Supplement to the Offering Circular (as defined below) dated 29 May 2013

IBERDROLA FINANCE IRELAND LIMITED

(*incorporated with limited liability in the Republic of Ireland but with its tax residence in the Kingdom of Spain*)

EUR 1,500,000,000

Global Medium Term Note Programme

unconditionally and irrevocably guaranteed by

IBERDROLA, S.A.

(*incorporated with limited liability in the Kingdom of Spain*)

This supplement (the "**Supplement**") to the base prospectus (the "**Base Prospectus**") and the listing particulars (the "**Listing Particulars**) dated 29 May 2013 (collectively, the "**Offering Circular**) constitutes a supplement to the Offering Circular pursuant to Article 16 of Directive 2003/71/EC (the "**Prospectus Directive**") in the case of the Base Prospectus and pursuant to the Irish Stock Exchange rules (the "**Listing Rules**") in the case of the Listing Particulars and is prepared in connection with the Euro 1,500,000,000 Global Medium Term Note Programme of Iberdrola Finance Ireland Limited (the "**Issuer**") and unconditionally and irrevocably guaranteed by Iberdrola, S.A. ("**Iberdrola**").

Terms defined in the Offering Circular have the same meaning when used in the Supplement.

The Supplement is supplemental to, and should be read in connection with, the Offering Circular issued by the Issuer.

The Issuer and Iberdrola accept responsibility for the information contained in the Supplement. To the best of the knowledge of the Issuer and Iberdrola (each having taking all reasonable care to ensure that such is the case) the information contained in the Supplement is in accordance with the facts and does not omit anything likely to affect the import of such information.

The Supplement has been approved by the Central Bank of Ireland as competent authority under the Prospectus Directive 2003/71/EC (the "**Prospectus Directive**"). The Central Bank of Ireland only approves the Supplement as meeting the requirements imposed under Irish and EU law pursuant to the Prospectus Directive.

The Supplement has been approved by the Irish Stock Exchange pursuant to the Listing Rules.

Industry Regulation and functioning of the Electricity and Gas System

The following replaces the description of the industry regulation and functioning of the electricity and gas system in pages 266 to 295 of the Base Prospectus:

INDUSTRY REGULATION AND FUNCTIONING OF THE ELECTRICITY AND GAS SYSTEM

Both Iberdrola and certain of the fully and proportionately held consolidated subsidiaries engage in electricity business activities in Spain and abroad that are heavily affected by the respective regulatory frameworks. The following is a description of the main regulations affecting the Iberdrola Group:

Industry Regulation and functioning of the Electricity System in Spain

The electricity sector is currently regulated by the Electricity Sector Law 54/1997, of 27 November 1997 (the Electricity Sector Law). This law and its subsequent updates have incorporated the provisions contained in Directives 96/92/CE, 2003/54/EC and Directive 2009/72/EC concerning common rules for the electricity internal market.

The Electricity Sector Law and the subsequent implementing legislation established, *inter alia*, the following principles:

(a) Separation of activities

The Law prescribes a separation between the activities carried out in the competitive sector and others that are considered to be regulated activities. Companies that carry out any activities defined by the law as regulated (economic and technical management of the system, transmission and distribution) must have these as their sole corporate purpose and cannot, therefore, engage in unregulated activities (generation or supply to either eligible or last resort customers or other activities unrelated to electricity or activities abroad).

However, a group may carry out incompatible activities provided that these are performed by different companies within it. In addition, it prescribes a separation between regulated and deregulated activities for accounting purposes.

In addition, Law 17/2007, which incorporated European Directive 2003/54/EC, introduced the functional separation of regulated activities.

Finally, Royal Decree-Law 13/2012 included the transposition of Directive 2009/72/EC, amending the Electricity Sector Law. Thus, new provisions are introduced to achieve effective separation of supply and generation activities from network activities and strengthen the role of national regulatory authorities and public service obligations.

(b) Introduction of competition in power generation activity through the following measures:

Since 1 January 1998, the producers of electricity, other than the special cases and exceptions provided for by law, have tendered hourly bids for the selling price of electricity of each of the production units owned by them. The operating order of the production units is established on the basis of the lowest bids made until demand is satisfied in each programming period as a result of matched supply and demand. There is also the option of recourse to the intraday markets (six every day), where operators can adjust their positions relative to what they offered on the daily market. Meanwhile, the production facilities contribute to the provision of whatever additional services may be necessary to guarantee adequate supply, obtaining additional remuneration for such services. The organisation and regulation of the electricity production market was defined and implemented by Royal Decree 2019/1997, of 26 December.

Although forward trading was initially subject to stringent regulatory constraints, these obstacles have now been eliminated and its use has begun to increase, reaching levels comparable to the volume of contracts in a well-developed market.

In addition to the market remuneration, the Ministry of Industry, Energy and Tourism may establish remuneration entailing payment for capacity. In this regard, orders ITC 2794/2007, ITC 3860/2007 and ITC 3127/2011 regulate said payments for capacity, which consist of an investment incentive, an environmental incentive and an availability service. The Royal Decree-Law 13/2012 amends, temporarily during 2012, the investment and the environmental incentives. The Royal Decree Law 9/2013 changes the amount of the incentive of investment and the collection right period.

Order ITC/400/2007 instituted the regulation of auctions to buy energy that would then be supplied at the regulated tariff (CESUR). Since 1 July 2009, the last resort suppliers have acquired energy for supply to customers signed up for the last resort tariff. The outcome of the auctions feeds into the calculation of the additional rate for last resort tariffs.

The installation of new generating facilities is deemed to be liberalised, without prejudice to the obtainment of the necessary authorisations.

Producers are entitled to use in their generating facilities the primary energy sources that they deem most appropriate, subject to such restrictions, as for example in respect of the environment, as might be provided for in current legislation.

An option is being considered to prioritise the dispatch to facilities that use domestic fuel (such as domestic coal) as their primary energy, provided that it does not represent more than 15 per cent. of the total primary energy required for the production needed to satisfy domestic demand and that the necessary measures are adopted to avoid distorting the market price. In this respect, Royal Decree 134/2010 accepted this option and introduced a Security of Supply Restriction procedure which established an obligation on certain owners of coal-fired thermal units to acquire set amounts of this fuel at set prices each year according to a Secretary of State for Energy ruling. Furthermore, this Royal Decree gives priority in the dispatch to said coal-fired thermal units over the other thermal units in the system, up to a certain maximum annual amount of electricity production, which is also set in the aforementioned Secretary of State for Energy ruling and which must comply with the 15 per cent. limit at all times. In addition, regulated remuneration is established for these thermal units designed to reflect the full costs relating to their production associated with the aforementioned maximum annual amount of domestic coal-based electricity production. The Security of Supply Restriction procedure was applied for the first time on 26 February 2011. A maximum annual amount of domestic coal-based electricity production of 24.7 TWh was established for 2012. At the end of the year, the actual amount produced was 22.2 TWh. For 2013, the maximum amount is 20.05 TWh.

