

Utilities Flash Report

Analysis of the Italian Utilities Sector – Full Year 2012



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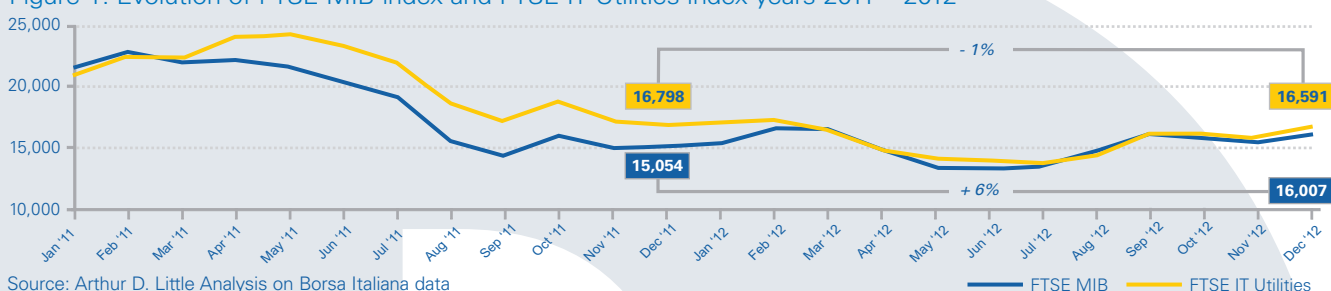
Industry Indicators Overview

In 2012, the FTSE IT Utilities index revealed a fluctuating performance. Due to disappointing 2011 results and the economic and financial tensions in the Eurozone, the first semester registered a downward trend. However, in the second half of the year, FTSE IT Utilities performed strong, recovering back to 2011 year-end values, with the total annual decrease at -1%.

This recovery is underscored by the following factors:

- Stronger common commitment in the management of the European crisis, confirmed by the BTP-Bund spread reduction and the consequent improvement in the debt cost
- Strong performance by the main Italian utility companies, supported by mid-year results and confirmed in Q3 financial reports.

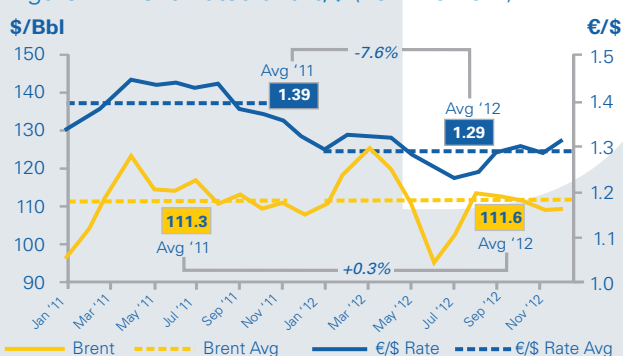
Figure 1: Evolution of FTSE MIB index and FTSE IT Utilities index years 2011 – 2012



However, 2012 was characterized by significant uncertainty surrounding the global macroeconomic situation:

- Brent: had an average value in 2012 that was in line with 2011. It recorded a very volatile trend over the year due to the Middle Eastern geopolitical tensions and the general economic instability: over 120\$ in H1, under 100\$ in Q3 and then it adjusted at 110\$ in Q4. The trend was also confirmed in Q1 2013
- In 2012, the Euro suffered as a result of the EU economic crisis. A clear weaker trend also emerged against the dollar compared to 2011 (-7.6%). During the last quarter it recovered back to 1.30 due to the Fed expansionary monetary policy and the positive results of Germany.

Figure 2: Brent Dated and €/€ (2012 vs 2011)

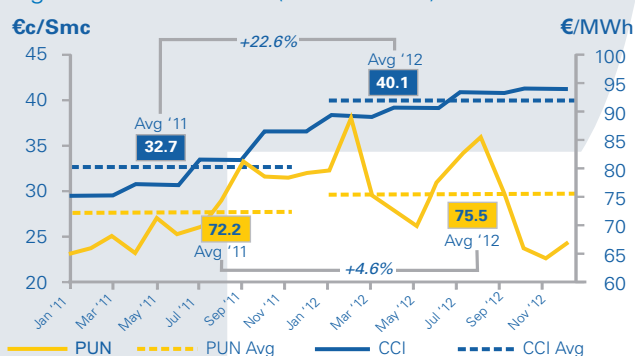


PUN – national single price index – evolution is not immune to the above-cited events.

