

# Elements of risk and uncertainty



## Introduction

This chapter illustrates the main uncertainties that characterise Snam's routine operations, in spite of most of them being regulated and therefore exposed to regulatory and compliance risk, all types of risk relating to the business operations that are the subject of careful analysis.

The main risks identified by Snam are classified in the following categories:

- strategic
- legal and non-compliance
- operational
- financial

## STRATEGIC RISKS

### Regulatory and legislative risk

**Regulatory and legislative risk** for Snam is closely linked to the regulation of activities in the gas sector. The relevant directives and legal provisions issued by the European Union and the Italian government and the resolutions of the Energy, Networks and Environment Regulatory Authority (ARERA) and the National Regulating Authorities of the countries in which the foreign affiliates operate and, more generally, changes to the regulatory framework may have a significant impact on the Company's operating activities, financial position and results. It is not possible to predict the effect that future changes in legislative and fiscal policies could have on Snam's business and on the industrial sector in which it operates. Considering the specific nature of its business and the context in which Snam operates, changes to the regulatory context with regard to criteria for determining reference tariffs are particularly significant.

### Macroeconomic and geo-political risk

Because of the specific nature of the business in which Snam operates, there are also **risks associated with political, social and economic instability in natural gas supplier countries**, mainly related to the gas transportation sector. Most of the natural gas transported in the Italian national transportation network is imported or moved through countries in the MENA area (Middle East and North Africa, particularly Algeria, Tunisia, Libya and, in terms of the TANAP-TAP, Turkey along with the states bordering the Eastern Mediterranean) and in the former Soviet bloc (Russian Federation, Ukraine and in the future, Azerbaijan and Georgia), nations subject to political, social and economic instability which could evolve into potential crisis scenarios in the future.

In particular, the import and transit of natural gas from/and through these countries are subject to an extensive set of risks, including: terrorism and common crime, changes in political-institutional balances; armed conflict, socio-political and ethno-sectarian tensions; disorder and unrest; inadequate legislation on insolvency and creditor protection; limits on investment and the import and export of goods and services; introduction of and increases in taxes and excises; forced renegotiation of contracts; nationalisation of assets; changes in trade policies and monetary restrictions.

If a Shipper using the transportation service via Snam's networks cannot procure the transportation of natural gas from/or through the aforementioned countries because of said adverse conditions, or in any way suffers from said adverse conditions, to an extent such so as to determine or incentivise the consequential inability to fulfil contractual obligations towards Snam, this could have negative effects on the Snam Group's operations, results, balance sheet and cash flow; these risks also directly influence the results of SNAM's investment in TAP.

### Commodity risk associated with changes in the price of gas

With reference to the **risk connected with changes in the price of natural gas**, however, pursuant to the regulatory framework currently in force, changes in the price of natural gas to cover Fuel Gas and network leakages do not represent a significant risk factor for Snam, since all gas for its core activities is provided by Shippers in kind. Similar coverages of risk are guaranteed by the regulations of countries in which the foreign affiliates operate or the relative transportation contracts. However, in relation to transportation activities, the Energy, Networks and Environment Regulatory Authority (ARERA) has defined, starting with the third regulatory period (2010-2013), procedures for payment in kind, by users of the service to the leading transportation company, of quantities of gas to cover

unaccounted-for gas (UFG), due as a percentage of the quantities respectively injected into and withdrawn from the transportation network. Specifically, the Authority, by means of Resolution 514/2013/R/gas, defined the permitted level of the UFG given the average value registered over the last two years, and decided to keep this amount fixed for the entire regulatory period in order to incentivise the main transmission system operator to deliver further efficiency improvements. This approach was subsequently confirmed for the years 2018 and 2019 of the transition period as well. For the relevant regulatory period, amounts of UFG higher than the permitted level would not be compensated. In view of the aforementioned mechanism for the payment in kind of UFG, there is still uncertainty about the quantities of UFG withdrawn over and above the quantities paid in kind by the users of the service. The change in the regulatory framework currently in force on the payment in kind of natural gas could have negative effects on the Snam Group's operations, results, balance sheet and cash flow.