Plants with less than 50 MW of installed capacity that qualify as co-generation facilities under Law 54/1997 or plants whose primary energy source is renewable, can come under the Special Regime, with a separate regulatory system and remuneration that is different from the market price.

RDL 9/2013, of 12 July, has introduced substantial changes in the economic regime applicable to renewable facilities. The following provisions are worth highlighting in relation to this new remuneration scheme:

(i) The current economic framework applicable to renewables facilities[1] (although transitorily applicable until the developing regulations of RDL 9/2012 are enacted) is repealed and the new economic regime to be approved by the Government will be applicable since the entry into force of the RDL 9/2013 (i.e. 14 July 2013). The right of first dispatch and priority of access to the electricity grid is maintained.

(ii) The moratorium on new renewable facilities in force since 27 January 2012 for the construction of new renewable facilities is still valid but can be superseded by the new regulation when new capacity is needed.

(iii) Renewable Facilities will have to participate in the Pool, but will be paid (in addition to the income for the electricity sold valued at market prices) an annual regulated remuneration made up of (a) a regulated remuneration for investments in capacity, and (b) a regulated remuneration for operation costs, if these costs are higher than market price. The regulated remuneration, which is paid during the entire regulatory useful life of the facilities, will afford the facilities a reasonable return. The reasonable return, before taxes, to which the specific remuneration should turn around will be the average 10-year bonds' yield on the secondary market plus a margin (for existing facilities set out in 300 bp).

(iv) The basic parameters to calculate the specific remuneration are set out in the RDL 9/2013 and will be further developed by other regulations. The specific remuneration will be integrated by:

a. Investment Remuneration: Remuneration is based on an investment remuneration (as a factor of the installed capacity) which is designed to compensate for investments in capacity that cannot be recovered through sales of electricity in the market and is to be determined by reference to the net asset value of a standard generation facility of an efficient and well-run undertaking; and

b. O&M compensation: If the O&M costs for a given technology per unit of electricity generated exceed the estimated electricity sales proceeds for that same unit (again by reference to the O&M costs of a standard facility)

(v) All renewable facilities need to be registered with the new remuneration administrative registry created by RDL 9/2013. Existing facilities already entitled to receive feed-in tariffs will be automatically registered in such Registry. The administrative registry shall contain for a relevant facility the following details: (i) its capacity; and (ii) the standard facility to which it is associated.

As of this date, developing regulations of the provisions of RDL 9/2013 have been circulated and are in process of public consultation.

(c) Guarantee of the proper functioning of the system, by means of the following measures:

(i) System:

Red Eléctrica de España, S.A. carries on the transmission management and system operation activities which, pursuant to the Law, have been unbundled for accounting purposes. As system operator, it is responsible for managing the adjustment markets to guarantee a balance between energy demand and generation.

(ii) Market:

[1] Royal Decree 661/2007, of 25 May, Royal Decree 1578/2008 and article 4 of Royal Decree-Law 6/2009, of 30 April.

In 1998, OMEL, S.A. ("OMEL") was created for managing the Spanish peninsular electricity market. The offshore system was run following its own rules.

Iberian Electricity Market ("MIBEL"). On 1 October 2004, Spain and Portugal agreed the International Convention setting up an Iberian Market for Electric Power between the Kingdom of Spain and the Republic of Portugal. In January 2008, this agreement was revised at the Braga Summit to comply with the March 2007 Regulatory Compatibility Plan.

Since July 2006, the Portuguese and Spanish forward markets have operated together and since July 2007 the short-term markets have done so. Several of the measures described above are designed to implement a single Iberian market for electricity.

Currently, the Operation of the Iberian market is split between two companies: **OMIE** (OMI-Polo Español) which is responsible for managing the daily and intraday markets for MIBEL and futures auctions for last resort demand in the Spanish system (**CESUR**), and **OMIP** (OMI-Polo Portugués) which runs the overall MIBEL futures markets.

The International Convention between the Portuguese Republic and the Kingdom of Spain, setting up a single Iberian market for electricity, revised according to the Braga Agreement on 18 January 2008 in Braga, envisaged the creation of the 'Iberian Market Operator (*Operador del Mercado Ibérico*, ***OMI***) by merging OMIE and OMIP, via two shareholding companies with head offices in Spain and Portugal, 10 per cent. cross shareholdings and a corporate structure comprising the current two market operating companies. As at 31 December 2011, this reorganisation process was complete.

(d) Legislation applying to regulated activities:

The Electricity Sector Law establishes that distribution and transmission are classified as regulated activities that are not subject to the free competition and market regime.

On 1 December 2000, Royal Decree 1955/2000, regulating the transmission, distribution, retailing and supply activities and electricity facility authorisation procedures, was approved. The basic aim of this Royal Decree was to establish the measures required to guarantee the supply of energy and the authorisation procedures relating to all electricity facilities that are authorised by the Spanish Government.

On 15 February 2008, the government approved Royal Decree 222/2008, establishing the prevailing remuneration framework for the electricity distribution business. Pursuant to this Royal Decree, the remuneration paid for distribution activities will be set for regulatory periods of four years and will be calculated using a reference network model as a technical comparison tool. A reference network model is a model that maps out, for all Spanish territory, the areas in which each distributor is active and determines the reference distribution network needed to link up the transmission network, where applicable, and distribution network with the final consumers of electricity, based on their geographical location, feed voltage and demand for power and electricity.

The reference remuneration of each distribution company will be calculated by the sum of three components: (i) remuneration for investment, (ii) remuneration for operating and maintenance and (iii) remuneration for all other costs necessary to exercise distribution activities, which will include commercial management, network planning and energy management costs.

Within each period, the annual remuneration is calculated by updating the base remuneration of the previous year, in line with the CPI and IPRI, and adding the remuneration for the new investments made. Annual incentives are also set for enhancing quality and reducing losses.

The quality incentive is established in Appendix I of Royal Decree 222/2008. In general, the incentive consists of comparing utilities' global quality indicators with target indicators, resulting in penalties or bonuses. The limits of the incentive/bonus are 3 per cent. of the remuneration.

The legislation regulating the incentives for losses is Order ITC 2524/2009 of 8 September 2009. This incentive is calculated as the sum of (a) the difference between the actual loss percentage and a target, (b) a loss price and (c) the power flowing through the networks of distribution companies. The limits of the incentive/bonus are 2 per cent. of the remuneration. Order IET/3586/2011 of 30 December 2011 made some technical corrections to the calculation of access tariffs.