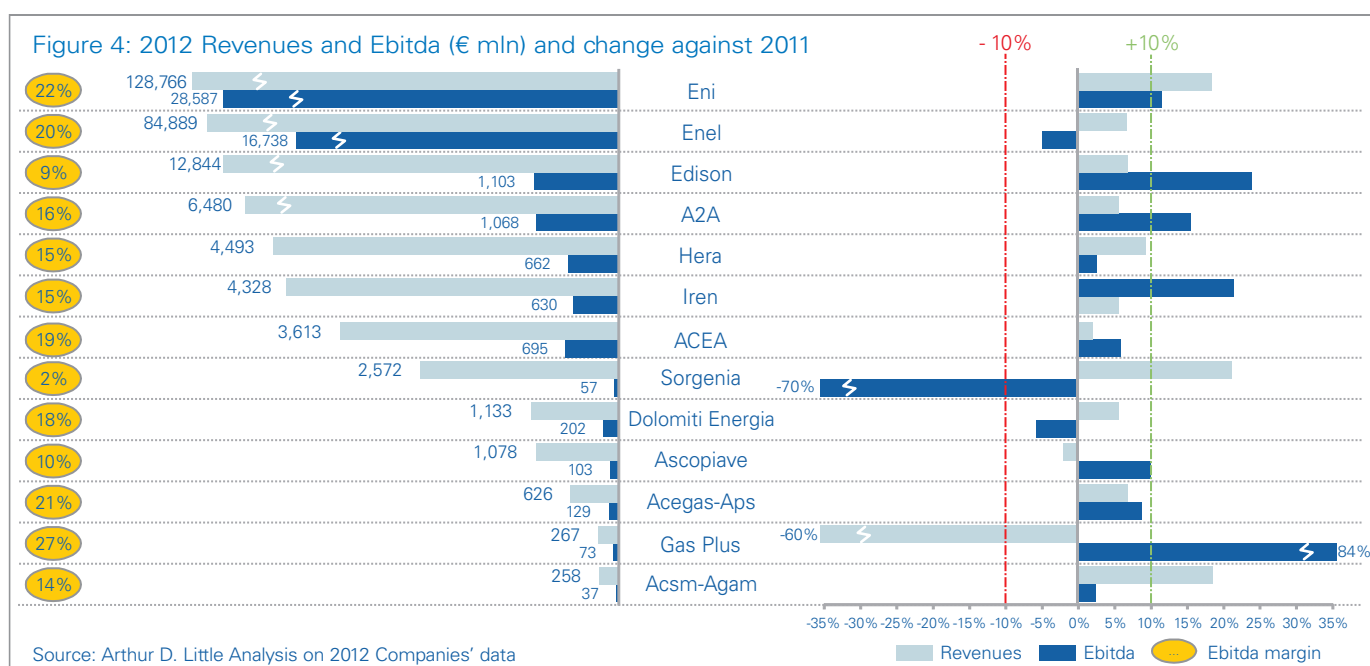
Due to heavy fluctuations, from July the price level suffered the downwards effect of the strong reduction in energy demand and in November, it reached 64 €/MWh, the minimum level over the last two years.

In 2012, CCI – tariff component relative to wholesaling commercialization (raw material) – had an average value of 40.1 €/Smc (+22.5% compared to 2011), despite the introduction of the new calculation method, which started from Q2 and included a greater weight of spot contracts in order to lower end customers' gas prices.

Figure 3: CCI and PUN (2012 vs 2011)



Economic and Financial Results



The 2012 full-year figures confirmed the positive trend already seen in the previous quarters for almost all Utilities in the panel. This is despite the high cost of the commodities, the negative macroeconomic situation, the uncertain regulatory framework and the end of CIP6 incentives. In particular, revenues mainly registered growth due to:

- Gas and electricity businesses: price increase in energy commodities, enlargement of consolidation area due to the acquisition of new clients as a result of commercial activities, new concessions for network businesses and M&A deals which were fully effective from 2012 (A2A and Edipower, Iren and ERG, Ascopiave and Amgas Blue)
- Waste Business: electricity production increase for the activation of new WTE plants (Acea and Hera)
- Water Business: tariff balances and increases due to the coverage of higher costs and investments (Acea, Acegas-Aps, Hera)

In spite of these circumstances, Ascopiave and Gas Plus registered a reduction in revenues. The former (-2%) due to the lower gas wholesale volumes, the latter (-60%) following the implementation of a rationalization strategy regarding the commercial area and its customer portfolio.

Most operators turned increased revenues into higher margins. Regarding the companies in the panel, Sorgenia and Edison are the only ones that achieved an *Ebitda Margin* lower than 10%, despite Edison's marginality increasing because of the positive conclusion of the arbitrations on long-term contracts with RasGas and ENI.

