

29 May 2013

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Request for information – Rate Regulation

Dear Board members

Terna Spa welcomes the opportunity to respond to the International Accounting Standards Board's (IASB) Request for Information (RFI) about Rate Regulation.

We are interested in the project of a new standard on Rate-Regulated Activities, since most of the revenues of our Company derives from activities subject to tariffs established by Electricity and Gas Authority (AEEG).

Overall, we support the decision of the Board to develop an IFRS that provides a guidance on how entities should account for the effects of rate regulation. In particular we welcome the purpose of the Board to restart the project.

Our detailed answers to your invitation to the abovementioned request for information are attached.

Yours sincerely,

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The regulated industry and why it should be considered

Question 1

For the types of rate regulation that you think would be useful for us to consider in the Discussion Paper (or would not be useful to consider, if applicable), what types of goods or services are subject to the rate regulation being described?

In providing this information, please also tell us:

- (a) whether you are a rate-regulator, a financial statements preparer, auditor, user or other (please specify);
- (b) what jurisdiction the rate regulation that you are describing is in;
- (c) whether that jurisdiction is a recent adopter of IFRS; and
- (d) whether the main suppliers of the rate-regulated goods or services (ie the rate-regulated entities), including your company if applicable, are predominantly private-sector entities, government entities or closely related to the rate regulator.

If the jurisdiction has not adopted IFRS, your views are still useful to us. It would be helpful if you could include information about what local GAAP is applied and how the effects of the rate-regulatory scheme are reported in accordance with that local GAAP.

Answer 1

We think would be useful to consider in the Discussion Paper the Italian rate-regulatory scheme of energy.

- (a) Terna is a financial statement preparer.
- (b) The rate regulated activities of the Group, at the present, is limited to Italian regulatory framework, established by the national Electricity and Gas Authority (AEEG);
- (c) IFRS are mandatory in Italy for listed companies since 2005 for the preparation of consolidated financial statements and since 2006 for separate financial statements.
- (d) Terna is the unique Italian Transmission System Operator (TSO) and the owner of about 99% of the National High Voltage Electricity Transmission Grid. As such, the company is responsible for energy transmission and dispatching throughout the entire national territory. He holds a governmental concession in regulated monopoly. Terna spa (the parent company) has been listed in the Italian Stock Exchange since 2004. Its major shareholder is Cassa Depositi e Prestiti¹, with 29.85% of shares. The remaining nearly 70% is divided between institutional and retail investors.

¹ Cassa Depositi e Prestiti (CDP) is a joint-stock company under public control, with the Italian government holding 70% and a broad group of bank foundations holding the remaining 30%

1. The objectives of the rate regulation

Question 2

What are the objectives of the rate regulation and how do they influence the interaction between the rate regulator, the rate-regulated entity and customers?

In providing this information, please tell us:

(a) what are the high-level objectives of the rate regulation (for example, to restrict prices or to influence the levels of supply and demand or to restrict or encourage competition); and
(b) how these objectives are reflected in the nature of the rate-setting mechanism? For example, to what extent:

- (i) is the rate-setting mechanism designed to give the rate-regulated entity a 'fair rate of return' (for example, a cost-plus mechanism) or is the focus more on reducing the cost to customers (for example, a price-cap or other incentive-based mechanism);
- (ii) are there incentives to meet targets that are not directly related to the cost-rate relationship (for example, efficiency, service levels, infrastructure investment, increased supply capacity or reliability, use of alternative resources or reduction in customer demand or usage);
- (iii) does the rate regulation fix the price per unit or does it provide some flexibility for the entity to set prices (for example, through price ranges or caps, based on either unit prices or total revenue or total profitability); and
- (iv) are there other aspects of the rate-setting mechanism that reflect any specific objectives not envisaged above?

Answer 2

In accordance with the transmission and dispatching concession, Terna guarantees the safety, quality and reliability over time of the electric system. It ensures equal access conditions to all grid users.

(a) The high level objectives of the rate regulation are:

- the improvement of the efficiency;
- the quality of services.

(b) (i) The components considered for determining the transmission and dispatching tariffs mainly belong to three categories:

- Remuneration of the Regulated Asset Base (RAB);
- Amortization;
- Operating costs (opex).

The value of the **RAB** (Regulated Asset Base) is remunerated at a market-based WACC, whilst the value of the RAB is annually updated on the basis of Terna's net investments and revalued with a gross fixed investment deflator index in order to offset inflation effects.

The regulation also guarantee the **recovery of depreciation** in real terms, as recognised costs for depreciation are annually adjusted for new investments and dismissals are revalued with the gross fixed investment deflator index.

Opex are recognised according to a price-cap $(1 - X + rpi)$ + profit sharing mechanism: yearly the recognized operating expenses are updated based on the inflation, the volume of activities and an annual linear reduction mechanism - known as the x-factor, whilst at the end of each regulatory period, 50% of the difference between the actual and recognised operating expenses is deducted from the recognized expenses at the end of the regulatory period; the remaining 50% is absorbed in the subsequent 8 years.

(ii) AEEG introduced over time specific incentive schemes aimed at incentivizing service improvement, both in technical and economic terms. Implicit in the incentive schemes is the assumption that if the objectives are achieved the benefit for the system will be a multiple of the incentive paid to Terna.

Incentive mechanisms were provided for the quality of the transmission service, the improvement of forecasts regarding energy demand and wind power production, the reduction of the volume of the resources used on the MDS (Market for Dispatching Service) and the acceleration of investments to develop the NTG (National Transmission Grid).

(iii) Unitary prices for transmitted and dispatched energy are set by the regulator. The regulated entity cannot change unitary prices.