Order ITC/3353/2010 of 28 December 2010 establishes the final distribution remuneration for 2009 and 2010 (Note 4.y). Order IET/3586/2011 of 30 December 2011 established provisional remuneration for 2011 and 2012, and makes a slight adjustment to the final remuneration of 2010 for certain companies.

Royal Decree-Law 13/2012, of 30 March, transposes into national legislation some aspects of the directives on internal markets in electricity and gas and electronic communications; it also adopts measures to correct deviations between costs and revenues within the electricity and gas sectors. With this aim, it reduces the remuneration for distribution for 2012 established in the previous order and changes the remuneration system, establishing that new facilities commissioned in a given year will receive their remuneration two years later (previously, it was one year later). It also indicates that financial compensation should be made on the basis of net assets.

With regards to the electricity transmission business, Royal Decree 325/2008 established the new remuneration regime for facilities brought into service after 1 January 2008. It provided that the remuneration of each transmission facility commissioned after 1 January 2008 will consist of two components:

- Remuneration for investment.
- Remuneration for operating and maintenance costs.

Order ITC/368/2011 of 21 February 2011 approves the new reference unit values for investment costs, operating and maintenance costs for these facilities. Transmission facilities prior to 1 January 2008 continue to be governed by the model and standard costs established in Royal Decree 2819/1998. Royal Decree-Law 13/2012 cited above, together with the Royal Decree-Law 20/2012, of 13 July, on measures to ensure fiscal stability and promote competitiveness, reduce the transmission remuneration under the same criteria considered for the distribution activity. On the other hand, the Royal Decree-Law 13/2012 suspends the administrative authorizations for new transmission facilities until the approval of a new plan.

Royal Decree-Law 2/2013, of 1 February, on urgent measures in the electricity sector and the financial sector replaces the Consumer Price Index used for the update of the remuneration of regulated activities and replaces it with the Consumer Price Index at constant tax excluding unprocessed food and energy products.

Finally, the Royal Decree-Law 9/2013, amends the Electricity Sector Law, providing new remuneration principles for the transmission and distribution activities. First, it establishes that, for the remuneration of these activities, an “efficient and well-run company” will be considered applying uniform criteria throughout the Spanish territory. Secondly, it establishes that these economic regimes allow adequate remuneration of a low-risk activity. In application of these principles establishes a rate of return on assets linked to Government Bonds plus a spread.

As of this date, there are detailed regulatory proposals in process of public consultation to develop these principles.

(e) Progressive liberalisation of electricity supply and introduction of supply activity:

The Electricity Sector Law provided for the gradual deregulation of the electricity supply market, progressively giving each of the different types of customer segments the possibility of choosing their own supplier. All electricity consumption has been deregulated since 1 January 2003. This means that consumers who so wish can freely contract their energy requirements with the supplier of their choice, paying an access tariff (or access tall) for the right to use the networks. Royal Decree-Law 14/2010, of 23 December, which amended the Electricity Sector Law, extended the application of access tolls to electricity producers.

The new regime gives qualifying customers and suppliers the right to use the transmission and distribution networks, setting a single access tariff or toll applicable nationwide for use of the networks and other charges (such as renewable premiums, or non-peninsular territories compensations), without prejudice to any specialised services provided due to voltage and/or network usage requirements, on the basis of whether transmission or distribution networks are involved. Royal Decree 1164/2001, published on 26 October 2001, established the access tariffs for the electricity transmission and distribution networks, which have been updated each year.

From 1 July 2009, the system of 'Last Resort Supply' has been in place. Low-voltage customers with a contracted capacity of less than 10 kW who do not choose another supply option shall be supplied by a last -resort supplier at a price calculated automatically. This additional rate is called the last resort tariff. Iberdrola Comercialización de Último Recurso, S.A.U. has been designated, among others, as last resort suppliers of electricity and natural gas in Spain.

(f) Price formation and tariff structure:

On 4 July 2007, the government published Law 17/2007, amending the Electricity Sector Law 54/1997, of 27 November to bring it in line with the provisions of Directive 2003/54/EC of the European Parliament and of the Council, of 26 June 2003, on Common Standards for the Domestic Electricity Market. This law establishes the concept of last resort supply and the additional calculation mechanism used to set last resort tariffs based on the cost of energy, the access tariff and an additional cost for commercial management. This was developed through Royal Decree 485/2009 which implements the last resort supply and sets the terms and scope of application. Order ITC 1659/2009 lays down the mechanism for transferring customers from the tariff market to last resort electricity supply and, specifically, the procedure for calculating and structuring last resort tariffs. Through this procedure, the last resort tariff is calculated as an additional rate replicating supplier costs. In this way, energy acquisition costs, regulated access tolls and commercialization costs are included.

Since 1 July 2010, the last resort tariffs are calculated and published quarterly, coinciding with each calendar quarter in accordance with the ruling of the Directorate General of Energy Policy and Mining.

(g) Social Tariff:

On 7 May 2009, Royal Decree-Law 6/2009 was published, adopting certain energy sector measures and approving the social tariff (*bono social*). Among the main features, it creates a social tariff for certain consumers with certain social, consumption and purchase power characteristics supplied at the last resort tariff at their normal residence. This tariff is calculated as the difference between the last resort tariff and the tariff indexed to a reference value, the so-called reduced tariff. This reduced tariff will be the prevailing tariff applicable to domestic consumers at the date the Royal Decree took effect, although it may be modified via the Ministry of Industry, Energy and Tourism. Until these social and economic indicators are developed for application, the social tariff will apply to natural persons in their normal residence supplied under the last resort scheme with contracted capacity of less than 3 kW, to large families or families whose members are all unemployed and to certain pensioners over 60 years of age receiving minimum pensions. Subsequently, the General Secretary for Energy's Resolution of 26 June establishes the procedure for implementing the social tariff.

The Royal Decree-law 9/2013 sets out the financing of the social tariff costs. Such costs shall be borne by the parent company of the vertically integrated companies. The allocation of the social tariff costs among such companies will be made according to the number of supplies connected to the distribution network and the number of customers of the supply business of the group.

(h) Load Manager

Royal Decree-Law 6/2010 introduces the idea of the "load manager", which is defined as follows: "companies providing energy charging services defined in article 9.h) of Electricity Sector Law which, whilst defined as consumers, are authorised to resell electricity for power recharging services for electric vehicles". The same Royal Decree sets forth the requirements and obligations of these agents. It also created a new super off-peak tariff applicable to contracts of up to 15 kW, thereby creating a third hour period (from 1 a.m. to 7 a.m.) aimed at encouraging the charging of electric vehicles in this period.

(i) Emission allowances:

Regarding environment regulations, the issue of CO_2 emissions rights or "allowances" should be noted. This concerns the obligation placed on companies by Directive 2003/87/EC to hold an emission allowance for every tonne of CO_2 emitted by a plant.

