

## Italian gas distribution tenders

*An opportunity for utilities companies and infrastructure funds*

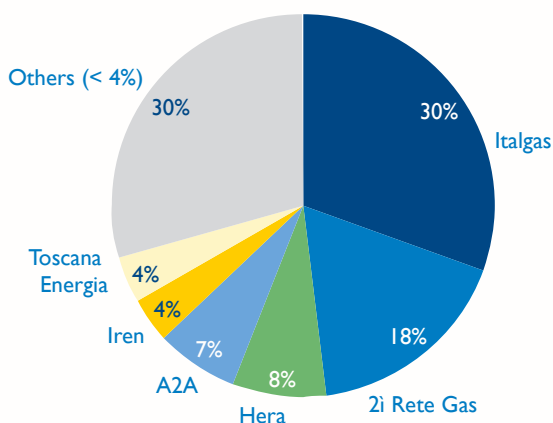


The Italian gas distribution sector is expected to face a new tender season in the short to medium term. All the concessions in the country have been bundled together in order to create ATEMs, concessions larger than the average DSO size. Each ATEM will be awarded after a tendering process. Utilities as well as infrastructure funds thus have a window of opportunity to invest in the Italian market, which is undergoing a consolidation process.

### The Italian gas distribution sector

The Italian gas distribution sector is highly fragmented: the top six DSOs represent ~70% of the existing **22 million delivery points (DPs)**, while the remaining 30% is split among more than **200 players**.

#### Market share (#DPs)



Source: Arthur D. Little analysis on MSE and AEEGSI data

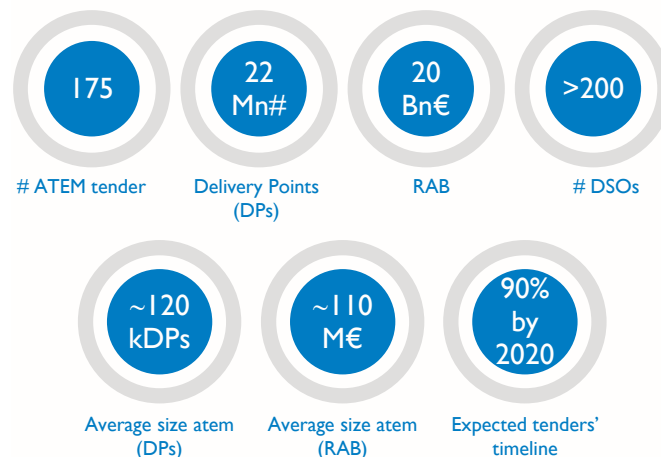
In order to increase companies' efficiency and improve the quality of service delivered, the government decided that consolidation of the sector was required. It introduced the **ATEM concept**: ministerial decree 226/2011 divided the Italian territory into **175 ATEMs** ("minimum concession area") for the next tenders and defined an ATEM tender calendar.

The size of an average ATEM is around 120,000 DPs, 20% more than DSOs' average size (~100,000 DPs).

Few operators are likely to have all of the technical and financial capabilities to be competitive in the upcoming ATEM tenders. (E.g., bidders should manage at least 50% of ATEM DPs to participate to the tender.)

On the other hand, in the majority of ATEMs (~70%), the **first DSO** ("incumbent") **manages more than 50% of DPs**. Market share represents one of the main entry barriers for future tenders: the greater the incumbent's capabilities and willingness to retain the ATEM, the lower the ATEM's contestability.

#### Key numbers



Source: Arthur D. Little analysis on MSE and AEEGSI data

The **total value of the Regulatory Asset Base (RAB)** that will be renegotiated through ATEM tenders is estimated at around **€20 billion** (about €110 million per ATEM).

This scenario will impact the market in two main ways:

- The number of active operators is expected to decrease sharply after the next round of tenders.
- Several operators will be looking for financial and industrial partners to increase their likelihood of success.

