

TECHNICAL SHEET

APPROVAL OF THE WATER TARIFF METHOD FOR THE SECOND REGULATORY PERIOD (MTI-2)

664/2015/R/IDR (*)

With resolution 664/2015/R/IDR, the National Regulatory Authority for Electricity Gas and Water approves the Water Tariff Method for the second regulatory period 2016-2019 (MTI-2), establishing the rules for the calculation of the allowed costs for tariff approval as well as for the identification of macroeconomic and risk-sharing parameters.

This measure, adopted following the outcome of a consultation process (DCO 406/2015/R/IDR and 577/2015/R/IDR) and dedicated meetings, confirms the general configuration of the Water Tariff Method for the first regulatory period, introducing new elements with the purpose of taking into account the need of promoting investments, the sustainability of tariff charges to final users and the introduction of quality improvements, as well as management rationalisation, given the greater complexity of decisions delegated at the decentralized level pertaining to the operators' aggregation processes, resulting from the gradual implementation of the "Sblocca Italia" Decree (decree law no. 133/2014), which, among other things, provided for activation of a unique operator at the Optimal Territorial Level for cases where this has not yet been implemented.

The tariff regulation applied in the second regulatory period is based on the following:

- ✓ a *matrix of regulatory schemes* (6 different schemes) from which each Local Authority selects the most appropriate based on the following:
 - need for investment based on the value of existing infrastructure;
 - changes in the operator's objectives or activities (mainly due to aggregation processes or significant improvements in quality of services provided);
 - amount of operating costs per inhabitant served by the water service operator compared to the average per capita Opex estimated from the year 2014 for the entire sector;
- ✓ a *virtual regulatory scheme*, in cases where, during the aggregation process, the Local Authority does not have information on more than half the population served by the new operator. This scheme allows for the adoption of specific assumptions in the assessment of initial cost components;
- ✓ *specific regulatory conditions*, individually based, which may be applied only when accepting equalization access requests, and have limited pre-set duration.

Resolution 664/2015/R/IDR provides for a *four-year regulatory period term* for the calculation of the tariff multiplier and of the recognized cost components, with a *two-year* update of the RAB value, the updatable qualified operating cost components and any changes regarding the calculation of the interest and tax components. It is also possible to have an *interim* period revision of tariff arrangement upon a justified request based on extraordinary circumstances likely to affect the economic and financial balance.

Tariff multiplier ϑ is confirmed, to be applied to the fixed and variable components of the tariff structure adopted by each operator in the base year 2015, as well as the provision of a cap to the annual increase of the tariff multiplier.

As far as the **exclusion from tariff updating**, the measure provides that, in addition to the cases already in place in the first regulatory period (non-adoption of the Charter of Services, Billing a set minimum water consumption to domestic users, non-delivery of the activity to the designed unique local operator, right to operate a service declared invalid or with a pending court dispute), the following be excluded:

- all operators other than entrusted local ones, terminated *ex lege*, who operate the service in the absence of a legal title compliant with prevailing legislation;
- operators that are not equipped with the means of implementation needed to fulfil verification requirements regarding the quality of water intended for consumption;
- operators that do not pay the Energy and Environmental Services Fund (CSEA) of the specifically established tariff components, including the UI1 component.

In order to determine the actual coverage of the cost components for obtaining funding, in continuity with the previous regulatory period, the National Authority maintains the recognition of only the standard financial and fiscal costs, using a **real risk-free** rate, estimated on the basis of Euro Zone government bond return rates with a ten year maturity and with at least an AA (r_f^{real}) rating, adjusted through the Water Utility Risk Premium (**WRP**), set at 1,5%. In light of current legislation and special characteristics of the water sector, the **ERP** parameter value is confirmed to 4% and of the β parameter to 0.8. On the basis of generally more favourable conditions for obtaining financing, as shown in the latest surveys, the rate of return on assets whose interest is subject to the tax shield (parameter K_d) is expected as a 2,8% value .

In order to favour the realization of priority investments and containing their debt burden, the pre-funding of new investment components is confirmed, providing that the value of the parameter ψ , which quantifies the need for additional funding sources with respect to the revenue from the tariff components covering the cost of fixed assets, may be selected within the 0.4-0.8 range.

As for **operating costs**, the resolution 664/2015/R/IDR maintains the distinction between endogenous and updatable operating costs, introduces a type of Rolling Cap regulation also on water supply costs from third parties and provides - in case of operators integration process or significant improvements in the quality of services - the possibility of recognition of related additional charges, upon justified request by the local government Agency in possession of a valid data set (thus not appealing to the requirements for applying the "virtual regulatory scheme") .

As for **environmental and resource costs**, the new MTI-2 increases the types of charges that can be included in the ERC component, confirming the inclusion of local charges for water resources use and for contributions to *Mountain Communities*, and providing for the gradual enhancement of some operating costs pertaining to water treatment and purification and the reduction of network losses.

As for **arrears costs**, the measure defines the criteria for the recognition in the tariff of a portion (80% of the arrears costs actually incurred by operators), considering the different incidence of the phenomenon across the country, and at the same time incentivizing the adoption of efficient

credit management mechanisms, also taking into account recent arrearage provisions introduced by the so-called “Collegato Ambientale” (Law No. 221), approved definitively by the Chamber of Deputies on 22 December 2015.

The new MTI-2 tariff method also provides incentivizing mechanisms to improve the **contractual and technical quality** of the service, by introducing a rewards/penalties mechanism, funded by a specific tariff component (UI2), mandatory for all operators, to be allocated to a specific quality fund that, to start, will reward Best Practices, thereby promoting the growth of contractual quality levels with respect to the parameters defined by resolution 655/2015/R/IDR.

As for **end user tariffs**, resolution 664/2015/R/IDR delegates to the Local Authorities the possibility of modifying their structure while respecting the rules established by the National Authority (including not increasing or decreasing by more than 10% the tariff revenues for each user category). The resolution also delegates to a subsequent measure the definition of the new charging structure for collection and treatment to be applied to industrial users.

Finally, as in the previous tariff method, the mechanism to overcome any tariff preparation inertia by the relevant local actors is confirmed.

The new criteria are effective starting from **1 January 2016**, so that the Local Authority or other competent body may send to the National Authority all of the documentation (Intervention program, financial plan, operations management agreement, accompanying report, deliberative tariff preparation acts and updating of the necessary data) by 30 April 2016, for approval.

(* This sheet is for disclosure purposes only; it is not a measure.