As part of the "Green Package" of the EU, in 2009 Directive 29/2009 was published, amending Directive 2003/87. This new Directive extends the Emissions Trading Scheme in EU beyond 2012. The main changes introduced are that the method of allocation of rights is, by default, the auction; however, the Green Package also provides transitional free allocation in some cases, the extension of the system to the next compliance period 2013-2020, to be followed by periods of 8 consecutive years in the amount of allowances determined at EU level. It also provides that the rights (EUAs) are "draggable" between periods. The Directive 29/2009 and 101/2008, which incorporate aviation into the European emissions trading, are incorporated into Spanish law by Law 13/2010.

(j) Revenue shortfall:

The Electricity Sector Law introduced the liberalisation of electricity generation and supply activities. However, it was noted that the sustainability of the system was heavily dependent on the tariff system. The difference between the access tariff revenue established by the Government and real costs related to these tariffs resulted in a revenue shortfall which led to problems and modifications in the functioning of the system.

To fund this shortfall, which is deferred through the recognition of long-term collection rights recovered by the annuities incorporated to access tariffs to annual fees, a series of measures have been adopted that so far have proven to be insufficient.

Royal Decree-Law 6/2009, of 30 April, amended the Electricity Sector Law, in order to set limits to the increase in the deficit and defines a framework for the gradual sufficiency of the access tolls. It also addresses the mechanism for funding the tariff deficit. It also regulates the transitional period until that date, limiting the revenue shortfall in the settlements of regulated activities in the electricity industry for 2009, 2010, 2011 and 2012 to EUR 3,500 million, EUR 3,000 million, EUR 2,000 million and EUR 1,000 million, respectively.

In addition, it states that if the settlements of regulated activities in each period result in a higher revenue shortfall than expected, the excess would be recognised in the provisions approving the access tolls for the ensuing period.

At the same time, it envisages the assignment of the related present and future collection rights to a securitisation fund set up for this purpose, which will issue the related liabilities via a competitive mechanism in the financial markets with a Government guarantee.

Royal Decree-Law 6/2010 of 9 April, re-emphasises the aim of eliminating this shortfall and is more precise than the provisions of Royal Decree-Law 6/2009, while it also states that electricity companies designated to temporarily finance the deficit are also required to finance the *exante* deficits until the securitisation fund sells the related recoverables to third parties. It also requires these companies to fund any temporary shortfalls above the *exante* deficit, recognising their right to receive the amounts financed, plus interest, in the following year through an increase in access tariffs.

Royal Decree 437/2010 which develops the securitisation process for the revenue shortfall in the Spanish electricity system was published on the same date. This legislation specifies the collection rights and the initial holders, regulates the method for determining the price and conditions of the assignment, and lays the framework for the procedure for issuing the financial instruments comprising the fund's liabilities.

However, as the tariff increases have precluded the established limits from being observed, Royal Decree-Law 14/2010 was published in December 2010 establishing urgent measures to correct the shortfall. Among other things, this legislation raised the maximum limits for 2010, 2011 and 2012, to EUR 5,500, EUR 3,000 and EUR 1,500 million, respectively, and led to an amendment of the 2011 Spanish Budget Act to include up to EUR 22,000 million of guarantees for the electricity system shortfall securitisation fund.

Royal Decree 1307/2011, of 26 September, which amends Royal Decree 437/2010, provides flexibility to the procedure for issuing financial instruments more

competitively. In this regard, it introduces the possibility of the simple sale of securities, thus enabling the electricity system deficit securitisation fund to take advantage of this form of financing and helping achieve the overall objective of minimising financing costs over the life of the fund. To achieve the twin objective of minimising prices and launching competitive issues, in simple sale transactions Royal Decree stipulates that one or more subscribing entities must be selected on an individual basis using a competitive procedure based on criteria such as term, price and volume to be subscribed.

Due to the excess in the revenue shortfall that the government estimates for 2012, the Royal Decree-Law 29/2012 is approved. Since the Government does not consider it appropriate to increase the access fees for 2013, this Royal Decree-Law establishes that the amount of the imbalance resulting from the final settlement of the CNE for 2012 will be considered a revenue shortfall of the system and it will generate collection rights that may be assigned to FADE. This amount is additional to the €1,500 million deficit already recognized.

A new law on fiscal measures was approved on 27 December 2012. Law 15/2012, of December 27, on tax measures for energy sustainability, includes three new taxes that came into force on 1 January 2013:

The amounts collected will be applied in principle to bear specific electricity costs and therefore it should reduce the future tariff deficit. By way of summary, the new taxes will be the following:

- tax on generation (tax rate 7 per cent. on the value of energy);
- tax nuclear installations or activities and on the production of radioactive waste for generation purposes and the tax on radioactive waste storage;
- tax on the use of continental water resources (tax rate 22 per cent. on the value of energy, with some exceptions, such as a reduction of 90 per cent. on the tax rate for pumping facilities and plants under 50MW); and
- tax on the use of gas (tax rate, €0.65/gigajoule, except for “professional” use, for which it is set at €0.15/gigajoule), coal (€0.65/gigajoule) and fuel-oil (tax rate, €12.00/ton fuel-oil), the two last ones for electricity generation purposes.

This Law also establishes that the annual Laws of the State Budget will finance the electricity system costs by an amount equal to the sum of the estimated annual revenue derived from the taxes included in this law plus the estimated income coming from the auctioning of allowances of greenhouse gases, this last one with a maximum of €500 M.

Finally, this law amends the Electricity Sector Law to eliminate the regulated premium for the electricity generated from fossil fuels in renewable energy installations.

The Law 17/2012 states that the Laws of the State Budget of each year will fund electricity system costs related to promotion of renewable energy, for an amount equal to the estimated annual revenues derived from the taxes included in the Law 15/2012 and 90% of the estimated revenue from the auctioning of emission rights of greenhouse gases, with a maximum of 450 million euros.

On 16, 17 and 18 March 2011, the Supreme Court handed down a judgment on the claims filed by the electricity companies against the regulations for recognising the

financial costs relating to the deficit of 2006. The Supreme Court considered that the EURIBOR interest rate was not sufficient to totally restore the capital of the companies obliged to finance the tariff deficit.

The key argument that the Supreme Court took into consideration was that the guiding criterion for setting the spread should be that "*the companies holding the collection rights do not suffer any economic loss due to the deferral of a payment due to them and, accordingly, the recovery of the amounts advanced by them should include compensatory interest to ensure full reimbursement*". The Supreme Court argued that, given the market situation at that time, the electricity companies had to seek financing on the capital market and that the cost of the debt borne by them, which included the amount necessary for meeting the deficit financing obligation, was higher than the rate of interest stipulated in additional provision 8 of Royal Decree 485/2009 and therefore, since that the latter was not sufficient, it required the addition of a spread or margin.

