

8. RISK MANAGEMENT



DHAULAGIRI

Since 1808 to 1832 Dhaulagiri was considered the highest mountain of the planet, but alpinists focused on it only in the early 1950-s. Only the 8th expedition to the mountain was a success.

In 1960 a team of the best European alpinists was formed basing on a team from Switzerland. To transfer the expedition itself and its cargo the team used a light aeroplane. It was the first time when machinery was used for conquering 8000-ers. The expedition was led by Max Eiselin, a participant of 1958 abortive attempt and author of North-Eastern spur ascent. On May 13 Diemberger, Diener, Schelbert, Forrer, Navang Sherpa and Nyima Sherpa successfully reached the peak from the camp arranged at 7 800 m. Later the route became classic.

Nevertheless, Dhaulagiri north-eastern spur still remains one of the complicated classic 8000-er routes.

The model of internal control and risk management system

Internal control and risk management system is an element of our corporate governance system. It includes a range of procedures, methods and mechanisms of control, created and used by the Board of Directors, Audit Commission, executive bodies and employees of the Company to ensure reasonable guarantees regarding the achievement of the following goals:

- Efficiency of process administration;
- Observation of legislative requirements, that may apply to the Company's operations, as well as requirements of the Company's internal documents;
- Prevention of malpractices of the Company's employees and third parties with the Company's assets;
- Authenticity, completeness and timeliness of all types of reporting.

The system is polished up on all management levels of the Company. Preventive (monitoring) control includes build-up and optimization of processes with baseline control procedures (taking account of implementation expenses and effect) as well as regulation of activities, including description of processes, participants (their authorities and responsibilities) and identification of milestones and control activities. Besides, this type of control includes risk management measures (monitoring, identification and risk evaluation, development and implementation of risk management measures). In-process control includes control procedures by process owners (heads of structural units) and employees during the execution of their functions and control over the achievement of qualitative and quantitative performance indicators and separate lines of activities (monitoring of process efficiency, corrective measures). Follow-up control includes internal audit (inspections of structural units, processes, projects and lines of activities, evaluation of reliability and efficiency of internal control system, participation in internal investigations of abuses, frauds, damages to the Company and its SACs, inappropriate expenditures), external audit (audit of annual financial statements under Russian Accounting Standards and evaluation of status of the Company's internal control system), inspections (control over financial and operating activities of the Company to check whether it complies with the Russian legislation, charter and internal documents of the Company) as well as auto-evaluation (heads of structural units or senior management evaluate reliability and efficiency of the internal control system).

The participants of the internal control system are:

- Board of Directors and its Committees;
- Audit Commission;
- Management Board;
- General Director;
- Collegiate consultative bodies formed by the sole executive bodies to execute specific functions;
- Heads of structural units;
- Employees of structural units fulfilling control procedures as their working functions;
- Internal Audit and Risk Management Department.

Principles of functioning, processes and procedures of risk management and internal control system are regulated by the Risk Management Policy and Internal Control Policy. Under the documents we approved the Regulations on the control environment and risks of "Metering and Transmission" business process, Regulations on the control environment and risks of "Exploitation" business process, Regulations of the control

environment and risks of "Procurement" business process and Regulations on the control environment and risks of "Connection" business process.

Resolutions on risk management adopted by the senior management of the Company comply with the Russian legislation and ensure reasonable correlation of beneficial effect and expenses. Executing risk management solutions the Company regularly analyzes its practical efficiency. The Company emphasizes the following risk management operating procedures:

1. Insurance of property, production facilities and transport, civil responsibilities, medical insurance and other types of insurance;
2. Diversification of market channels to distribute consumer shares in overall consumption structure;
3. Refusal to interact with unreliable contractors;
4. Diversification of procurement of materials, inventories, equipment and services to lower dependence of the Company from stand-alone contractors;
5. Refusal to implement high-risk investment projects.

