

METHODOLOGY AND CRITERIA FOR THE EVALUATION OF INVESTMENTS IN INFRASTRUCTURE PROJECTS AND APPLICATION PROCEDURES FOR INCENTIVES RELATED TO HIGHER RISKS INCURRED BY PROJECTS OF COMMON INTEREST (ARTICLE 13 (6) OF REGULATION (EU) No 347/2013)

A. Scope

1. Methodology and criteria reported in this Annex A to Decision of the Italian Regulatory Authority for electricity gas and water (AEEGSI) 446/2014/R/COM apply to Projects of common interest, as defined in Article 2 of Regulation (EU) No 347/2013 (PCI), falling under the jurisdiction of AEEGSI.
2. Pursuant to the provisions of Article 13 (1) of Regulation (EU) No 347/2013 (the Regulation), this Annex does not apply for projects of common interest (PCI) that have obtained one of the following exemptions:
 - a. an exemption from Articles 32, 33, 34 and from Article 41 (6), (8) and (10) of Directive 2009/73/EC pursuant to Article 36 of Directive 2009/73/EC;
 - b. an exemption from Article 16(6) of Regulation (EC) No 714/2009 or a derogation from Article 32 and Article 37(6) and (10) of Directive 2009/72/EC pursuant to Article 17 of Regulation (EC) No 714/2009;
 - c. an exemption under Article 22 of Directive 2003/55/EC;
 - d. an exemption under Article 7 of Regulation (EC) No 1128/2003.

B. The current regulatory framework

3. The approach adopted by AEEGSI for tariff regulation of electricity transmission, natural gas transportation and storage, and liquefied natural gas (LNG) regasification is aimed, consistently with the European and national legislative provisions, at pursuing the objectives of adequacy, efficiency and security of infrastructures, balancing these objectives with the protection of final customers.
4. In general, AEEGSI adopts a consistent methodology for tariff regulation of electricity transmission, natural gas transportation and storage, and LNG regasification, reflecting the specific features of each regulated activity and particularly the different levels of systematic risk.

5. For electricity and gas infrastructure tariff regulation, AEEGSI has adopted a hybrid approach with incentive-based regulatory schemes (*price-cap*) for tariff components that cover operating costs and *cost-of-service* regulation scheme for tariff components covering capital costs, without prejudice to the overall objective of ensuring the development of a cost-efficient service.
6. In relation to tariff components covering operating costs:
 - productivity targets (*X-factor*) are differentiated by activity (and, where applicable, on a firm by firm basis), reflecting assessments on the potential for efficiency gains estimated by the regulator, and are used as a tool to redistribute to network users the efficiency gains achieved during the previous regulatory periods and temporarily kept by network operators under the so-called *end-of-the-period profit-sharing* mechanism;
 - on the basis of this mechanism at the end of each regulatory period, in order to set tariffs for the following period, efficiency gains are symmetrically shared between network operators and network users;
 - annual tariff reviews based on *price-cap* include adjustments reflecting cost variations arising from unforeseeable and exceptional events, from changes in the regulatory framework and from changes in universal service obligations, as well as quality of service improvements, where applicable.
7. In relation to tariff components covering capital costs:
 - fixed assets are included in the regulatory asset base (RAB) only if investments costs are efficiently incurred and are consistent with security of the system, follow cost-effective criteria and, where provided for, are included in the ten-year development plans prepared by network operators and approved by the competent authorities in accordance with the provisions of Legislative Decree No 93/11;
 - the RAB value is based on the 'historical revaluated cost' approach; capital costs are included in the RAB with a maximum lag of two years and are based on the data resulting from the accounting records of network operators;
 - assets under construction are also included in the RAB;
 - for all regulated activities regulatory mechanisms are being implemented aimed at offsetting financial effects connected to the regulatory lag;
 - the rate of return on invested capital is calculated as a weighted average cost of capital (WACC); the cost of equity is determined on the basis of the capital asset pricing model (CAPM) and reflects the systematic risk that is typical of each regulated activity;
 - in particular for each activity the systematic risk is assessed by estimating the value of the *beta* parameter used in the context of CAPM;
 - the rate of return on invested capital for each regulated activity is set at the beginning of the regulatory period. For electricity transmission, natural gas transportation and storage, and for LNG regasification the length of the regulatory period is now of four years;

