JOHN COOK ON ENI/SRG: DECONSOLIDATION FROM A LEGAL PERSPECTIVE

1. I have been asked by Knight Vinke to advise on the provisions of Directive 2009/73/EC ("the Directive"), its 3 alternatives, its application in Member States and the position of Eni and Snam Rete Gas ("SRG") in the context of the Directive. In what follows, I start with a brief background to the Directive and then I set out my opinion below.

2. For many years the European Commission has had major concerns at the ability and propensity of vertically-integrated energy groups (often state-owned) to act in anti-competitive, not transparent, and discriminatory ways to deter new entry, protect incumbents' dominance, and stifle competition. The 2006 energy sector report, coupled with high profile investigations under the EC Competition Rules, reinforced the Commission's concerns. These concerns led the European Commission to propose a more radical Directive with the overriding objective of ensuring that producers, suppliers and network operators acted independently and in their own best commercial and financial interests. To achieve this, the Directive required ownership unbundling (i.e., separation of the ownership of producers and suppliers from that of network operators). The essence of this ownership unbundling is the breaking down of control over network operators to ensure that they act independently (Art. 9.1 of the Directive).

3. However, because ownership unbundling would, in some cases, have compelled privatisation, contrary to the EC Treaty, the European Commission developed an alternative which allows common ownership to continue, but requires the network operator within a vertically-integrated energy group to be established, governed, financed, and managed as an entirely independent entity: the Directive prescribes a number of features and safeguards which guarantee that a network operator is free from influence and control of other group companies.

4. The features and safeguards are set out in Chapter IV of the Directive and contain identical characteristics to those developed in the context of EC Merger Control by which the European Commission judges whether one company has control over another. The Directive adopts the definition of "control" from the EC Merger Regulation to mean decisive influence, i.e., the ability to determine the commercial and financial strategy of a company.

5. The Directive requires Member States to restructure their natural gas sectors so as to separate the gas transportation and storage businesses from all other activities in the gas sector. Under the Directive, there are three ways in which this can be effected:

   Option 1. by ownership unbundling to create structurally separate businesses;

   Option 2. by maintaining vertical integration (common ownership) but by placing the gas transmission activities into an "independent transmission company" or by ring-fencing with the same result;

   Option 3. by showing that on 3 September 2009 (when the Directive became law in the EU) arrangements already existed in the relevant Member State to "guarantee more effective independence of the transmission system operator" than under the Directive.

6. I believe whether the option 1, 2, or 3 is chosen, the same result must be achieved – that Eni does not control SRG. In practice, options 1 and 2 are the only alternatives that can be adopted in Italy. Option 1 would require

separation of SRG and Eni. The implications of option 1 are clear. I have focused therefore on the implications of option 2 in what follows below.

7. The Directive lays down certain essential elements to establish the independence of the transmission system operator ("TSO"):
   a. The TSO must be self-sufficient and self-standing – Art.17
   b. The TSO must function in all respects as a TSO – Art.17
   c. The TSO must have independent decision-making powers
   d. The TSO shall not discriminate against different persons or entities and shall not restrict, distort or prevent competition in production or supply – Art.18
   e. The TSO must have independent management and employees – Art.19
   f. The TSO must have a supervisory body[1] – Art.20
   g. The TSO must have a compliance program and compliance officer to ensure its independence – Art.21
   h. The TSO must have the freedom to develop and invest in its system (including to raise finance on the capital markets and to pursue its own 10 year strategic plan).

8. The essential requirement in the Directive, as far as option 2 is concerned, is that gas transportation and storage businesses should not be under the control of an entity that is also engaged in the production and/or supply of natural gas. "Control" for this purpose is defined in the Directive (Art.2(36)) in exactly the same terms as in the EC Merger Regulation, i.e., "the possibility of exercising decisive influence"[2]. In other words, regardless of the option that the Italian authorities choose under the Directive, my view is that Eni would lose control over SRG when it is implemented: in the case of option 1 because Eni would no longer own shares in SRG and in the case of option 2 because it would have to ensure that SRG was independent in the sense of having to meet the requirements described in paragraph 7 above.