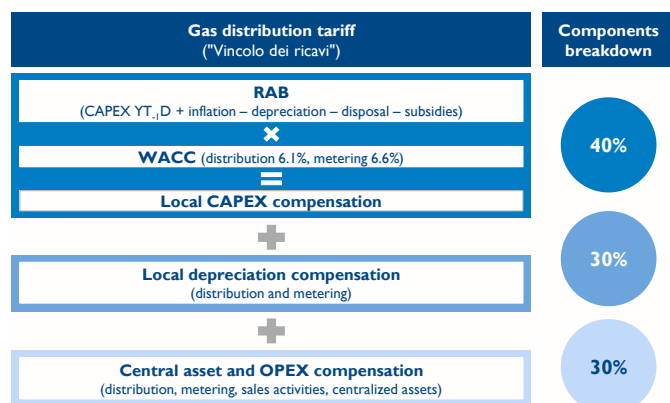
## The Italian regulatory framework...

The gas distribution concessions' regulatory framework – recently completed by the regulator and the Ministry of Economic Development (MSE) – is based on the following pillars:

- Clear rules for **tariff calculation**: six years regulatory period (ending 2019) and asymmetric regulation to increase competition
- A **standardized tender process** (DM 226/11) in terms of technical and financial requirements, awarding criteria, offer structure and employment safeguard clause
- A defined **tender timeline**: the first round of ATEM tenders has already started – with some delay
- **Standard guidelines** to calculate outgoing DSOs' asset reimbursement values ("VIR") when not otherwise specified in concession agreements

The current **tariff calculation** model is based on parametric remuneration of OPEX/central assets and allowed return for local distribution and metering assets (RAB).

## Revenues model



Source: Arthur D. Little analysis on MSE and AEEGSI data

The regulatory period for the WACC will last six years, in place until the end of 2021, with a mid-review effective in 2019.

To create more intense competition in the bidding process, the authority introduced an **"asymmetric regulation"** in the definition of the tariff rules that are applicable to the new ATEM concessions:

- For the share of ATEM acquired from outgoing DSOs, tariffs will be calculated on the basis of the VIR effectively paid (instead of the RAB previously recognized for the municipalities within the ATEMs): "real money spent, real money recognized in tariff"
- For the share of the ATEM already managed by the concessionaire, tariffs will be calculated on the basis of the previous RAB (CAPEX remuneration continues as before).

In both of these cases, at the end of the 12-year ATEM concession the DSO will have the right to cash-in the VIR (inflated and depreciated) plus the CAPEX made in the concession period (inflated and depreciated).

For the coming regulatory period, the tariff calculation model is expected to switch to a new mechanism based on **standard prices and an output-based model** in order to increase the "cost-benefit" balance for the customer (new consultation document – DCO 456/2016).

The **original tendering schedule** has been delayed, but most municipalities are expected to publish the tenders during the next three years (2017–2019). As of today:

- Less than 15 calls for tender have been published, a stark difference from the 74 originally planned
- The first tender – ATEM Milano 1 - ended the preparation phase with two participants, a2a (the outgoing concessionaire) and 2i rete gas

In this scenario, DSOs will have to manage multiple bids at the same time; larger operators will thus have a competitive advantage in terms of financial and technical capabilities.

## ...will drive the consolidation process

In the coming years, more than 6,800 concessions will be aggregated into 175 ATEMs, which will go through a regulated tendering process. At the same time, the number of DSOs is expected to decrease from around 200 to 40 by the end of the process.

Several DSOs have already declared their willingness to find partners and announced and/or finalized joint-venture agreements with Italian or foreign investors: Erogasmet/Osaka Gas JV (Osaka fully subscribed €75 mln of Erogasmet's capital increase), Lario Reti (looking for a partner in the gas distribution and energy retail business), Agam Alessandria (looking for a financial partner), Cogeser (looking for a partner to participate in the Milano 4 tender), Ascopiave/AEB-Gelsia (MoU to merge business units), Salerno Energia Distribuzione (looking for a partner to participate in five ATEM tenders in Southern Italy), Amgas Bari (looking for a partner to participate in the Bari 1 tender).

## Expected post-tenders competitive scenario

From around 200 Operators... ...to around 40 Operators



Source: Source: Arthur D. Little analysis

Industrial and financial partnerships represent a key factor in strengthening incumbents' own technical and financial competitiveness in an attempt to ward off potential rivals.

## The ATEM tender process

Ministerial Decree 226/2011 defined a standard tender process in terms of procedure, awarding criteria and timeline.

However, before entering into the tender process, the DSO must have a clear view about the ATEMs it wants to compete in (or exit from) and how aggressive its offer will be. For this purpose, target ATEMs need to be identified and ranked on the basis of a list of selection criteria.