On the other hand, Sorgenia suffered from the higher cost of Libyan gas and the contraction of thermoelectric and renewable generation (-70% Ebitda variation).

Negative Ebitda variations against 2011 were also reported for Dolomiti Energia (-6%) and Enel (-5%), as both were affected by marginality reduction in the electricity generation business.

To confirm the consolidation trends in place, we report some important corporate transactions:

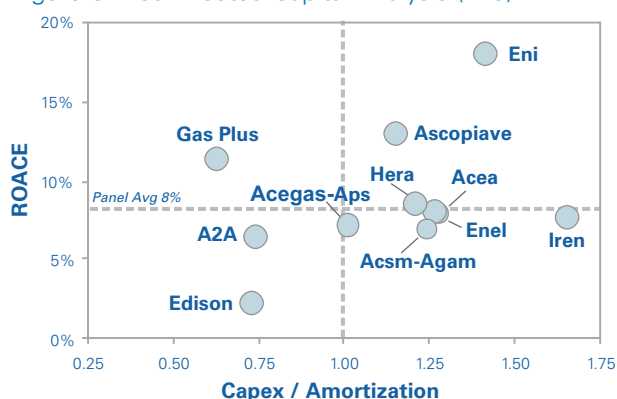
- A2A acquisitions of Edipower control, with effects on consolidation perimeter starting from June 2012
- Merger of Acegas-Aps into Hera, effective since January 2013
- Merger of Toscana Energia Clienti into ENI, effective since November 2012
- JV between Iren and F2i for the acquisition of Amiat-TRM (waste), at the end of 2012.

The financial analysis (Figure 5) shows an improvement for most of the companies thanks to the growth of their marginality and to the reduction of their net financial position (NFP) through corporate rationalization strategies. It is important to highlight:

- An average value NFP/Ebitda equal to 2.84x lower than 2011, with a range between 0.5x (ENI) and 4.1x (A2A)
- An average value NFP/Total sources of financing fundamentally unchanged and equal to 0.45x, with a range between 0.2x (ENI) and 0.7x (Acea)
- Focusing on NFP/Ebitda ratio, hereafter the main points:
 - Almost halved ratio (from 4.4x to 2.4x) for Edison due to Edipower divestiture
 - Reduction for Gas Plus (from 5.4x to 2.0x) and for Ascopiave (from 2.16x to 1.66x) due to marginality improvement
 - Improvement for ENI (from 1.1x to 0.5x) that benefits from the Snam de-consolidation and a growing marginality.

Even with an unchanged value compared to 2011 (equal to 2.6x), ENEL started a de-leveraging process, realizing a rationalization strategy that will continue during the next five years.

Figure 6: Net Invested Capital Analysis (NIC)



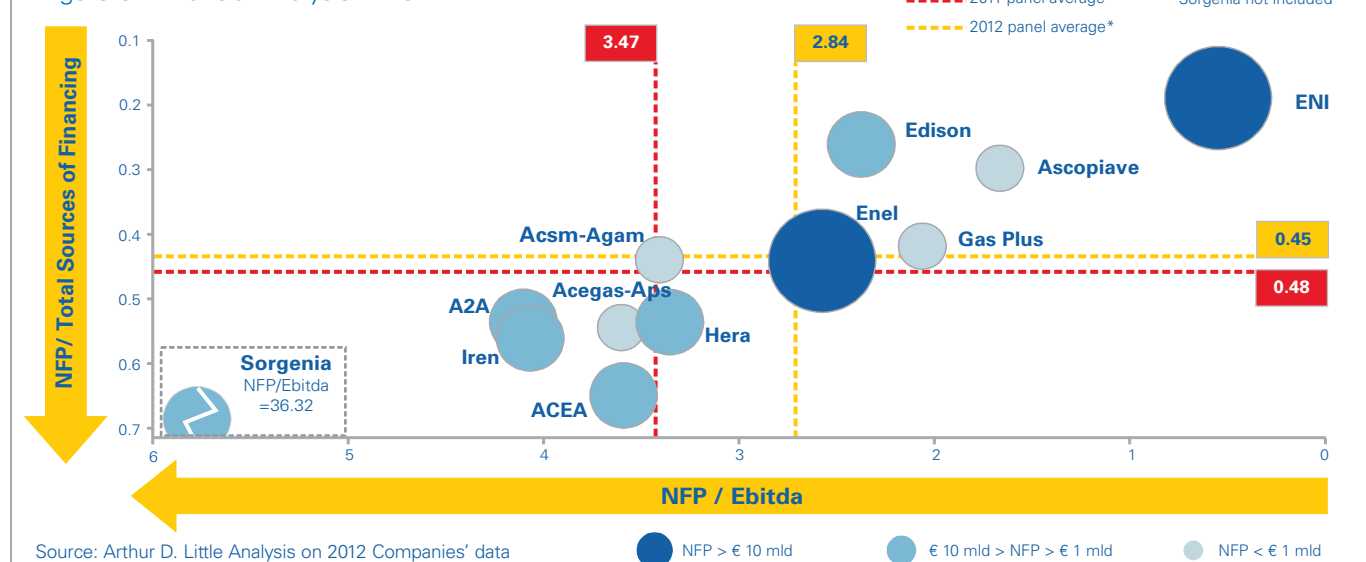
Nota: regarding amortization it is here reported the data communicated by the companies. Acea, Acegas, Ascopiave, Edison, Enel, Hera and Sorgenia might include depreciations