9. I have read the advice of Dr. Livne, who points out that Eni and SRG as listed Italian companies must use IFRS when publishing their consolidated financial statements. Dr. Livne points out that under IAS 27, companies must consolidate entities over which they exercise "control". This is defined in IAS 27 as the "power to govern the financial and operating policies so as to obtain benefits from its activities". A company which ceases to have "control" over another is no longer in a position to consolidate the other entity. A majority shareholding in another company would normally be regarded as evidence of control but the presumption is rebuttable. The question that arises is whether "control" in IAS 27 has the same meaning as "decisive influence" under the Directive. In my opinion, the meaning of "control" in IAS 27 is an identical concept to "decisive influence" as set out in the Directive.

10. It follows that the implementation of the Directive would have accounting consequences: if the Italian authorities were to implement option 1, Eni and SRG would no longer be part of the same group and they would account for their activities separately. If the Italian authorities were to implement option 2, Eni would no longer have the power to govern the financial and operating policies of SRG and therefore would lose its dominant influence (or control) over SRG – even if it continued to hold the majority of SRG's shares. The Directive must be implemented in such a way as to ensure that SRG's decision-making powers eliminate Eni's

[1] Under the Directive a (newly created) Supervisory Body appoints the management of the network operator and not the vertically integrated undertaking such as Eni, and, although the vertically integrated undertaking may have a single person majority of representatives in the Supervisory Body, decisions have to be both notified and approved by the regulatory authority to be identified pursuant to the Directive

[2] Article 3 of EC Merger Regulation

ability to use its shareholding to govern SRG's financial and operating policies and thereby obtain benefits. The consequence of this is discussed in Dr. Livne's advice.

11. It should be noted that there is no specific provision in the Directive requiring vertically integrated gas groups (such as Eni) to deconsolidate their gas transportation and storage activities. The Directive does not confer a specific right to that effect on individuals, in contrast, for example, with the duty of a TSO not to discriminate in favour of group companies (Directive Art. 13.1 (b)) which will be enforceable against the TSO irrespective of the steps taken (or not taken) by Member States to implement the Directive. It is the change in status of the gas transportation and storage businesses (i.e., when they become independent TSOs in the case of option 2) which takes away the power of the vertically integrated groups to control these businesses and this, as Dr. Livne points out, has an impact on their financial statements.

John Cook

26 April 2010

DR. LIVNE ON ENI/SRG: DECONSOLIDATION FROM AN ACCOUNTING PERSPECTIVE

Introduction

1. I have been asked by Knight Vinke to advise on whether Eni would have to deconsolidate Snam Rete Gas SpA ("SRG") given the provisions of Directive 2009/73/EC ("the Directive").

2. At present Eni holds a majority of the voting shares of SRG and consolidates its results. If the Directive is implemented by the Italian authorities by way of Option 1 (as described in John Cook's Advice to Knight Vinke dated 26 April 2010), then Eni would no longer hold shares in SRG and would not be required to consolidate SRG's results when presenting its own consolidated financial statements.

3. This paper focuses on the accounting implications of Option 2 (as set out in John Cook's Advice). In this paper, I consider:
    a. the accounting principles that govern the requirement to present consolidated financial statements;
    b. the impact of the implementation of the Directive on the control relationship, if any, between Eni and SRG

The relevant accounting principles

4. Both Eni and SRG, as listed companies in the EU, are subject to the requirements of Regulation (EC) No 1606/2002 of the European Parliament and of the Council which requires them to comply with "adopted international accounting standards" published by the IASB. To the extent that any conflict arises between accounting principles in Member State law (in this case Italian law) and those set out in the adopted international accounting standards, it is settled law that the EU Regulation prevails. The EC press release (IP/02/827, 7th June 2002) issued at the time that the Regulation was published states that "unlike Directives, EU Regulations have the force of law without requiring transportation into national legislation." I therefore have focused this discussion entirely on the accounting principles set out in the adopted international accounting standards.

5. The overriding requirement for all published financial statements under international accounting standards is set out in IAS 1.15, which states (emphasis added):

> **"… Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation ..."**

6. In this case the relevant accounting principles are set out in IAS 27 ("the Standard"). The overriding principle set in the Standard is that a reporting company should consolidate the results of all other companies which it controls when presenting its financial statements. "Control" is defined in IAS 27.4 as

"… **the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities** …"

7. There are no specific indicators or guidelines in IAS 27 as to what it takes to govern financial and operating activities of an entity, and what such activities may be and so this is open to interpretation. As an example, Ernst & Young's guide to the revised IFRS 3 and IAS 27 suggests the following:

   a. Operating policies generally would include those policies that guide activities such as sales, marketing, manufacturing, human resources, and acquisitions and disposals of investments.

   b. Financial policies generally would be those policies that guide dividend policies, budget approvals, credit terms, issue of debt, cash management, capital expenditures and accounting policies.