### Market risk

With reference to the **risk connected with demand for gas**, based on the tariff system currently applied by the Authority to natural gas transportation activities, Snam's revenue, via its directly controlled transportation companies, is partly correlated to volumes transported. However, the Authority has introduced a mechanism to guarantee the portion of revenues correlated to volumes transported. This mechanism provides for the reconciliation of revenues more than 4% higher or 4% lower than the reference revenues correlated to volumes transported. Under this mechanism, approximately 99.5% of total revenue from transportation activities is guaranteed. Based on the tariff system currently applied by the Authority to natural gas storage activities, Snam's revenue, via Stogit, correlates to infrastructure usage. However, the Authority has introduced a mechanism to guarantee reference revenue that allows companies to cover a significant portion of revenues recorded. For 2016 and 2017, the minimum guaranteed level of revenue recorded was approximately 97%. The Authority is reviewing an integration of such mechanism which, for subsequent years, will result in reliance on the guaranteed minimum level of revenue, as well as the storage company's efficiency in terms of managing capacity allocation procedures and service provision procedures, following a procedure launched by the Authority. The change to the regulatory framework in force could have negative effects on the Snam Group's operations, results, balance sheet and cash flow. Abroad, protections from market risk are offered by French regulations and by long-term contracts of TAP, IUK (expiring in September 2018) and Austria (differentiated expiries for TAG And GAS Connect starting from 2023); in Austria and the United Kingdom (with respect to Interconnector), regulations do not guarantee coverage of volume risk.

### Climate change risk

Compliance with greenhouse gas regulations in the future may require Snam to adjust its facilities, and to control or limit its emissions or undertake other actions that could increase the costs of complying with the regulations in force, and therefore have negative effects on the Snam Group's operations, results, balance sheet and cash flow.

The **risks connected with the emissions market** fall within the scope of the European Union Directives on the sale of permits relating to carbon dioxide emissions and the rules on controlling emissions of certain atmospheric pollutants. With the launch of the third period of the EU emissions trading system and regulatory period (2013-2020), the main aim was to update laws on greenhouse gas emission authorisations and to continually reduce free emission allowances. The allowances are assigned to each plant on a gradually decreasing basis, and are no longer constant, and also depend on the actual functionality of the plants. The further evolution under way in European regulations could result in the identification of new methods for managing the necessary allowances, in particular through possible bonus mechanisms, to be agreed upon with the Authority, for the reduction of emissions from owned plants.

Climate change scenarios could trigger a change in people's conduct and have an impact on natural gas demand and on volumes transported, and could also influence the development of alternative uses of gas and the promotion of new businesses.

Climate change could also increase the severity of extreme weather events (floods, droughts, extreme temperature fluctuations), worsening natural and hydro-geological conditions in some areas with a possible impact on the quality and continuity of the service provided by Snam as well as on Italian and European gas demand. With reference to the effects of changes in gas demand on the balance sheet, income statement and cash flows of the Snam Group, please refer to the "Market risk" section above.

## LEGAL AND NON-COMPLIANCE RISK

**Legal and non-compliance risk** concerns failure to comply, in full or in part, with the European, national, regional and local rules and regulations with which Snam must comply in relation to the activities it carries out. The violation of such rules and regulations may result in criminal, civil and/or administrative sanctions, as well as damage to Snam's balance sheet, financial position and/or reputation. As regards specific cases, the infringement of regulations on the protection of workers' health and safety and of the environment, and the infringement of anti-corruption rules, inter alia, may also result in (possibly significant) sanctions on the Company based on the administrative responsibility of entities (Legislative Decree 231 of 8 June 2001). With regard to the **Risk of Fraud and Corruption**, Snam believes it is of vital importance to ensure a climate of fairness and transparency in corporate operations and repudiates corruption in all its forms in the widest context of its commitment to abiding by ethical principles. Snam's top management is strongly committed to pursuing an anti-corruption policy, trying to identify possible areas of vulnerability and eliminating them, strengthening its controls and constantly working to increase employees' awareness of how to identify and prevent corruption in various business situations.

