel under an agreement. Although the details of this agreement are still to be finalised, the operator will assume Enel's contracted power purchase deals with independent power producers.