Source: Arthur D. Little Analysis on 2012 Companies' data

The NIC analysis (Figure 6) shows that:

- Companies focused on gas businesses or upstream activities report higher profits when there is a good NIC replacement rate (in particular Ascopiave and Eni).
- Other multi-utilities demonstrate lower profit levels, revealing a high propensity to asset replacement, with a capex/amortization ratio > 1 (excluding A2A and Edison).

Figure 5: Financial Analysis in 2012



Source: Arthur D. Little Analysis on 2012 Companies' data

● NFP > € 10 mld

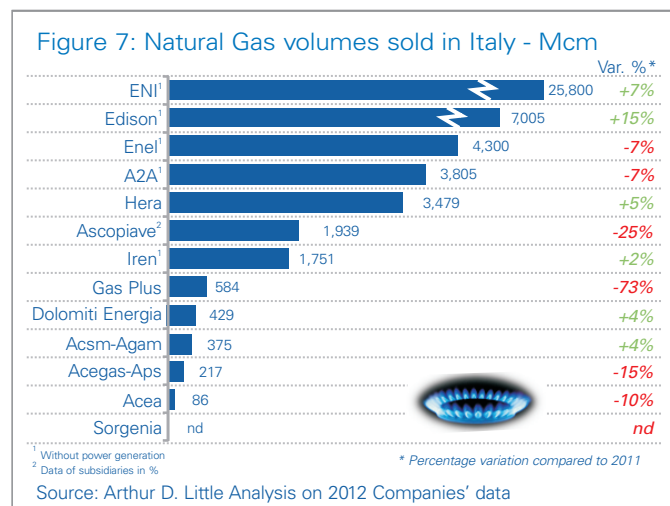
● € 10 mld > NFP > € 1 mld

● NFP < € 1 mld

Industry Focus: Natural Gas

Gas Sales

Gas sales to end customers are aligned to 2011 figures, due to a soft increase in the residential segment and a small decline in the industrial sector. The operators' contradictory trends are derived both from different portfolio strategies implemented for the retail market and from their exposure to trading activities.



Among the main regulatory interventions occurred during 2012, it is important to highlight:

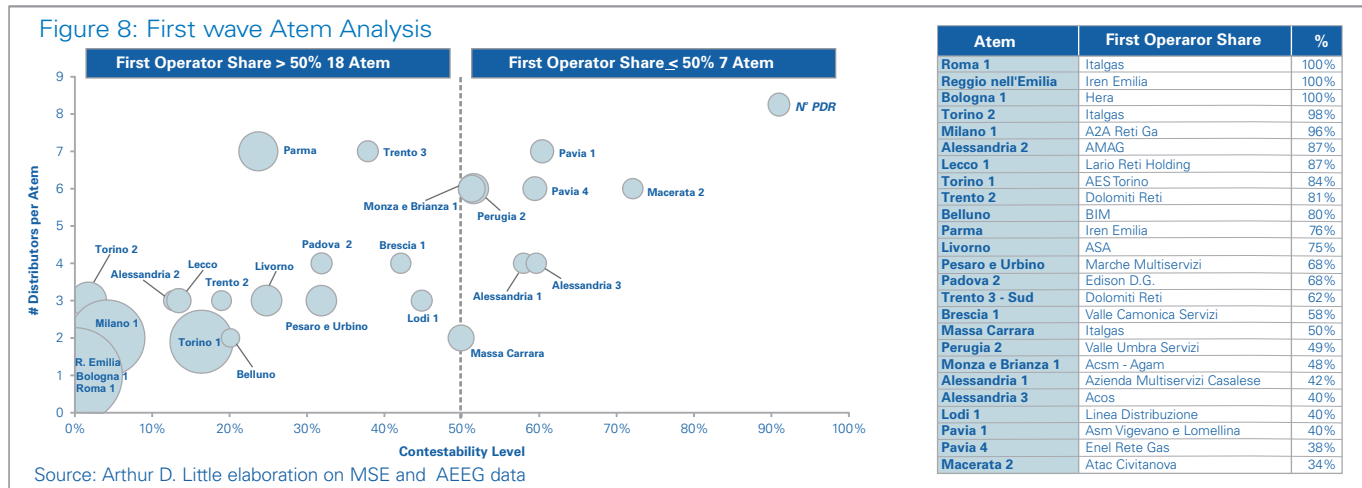
- **A new gas balancing system** was introduced in December 2011, thanks to AEEG resolutions 45/11 and 81/11. This forced operators to redesign their logistic activities in order to be able to operate on a dedicated