Reputational checks and accepting and signing the ethics and integrity agreement are pillars of the control system designed to prevent the risks associated with illegal behaviour and criminal infiltration of our suppliers and subcontractors, with the goal of guaranteeing transparent relations and professional morality requirements throughout the production chain and for the entire duration of the association; in this context in 2017, during the "Snam 75 & Partners' Day" event, Snam dedicated a special area to the subject of ethics and transparency as excellence and innovation in business operations.

Snam has been working since 2014 in partnership with Transparency International Italia and joined the Business Integrity Forum (BIF) and, in 2016, became the first Italian company to join the Global Corporate Supporter Partnership.

In the course of 2017, Snam started to work with the OECD as the first Italian private sector company on the Business and Industry Advisory Committee (BIAC).

Snam also partnered with the Ministry of Foreign Affairs, participating in the "VIII Italy - Latin America and Caribbean Conference" and the "Italian Business Integrity Day" held at the Italian Embassy in Washington.

During these events, the company described the instruments enacted on transparency and the fight against corruption.

In the first half of 2018, Snam continued with its collaboration with Transparency International Italia and with the OECD, participating in a series of events dedicated to the matter of transparency and integrity as well as the best practices of good governance and the prevention of corruption at global level, such as the 27th Session of the United Nations Commission on Crime Prevention and Criminal Justice organised by the Ministry of Foreign Affairs and International Cooperation at the United Nations headquarters in Vienna and seminars organised by the OECD in Saint Petersburg and Moscow, taking part with respect to the subjects of integrity and the fight against corruption.

## OPERATIONAL RISKS

### Gas storage concessions

The risk linked to **maintaining storage concessions** is associated for Snam to the business in which the subsidiary Stogit operates on the basis of concessions provided by the Ministry of Economic Development. Eight of the ten concessions (Alfonsine, Brugherio, Cortemaggiore, Minerbio, Ripalta, Sabbioncello, Sergnano and Settala) expired on 31 December 2016 and can be renewed no more than twice for a duration of ten years each time. With regard to these concessions, Stogit submitted – within the statutory terms – the extension request at the Ministry of Economic Development and the proceedings are currently pending before the Ministry. Pending said proceedings the Company's activities, as provided for by the reference regulations, will continue until the completion of the authorisation procedures in progress envisaged by the original authorisation, which will be extended automatically on expiry until said completion.

One concession (Fiume Treste) will expire in June 2022 and has already been renewed for the first ten-year extension period in 2011, and another concession (Bordolano) will expire in November 2031 and can be extended for a further ten

years<sup>35</sup>. If Snam is unable to retain ownership of one or more of its concessions or if, at the time of the renewal, the concessions are awarded under terms less favourable than the current ones, there may be negative effects on the Company's operations, results, balance sheet and cash flow.

### Malfunctioning and unforeseen interruption of the service

The risk of the **malfunctioning and unforeseen interruption of the service** is determined by accidental events, including accidents, breakdowns or malfunctions of equipment or control systems, reduced output of plants, and extraordinary events such as explosions, fires, earthquakes, landslides or other similar events outside of Snam's control. Such events could result in a reduction in revenue and could also cause significant damage to people, with potential compensation obligations. Although Snam has taken out specific insurance policies to cover some of these risks, the related insurance cover could be insufficient to meet all the losses incurred, compensation obligations or cost increases.

### Delays in the progress of programmes involving the construction of infrastructure

There is also the concrete possibility that Snam could incur **delays in the progress of infrastructure construction programmes** as a result of several unknowns linked to operating, economic, regulatory, authorisation and competition factors, regardless of its intentions. Snam is therefore unable to guarantee

that the projects to upgrade and extend its network will be started, be completed or lead to the expected benefits in terms of tariffs. Additionally, the development projects may require greater investments or longer timeframes than those originally planned, affecting Snam's financial position and results.

Investment projects may be stopped or delayed due to difficulties in obtaining environmental and/or administrative authorisations or to opposition from political forces or other organisations, or may be influenced by changes in the price of equipment, materials and workforce, by changes in the political or regulatory framework during construction, or by the inability to obtain financing at an acceptable interest rate. Such delays could have negative effects on the Snam Group's operations, results, balance sheet and cash flow. In addition, changes in the prices of goods, equipment, materials and workforce could have an impact on Snam's financial results.