Key risk factors

The Company's operations are influenced by a range of factors that the Company is unable to have a chokehold on. Several factors named below are macro economical and affect all companies. Some lines of activities can be especially susceptible to certain risk factors. Risks in energy transmission, to a certain extent, are derivatives of risks related to wholesale and retail energy markets. These evolving markets, in their turn, have a higher risk level than developed markets of other services and products and include significant legal, economic and political risks. A proportion of political risks in overall risk volume is inconspicuous. An aggressive growth of wholesale and retail energy markets enable most likely to assume that the information may rapidly



get outdated. Existing uncertainty in information as a result of factor dynamism may impact future operations, possible sale of the Company's assets and observation of due dates. Besides, some risks, insignificant for the moment, may become drastic in future.

Industry risks

Energy transmission and connection are state-regulated services. Approval of the Company's tariffs by regulators has a direct influence on revenues and produces the following risks:

- tariffs prescribed below economically feasible levels;
- reduced revenues due to changed actual structure of energy transmission (in terms of voltage levels) in comparison to the structure approved during tariff approval procedure;
- reduced revenues due to decreased actual transmission volumes compared to previously approved volumes approved as a result of dropped energy consumption.
- additional expenses caused by cross-subsidization that impedes to set economically feasible tariffs for various voltage levels;
- risks related to changed legislation on pricing for electric and thermal energy on retail markets.

The usage of RAB methodology causes additional risks when regulators do not approve iRAB evaluated by independent appraisers and affirm rate of return below fair levels, as a consequence, complicating fund-raising to finance the investments. To keep tariffs for end-users down the government limits the growth of a regulated part of a tariff making it an unfavorable factor for the Company. Tariff increase for subsequent years should not exceed federal forecasts of social and economical development for 2014–2016. Permenergo is one of the pilot branches to shift to RAB regulation in 2009 (other

branches use RAB since 2011). After 2012 RAB re-boot adjusted long-term regulation parameters were approved. Also, it is entirely possible that under a limited upturn of end and network tariffs the regional regulator may affirm a considerable revenue growth for stand-alone grid companies by cutting (or making permanent) revenues of IDGC of Urals in favor of other grid companies.

Poor equipment status caused by its physical and moral depreciation may generate such operating risks as deterioration of exploitation and economic indicators of equipment, unfavorable ecological aftermath, incident threat accompanied by partial or full energy short-delivery and corresponding adverse social consequences, industrial injuries of the personnel and complicated incident threats. Occurrence of the risks may lead to equipment failures and demolition of facilities. Complicated incidents may lead to separation of energy system, rolling blackouts, critical operating modes of equipment. A possibility of equipment failures is average. To prevent the risks the Company takes measures to ensure reliability of equipment and facilities up to the mark – 100%–completed repair programs, modern non-stop diagnostic methods, optimization of structure and volume of spare parts, implementation and upgrade of emergency automation, tender selection among servicing and supplying companies.

Risk management related to the observation of industrial security requirements as a part of industrial risk management structure is provided by the observation of federal legislation on industrial security and industrial control system operating under it. Ecological risks include drainage-mixed oil leaks from substations without oil receivers into rivers and lakes causing possible oil pollution. These violations of pollution control regulations may inflict high fines. The Company identified ecological aspects and evaluated the impact on the environment. Crucial ecological aspects are oil spills during exploitation, maintenance, repair of oil-filled equipment and vehicles, storage of equipment and oil products as well as on-and-off loading. To reduce the weight of ecological aspects we prepare and take measures annually included into production programs of the Company. The Company also operates under ISO 9001:2008, State Standard GOST R ISO 9001–2008, ISO 14001:2004, State Standard GOST R ISO 14001–2007, OHSAS 18001:2007, State Standard GOST 12.0.230–2007, including Ecological Management System (EMS). We obtained Document of Compliance #12.0615.026 dd. 27.06.2012 to confirm ISO 14001:2004 compliance.

Risks related to uncertainties of transmission limits lies in the lack of development plans stipulating consumption dynamics for a certain time periods in several regions and municipalities as well as in uncertainties related to recession terminal dates. The circumstances hinder exact forecasting of investments, able to satisfy growing energy demand in the medium and long term. The risk is minimized by unified sales department of the Company via cooperation with federal and local authorities over the preparation of regional mid- & long-term development plans and via advocating transmission tariffs with investment component focused on increased capacity of grid equipment. We have no risks related to the changing of prices for the Company's services on global markets since the Company does not transmit energy outside Russia. In our opinion, a risk related to possible price changes on domestic market, primarily to the downside is unlikely.