balancing platform (PB GAS) managed by GME, where they submit daily demand bids and supply offers for the storage resources that they have available.

- **Review of calculation method for the natural gas price in the regulated market:** after a long period of consultation activities that resulted in the DCO 58/13, from October 2013, the tariff component related to raw material (CCI) should be completely linked to an auction-trading mechanism managed by GME. Moreover, the review of QVD (tariff component relative to commercialization activities) is pending (DCO 106/13), again with effect from the new gas year, which should partially compensate the price reduction predicted by DCO 58/13.

Gas Distribution

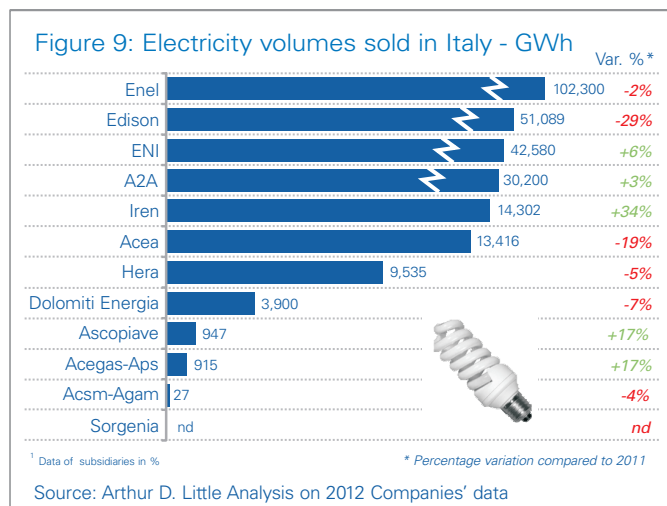
In 2012 the **reform of the gas distribution segment - related to the introduction of standard criteria for gas concessions tenders** - was completed, in particular: servicing contract template, compensation for the releasing authorities, and a technical form for RIV (Residual Industrial Value) calculation. However, the document about the IV regulatory framework is also at a consultation stage: this document will define the new calculation method of the starting RAB and the recognition in tariff of the possible gap RIV/RAB with relevant impacts on the investment evaluation for the competition's participants. Municipalities are starting the activities to proceed with Atem (minimum territorial district) tenders.



Industry Focus: Electricity

Sales

There has been a significant decrease of electricity sales volumes due to the contraction of domestic demand. On the other hand, positive performances have been shown by Iren, Ascopiave Acegas-Aps, Eni and A2A thanks to their commercial strategy oriented to the acquisition of new customers.



Power Generation

Regarding the **renewable energy industry**, the Fifth feed-in scheme (V Conto Energia) issued on July 2012, confirmed the path toward grid parity for photovoltaic generation. The achievement of the cap of € 6.7 bn is forecasted by May 2013: beyond this limit, the current incentive system will be