(iv) In order to mitigate the impact of energy volume fluctuations on the regulated entity revenues, presently, in case the actual annual energy falls outside a 0.5% dead band of the energy used to set tariffs, the regulated entity must return / is entitled to receive an amount of money equal to the energy outside the dead band multiplied by the unitary tariff, thus limiting the volume risk/opportunity to 0.5% of recognised costs.

2. The rights and obligations established by the rate regulation

Question 3

What sort of rights or obligations does the regulation create?

In providing this information, please consider:

- (a) whether the rate-regulated entity has an exclusive right to operate in the market;**
- (b) if the entity's right to operate in the market is established by licence:
 - (i) is there a cost to acquire the licence; and**
 - (ii) can the licence be revoked, renewed or transferred;****
- (c) how competition is excluded or encouraged;**
- (d) how the rights and obligations are expressed, for example, as a cap on the rate of return, as the right to recover entity-specific costs, as a right to recover an allowed level of costs (whether or not incurred by the entity), or as a right to recover specific types of costs without limit if and when incurred; and**
- (e) whether the entity can choose to stop providing the goods or services that are subject to rate regulation and, if so:
 - (i) how is this achieved; and**
 - (ii) what are the consequences for the entity?****

Answer 3

- (a)** Terna, as concession holder, has the **exclusive right** to exercise the activities of transmission and dispatching of electricity, including the unified management of the NTG. As the Company is the main owner of the NTG, it operates substantially in a monopolistic regime. It is responsible for transmitting and dispatching electricity along the high-voltage and very-high-voltage grid throughout the whole of national territory, including operation, maintenance and development of the NTG.
- (b)** On 2005 Terna became owner of the concession for transmission and dispatching activities by the acquisition of the TSO business unit of GRTN (Gestore della Rete di Trasmissione Nazionale – National Transmission Grid Operator).
 - i. therefore Terna obtained the license for electricity transmission and dispatching activities in Italy; as established in the Decree issued by the Ministry of Productive Activities on 20 April 2005.
 - ii. The licence could be revoked by the Government if Terna infringes seriously the obligations of the concession. this license runs for twenty-five years, renewable for another twenty-five year.
- (c)** Terna holds a governmental concession, in this regulated monopoly fair tariffs are fixed by the Authority.
- (d)** The rights and obligations are expressed as a right to recover an allowed level of operating costs according to a price-cap mechanism. Through the profit sharing system the electric system absorbs the differences between actual and recognized costs, if positives for Terna.
- (e)** Terna cannot choose to stop providing the transmission and dispatching services. In the electricity market Terna provides non-discriminatory access and pricing to wholesale transmission customers.

Terna indeed has an **obligation to connect** to the NTG all subjects who request, without compromising the **continuity of the service** (Service continuity should be considered as the lack of interruptions in the electricity supply, while voltage quality refers to characteristics such as frequency, wave band and shape).

3. The enforcement of rights and obligations

Question 4

For the rights and obligations identified in response to Question 3, how does the rate-regulated entity enforce its rights, or how does the rate regulator enforce the settlement of the rate-regulated entity's obligations?

In providing this information, please tell us:

- (a) does the rate regulation provide for retrospective recovery or reversal of under- or over-recoveries of allowable costs? If so, how is this achieved, for example through cash payments or other asset transfers to or from parties outside the rate-regulated entity (such as individual customers or groups of customers, the rate regulator or the government);
- (b) are the rights and obligations separable from the business; and
- (c) what happens to the rights or obligations when the entity ceases to provide the rate-regulated goods or services?

Answer 4

- (a) As mentioned above, both for transmission and dispatching tariffs:
 - if the effective opex are lower than the guaranteed/allowed, at the end of each regulatory period the 50% of the difference between the actual operating expenses of the regulatory period and the covered ones is deducted from the recognized expenses; the remaining 50% is absorbed in the subsequent 8 years;
 - if the effective opex are higher than the guaranteed/allowed because of new investments, the recognised opex will be adjusted accordingly.
- (b) The right and obligations of the concession aren't separable from the business.
- (c) Not applicable. Terna cannot cease to provide the services.

5. The recovery or reversal of cost and income variances

Question 5

How does the rate regulation ensure the recovery or reversal of under- or over-recoveries of allowable costs (ie variance amounts) (if applicable)? Are these mechanisms effective in recovering or reversing those amounts within the targeted time frame?

In providing this information, please tell us:

- (a) what is the mechanism for tracking the recovery or reversal of such variance amounts;
- (b) how does the rate-setting mechanism adjust for unexpected changes in demand for the rate-regulated goods or services;
- (c) has there been a recent trend whereby the balances of the variance amounts have been increasing? If so:
 - (i) is this caused by an increase or a decrease in the demand of the rate-regulated goods or services;
 - (ii) has the trend resulted in a net debt position (ie under-recovery of costs) or a net credit position (ie over-recovery of costs); and

(iii) what are the main components of the variance amounts (ie what are the main categories of cost or income variances)?

Answer 5

- (a)** At the beginning of each year (n), Terna provides to the Authority the overall energy transmitted in the previous year (n-1) to determinate the final balance tariff. At the following year (n+1) the Authority recognizes the difference through the abovementioned mitigation system.
- (b)** The decrease in demand of energy, expected but not quantifiable at the beginning of the regulatory period, is substantially neutralized by the mitigation system. The Authority is committed to face the volatility of cash flows generated by the changes in demand developing new mechanisms applicable in the future.
- (c)** The mitigation system substantially neutralizes the negative effects of the decrease in demand but the delay in the cash flows coming from this mechanism creates a negative impact in the net financial position.