On the whole, the risks may be minimized by increased operating efficiency due to production cost-cutting programs (establishing competitive environment in procurement and service processes, cost-cutting of repair, exploitation and construction procedures, etc.) and well-balanced financial policy. We believe that possible deterioration of sector environment and negative changes in exploitation and evolution of grids may affect the Company's operations but still they should not have a significant influence on discharge of obligations.

Federal and regional risks

Federal and regional risks are mainly determined by global macro-economical factors occurring on global level, in Russia and regions. These factors may have a negative impact on possible fund raising, liquidity ratios, investment and operating efficiency and, finally, on shareholder value of the Company. Besides, recession negatively influences the production volume and energy consumption causing Company's revenues to decline. The key factor of the macro-economical risk is an ongoing global crisis influencing commodities and financial market indicators: oil and energy prices as well as primary resources prices, cost of capital, exchange rates, inflation. The Russian economy, along with BRICS economies, belongs to emerging markets and is vulnerable to global recession. This is determined by its dependence on energy resource prices, low volume and volatility of the Russian stock market, transiency of domestic bank system. To minimize the consequences of the risk we undertake measures aimed at the optimization of debt share in overall capital structure, attraction of long-term borrowings and loans with fixed interest rates, increased efficiency of operating and investment expenses of the Company.

Regional risks appear when a regional regulator ignores a part of reasonable expenses recited by the Company for inclusion into a tariff. This fact may have a strong impact on the implementation of the investment program. We do not expect unfavorable changes of political situation in the service area impinging our operations and economic situation in the short run. The majority of such risks cannot be controlled by the Company due to their scale. In case political and economical situation in Russia or any constituent part of it undermining our operations is upset, the Company intends to take anti-crisis measures to reduce negative effects as much as possible (cost-cutting, decreased investment plans, reduced debt financing of operations, well-balanced financial policy). We also work in close cooperation with governmental bodies and other interested parties to reduce the risks. A possibility of military conflicts and state of emergency in Russia and its con-

stituent parts is low. In case military conflicts occur, the Company may be influenced by risks of disabling of fixed assets. We cover the risks via insurance of a major part of our assets.

Financial risks

Under its financial model the Company encounters factors that may lead to scarcity of funds required to finance investments and operations. The most important risk factors are related to the imperfect retail market mechanisms and are disclosed as industry risks. Nevertheless, there are risks that may potentially influence financial and operating results.

Negative influence of the inflation on our financial and operating activities may be related to the loss of real value of receivables, increased interest rates and increased construction expenses. Existing inflation does not have a significant influence on our financial status. According to the plans of the Russian Central Bank to control inflation and its forecast values, the inflation will not have a significant influence on financial operations of the Company. Adverse changes of exchange rates can influence operating and investment efficiency indicators of the Company. Currency risks do not have much influence on us, since all payments are done in RUR. Nevertheless, taking into account that several items purchased by the Company contain imported parts, a considerable growth of the currency rate may lead to appreciation of purchased goods. In this respect the Company adheres to the policy aimed at import substitution and conclusion of long-term agreements with no price boosts on purchased goods.

Changes of the refinancing rate of the Russian Central Bank shows macro-economical situation and influences the cost of credit resources. Increased credit rates may lead to unplanned increase of expenses on corporate debt. To decrease interest risk we adhere to a well-balanced credit policy aimed at the optimization of credit portfolio structure and minimization of expenses on debt servicing. Our operations are influenced by risks that may lead to reduction of liquidity and financial stability of the Company. The most important factors are cross-subsidization of consumers and low payment discipline on retail market. The most important component of cross-subsidization is conclusion of last-mile contracts. The legislation does not stipulate relations between grid companies and FSK in terms of last mile contracts. In 2013 there were changes in the federal legislation stipulating compulsory last-mile mechanism in the Chelyabinsk region till 2017. Consumers from the Perm and Sverdlovsk regions shifted to direct transmission contracts with FSK.