8. It is the concept of control that is determinative of consolidation and there is a presumption in the Standard (IAS 27.13) that holding more than 50% of the voting rights of a company implies control – but this is a rebuttable presumption. For example, the Standard states that:

   a. "Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control." The Standard, however, does not elaborate on what constitutes exceptional circumstances in this case;

   b. conversely, where a reporting company ("A") owns 50% or less than 50% of the voting shares of another company ("B"), A must consolidate the results of B if it has control. The Standard lists a number of examples where a company holding less than 50% of the voting shares of another is nevertheless deemed to control it;

   c. this concept of control may become more encompassing in the future if new exposure draft ED 10 is adopted. ED 10 introduces the term "dominant shareholder" when considering whether or not consolidation should take place. ED 10 states (**emphasis added**):

      "… For example, a reporting entity can have the power to direct the activities of another entity **if the reporting entity is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed** and are not organised in such a way that they actively co-operate when they exercise their votes so as to have more voting power than the reporting entity …"

9. If adopted, ED 10 may make it more difficult for reporting companies with significant shareholdings in other companies to argue that they do not have control and therefore should not consolidate the results of the companies in which they hold significant shareholdings in their own financial statements.

10. The key issue in both IAS 27 (and ED 10) is the existence or lack of control. This should be based on the evidence, regardless of the level of the shareholding. I note from John Cook's opinion that the concept of control in IAS 27 (and ED 10) is in practice identical to that set out in the Directive, which is also the same as the concept of control in the EC Merger Regulation (see paragraph 8 of John Cook's Advice).

11. Given this, I believe that if control exists (or does not exist) under the EU Merger Regulation or the Directive, the outcome of the accounting decision with respect to control under IAS 27 (or ED 10) is likely to be the same.

12. Nevertheless, if Eni were to keep a majority shareholding, for Eni to deconsolidate SRG it will have to argue that, following the implementation of the requirements of the Directive, results in an exceptional circumstance, as per IAS 27.

The impact of the Directive on Eni and SRG

13. I now turn to the question of the likely impact of the Directive on Eni and SRG. In particular, I consider the appropriate accounting treatment that Eni should follow if the Directive is implemented by way of option 2 as set in John Cook's advice, assuming no change in Eni's shareholding in SRG.

14. Since the Directive has not yet been implemented in Italy, in the discussion below I assume that it will be implemented in a way that gives full effect to the principles embodied in the Directive (as set out by John Cook in paragraph 7 of his advice). The relevant principles from an accounting perspective appear to be the following:

    a) The TSO must be self-sufficient and self-standing;
    b) The TSO must have independent decision-making powers;
    c) The TSO must have independent management and employees;
    d) The TSO must have freedom to develop and invest in its system (including to raise financing on the capital markets and to pursue its own 10 year strategic plan); and
    e) The TSO must operate in a non-discriminating manner with respect to all users of its services whether or not they are shareholders.

15. Considering each of these in turn I note:

    a. The self-sufficiency and self-standing principle, if met, suggests to me that Eni will not be able to control SRG's decisions through, for example, the provision of finance;

    b. The principle that SRG should have decision-making capacity that is independent of Eni also seems to me to go a long way to demonstrate a loss of control by Eni. This will certainly be the case if, as John Cook states, the Directive must be implemented in such a way as to ensure that SRG's decision-making powers eliminate Eni's ability to use its majority shareholding to govern SRG's financial and operating policies and thereby obtain benefits similar to those it currently obtains;

    c. The condition of independent management seems to reinforce the previous condition. Building on the legal view that a full implementation of the Directive implies a loss of control whether or not there is a majority shareholding by Eni (as per paragraph 8 of John Cook's advice), I understand that under the Directive a newly created Supervisory Body will appoint the management of SRG and although Eni may have a single person majority of representatives in the Supervisory Body, decisions have to be both notified and approved by the regulatory authority to be identified pursuant to the Directive. Therefore, Eni will not be able to nominate key executives

(e.g., CEO, CFO) of SRG or other members of the board. Furthermore, assessing Eni's ability to use this power to control the financial and operating policies of SRG so as to obtain benefits from its activities, I note the following facts:

i. First, under the Directive Eni would not be able to nominate to SRG's Board any individual who serves (or has previously served) as one of its employees, directors or officers;
ii. Second, Eni would also be prohibited from employing SRG officers within certain periods of their leaving SRG;
iii. Third, under the Directive the directors of SRG must act in a non-discriminatory way with respect to all users of its services, regardless of whether they are its shareholders and in particular must act independently.