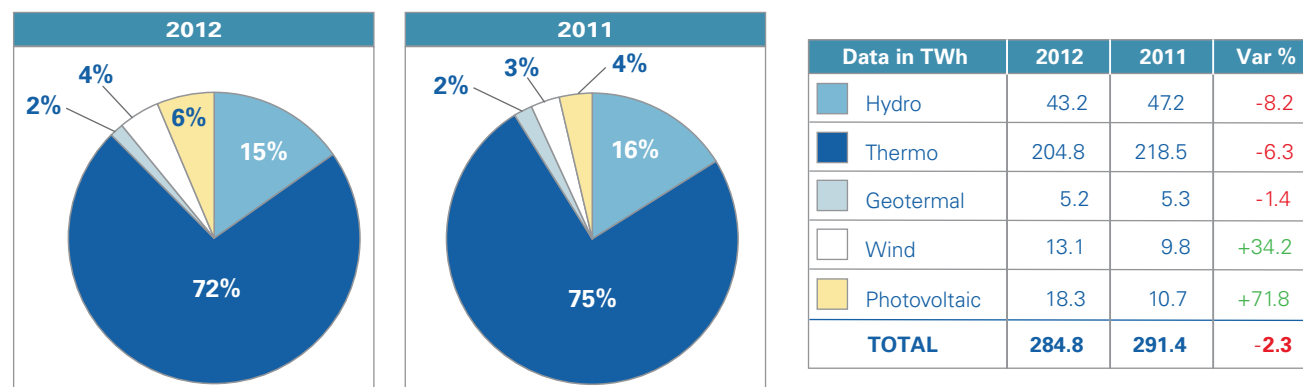
interrupted. Furthermore, the boom in renewable power generation and the decrease in end-user demand has resulted in a substantial reduction in production from traditional sources. As a consequence, operators of thermoelectric power plants need to cover their variable production costs in fewer hours of operation. The aim of the process is to regulate the **capacity payment** in order to ensure the appropriateness of the national generation capacity while providing the thermoelectric plant owners (selected by tenders) the opportunity to recover their marginality and sign supply contracts of capacity directly with Terna, the Italian grid operator. The final scheme of the **capacity payment regulation** (res. 482/12), prepared by Terna and approved by AEEG, will be submitted for the final examination of the Ministry of Economic Development.

Network

Regarding the Regulatory Framework, it is important to highlight:

- The issue of incentive concession scheme for the six pilot projects proposed by Terna (res. 66/13) related to power **storage systems**.
- The issue of the **IV regulation period** concerning electricity distribution tariffs. The main new elements introduced are the corporate reference tariff, which replaces the previous approach based on the average national tariff integrated with general and specific corporate equalization and the tariff structured by the end user (as it is in the gas industry).

Figure 10: Mix of primary energy sources used for electricity generation in Italy

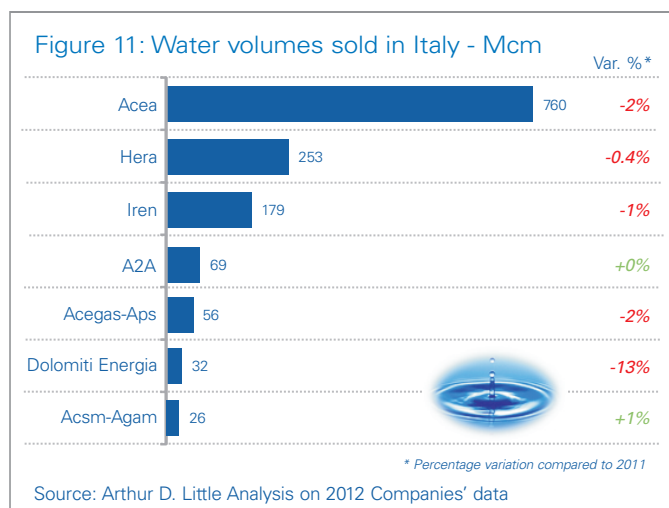


Source: Arthur D. Little elaboration on Terna data

Industry Focus: Water

Water Supply

Volumes supplied are aligned or slightly lower than 2011 figures, with no significant changes in the perimeter of consolidation for the companies considered in the panel.



Regulatory Evolutions

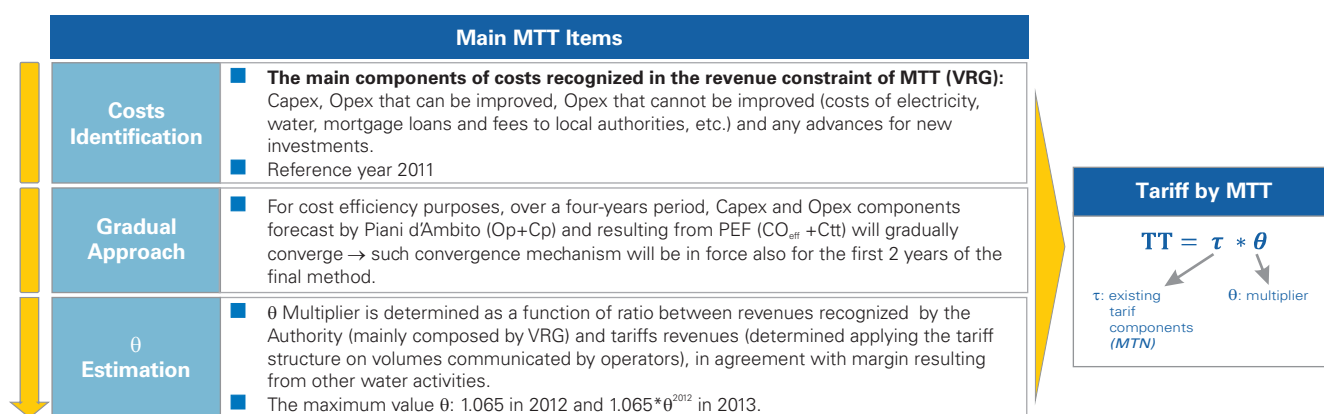
In 2012, AEEG became the regulatory body responsible for the water industry, publishing a series of measures, including:

- **Definition of Tariff Transitory Method (MTT) applicable to management with standard tariff method (MTN) and ex CIPE:** after a long consultation process with two

Resolutions (585/12 for MTN and 88/13 for ex CIPE), the Authority established the criteria to determine tariffs in 2012 and 2013 (see Figure 12) and published a calculation tool. The final tariff method is expected to commence on 1st January 2014 (one single method available for all types of management).

- In order to increase **transparency in the water industry**, through Resolution 586/12, the Authority introduced some new rules aimed at defining the contents of the bill to be adopted by 1st January 2014, the Service Charter (Carta dei Servizi) and all the quality indexes are to be published on their website by 30th June 2014, with two goals: to ensure more protection to final customers and to homogenize the set of information provided by operators.
- **With DCO 82/13**, the Authority began the consultation process to define the unbundling regulation for suppliers; it is also expected to require operators to submit the accounting data divided into ATO and the economic results per macro activities within each ATO (Resolution 347/12) for 2012-2013 tariffs.
- In addition, concerning the relevant topic on the client arrearage, with Resolution 87/13, the Authority started a process in order to adopt measures about the definition of mandatory contractual conditions for end customers

Figure 12: Tariff Transitory Method (MTT) for concessions with standard tariff method (MTN)

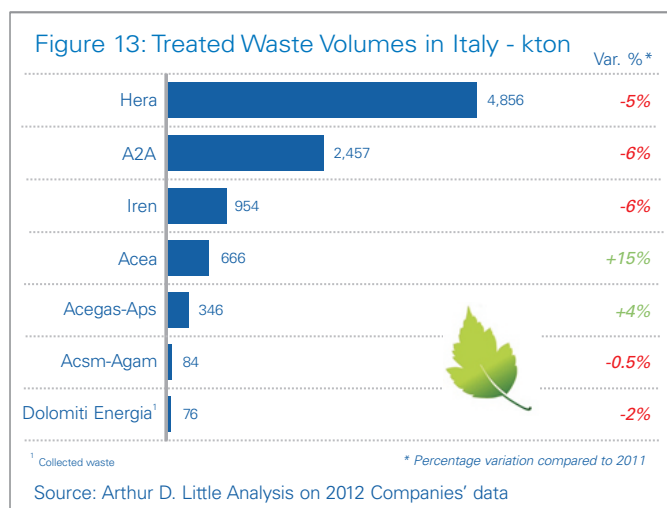


Source: Arthur D. Little Analysis

Industry Focus: Waste

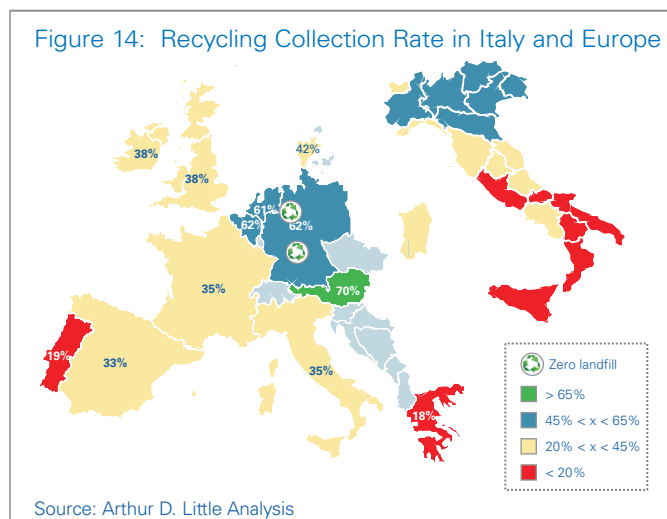
Waste value chain

2012 was characterized by a decrease of treated volumes due to the final consumption decline related to the weak Italian economy. Hera is still the market leader in terms of treated volumes, while Acea and Acegas-Aps show a growth thanks to the better performances of their WTE plants.



The average recycling collection rate in Italy (35% in 2010) is still below the 31st December 2012 target of 65%, stated in the Italian Environmental Regulation.

Regarding the **treatment and disposal phase**, landfills are still the most common method of waste disposal in Italy, as the average percentage of their utilization was 46% in 2010.