- every two years the rate of return on invested capital is reviewed to reflect the variation of the rate of return for risk-free activities. This measure has already been adopted for tariff regulation of electricity transmission, natural gas transportation and LNG regasification. The same measure was also proposed in consultation for natural gas storage tariff regulation with a view to its implementation from the period of regulation starting in 2015;
 - depreciation is calculated under a straight-line method for all fixed assets in use included in the RAB. Regulatory asset lifetime is established by taking into account the technical lifetime of the different types of assets; in case of early disposal of fixed assets included in the RAB, no compensation is envisaged.
8. The Italian tariff regulatory system offers stability and certainty for investors, ensuring transparency of allowed cost calculation procedures and of periodical review criteria, not only within each regulatory period but also in the transition from one period to another, thus reducing the so-called “regulatory risk” for network operators, with positive effects on the cost of capital and on the willingness to invest of network operators.
9. The tariff regulation, as described above, is complemented with specific measures aimed at promoting infrastructure development:
- in order to promote, in particular, adequacy and security of network infrastructures, specific measures, in the form of extra-WACC remuneration, have been adopted, differentiated for activities and type of investment. According to AEEGSI strategic guidelines for future regulation, this form of incentive should be progressively replaced with new *output-based* incentive mechanisms;
 - in order to facilitate compliance with deadlines set for the implementation of strategic network infrastructures, reward/penalty mechanisms have been introduced, though currently applicable only for electricity transmission, taking into account project milestones identified by AEEGSI. AEEGSI has planned a revision of the mechanisms based on *output-based* incentives in order to ensure the overall consistency of the regulatory instruments adopted;
 - an *output-based* incentive scheme (reward/penalty according to performance) is in force for the regulation of electricity transmission quality of service, based on the trend over time of Energy Not Supplied in comparison with targets set at the beginning of the regulatory period;
 - with regard to volume risk mitigation, specific mechanisms have been adopted to guarantee revenues for electricity transmission, natural gas transportation and storage, and LNG regasification; such mechanisms are differentiated on the basis of tariff structures and are consistent with a selective approach that, for new investments, tends to limit their application only to strategic infrastructure referred to in Article 3 of Legislative Decree No 93/11.
10. In particular, with regard to current regulatory periods:

- electricity transmission tariffs are regulated by AEEGSI Decision 29 December 2011 ARG/elt 199/11 and its Annex A, “Testo integrato delle disposizioni dell’Autorità per l’erogazione dei servizi di trasmissione e distribuzione dell’energia elettrica – Periodo di regolazione 2012-2015”, and Annex C, “Testo integrato delle condizioni economiche per l’erogazione del servizio di connessione – Periodo di regolazione 2012-2015”, as subsequently amended;
- natural gas transportation tariffs are regulated by AEEGSI Decision 14 November 2013, 514/2013/R/GAS and its Annex A “Regolazione delle tariffe per il servizio di trasporto e dispacciamento del gas naturale per il periodo di regolazione”, as subsequently amended;
- LNG regasification tariffs are regulated by AEEGSI Decision 8 October 2013, 438/2013/R/GAS, and its Annex A “Regolazione delle tariffe per il servizio di rigassificazione del gas naturale liquefatto, per il periodo di regolazione 2014-2017”, as subsequently amended;
- natural gas storage tariffs are regulated by AEEGSI Decision 3 August 2010, ARG/gas 119/10 and its Annex A “Regolazione delle tariffe per il servizio di stoccaggio di gas naturale per il periodo di regolazione 2011-2014”, as subsequently amended¹.

