

CNMC COMMUNICATION ON THE ECONOMIC AND FINANCIAL CAPACITY REQUIREMENTS FOR COMPANIES CARRYING OUT ACTIVITIES OF INTEREST FOR THE ENERGY SUPPLY IN SPAIN.

The Spanish National Regulatory Agency for Energy ("**Comisión Nacional de los Mercados y la Competencia**" or "**CNMC**") issued Communication 1/2019, of 23 October, on the definition of ratios to assess the level of indebtedness and the financial and economic capacity of the companies that carry out regulated activities, and to fix the recommended values for these ratios ("**Communication 1/2019**"). The purpose of Communication 1/2019 is to publish the methodology the CNMC is going to use to assess the solvency of some companies operating in the energy sector.

WHAT IS THE AIM OF THE METHODOLOGY OF COMMUNICATION 1/2019?

The CNMC is to use this methodology when taking notice of the acquisition of some stakes in the energy sector, in order to decide if it imposes any conditions on some transactions affecting companies of the energy sector, according to their indebtedness level and financial capacity, pursuant to the ninth additional provision of Law 3/2013, 4 June ("**Law 3/2013**").

This methodology is also to be used for the preparation of financial analysis reports by the CNMC on (i) the companies involved in the gas sector, (ii) the more relevant companies involved in the power sector and (iii) the companies that carry out activities in the hydrocarbon sector, such as oil refining, transport by pipeline and petroleum-based storage, pursuant to article 4 of Order ITC/1548/2009, 4 de June.

In addition, the CNMC announces this methodology shall be applied in any financial analysis of companies within the scope of Communication 1/2019.

Last but not least, the CNMC is preparing the new regulations for the retribution of the regulated activities of the energy sector, and is now considering a penalty for companies whose financial ratios do not comply with high financial standards, according to Communication 1/2019. In case these regulations are finally approved, any failure to comply with the financial capacity, as established by Communication 1/2019, shall reduce the retribution of those companies.

WHEN IS THE CNMC ENTITLED TO IMPOSE CONDITIONS IN RELATION TO THE ACQUISITION OF STAKES IN THE ENERGY SECTOR?

The CNMC may impose conditions in these transactions:

- a) When **companies performing Regulated Activities acquire**, directly or indirectly, **stakes in other companies (or assets of any nature) that**, according to their value or other circumstances, **have a relevant impact or significant influence on the development of the activities of the company that carries out the Regulated Activity**.
- b) **When a non-EU or non-EEA company acquires any stake that provides significant influence in the management of companies that**, directly or indirectly, **(i) carry out Regulated Activities, (ii) are holders of assets to carry out Regulated Activities, (iii) are holders of strategic energy assets** (because these assets are included in the National Critical Infrastructure Catalogue, or because these assets are nuclear power plants, coal fired power plants of special relevance for the national coal consumption, oil refineries, oil pipelines or petroleum-based product storages).

- c) When **a non-EU or non-EEA company acquires assets to carry out Regulated Activities or strategic energy assets**, as formerly defined.

All these transactions shall be reported to the CNMC within a term of 15 working days following the transaction.

The CNMC shall decide in 30 working days whether to impose any conditions on the transaction, in the event this transaction represents a real and sufficiently serious threat to the energy supply guarantee.

Transactions included in points b) or c) that are concluded by EU or EEA companies shall also be reported to the CNMC within the same term. However, the CNMC shall not impose conditions on these transactions.

WHICH ARE THE REGULATED ACTIVITIES, FOR THE PURPOSES OF THIS PROCEDURE?

In the power sector, Regulated Activities are system operation, transmission and distribution of power (these are the regulated activities in accordance with article 8.2 of Law 24/2013, 26 December, on the Power Sector), together with market operation and activities in island or non-peninsular territories.

In the gas sector, Regulated Activities are regasification, basic storage, transport and distribution (these are the regulated activities in accordance with article 60.1 of Law 34/1998, 7 October, on the hydrocarbons sector), together with technical management of the gas system.

In the hydrocarbons sector, Regulated Activities are oil refining, oil transport by pipeline and petroleum-based products storage.

WHEN DOES THE ACQUISITION OF STAKES IMPLY A SIGNIFICANT INFLUENCE?

There is no definition in Law 3/2013 on what the meaning of significant influence is for this specific purpose.

International Accounting Standard 28, point 5, presumes that if an entity holds, directly or indirectly, 20 per cent or more of the voting rights of the investee, the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly, less than 20 per cent of the voting rights of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- a) representation on the board of directors or equivalent governing body of the investee;
- b) participation in policy-making processes, including participation in decisions about dividends or other distributions;
- c) material transactions between the entity and its investee;
- d) interchange of managerial personnel; or
- e) provision of essential technical information.