To proceed with the execution of these judgments, Royal Decree-Law 20/2012 recognizes for the 2006 deficit a spread of 65 basis points over EURIBOR, equal to that which resulted from the second auction of the collection rights for the ex-ante deficit financing held on 12 June 2008. The amount corresponding to this increased financial cost has been perceived in 2012.

Finally, the Royal Decree-Law 9/2013 modified the Electricity Sector Law considering that the tariff deficit for 2012 is final in order to allow its securitization and establishing the maximum amount to be given in guarantees by the Kingdom of Spain in the context of tariff deficit securitization for year 2013 cannot exceed EUR 4 billion. Such Royal Decree-Law also contemplates that the State Budget will finance 50% of electricity generation extracosts of non-peninsular systems, repealing the provisions of Royal Decree-Law 6/2009 in this regard which foresees to pass on 100% of such costs from the State's budget from 2013.

Industry Regulation and the functioning of the Gas System in Spain

The natural gas sector in Spain has undergone significant changes in structure and operation in the last 10 years, from a monopoly to a fully open market, driven mainly by the deregulation measures in European Directives (1998/30/EC, 2003/55/EC and 2009/73/EC) aimed at opening up markets and creating a single European gas market.

These liberalised principles have been incorporated and developed in Spanish law through Law 34/1998 on the Hydrocarbons Sector (the "Hydrocarbons Sector Law"), which began the deregulation process and, more recently, through Law 12/2007 which completed it.

The 1998 Hydrocarbons Sector Law laid the foundations for the new gas system, particularly with regard to the separation of activities (regulated and deregulated), the introduction of third-party access to the regulated assets, the abolition of the former concessions for piped gas supply and their conversion into regulated administrative permits, and the establishment of a timetable for progressive market deregulation.

In line with these principles, the gas system has been structured around two types of activity: regulated activities (regasification, storage, transportation and distribution) and deregulated activities (trading and supply).

With regard to the separation of activities, Law 34/1998 provides for the legal separation of deregulated and regulated activities and the segregation for accounting purposes of the various regulated activities. In addition, with the publication of Law 12/2007, Spain moved a step closer

to achieving functional separation between network activities and deregulated activities and between network activities and technical system management. In 2012 the Government approved Royal Decree-Law 13/2012 in order to implement Directive 2009/73/EC establishing additional separation measures in the management of the transmission network.

Although the Hydrocarbons Sector Law had established the general principles underpinning the new Spanish gas system, the sector's deregulation did not commence in practice until 2001, following publication of Royal Decree -Law 6/2000, on urgent measures to intensify competition in the goods and services markets, and Royal Decree 949/2001, regulating third party access to gas installations and establishing an integrated economic system for the natural gas sector.

The first of these decrees enacted certain elements of the Hydrocarbons Sector Law with the aim of fostering measures that would facilitate the elimination of entry barriers for new supply companies. In particular, it created the Technical System Manager (ENAGAS, S.A.), providing for a 25 per cent. gas release under the contract for natural gas brought from Algeria through the Maghreb pipeline, and brought forward the timetable for deregulation.

The second, Royal Decree 949/2001, established, firstly, the specific terms and conditions for third-party network access and, secondly, a remuneration system for regulated activities and a cost-based system of tariffs, tolls and charges structured according to pressure levels and consumption bands.

The publication of the specific criteria to be applied for third-party network access (guarantees, capacity assignment criteria, grounds for refusal, etc.) and the actual level of the tariffs, tolls and charges were key in encouraging new operators to enter the market. The remuneration assigned to each company as well as the tariffs, tolls and charges are updated periodically by ministerial orders and resolutions.

The economic system also established a settlement procedure that would allow for the redistribution of revenues collected in the form of tariffs, tolls and charges between the various regulated activities in accordance with the remuneration method established. The body responsible for effecting this redistribution is the National Energy Commission.

Other issues relating to the regulation of the transmission, distribution and supply businesses, the administrative authorisation procedures for natural gas facilities and the regulation of certain aspects of the supply business are dealt with in Royal Decree 1434/2002.

As for the technical operation of the system, the operating regulations are established in Order ITC 3126/2005 enacting the Gas System Technical Management Rules. *Inter alia*, these regulations establish that each operator is individually responsible for maintaining its liquidity and enacting specific protocols for the conduct of the Technical System Manager in exceptional operating circumstances.

Despite the sector's progressive deregulation, prevailing regulations uphold the state's obligation to ensure the safety and continuity of supply. To this end, Royal Decree 1766/2007 stipulates that direct market suppliers and consumers must maintain minimum security stocks equivalent to 20 days' consumption. In addition, it limits the maximum percentage of gas supplies that may be sourced from a single country to 50 per cent.

The state also maintains responsibility for obligatory planning work for certain infrastructures (gas pipelines forming the core transmission network, the secondary transmission network, determining the total liquid natural gas regasification capacity necessary to supply the system and core natural gas storage facilities). For all other infrastructures, the state's planning work is

provisional only. As part of this process, planning is carried out by the government with contributions from the regional governments of Spain and subsequently submitted to the Congress for approval. In 2012 Royal Decree-Law 13/2012 brought in a series of measures to stop the construction of new transmission infrastructure, in the context of reduced gas demand.

As mentioned above, in Spain the deregulation process was completed with Law 12/2007 transposing Directive 2003/55/EC. The two key changes enacted by this law were the elimination of regulated supply and the functional separation between network activities and deregulated activities.

In the Spanish gas system, the market deregulation process was completed on 1 July 2008 with the elimination of regulated supply for Group 3 customers and the creation of Last Resort Supply. Currently, low-pressure customers with annual consumption of less than 50,000 kWh who do not choose another supply option shall be supplied by a last-resort supplier at a price calculated automatically. This additional rate is called the last resort tariff.

Iberdrola Comercialización de Último Recurso, S.A.U. has been designated as last resort supplier of electricity and natural gas in Spain.

Industry Regulation in the UK

The principal laws that govern Scottish Power, Ltd.'s (Scottish Power) activities are the Electricity Act 1989 and the Gas Act 1986, as substantially amended and supplemented by numerous subsequent enactments, including the Gas Act 1995, the Utilities Act 2000, the Energy Act 2004, the Energy Act 2008, the Energy Act 2010, the Energy Act 2011 and various European Union (EU) directives. A further Energy Bill was introduced into the UK Parliament in November 2012 and remains under consideration. The Energy Bill continues its passage through Committee Stage in the House of Lords, with the plan remaining to enact the Bill by the end of 2013.