Some of the typical **selection criteria** used to rank ATEMs' attractiveness are:

- **ATEM market share:** the greater the Incumbents' share in an ATEM, the greater the financial barriers and the DSO's technical knowledge of the ATEM.
- **VIR-RAB:** the difference between VIR and RAB is subject to a discount in the economic offer; ATEMs in which the difference is large are less attractive because the economic offer is more expensive (especially for the incumbent).
- **Competition:** ATEMs in which competition is expected to be low are more attractive from an economic point of view.
- **Geographical contiguity:** economies of scale and efficiency are positively correlated with ATEM contiguity and combination with other businesses (e.g. electricity distribution and water).
- **Publication date:** technical and financial capabilities are limited, and some ATEMs could or could not be selected depending on the timing.
- **Profitability:** in terms of IRR, NPV, EBITDA margin, etc., some ATEMs can be more profitable than others due to a balanced mix of factors.

Most of these criteria are based on estimated data that will be finalized only when tenders are published. A successful strategy would, first of all, be a "rolling-based" strategy that could evolve according to new data and information.

## Tender process



Source: Arthur D. Little analysis

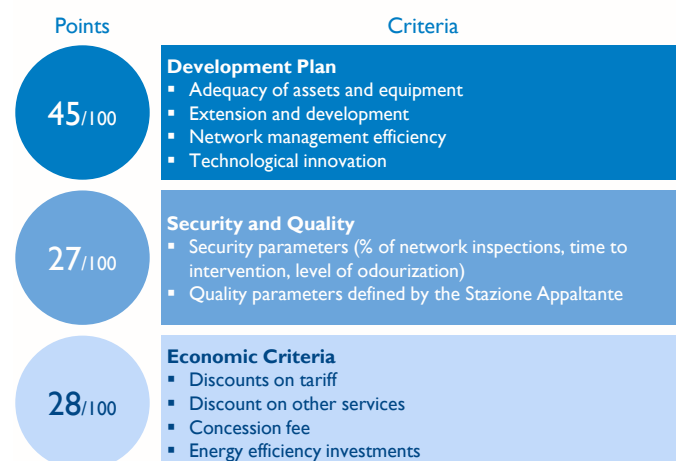
The **bid preparation** phase is expected to last six to eight months, though the deadlines of the first tenders already published have been postponed for several reasons.

In our experience, some key success factors for the offer preparation phase can be identified:

- Preliminary definition of team, role and responsibilities, as well as project management tools.
- Technical skills and good knowledge of an ATEM's peculiarities in order to develop a high-quality development plan.
- Clear understanding of the competition level to optimize the economic offer.

The **bid evaluation** is based on a standard scoring system mainly focused on technical criteria (development plan and level of quality and security).

## Awarding system



The final step is represented by the **asset transfer** from the outgoing concessionaire to the new one. Disputes mainly related to the residual value of the assets and to the quality parameters of the awarding criteria may come from unsuccessful bidders.

After the transfer of the assets to the new concessionaire, a **post-merger integration process** has to be managed to minimize inefficiencies and to achieve economies of scale:

- Asset portfolio reorganization and data migration between the IT/accounting systems
- “New” personnel hiring and training process
- Process and organization reengineering

## Opportunities for utility companies and infrastructure funds

In this scenario, several Italian DSOs could have the chance to exploit their assets by either exiting the business (at a value between RAB and VIR) or looking for an industrial/financial partner to participate in target ATEM tenders.

Investors can leverage this tender-season opportunity to enter the Italian gas distribution sector, which is characterized by the following main elements:

- Clear and stable regulatory framework
- Ongoing consolidation process with an opportunity to achieve significant economies of scale
- Huge CAPEX plan to be developed for each ATEM (smart meters and grid renewal)
- Predictable cash flow during ATEM concession and final value after 12 years
- Dividend flows expected to start later in the concession period due to CAPEX plan
- Debt/RAB ratio around 60%
- Profitability strictly linked to offer conditions

Arthur D. Little has worked with several gas distribution companies, helping them with strategic, regulatory, operational and technical topics, as well as M&A transactions (buy side and sell side).

Thanks to our experience, ADL is the right partner to help investors in addressing this opportunity by assisting in the following main areas:

- Market analysis and scouting
- Regulatory analysis
- Business due diligence
- Technical due diligence (including VIR assessment)
- Business plan and valuation
- Transaction support

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## Arthur D. Little

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