Legal risks

Since the Company operates in Russia and does not export goods and services abroad, there are legal risks occurring during domestic operations typical for the majority of companies operating in Russia. Legal risks, particularly, are related to ambiguous interpretation of legislation that may lead to wrong tax calculation and payment. To decrease the risks our accounting department cooperates with legal department to improve the methodology for tax payables calculation and to control its compliance with the existing legislation. Besides, there are risks related to changes in legislation, wrong legalities and legal advices. To minimize the risks almost all operations undergo an obligatory preliminary legal expertise. The Company has risks related to changes in legislation regulating shareholder and corporate relations. As an issuer, the Company is vulnerable to risks related to the appeal of major and interested-party transactions of the Company by shareholders (if such transactions are made without a proper preliminary approval by the Board of Directors or General Shareholder Meeting as well as if they are approved with violations of procedures). To minimize the risks there is an obligatory preliminary legal analysis of transactions to check whether reasons for preliminary corporate procedures stipulated by the legislation or charter exist. If required, such transactions are submitted for the review by competent management bodies of the Company. Risks regarding shareholder relations include, particularly, risks related to the registration of rights for shares, risks of corporate greenmail, risks of actions taken by unfriendly shareholders to put General Shareholder Meetings under jeopardy. To minimize the risks our register is administered by a professional registrar with a good background. We also work in close cooperation with shareholders.

Risks, related to changes in legislation on currency regulation and control, have almost no impact on our operations since we have no plans for outside operations. Our prices are in RUR and our settlements cannot be acknowledged as settlements with foreign suppliers. Like any other company we are taxpayers. Taxes in Russia are regulated by the Tax Code, several federal laws approved in accordance with the Russian Tax Code, regional and municipal laws. These laws always have unclear wording or use terms and notions with no accurate definition. Besides, the Russian Ministry of Finance and Federal Tax Service, authorized for official interpretation of the legislation, often provide explanations or comments contradicting tax legislation and existing legal practice. Tax authorities are at the same time guided by such regulations and explanations focused on the

replenishment of the budgets and often violate rights and interests of a taxpayer. Preparation and submission of tax books alongside with other elements of tax regulation system is primarily the competence of tax authorities entitled to charge additional taxes and levies, penalties and fines. As a result, the tax risks in Russia are higher than the similar risks typical for countries with developed economy and tax legislation. Tax risks may have several symptoms: a possibility of new taxes and levies, of increased existing taxes, expansion of tax base, changes in terms and procedures for tax payments, submission of tax books. The risk of increased taxes is the most important risk for the Company. The senior management reckons that the Company complies with the legislation in full, but still this does not eliminate potential risks of tax prosecution in case of changes in fiscal policy on taxes and levies and changes in court practices negative for taxpayers. Tax legislation changes in 2013 had no significant changes on financial interests of the Company. These changes include modification of appeal procedures, inspection procedures, legislation on related-party transactions and on invoicing procedures, changes in the determination of depreciation value of fixed assets (calculation of income tax), depreciation charges, mobilization cost record and other changes related to the Russian Tax Code. The Company plans its operations with regard to the above-mentioned changes.

At present and as of the reported period the Company's operations do not include operations regulated by the legislation on custom and currency checks. Therefore, changed rules of custom and currency checks are not significant legal risks for the Company. Our key operations – energy transmission and connection – are not subject to licensing. Changes in the legislation in this respect did not impact our operations. In case there is a requirement to have a license, the Company shall take all possible measures to obtain it.

Decree of the Federal Tariff Service #209-e/1 dd. 11.09.2012 approved new methodic recommendations on the determination of connection fees effective since 11.12.2012. There were significant changes in principles and approaches to the calculation of connection fees. During the calculation of a fee, existing connection tariff rates were lower than previous ones since new methodology does not include the following:

1. Accounting of the following costs as a part of a connection fee:
 - installation of automatic metering;
 - installation of telemetric systems;
 - installation of relay protection and emergency automation systems, communication channels and compensation of capacity current.