Other laws relating to subjects such as environmental protection, health and safety, and planning and competition are also very important parts of the framework in which Scottish Power operates. These laws are enforced respectively by the Environment Agency (or in Scotland, the Scottish Environmental Protection Agency); the Health & Safety Executive; local and national planning authorities; and the Office of Fair Trading ("**OFT**") working concurrently with the Office of Gas and Electricity Markets ("**OFGEM**"). Certain aspects relating to customer protection are imposed by the Authorities of Fair Trading, OFT and OFGEM.

The Authority

The Utilities Act 2000 replaced individual gas and electricity regulators with one regulatory authority, the Gas and Electricity Markets Authority ("**GEMA**"), comprising a chairman and other members appointed by the Secretary of State for Energy and Climate Change. GEMA is supported by a non-ministerial Government department, OFGEM. The main instrument of regulation used by GEMA is the licensing regime which in most cases requires the various aspects of the energy industry (such as transmission, distribution, generation, supply) to be carried out under a licence to which standard conditions apply. In addition, there are a number of statutory obligations, known as relevant requirements, which are enforced by GEMA as if they were licence conditions.

GEMA's principal objective is to protect the interests of present and future consumers, wherever appropriate, by promoting effective competition. From the perspective of Government, the interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them;

and before GEMA protects consumers' interests by means of market competition and they must consider whether an alternative course of action would better protect those interests.

In furthering this objective GEMA must ensure that all reasonable demands for electricity and gas are met, ensure that licence holders are able to finance the activities they are obliged to undertake, and contribute to the achievement of sustainable development.

Numerous other duties are also required to be taken into account, but do not override the principal duties. They include the interests of customers who are disabled or chronically sick, of pensionable age, have low incomes or are residing in rural areas. They also include the interests of users of other utilities, promoting the efficient running of the companies in the industry, protecting the public from danger, securing a diverse and viable long term energy supply, and complying with good regulatory practice.

GEMA's functions include the granting of licences (and revoking them certain limited circumstances), making changes to licence conditions (including the operation of price controls for the monopoly network functions), reviewing industry code modification proposals, operating schemes for promoting renewable electricity and energy efficiency and enforcement of the industry's obligations.

GEMA has power to impose monetary penalties for past and ongoing breaches of licence conditions and relevant requirements established for supply. Fines can be up to 10 per cent. of the licensee's applicable turnover. The Secretary of State and GEMA have to provide an annual report to Parliament on the security of energy supply and also the capacity of the network to deliver that energy. This will form a key input into the capacity mechanism under the Electricity Market Reform (see below).

Licences

Companies within the Scottish Power Group hold licences for various functions including:

- The supply of electricity;
- The generation of electricity;
- The distribution of electricity in the South Scotland area;
- The distribution of electricity in the Manweb area (Merseyside and North of Wales);
- The transmission of electricity in the South Scotland area;
- The supply of gas;
- The shipping of gas (that is, arranging to insert it into and remove it from the public network); and
- The transportation of gas to certain specific sites (such as proposed new gas fired power stations).

The same company is not permitted to hold both an electricity transmission or distribution licence and an electricity supply licence or generation licence. Similarly the same company is not permitted to hold a gas transporter licence and a gas supply or gas shipper licence. However it is possible for different entities within the same group to hold such licences.

The EU third package electricity directive (2009/72/EC) sets down additional restrictions about the ownership of transmission companies. On 19 June 2012, Scottish Power Transmission Limited ("SPTL") was certified by OFGEM under Article 9(9) of the Directive, with the approval of the EU Commission, on the grounds that SPTL's arrangements guarantee more effective independence than the "ITO" arrangements in Chapter V of the Directive. As a result, the unbundling provisions do not apply to SPTL.

The conditions of licences regulate such matters as:

- for network licensees, the quality of service and the charges that can be made.
- for supply to domestic consumers, consumer protection provisions including rules on debt and disconnection, cost reflective pricing (especially in relation to payment methods) and on fair marketing.
- for most types of licence, rules requiring adherence to industry codes that set down the detailed technical rules for operating the industry, and providing for OFGEM to determine whether proposed changes to the codes should go ahead.

The Gas Act 1995 and Utilities Act 2000 introduced standard licence conditions to ensure that all holders of a particular licence type are normally subject to the same conditions. The Secretary of State determined the initial standard licence conditions, although subsequent modifications are made by GEMA. Under the Electricity and Gas (Internal Markets) Regulations 2011, modifications, whether to the conditions of an individual licence or to the standard conditions, no longer require any consent by the licence holders. However, the licence holder(s) in question, and certain other persons or bodies who are materially affected, can appeal the matter to the Competition Commission on matters of procedure and/or substance.

The Energy Acts 2008, 2010 and 2011 contain clauses allowing the Secretary of State to modify licence conditions without the consent of the licence holders (and without appeal to the Competition Commission) for certain specified purposes, including the introduction of smart meters, the introduction of feed-in tariffs for small scale renewable or CHP generation, the creation of a renewable heat incentive, implementing assistance schemes for people in fuel poverty (it applies to customers who spend over a specific percentage – –currently 10 per cent. – of their salary), setting notice periods to be given for tariff changes, the limitation of excessive returns in the balancing market, setting up the Green Deal (as provided for in the Energy Act 2011 which seeks to reduce costs with respect to carbon emissions) energy efficiency scheme, providing additional information on consumer bills and facilitating the proposed special administration regime in the event of supplier insolvency. In most cases, these powers are time limited. Changes to licence conditions can also be made without licensees' consent pursuant to an EU obligation, using powers established in the European Communities Act 1972.

When OFGEM makes a decision on modifying an industry code which runs contrary to the views of the relevant industry governance body, the decision can, with certain exceptions, be appealed to the Competition Commission.

Competition Legislation

GEMA also has concurrent powers with the **OFT** to apply the Competition Act 1998, the Fair Trading Act 1973 and the Enterprise Act 2002 to the energy sector in Great Britain. The Competition Act 1998 is based on Articles 81 and 82 of the EC Treaty (now Articles 101 and 102 TFEU) and GEMA can levy fines of up to 10 per cent. of turnover for breaches of the prohibitions on anticompetitive agreements or abuse of a dominant position.

Under the Enterprise Act, the GEMA and the OFT have powers to initiate a market investigation where it appears that competition has been prevented, restricted or distorted in relation to commercial activities related with the electricity or gas markets (and where it would not be more appropriate to proceed under the Competition Act 1998 or using other powers). Features that could be examined are the structure of the market (or any aspect of its structure), the conduct of companies operating within it, and the conduct of such companies' customers. The market is assessed according to a competition-based test.