C. Application procedures for incentives provided under Article 13 of Regulation (EU) No 347/2013

11. The existing regulatory framework for electricity transmission, natural gas transportation and storage, and LNG regasification, as described in paragraph B of this Annex, is considered adequate by the Authority to support an efficient and effective development of network infrastructures, in line with EU energy and climate policy objectives as well as with final customers protection.
12. Project promoters who deem their PCIs present higher risks, with regard to their development, implementation, operation and maintenance, compared to risks normally associated with infrastructural projects (whose recovery is regulated by the provisions described in section B.) can submit an application to the AEEGSI for the acknowledgement of the incentives according to Article 13 (1), first subparagraph, of Regulation (EU) No 347/2013.

I. Notification of relevant data for investments risk assessment

¹ As concerns natural gas storage, the process for the periodic review of the regulation is currently ongoing; in the context of the proceedings for the definition of tariffs and quality of service regulation for natural gas storage for the fourth regulatory period (Decision AEEGSI 27 February 2014, 79/2014/R/GAS), three consultation papers were issued, two of which focused on tariff regulation (consultation papers 24 April 2014, 189/2014/R/GAS and 7 August 2014, 417/2014/R/GAS) and one focused on quality of service regulation (consultation paper 10 July 2014, 336/2014/R/GAS).

13. PCI promoters must submit the application referred to in paragraph 12, or be considered null and void, along with all the necessary information for a proper evaluation of the actual risk faced by projects, in accordance with the following sections from II to VIII.
14. PCI risk assessments prepared by promoters for admission to the incentives according to Article 13 of Regulation (EU) No 347/2013 shall rely on the same assumptions and on the same data set used for the cost-benefit analysis submitted pursuant to the provisions of Annex III.2(1) of Regulation (EU) No 347/2013 and in particular on the same data and on the same assumptions used to evaluate the financial sustainability and the socio-economic net benefit.
15. In the event that, with respect to the date on which the promoter has submitted data used for the cost-benefit analysis, referred to in paragraph 14, significant differences emerge in terms of the project costs and expected revenues, due to a different stage in the implementation of the project, the promoter must provide detailed justifications for these differences.

II. Identification of the nature of the specific risk of the project

16. The promoter shall provide AEEGSI with a report on risks faced by the PCI, giving details of the nature of these risks, referring to the following types of risks:
 - a. the risk of cost overruns compared to expected project costs;
 - b. the risk of time overruns compared to the project timescale;
 - c. the risk of *stranded assets*;
 - d. risks related to the identification of efficiently incurred costs;
 - e. liquidity risk.
17. The promoter shall identify potential risks concerning the use of new transmission technologies, both onshore and offshore.

III. Economic quantification of the effects of specific project risks

18. The promoter shall make the necessary arrangements to quantify in economic terms (higher costs or lesser revenues) the effects of the risks faced by the project while highlighting the magnitude and the probability of these risks.

IV. Risk mitigation measures

19. The promoter shall demonstrate that it has adopted all the risk mitigation measures that are reasonably available. The promoter shall provide a list of the risk mitigation measures taken, providing further evidence of the measures and of the procedures followed or that he intends to follow to ensure that costs are kept to a minimum.

V. Justification of the risk profile

20. The promoter shall provide the information that is necessary to assess how reasonable is the choice of a higher risk project compared to alternative lower-risk projects, in relation to the net positive impact of the project.

VI. *Higher risks than a comparable project*

21. The promoter shall demonstrate, by means of both a qualitative description and a quantitative estimate, that a PCI presents a higher risk in respect of a comparable project.

VII. *Risk mitigation of ordinary regulation*

22. The promoter shall demonstrate, both by means of a qualitative description as well as by quantitative estimates, that the regulatory instruments already in place, referred to in point B. of this Annex, are insufficient to mitigate the risk and do not offer a level of remuneration adequate to the specific PCI risk level.

VIII. *Information concerning subsidies, grants or cross-border cost allocation contributions*

23. The promoter shall provide all relevant information concerning subsidies, grants or cross-border cost allocation contributions from which the PCI has benefited, is benefiting or will benefit.