2. Accounting of income tax.

Besides, Federal Tariff Service and regional regulators declare a right of applicants to independently select a connection fee – fees calculated under payment formula based on standard rates or under maximum capacity rate. At present it creates considerable risks for the Company, since an applicant shall always select the cheapest fee calculation and rate. Applicant’s fee shall not compensate connection expenses incurred by the grid company in full resulting in negative financial figures on connection. In 2012 the Government approved Decree #442 dd. 04.05.2012 stipulating key statements for operations of retail energy markets; rules of full and/(or) partial consumption limitations and changes introduced into Government documents on retail market operations.

Risks related to our operations

One of the risk factors is imperfect retail mechanisms resulting in controversies between grid and supply companies regarding energy and capacity consumption used for tariff calculation. As a result, there appears debatable and overdue debt for the Company’s transmission services ending in the decreased liquidity and financial stability of the Company. The Company takes measures to eliminate causes of conflicts with consumers, to decrease debatable and overdue debt, to cooperate with federal authorities preparing changes into retail market rules, on court practice and creating positive precedents. Besides, the Company implements programs on perspective metering development adopted by the Board of Directors.

Large industrial consumers subsidize other consumers, including residents, and this is also a significant risk factor. Several large industrial consumers connected

to UNES networks pay for the transmission services according to the transmission tariffs in cases when grid facilities are rented by the Company under the last mile contracts between us and FSK. In 2010–2013, due to the lack of last-mile legislation, several large industrial consumers migrated to direct contracts with FSK via judicial decisions. According to item 5, article 8 of Federal Law #35-FZ dd. 26.03.2003 on Energy sector till 01.01.2014 UNES is entitled to rent grid facilities to regional grid companies upon approval of the federal executive authorities. Russian Government Decree #1173 dd. 27.12. approved the Rules regarding the transfer of UNES grids into rent by regional grid companies. Since the beginning of 2011 the transfer of UNES facilities into rent is approved according to a resolution adopted by regional executive bodies. According to the decree the transfer is approved if direct contracts between FSK and consumers are cancelled and if a written letter from the regional head is forwarded. In 2012 the Ministry of Energy approved Decree #403 dd. 24.08.2012 under which IDGC of Urals and FSK concluded UNES facilities rental contracts (last mile contracts) for 2013. Transmission of energy using UNES facilities rented by the Company under last mile contracts is included by federal and regional regulators in planned transmission volume for 2013. Since 2014, according to Federal Law #308-FZ dd. 06.11.2013, last-mile mechanism is retained only in a number of regions (for instance, the Chelyabinsk region). Consumers connected to UNES networks pay for the transmission services according to privileged HH1 tariff including cross-subsidizing. There is also a possibility to prolong last-mile contracts on the Chelyabinsk region till 2017. Consumers situated in other regions on our service area have moved to direct contracts with FSK.





One of the regulatory risks is a risk of decreased demand for connection and transmission in comparison to planned volumes used by regulators during tariff approval procedures. To reduce the risk the Company continues to monitor applications and form a forecast of productive supply, connection demand based on the applications as well as submit increased number of applications related to individual connection fee to regulators. At the same time due to a large amount of applications for connection the Company is not always able to fully satisfy the demand, this can negatively influence the revenues due to the loss of potential consumers as well as violation of anti-monopoly legislation in terms of transmission and connection. To resolve the problem the Company improves the procedure of connection application processing. We also explain our consumers the peculiarities of connection process, including dissemination of information on the services and creation of client centers.

Due to regulatory documents adopted at the end of 2012 simplifying the procedure related to the withdrawal of last resort provider status from energy supply companies the Company encountered new risks related to the necessity to assume authorities and liabilities of last resort providers from energy supply companies. During 2013 several subsidiaries of Russian Grids took over the functions of providers of last resort. There were some contests on the assignment of provider of last resort status but grid companies are not entitled to participate in the contests under the present legislation. To minimize the risks the Com-

pany interacts with federal and regional authorities, mass media, wholesale market infrastructure organizations, law enforcement bodies as well as companies with withdrawn provider-of-last-resort status on the functions of last-resort provider and debt settlements. Besides, we form legislative initiatives on the optimization of substitution procedures.