The Government introduced the Enterprise & Regulatory Reform Bill in May 2012 intended to merge the Competition Commission (CC) and OFT, creating a single Competition Market Authority ("CMA"). The CMA, which is expected to start operations in April 2014, will retain most of the functions and powers of the CC and OFT. The Bill is intended to give the CMA increased powers to halt and unwind mergers and conduct cross market investigations. It is also intended that the CMA will be subject to statutory timescales on first stage inquires and investigations and second stage development of remedies.

Price controls

Prices for the sale of electricity and gas by utilities to final consumers are not controlled in Great Britain. There is no controlled tariff for certain categories of consumer, although all the major suppliers offer a system of rebates and other benefits for certain disadvantaged customers in accordance with the Warm Home Discount Regulations 2011. The total cost of the Warm Home discount measures for Scottish Power in 2012-13 is likely to be of the order of £5 per customer account and (as with any other cost) it is open to suppliers to factor this cost into their tariffs. OFGEM has implemented licence modifications requiring any price variation by payment method to be cost reflective, but has allowed the licence condition requiring broader non-discrimination in charges to lapse.

Similarly, there are no controls other than those established in the Competition Act 1998 on prices charged to commercial customers or on the wholesale electricity and gas markets.

Since 29 October 2012, there has been a Transmission Constraint Licence Condition (TCLC) applicable to electricity generators. This prohibits the making of excessive gains as a result of generators making uneconomic dispatch decisions or when offering downward flexibility to the grid. OFGEM have issued guidance on their intended approach to the interpretation and enforcement of the TCLC which recognises the factors that generators are required to take into account in scheduling decisions and bid pricing. Rulings under the TCLC are subject to review by the Competition Appeals Tribunal, rather than the more limited review by the Court for other OFGEM enforcement decisions, and the condition will lapse five years after its introduction, with a possible extension for a further two years.

OFGEM is carrying out a consultation on the proposals for the retail market review programme for limiting the products that can be sold in the domestic energy market. The proposals include constraints on the number and make up of tariffs (with a cap of four core tariffs plus variations by parameters such as payment method, metering type and region), prescribed information requirements and requirements to notify customers about cheapest tariffs. It is also proposed to impose Standards of Conduct in the treatment of Customers covering all aspects of the supplier-customer relationship. The Government is also planning to take powers in the new Energy Bill to impose similar requirements, over-riding any possible appeal to the Competition Commission. It is likely that the proposals will be finalised during or after summer 2013.

The transmission and distribution networks are however recognised to be a natural monopoly. Their prices have so far been controlled according to a five-year formula known as **RPI-X**. The regulator assesses the costs of an efficient network operator and the likely capital programme in

order to calculate the return needed to meet a target return on capital. Various incentives are then added to the formula which also takes account of the Retail Prices Index (RPI) and any projected efficiency improvements (-X) in order to calculate the permissible revenues for the network.

This framework is being replaced by the new RIIO framework (Revenue = Incentives + Innovation + Outputs). RIIO is similar to RPI-X, but there are several important changes. These changes are to be applied over the next price reviews which will affect regulatory periods of 8 years (with a limited review after 4 years), using a market index for checking the debt cost, and the introduction for electricity of an amortisation period of the installations of 45 years which replaces the 20 years period under RPIX. Also, the process for setting the controls has changed with a "fast track" process designed to conclude the negotiation in advance for companies who submit business plans that are acceptable to OFGEM.

In transmission, SPTL's final RPI-X control ended in March 2013. SPTL was fast-tracked in its RIIO process and the agreed RIIO controls will start in April 2013.

The distribution controls for Scottish Power's networks in the South of Scotland and the Manweb were reset in April 2010 ("DPCR5") and it is expected that they will be checked under the RIIO framework, with a new control (RIIO-ED1) which will enter into force in April 2015. Scottish Power Networks has recently submitted OFGEM its rich business plan referred to RIIO-ED1 in the context of the negotiations driving to the new regulatory period.

Other issues

Other key elements of the regulatory regime in Great Britain include:

(a) *The Renewables Obligation ("**RO**")*. The United Kingdom intends to source 30 per cent. of electricity from renewable sources by 2020 and the RO, introduced in 2002, is currently the main support scheme for renewable electricity projects in the United Kingdom. The Renewables Obligation Orders (which apply separately to different parts of the United Kingdom within a unified scheme) place obligations on suppliers of electricity to source an increasing proportion of their electricity from renewable sources (based on the higher of specified minimum targets and the expected level of renewable energy production in the year plus 10 per cent "head-room"). Suppliers meet their obligations by presenting sufficient Renewables Obligation Certificates "ROCs") and/or paying a set "buy-out" price into a fund.

The proceeds of the fund are paid back to those suppliers that have presented ROCs in proportion to the number of ROCs presented. Since April 2009, the RO has been "banded" so that differing technologies get different levels of support, depending on their expected costs. A review of bandings concluded in 2012, as a result of which new projects commissioning in April 2013 (or later for some technologies) will receive revised levels of support. The Government is considering whether further revision to the banding for onshore wind is needed from April 2014.

Projects that started generation before 1 April 2009 receive support until 31 March 2037 and projects that started after 1 April 2009 receive support for 20 years subject to closure of the RO on 31 March 2037. The UK Government has indicated that the RO will close for new projects on 1 April 2017, to be replaced by a new aid scheme relating to the Energy Market Reform ("**EMR**"). It will continue to operate for new facilities joining the RO before this date, but from 1 April 2027 the Energy Bill proposes to change its form to a premium payment.

(b) *European Union Emissions Trading Scheme (EU-ETS)*: like all EU Member States, generators in the UK participate in the EU Emissions Trading Scheme ("EU ETS"). The Department of Energy and Climate Change ("DECC") has responsibility for administering the National Allocation Plan. So far, the majority of European Union Allowances ("EUAs") have been issued as free allowances: the UK government decided to auction or sell 7 per cent. of EUAs issued under its Phase II NAP (closing 2012). From 2013, the government will be required to auction all allocations to the power sector. The Climate Change Act 2008 set out a trajectory towards reducing greenhouse gas emissions to 20 per cent. or less of 1990 levels by 2050, with interim reduction targets.

(c) *Domestic Energy Efficiency schemes*. Energy suppliers who supply over 250,000 domestic customers ("obligated suppliers") are subject to significant requirements to achieve energy efficiency improvements among their customers. As with any other cost, the costs of making those improvements (less any money received from the customer directly or through the Green Deal – see below) can be factored by suppliers into tariffs, subject to the need to remain competitive in the market.

The Carbon Emissions Reduction Target "CERT") and Community Energy Saving Programme ("CESP") schemes ended in December 2012 although OFGEM has invited those who were unable to complete their obligations on time to undertake mitigation actions (that is further insulation) until 30 April 2013. CERT required obligated suppliers to achieve a specified amount of carbon reduction, benchmarked against eligible measures such as cavity wall insulation, loft insulation and appliance improvements. CESP applied to obligated suppliers and also large generators. It is designed to achieve concentrated energy efficiency upgrades, largely going beyond the normal CERT measures, in very low income areas.