D. Examination of applications by the Authority

24. For each application submitted by promoters pursuant to the provisions of Article 13 of Regulation (EU) No 347/2013, AEEGSI will start a proceeding in order to:
 - a. verify the results of the cost-benefit analysis undertaken in accordance with the provisions of Article 11 of Regulation (EU) No 347/2013 and in particular the quantification of the net socio-economic benefit of the project;
 - b. assess the consistency of the information and data submitted for the evaluation of the specific risk of the project with the data used to carry out the cost-benefit analysis submitted according to the provisions of Annex III.2(1) of Regulation (EU) No 347/2013, in particular risk assessment should rely on the same data and on the same assumptions used to assess the financial sustainability and to quantify the socio-economic net benefit;
 - c. evaluate the adequacy of risk mitigation measures adopted by the project promoter;
 - d. evaluate the justification of the specific risk profile of the project in relation to the net positive impact of the project, assessed in coherence

with the CBA methodology, according to Article 11 of Regulation (EU) No 347/2013;

- e. assess to what extent the risk is higher than the risk of a comparable project;
- f. assess the nature and the magnitude of the project risks and evaluate, on the basis of an economic quantification, the probability of an economic impact in terms of higher costs or lower revenue;
- g. assess to what extent the project-specific risk that constitutes a systematic risk is already reflected in the allowed cost of capital, taking into account that a non-systematic risk should not be rewarded, as it can be diversified away by the project promoter;
- h. assess if full or partial risk mitigation measures are already provided by the current regulation;
- i. verify if and to what extent a project already benefits from subsidies, grants or from cross-border cost allocation contribution, in order to avoid over-compensations of project promoters.

E. Cases of exclusion from incentives

25. The following cases are excluded from admission to incentives established under Article 13 of Regulation (EU) No 347/2013:

- a. projects where the promoters do not disclose to the Authority the information necessary to apply the common risk assessment methodology and, in particular, do not substantiate the existence of higher risks regarding the project, along with the provision of reliable estimates on the net positive impact and the cost-benefit ratio of the project;
- b. projects where the risks are already reflected in the allowed cost of capital or where appropriate risk mitigation measures are already in force;
- c. projects where the promoters have not adopted, where possible, appropriate mitigation measures;
- d. projects that already benefit from subsidies, grants or from cross-border cost allocation contribution, which already compensate the higher risk incurred in comparison to a comparable project;
- e. projects where the ordinary tariff regulation already adequately compensate the risks and uncertainties related to the project.

F. Instances of admission to the incentives provided for under Article 13 of Regulation (EU) No 347/2013

26. For projects admitted to the incentives provided under Article 13 of Regulation (EU) No 347/2013, the Authority will calculate the incentive according to the following principles:

- a. the incentives are commensurate with the project's specific risk level as borne by the project promoters;
- b. the monetary value of the incentives shall not result in project promoters receiving an overall compensation exceeding the monetary value of the project's net benefits;
- c. the amount of the incentive ensure a reasonable split of the welfare gain associated with the implementation of the project between the project promoters and network users.

G. Preliminary consultations to the Authority's decisions upon requests referred to in subparagraph C.

- 27. AEEGSI decisions regarding the admission of a project to the incentives according to Article 13 of Regulation (EU) No 347/2013 or the adoption of specific mitigation measures related to the proceedings indicated in paragraph 24 of this Annex need a public consultation. Public consultations are also necessary for applications that fall within the cases of exclusions from incentives identified in section E. of this Annex (Cases of exclusion from incentives).
- 28. Promoters may request that parts of the application, for personal, commercial, industrial or financial confidentiality reasons, be considered confidential and not subject to publication. AEEGSI reserves the right to assess such requests in relation to the effectiveness of public consultation.
- 29. As regards the proceedings reported in paragraph 24, the provisions of the *Regolamento recante disciplina delle procedure istruttorie dell'Autorità* (Regulations of proceedings of AEEGSI), according to the Decree of the President of the Republic dated 9 May 2001, no. 244, are applied.