d. The fourth condition speaks about strategic and operational independence. In this case, it seems that the test of control set out in IAS 27.4 will not be met if the Directive is implemented in a way that gives effect to this principle in full.

e. Lastly, I note from Eni's 2009 annual report that it derives structural synergies from its ownership of SRG. The extent to which these survive after the Directive is implemented is very likely to influence the accounting decision. I nevertheless note that SRG should act in a non-discriminatory way with respect to all users of its services and the other requirements that it should be independent of Eni. Of course, this does not rule out the possibility that both SRG and Eni might derive benefits by co-operating with each other (as independent parties each pursuing its own interests) – but this would not argue for the existence of control if these benefits are not unusual relative to other customers and/or suppliers.

16. In conclusion, I take from John Cook's view that the purpose of the Directive is to ensure the financial and operating independence of gas transportation and storage businesses in EU Member States. Such independence requires that gas transportation and storage businesses will not be under the control of any party involved in the production and supply of natural gas. I further note from John's opinion (in paragraph 8 and 10 of his paper) that the Directive's option 2 is designed to achieve the same independence outcome as option 1 (requiring ownership unbundling), notwithstanding the fact the majority shareholding of SRG by Eni can be maintained. I therefore believe that deconsolidation will be a logical accounting outcome if the Directive is implemented in such a way that full effect is given to the independence objective. To the extent that Eni retains a majority stake in SRG, meeting these conditions will in all likelihood give rise to a special circumstance that supports deconsolidation according to IAS 27.

Dr. Gilad Livne

26 April 2010

CHRISTOPHER JOHN COOK MA

John Cook has an established reputation in the European and UK competition field. He worked at the UK Office of Fair Trading and the UK Department of Trade & Industry, advising on European Community law and international trade matters. Mr. Cook has also provided advice on the regulatory aspects of UK privatization regimes in the water, telecoms, and energy fields to oil and gas companies, regional electricity distributors, gas supply competitors of British Gas, the UK Home Office (in relation to the trade sale of IBA), water companies, electricity generation consortia, and the UK Cable Communications Association. He has also been involved in advising a number of public bodies on their statutory and EC obligations, including the UK Comptroller and Auditor General, English Heritage, the Millennium Commission and the Office of Rail Regulation.

Mr. Cook established and headed Norton Rose's Competition and EC Department (London and Brussels) from 1988 to 1997. From 1998 to 1999 he was Partner in Macfarlanes Competition and EC Unit and in 2000 he returned to Norton Rose as Partner of their Competition and Regulatory Group where he was International Managing Partner from 2004 to 2005 in Brussels. From 2006 to 2009, Mr. Cook was the senior member of O'Melveny & Myers' European Antitrust / Competition Group in London and he now operates as an independent consultant, specialising in European and UK law.

Mr. Cook has written widely on EU and competition issues, including in the leading publication in English, EC Merger Control, published by Thomson-Sweet-Maxwell, now in its 5th edition.

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Gilad Livne has been a Senior Lecturer at City University's Cass Business School since May 2005. Prior to that he was an Assistant Professor of accounting at London Business School (LBS). He received his MSc in 1994 and PhD, both in accounting at the University of California at Berkeley in 1996. Gilad is a CPA (Certified Public Accountant, Israel) and worked for several years as a senior auditor in Israel, after completing his BA in accounting and economics at Tel Aviv University.

Dr. Livne currently teaches financial statement analysis and company valuation at Cass, where he received an award for excellence in teaching. In addition to teaching at Cass and LBS, Gilad has also been teaching at the New Economic School (Moscow), Lancaster University, University of Lausanne (Switzerland), Oulu University (Finland). Gilad's research focuses on understanding how capital markets react to accounting information and the role of auditors, international accounting issues, fair value accounting, accounting for intangibles, the role of non-financial information, and auditor independence. Gilad has widely presented his research in conferences such as the annual meetings of the American Accounting Association, European Accounting Association, European Finance Association and in various universities in Australia, Europe, Middle East and the United States.

Dr. Livne has an extensive list of academic publications, including "An Empirical Investigation of the True and Fair Override in the UK," co-authored with Maureen McNichols, *Journal of Business, Finance and Accounting*, 36(1/2), 2009.