Tariff and quality regulation in the electricity sector for the fifth regulatory period (FRP)

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Topics

- Timing of the process
- Duration of the regulatory period
- Cost allowance
- Incentives
- Tariffs and allowed revenues

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Timing of the process - 1

DATE	Fifth price control period electricity (transmission and distribution)	Document
October 2014	Launch	Decision 9th October 2014, 483/2014
January 2015	Guidelines	Consultation (DCO) 15th January 2015, 5/2015
February 2015	Technical issues related to quality regulation	DCO 12th February 2015, 48/2015
May 2015	Smart distribution system	DCO 29th May 2015, 255/2015
July 2015	Cost allowance – initial views	DCO 9th July 2015, 335/2015

Timing of the process -2

DATE	Fifth price control period electricity (transmission and distribution)	Document
August 2015	Quality regulation – final views	DCO 6 August 2015, 415/2015
September 2015	Tariffs and allowed revenues – Initial views	DCO 24 September 2015, 446/2015
October 2015	Electricity transmission investments incentives	DCO 1 October 2015, 464/2015
November 2015	Final views	Expected
December 2015	Decision	Expected

Duration of the new regulatory period

- At the beginning of the consultation process (DCO 5/2015 and DCO 335/2015) AEEGSI was oriented to extend the duration of the new regulatory period to **six years** (2016-2021) and to introduce specific interim review mechanisms.

- During the consultation process it has been stressed by operators the necessity to guarantee **regulatory stability** and to have a reasonable period to **develop a new regulatory framework** based on a *totex* approach.

- In DCO 446/2015 AEEGSI modified its initial views . AEEGSI is now oriented to adopt a **4y+4y solution**. **AEEGSI's aim is to maintain a stable regulatory framework, reduce regulatory risk and give the time to properly develop the *totex* approach in the second part of the new regulatory period.**

Operating costs allowance in the first part of the FRP (FRP1)

- In the *FRP1* (2016-2019 in the hypothesis of a 4y+4y solution) proposed operating costs allowance criteria are **mostly similar to those applied in the current regulatory periods**.

- *Operating costs allowance* for year 2016 is to be determined on the basis of costs reported in the regulatory accounts in the test year (2014). Productivity gains achieved during the fourth regulatory period to be symmetrically shared between operators and customers (in continuity of approach).

- Operating costs allowance for the remaining years of *FRP1* is determined on the basis of a *price-cap* formulation.

- *X-factor* for *FRP1* to be set at least with the objective to redistribute to customers productivity gains achieved during the third and the fourth regulatory periods by year 2019.

Cost of capital allowance in the FRP1

- In FRP1 (2016-2019 in the hypothesis of a 4y+4y solution) cost of capital allowance criteria proposed are **mostly similar to those applied in the previous regulatory periods**.
- ***RAB*** is basically determined following a *historical revaluated cost* approach.
- AEEGSI is oriented to reduce the *regulatory lag*. Investments 2015 to be included in 2016 tariffs allowance (and so on).
- AEEGSI has put under assessment current regulatory assets depreciation time in order to check its technical consistency.

TOTEX APPROACH - 1

- AEEGSI proposed in DCO 5/2015 the adoption of a new approach based on total expenditure (*totex*) in the second part of the fifth regulatory period (FRP2).

- *Totex* approach is considered by AEEGSI more efficient compared to the present hybrid approach (*price cap* applied to operating costs and cost of service regulation applied to capital costs).

TOTEX APPROACH - 2

- DCO 335/2015 outlines the key features of *totex* approach:
  - focus on future expenditure;
  - output orientation;
  - stronger incentive to improve total productivity.
- The adoption of a *totex* approach implies giving more relevance to forecast and business plans. Due to information asymmetry, it is therefore necessary to introduce *truth telling* incentives in order to obtain credible business plans from regulated companies.
- *Totex* are generally managed with menus, aimed at combining productivity incentives and truth telling incentives.
- Cost assessment and total expenditure analysis play a key role in the implementation of *totex*.
- The adoption of *totex* requires also to strengthen enforcement, in order to control the actual level of outputs and of expenditure.

INCENTIVES – SMART DISTRIBUTION SYSTEM

- In DCO 255/2015/Reel AEEGSI presented its initial thoughts on new incentives for DSOs (on top of Quality of Service incentives).
- The huge impact of intermittent generation in Italy (27 GW of installed capacity from wind and PV) calls for new investments for "smart distribution systems" selectively in areas where Distributed Generation (DG) is very relevant (focus on in 1/4 of primary substations, whwere reverse power flow from medium to high voltage is observed for non neglectable time in the 2014)
- Until *totex* is introduced, DSO may not have enough willing to invest in new technology due to bias to capital-based investment that increase RAB more than technology-based investment
- As benefits for the system have been assessed, the AEEGSI proposal is to share a part of this system benefit with DSOs
- The new incentive will be output-based, reward-only. It could start on 2016 and should last for the FRP1.
- Call for ideas on possible incentives for urban areas (less DG-impacted).

INCENTIVES – TRANSMISSION

- In DCO 464/2015/Reel AEEGSI presented its initial thoughts on new incentives for TSO (on top of Quality of Service incentives, confirmed).
- AEEGSI strategic objective (see *Strategic Plan 2015-18*, 3/2015/R/eel) is an increased selectivity in investment decisions, based on Total System Benefit. This call for a change in Cost-Benefit Analyis, consistently with EU progress in CBA.
- Output based incentives are deemed to be more efficient as they leave to the most informed party (i.e. TSO) the opportunity to gain from cost savings, in the same time providing a stimulus to reach targets. Some schemes of output based incentives have been presented in consultation.
- Previous input based incentives will be progressively phased out. AEEGSI proposes to keep the previous regime until 2019 (end of FRP1) subject to time and cost estimates already approved. It has been stated intention to reduce extra-WACC (on major investments completed after 2015) from 2% to 1%.

ALLOWED REVENUE IN FRP1 - TRANSMISSION

- **AEEGSI has confirmed the view that transmission revenue cannot be completely exposed to fluctuation of electricity demand**

- At the same time AEEGSI is oriented to reconsider the present revenues guarantee mechanism (see DCO 446/2015)

- AEEGSI is oriented to adopt a more stable (in terms of expected revenue) binomial tariff, with a capacity component and an energy component.

- The adoption of a binomial tariff could be combined with the introduction of a regulatory menu, with solutions differing in terms of risks and returns.

- The idea of a menu is related to the consideration that the possible partial exposition to demand risk requires a higher return on invested capital.

ALLOWED REVENUES IN FRP1 - DISTRIBUTION

AEEGSI is basically oriented to confirm for FRP1 the distribution tariff system characterized by:

- a tariff for final consumers ("tariffa obbligatoria");
- reference tariffs for each distribution company, defining the allowed revenues that cover allowed costs;
- a revenue equalization fund, that allows to cover imbalances between allowed revenues and actual revenues obtained by the application of the tariffs for final consumers.

Also for the electricity distribution service AEEGSI is oriented to introduce regulatory menus, with solutions differing in terms of risks and returns and in terms of different quality requirements.

Thank you

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