The Company operates on a wide territory with various climatic conditions. There is a possibility of emergencies due to natural disasters that may lead to systematic failures in grid efficiency and shortages. Operating and technological risks influencing supply reliability are related mainly to high depreciation of facilities, failures in exploitation and operating modes of equipment, failures to execute repair plans in full. Besides, exploitation and technological risks may include incidents of natural and technogenic character, decreased efficiency of our asset management system, transition to constrained emergency modes as well as factors related to equipment exploitation (limit deviation from technical requirements, personnel mistakes, etc.). In case the risks occur, we can encounter both economic and reputation consequences. Besides, these risk factors influence losses increasing our expenses on energy purchase to compensate losses. To decrease the risks we take measures aimed at the increase of supply reliability and prevention of technological violation risks (line widening and clearing, facilities reconstruction, expansion of reserve power centers, enlargement of the fleet of automotive and special-purpose vehicles for accident recovery work, switchgear and telematics update, etc.).



The Company actively invests to update and expand its infrastructure, encountering a risk related to the efficiency decrease and capex depreciation during the execution of investment programs, innovative development and R&D programs. Growing investment programs demand considerable financial resources, both internal and external, raised under conditions satisfying RAB parameters. Even if the Company has enough financial resources to finance its investment program, the Company may violate planned terms for capex and delay the commissioning of the facilities from its investment program, including failures to discharge or untimely discharge liabilities of contractors and suppliers. Government Decree #159 dd. 27.02.2013 stipulates the exclusion of facilities from the Company's investment program that are not covered by regional development programs. Here we can encounter a risk related to increased incomplete construction due to the exclusion of such facilities. To decrease the investment risk the Company prepares its investment program taking into account the following efficiency criteria: increased availability of network infrastructure, decreased depreciation and update of grid facilities, high utilization of commissioned capacities. Integration of the investment program with regional development plans is a compulsory condition for the preparation of the investment program. Besides, the Company monitors investment programs and financing and analyzes reasons that led to deviation from the plan. The Company implements investment project management. We take measures aimed at the increase of project implementation quality and investment efficiency, decrease of construction unit cost, high utilization of commissioned facilities, development and implementation of comparative analysis system dealing with unit cost of construction—assembly works and materials, arrangement of innovative activities management system, automated investment management system.

Frequent changes of the Russian legislation (keeping in mind state regulation of the sector), wide range of regulatory requirements and limitations are risk factors related to failures to observe legislation and other

regulatory documents, requirements of regulators and supervisors as well as local documents of the Company determining internal policy, rules and procedures. The Company's operations are regulated and controlled by various institutions (Federal Antimonopoly Service, Federal Tariff Service, Federal Tax Service, Ministry of Energy, etc.). Besides, being a state-owned company, IDGC of Urals, OAO executes a range of instructions from the President and Government. In this respect the risk factors are of high importance. IDGC of Urals, being a monopolist, is subject to risk related to violations of anti-monopoly legislation (connection services, disclosure of information on the services and tender activities, etc.). To decrease the risk we monitor prompt processing of applications and appeals from consumers, we also regulate and control timely disclosure of information according to the Russian legislation.

The Company owns, rents or has a right for unlimited use of the majority of land plots with grid infrastructure on them. Nevertheless, some land plots have no proper registration. Besides, the legislation stipulates the term for re-registration of a right for unlimited use of property or rent till 01.01.2015. To minimize the risk the Company implements a program dealing with re-registration of right for unlimited use.

Another risk factor may occur when the Company is acknowledged a violator of antimonopoly legislation. The most risky operation is connection of applicants' equipment to the network. Appeals of applicants to regional anti-monopoly authorities and initiation of proceedings may be caused by violation of consumers' rights. Particularly, refusals to connect, failures to observe statutory terms for connection and other factors may result in it. Another disturbing factor is that the legislation provides the anti-monopoly authorities with a right to give a broad interpretation of commodity market limits. Thus, validated complaint may cause a turnover-based fine calculated from overall revenues. To reduce the risks we improve and simplify our business processes on connection as well as implement new forms of consumer relations (for instance, online servicing).