The analysis of the potential significant influence shall take into account any potential voting rights of the acquiror and any agreement of the acquiror together with other acquirors or partners to vote jointly in the company.

**WHICH ARE THE SPECIFIC RATIOS CONSIDERED BY THE CNMC TO ANALYSE THE FINANCIAL CAPACITY?
WHICH ARE THE RECOMMENDED RANGES OF VALUES OF THESE RATIOS?**

Ratio	Description	Range of recommended values
1	$\frac{\text{Net debt}}{\text{Net debt} + \text{Net equity}}$	Maximum 70%
2	$\frac{\text{Funds arising from operation} + \text{Interest expenditures}}{\text{Interest expenditures}}$	Minimum of 5.0
3	<ul style="list-style-type: none"> Companies with a value of net fixed assets with right to remuneration (RAB): $\frac{\text{Net debt}}{\text{RAB} + \text{Fixed assets under construction}}$ Rest of companies: $\frac{\text{Net debt}}{\text{Fixed assets} + \text{Fixed assets under construction}}$ 	Maximum of 70%
4	$\frac{\text{Net debt}}{\text{EBITDA}}$	Maximum of 6.0
5	$\frac{\text{Net debt}}{\text{Funds arising from operations}}$	Maximum of 7.3

In the event these recommended values are not met, the CNMC shall presume there is a real and sufficiently serious threat to the energy supply guarantee, because of the lack of financial capacity of the analysed company.

ARE ALL THE RATIOS AT THE SAME LEVEL WHEN ANALYSING THE FINANCIAL CAPACITY OF THE COMPANY, ACCORDING TO THE CNMC?

No. In fact, the CNMC establishes a general index to study the solvency of the company, which weights each of the ratios described above differently. This index, called Global Index of Ratios ("**IGR**"), is calculated in this way, by adding the weighted value of all those ratios:

$$IGR = 0.1 \times R1 + 0.05 \times R2 + 0.3 \times R3 + 0.2 \times R4 + 0.35 \times R5$$

As a result, ratio 5 is the most relevant ratio for the calculation of the solvency of the company, together with ratio 3.

It is important to highlight that, for the purpose of this calculation, every specific ratio shall have the value 1 when the ratio is met, and 0, otherwise.

Despite there being no legal reference, we are of the opinion that an IGR equal to or greater than 0.5 means compliance with the minimum financial capacity requirements.

Anyway, the CNMC has considered, in the draft regulations that is preparing for the establishment of a new methodology of the retribution of transmission and distribution of electricity assets, and transport of natural gas and liquefied natural gas assets, that an IGR lower than 0.9 shall reduce the retribution of these companies with a penalty, because of financial prudence reasons. This rule, if finally is approved, shall be applicable for the retribution of the fourth year of the following regulatory period.

DOES COMPLIANCE WITH IGR ALLOWS THE COMPANY NOT TO COMPLY WITH ANY SPECIFIC RATIO?

The fixation of an IGR, where every specific ratio has a relative value, implies, in our opinion, that what is really relevant for the CNMC is the fact that the company meets the minimum IGR value, not every one of the ratios.

However, we cannot completely rule out the CNMC reaching a different conclusion, with reasoned motives.

WHAT HAPPENS IN THE EVENT THE CNMC CONSIDERS THE COMPANY HAS INSUFFICIENT FINANCIAL CAPACITY?

Apart from the impact on the retribution, as described above, the CNMC may impose conditions on both the acquiror and the company that carries out the Regulated Activities or that is holder of any of the assets whose acquisition must be reported to the CNMC.

These conditions shall be proportional and must be based on the need to guarantee the energy supply.

When the acquired stake does not provide the acquiror with real control of the company, it is really doubtful that the CNMC may impose conditions on the acquired company, as a result of the proportionality principle.

IS COMMUNICATION 1/2019 BINDING?

Every transaction or commercial operation that may trigger the imposition of conditions by the CNMC will reasonably require the analysis of the compliance of the ratios in Communication 1/2019. So once this operation is concluded, these requirements will be compulsory.

Notwithstanding the above, these values are simple recommendations. Because of this, the CNMC will be able to deviate from these values, where there are proper grounds for doing so.

ARE THERE OTHER REASONS THAT ENTITLE THE CNMC TO IMPOSE CONDITIONS, REGARDLESS OF THE FINANCIAL CAPACITY?

Yes, because the existence of a real and sufficiently serious threat to the energy supply guarantee may be deducted from these issues:

- a) Security and quality of supply, in the sense of uninterrupted physical availability of the products and services on the market, at reasonable prices in the short and long term for all the users, regardless their geographical location.
- b) Security from investment risk or insufficient infrastructure maintenance that do not make it possible to ensure, continuously, a minimum group of the required services for the guarantee of supply.
- c) Lack of compliance of the legal, technical, economic and financial capacity requirements of the acquiror and the acquired company.

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