Terna

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EFRAG TEG
EFRAG RATE REGULATED ACTIVITIES WORKING GROUP

35 Square de Meeûs
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Dear Sir/Madam,

Generally, we agree with the ED's proposals, nevertheless based on our understanding, the clarifications and comments already discussed on ED, Terna would like to highlight its concerns about:

- **<u>Recognize regulatory income on Assets under Construction (AUC) as Regulatory returns (Par. B15) vs a Performance incentives (Par. B16 – B20)</u>**

  Under the applicable Italian regulation to TSO, the base remuneration will also consider the return on AUC, (i.e. RAB * WACC), similarly as to assets already in use. The purpose of this measure is to incentive the construction of strategical infrastructures, the rate of return (i.e. WACC) added to the TAC decreases over the time frame and the Group does not have any obligation to refund amounts already included in the TAC and therefore in the tariffs.
  We believe that the accounting outcome should reflect the substance of the agreement whereby the regulator has introduced such return to achieve a timely construction. The main objective of the standard is to fairly reflect the effect of the regulatory framework on the company financial statement; the comparability among companies is important but is an objective of secondary importance.
  In our view, a regulated entity should be entitled to show income over the construction period consistently with the essence of applicable regulations, which aims to remunerate the entity for managing large-scale construction projects and finalizing them on a timely manner. The entity has a right over that return that is included in the tariffs irrespective of the outcome of the construction project (i.e. successfully completed, cancelled, or changed). Therefore, we recommend that the IASB clarify the distinction in the ED between this type of return (paragraph B15) and performance incentive (paragraphs B16-B20) as we believe that in practice both are included in the regulatory agreement with the incentive to finalize the construction period in time. Finally, we note that the entity constructing the asset is not required to refund either the return or the performance incentive if the construction is not finalized; therefore we disagree with the use of these two concepts and, instead believe that the leading principle should be the substance of the regulatory agreement. In addition, we would recommend that the IASB assess the complexity of these proposals to defer the part of the revenue that relates to these returns, because entities would be required to allocate the revenues to the single asset under construction and these assets may be numerous.

- **<u>Time Lag - Regulatory returns (Par. B14) vs Regulatory Interest (Par. B21)</u>**

  As already introduced, Terna is the Italy's primary transmission and dispatching operator and our compensation is based on a tariff system established by the Regulatory Authority for Energy, Networks and Environment (ARERA). ARERA's Resolutions constitute the basis for compensating transmission (Resolution 654/15) and dispatching services (Resolution 351/07 as amended and supplemented) which, among others, address even the so-called "time lag".

  Specifically, ARERA allows us to add a return to the tariffs that includes a component related to the time value of money and other components, that provides us with a return more akin to a return on capital (i.e., regulatory WACC). We understand that this would imply that one of the components of the TAC, i.e., the regulatory interest rate, cannot be identified and this raises questions about how to discount the cash flows to measure regulatory assets.

  As a result, it is not clear for us whether to apply the principles in paragraphs 46 and 47 to discount estimated future cash flows due to the lack of a specific and distinct component in the TAC that meets the definition of regulatory interest. Furthermore, some may read the absence of a distinct regulatory interest component as the need for an entity operating under our regulation to apply, by default, the rate that is assessed by applying the guidance in paragraphs 50-53.

  Based on our understanding, this should not be the Board's intention, considering the guidance in paragraphs B23 and B24 and footnote (a) in paragraph IE36 which states "*the regulatory interest rate applied to the regulatory asset [in the example] is the regulatory return applicable to the regulatory capital base of which the regulatory asset is part. Thus, regulatory interest income for each year is 8% [the regulatory return as per paragraph IE32(b)] of the operating carrying amount of the regulatory asset (…)*".

  Terna would like the IASB clarifies how the proposals would apply in the circumstances above described (where there is no distinct regulatory interest rate). We believe that an entity should always use the regulatory interest rate as a proxy of the discount rate for all its regulatory assets and liabilities when it is clear that the regulatory interest rate is negotiated with the regulator and it represents the actual rate that the entity is entitled to recover. In our view, where the regulatory rates are applied no discounting should be required therefore, we recommend that the IASB clarifies this.

- **<u>Depreciation related to the inflated investments – Allowable expenses (Par. B3) vs regulatory returns (Par. B13):</u>**

  Paragraphs B3 - B27 of the Exposure Draft set out how an entity would determine whether components of total allowed compensation included in determining the regulated rates charged to customers in a period, and hence included in the revenue recognized in the period, relate to goods or services supplied in the same period, or to goods or services supplied in a different period. Paragraphs BC87 - BC113 of the Basis for Conclusions explain the reasoning behind the Board's proposals.

  The components may be challenging to implement in practice. If the regulatory agreement allows for the carrying amount of PP&E to be increased for subsequent inflation, we understand that this adjustment would be captured by the guidance in paragraph B13 of the ED regarding regulatory returns.

  Therefore, since the depreciation related to the inflated investments can be considered as allowable expense or as regulatory return, we believe that the Board should clarify if this conceptual exercise has any practical implication on an ongoing basis as we believe it will be complex and challenging to track distinctly artificially identified components of a single amount as defined by the regulation. We believe that the financial statements should reflect rights and obligations arising from the regulatory agreements while these proposals seem more written to achieve matching between IFRS expenses and regulatory income.

- **Effective date and transition (Parr. C)**

  Since the transition require a very significant effort we recommend a simplified retrospective approach, like the one detailed in IFRS 16. According to this alternative scenario, the entities would not restate comparative information, recognizing the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings at the date of initial application. The regulatory assets and regulatory liabilities should be measured using a method similar to the one documented in paragraph C8 of IFRS 16.

We hope that you will find our comments and observations helpful.

If you would like to discuss any of them, please contact me at cosimo.guarini@terna.it

Yours faithfully

Cosimo Guarini

Financial Statement and Reporting Manager