### Environmental risks

Snam and the sites where it operates are subject to laws and regulations on pollution, environmental protection and the use and disposal of hazardous substances and waste. These laws and regulations expose Snam to potential costs and liability connected to operations and its assets. The costs of possible environmental restoration obligations are subject to uncertainty as regards the extent of the contamination, the appropriate corrective actions and the sharing of responsibilities and are therefore difficult to estimate.

In relation to new climate-related agreements entered into at a global level (the Paris 2015 COP21, the Marrakech 2017 COP22) intended to favour the transition to a more sustainable economy which favours zero-emission energy sources, there could be regulatory and legislative risk correlated with the possible implementation of increasingly stringent legislation at European and domestic level.

Snam cannot predict whether and in what manner regulations and environmental laws may become stricter over time, nor can it provide assurances that future costs to ensure compliance with environmental regulations will not increase or that such costs may be recoverable within applicable tariff or regulation mechanisms. Substantial increases in costs relating to environmental compliance and other related aspects and the costs of possible penalties could negatively impact the business, operating results and financial and reputational aspects.

### Employees and personnel in key roles

Snam's capacity to carry out its business effectively depends on the abilities and performance of its staff. The loss of "key" personnel or the inability to attract, train or retain qualified personnel (particularly for technical positions in which the availability of appropriately qualified personnel may be limited) or situations in which the capacity to implement the

<sup>35</sup> The Stogit concessions issued prior to the entry into force of Legislative Decree 164/2000 may be extended by the Ministry of Economic Development no more than twice, for a duration of 10 years each, pursuant to Article 1, paragraph 61 of Law 239/2004. Pursuant to Article 34, paragraph 18 of Decree-Law 179/2012, converted by Law 221/2012, the duration of the single Stogit concession issued after the entry into force of Legislative Decree 164/2000 (Bordolano) is 30 years, with the possibility of extension for another 10 years.

long-term business strategy is influenced negatively due to significant disputes with employees could trigger an adverse effect on the business, financial conditions and operating results.

### Risk linked to foreign equity investments

Snam's investee companies abroad may be subject to regulatory/legislative risk, conditions of political, social and economic instability, market risks, and the cybersecurity, credit and financial and other risks typical of the natural gas transportation and storage segments identified for Snam such so as to negatively influence their operations, economic results, balance sheet and cash flows. For Snam, this could have negative impacts on the contribution to profit generated by such investments.

### Cyber security

Snam carries out its activities through a complex technological architecture relying on an integrated model of processes and solutions capable of promoting the efficient management of the gas system for the entire country. The development of the business and recourse to innovative solutions capable of continuous improvement, however, requires increasing attention to be focused on aspects of cybersecurity.

For this reason, Snam has developed its own cybersecurity strategy based on a framework defined in accordance with standard principles on the subject and focusing constant attention on Italian and European regulatory developments, especially as far as the world of critical infrastructures and essential services is concerned. First and foremost, this strategy involves adapting one's own processes to the provisions of standards ISO/IEC 27001 (Information Security Management Systems) and ISO 22301 (Business Continuity Management Systems) and the formal certification of conformity to the listed standards.

Alongside this and in accordance with technological developments, solutions aimed at protecting the Company from the cyber threats and malware are assessed and, where deemed appropriate, implemented. More specifically, Snam has defined a cyber-security incident management model intended to prevent and, when necessary, guarantee prompt remediation against events potentially capable of harming the confidentiality, integrity and availability of information processed and the IT systems used. At the basis of these activities is a Security Incident Response Team which, by relying on technologies that make it possible to collect and correlate all security events recorded throughout the company's IT infrastructure, has the task of monitoring all anomalous situations that could have negative impacts for the company and activate, when necessary, suitable escalation plans to guarantee the involvement of the various operating structures. Information sharing with national and European institutions and peers is used in order to improve the capacity and speed of response following various possible negative events.

A great deal of attention is also paid to increasing awareness and specialist training of personnel, in order to facilitate the identification of weak signals and raising consciousness about risks of a cyber-nature that could occur during the course of normal work activities.

**Financial risks** are described in Note 20, "Guarantees, commitments and risks – financial risk management", of the Notes to the condensed interim consolidated financial statements.