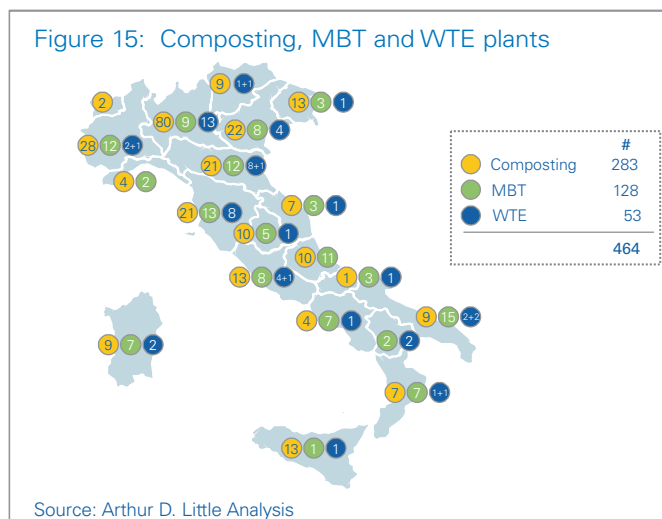


Comparing it with the European standards, Italy is still too late in the engineering and realization of waste treatment plants as reported hereafter:

- Composting plants are numerous, concentrated in the North of Italy, and characterized by low average capacity.
- WTE plants are mainly located in the North regions and their ownership and management is frequently linked to the most relevant multi-utility Italian Groups (e.g. A2A, Hera). There are lots of issues in terms of realization e.g. social concerns, operations and complex technologies.
- Strong growth for the MBT (Mechanical Biological Treatment) plants, (there are currently 128 in Italy) and represent a more accepted alternative to the landfills

Regulatory Evolution

- Through the sentence 199 of the Italian Constitutional Court in July 2012, the *in-house* business model turned back to be an available option at the same level of assigning through tenders the waste management service.
- With decree law 201/11, known as "Save-Italy" by Prime Minister Monti, a new waste tax was introduced, called «TARES». It has to entirely cover both the collection and treatment waste costs and other services provided by the municipalities. After a first postponement to July 2013, it seems reasonable to be moved to 2014



Outlook 2013 – What are the Challenges?

- The **macro-economic scenario** for 2013 appears to be weak with the continuing contraction of GDP and consumption. Brent is above 100 \$/bbl, and gas and electricity prices remain at high levels.
- The new National Energy Strategy (SEN) outlined the priorities by identifying specific initiatives that would have an impact on the strategic decisions of companies (for example energy efficiency, development of the Italian gas hub and electricity infrastructure).
- There is still an unstable **regulatory environment** that impacts all Local Public Services (gas distribution tenders, concession terms of waste management, profitability of water concessions) that does not allow Utilities to have a clear vision on the medium-long term.
- The huge amount of **planned investments** - in particular in network services, customers acquisition into the liberalized businesses and development of plants' capacity in the waste business - and the increasing difficulty to obtain loans will be the most important issue for all companies.
- Utilities will also have to decide how to face the impact of **technological innovation** on their business models: e-mobility (offering and business model), smart grid and smart home (management models and relationship with telco) and storage (technologies on which to invest).
- In front of these scenarios, the general trend will continue towards the concentration of operators in different modes as recently occurred (mergers, joint ventures with financial investors), rather than through target acquisitions.
- Open issues remain, such as the choices that small public companies are going to pursue (safeguarding their territorial presence or selling some assets to satisfy cash needs) and what the role (aggregators, potential targets or new JV partner) of medium-sized unlisted multi-utilities will be (such as Estra, LGH, AGSM Verona, AMGA Udine, and Dolomiti Energia).

Gas

- How will the logic of supply and sale of the big players change considering the alignment of PSV prices to European hubs and new ways to allocate storage capacity?
- What is the impact going to be on the market of new large infrastructures (OLT, Galsi TAP)?
- Will IVQ 2013 see the start of gas tenders?

Electricity

- After the golden age for photovoltaic, is it time to invest in biomass?
- How will the introduction of capacity payments and the future regulation on storage impact on margins?
- Will new commercial offers be able to push customers to move from the regulated segments to the free market?

Water

- What will the consequences be from the definitive tariff method (since January 1, 2014)?
- Financing needs to renew grids vs public ownership: is private/public governance the right answer?
- What impacts will be seen on the organizational structure after the new AEEG interventions on unbundling, transparency and service quality?

Waste

- What is the impact of the new waste tax TARES and when will it be introduced?
- What will the governance and business model adopted by the operators for the new concession look like?
- What is the right solution to landfill depletion in terms of financial and environmental sustainability?

Contacts

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