The Energy Company Obligation ("ECO") replaces CERT and CESP and runs from 1 January 2013 to 31 March 2015. It comprises three separate targets: the Home Heating Cost Reduction Obligation, which requires suppliers to deliver insulation and heating systems to vulnerable customers living in privately owned properties; the Carbon Saving Community Obligation, which requires suppliers to provide insulation and energy saving measures to properties in low income areas, including some in rural communities; and the Carbon Emission Reduction Obligation which requires suppliers to deliver solid wall insulation or non-standard cavity wall insulation to any applicable property.

(d) *The Community Energy Saving Programme (CESP).* CESP is an additional energy efficiency programme operated by domestic energy suppliers and large generators which is designed to achieve concentrated energy efficiency upgrades, largely going beyond the normal CERT measures, in a small number of targeted areas of intense economic need. Like CERT, CESP ends on 31 December 2012.

(e) *Energy Market Reform ("EMR")*: In July 2011, the UK government published its proposals for EMR, aimed at providing a framework for the necessary investment for decarbonisation of Britain's energy supply while maintaining security of supply and an acceptable level of costs. In December 2011, this was followed by updated technical information giving more details about the procedures to follow. The elements of the proposals are:

- a new incentive scheme, based on feed-in tariffs and contracts for difference to support low carbon generation, with the RO preserved for plants commissioning until April 2017;

- a capacity mechanism to support security of supply (market-wide mechanism);
- and an emission performance standard, to control the construction of high carbon plant.

National Grid will take a leading role in the administration of the CFD system and the capacity mechanisms in accordance with the criteria established by the Government. More details on the system are expected to be revealed in the consultations to address in 2013 and the legislation is set to be introduced this year as well.

In July 2013, DECC has published draft delivery plan for CFD and proposed capacity mechanism reliability standards and is expected to consult in short capacity mechanism arrangements and CFD head of terms.

(f) *Pollution Control: The Integrated Pollution Prevention and Control ("IPPC"), the Large Combustion Plant Directive ("LCPD") and the Industrial Emissions Directive ("IED").* This covers the regulatory regime for controlling pollution from certain industrial activities, including thermal combustion generation, and imposes limits on various categories of emissions. In particular, the LCPD limits the emission of sulphur dioxide (SO_2), oxides of nitrogen ("NO_X") and dust from power stations, whereby operators of such plants have the option of meeting those requirements or accepting a limited hours derogation prior to closure by the end of 2015. The IED puts in place a similar regime for 2016 and beyond, with more stringent standards. The IED is transposed into UK law through the Pollution Prevention and Control (Scotland) Regulations 2012 and amendments to the Environmental Permitting (England and Wales) Regulations 2010.

(g) *Green Deal*: The Green Deal is a mechanism that will allow householders and businesses to receive funding for energy efficiency measures, to be repaid through a surcharge on their electricity bill. Customers can sign up to Green Deal plans from January 2013 with suppliers collecting payments from March 2013. Suppliers are obliged to administer the cash collection arrangements on behalf of Green Deal Providers and may also participate as Providers themselves. Measures are not be designed by accredited providers and must meet the Golden Rule that the savings due to reduced consumption exceed the payments. In some cases, this will be achieved by the number receiving a subsidy through the ECO scheme described above. It is as yet unclear how enthusiastic consumers will be about taking up the Green Deal.

Industry Regulation in the USA

Electricity generation from renewable energy resources

In the United States, numerous State Governments and the Federal Government have adopted measures and implemented numerous regulations designed to foster the development of electricity production from renewable resources. State programmes have generally come in the form of (1) Renewable Portfolio Standards ("**RPSs**") that usually require utilities to generate or purchase a minimum amount of renewable electricity and (2) tax incentives. To date, the Federal Government has primarily supported renewable energy development through tax credits to production and investment as well as accelerated depreciation.

Twenty-nine states and the District of Columbia have adopted mandatory RPS requirements, which vary across the states but will generally range from 15-30 per cent. of utility generation by 2025. The requirements are typically implemented through a system of tradable renewable

energy certificates that verify that a kWh of electricity has been generated from a renewable resource.

Most States also offer a variety of tax incentives to promote investment in renewable energy resources. For instance, Washington and Colorado, among other States, exempt the sale and use of renewable energy equipment from taxation, which reduces development costs substantially. Several States reduce property tax requirements on renewable generation facilities through enterprise zones or similar designations, while Minnesota has substituted a fixed-rate production tax in lieu of property taxes. Other states, such as Texas, boost the construction of electrical infrastructure (Competitive Renewable Energy Zones, or "CREZ") to ease the transportation of renewable electricity towards load location.

In 1992 the US Congress enacted legislation that established a Production Tax Credit (**PTC**) of USD15/MWh (adjusted for inflation) for the production of electricity from wind power facilities with 10-year duration. This programme has been renewed on several occasions and has been expanded to include the production of electricity from several additional renewable resources, including biomass, geothermal, municipal solid waste and hydroelectric power. The production tax credit, which is currently valued at USD22/MWh, expired on 31 December 2012 but has been extended one more year, and will apply to those projects that will start construction in 2013. In 2005 Congress established a 30 per cent. investment tax credit ("**ITC**") for solar power projects. This investment credit is currently applicable to all solar projects placed in service prior to 1 January 2017. The purposes of the PTC and ITC are to make electricity production from renewable resources more competitive relative to fossil fuel and nuclear power facilities.

In response to the effects of the economic crisis in the US, in 2009 Congress approved legislation authorising companies eligible for the PTC to receive an ITC instead or, in the alternative, for companies eligible for the PTC or ITC to receive a cash payment equivalent to 30 per cent. of the eligible investment in a facility for projects which commence construction no later than 31 December 2011 (after an extension was agreed by U.S. Congress in 2010) and are placed in service prior to 1 January 2013 for wind facilities, 1 January 2014 for other projects currently eligible for the PTC, and 1 January 2017 for solar facilities.

In addition to the PTC and ITC, renewable energy facilities are eligible for accelerated five-year tax depreciation on their investments. This programme, which is known as the Modified Accelerated Cost Recovery System ("MACRS"), does not have expiration date.

As a result of 2009 and 2010 legislation, many facilities placed in service during 2008, 2009, and 2010 qualified for "bonus depreciation" which allows a 50 per cent. depreciation deduction in the year a facility is placed in service. Subsequent legislation in 2010 allows 100 per cent. depreciation for facilities placed in service after 8 September 2010 and no later than 31 December 2011, with facilities placed in service during 2012 receiving 50 per cent. bonus depreciation. This 50 per cent. bonus depreciation has been extended to projects placed in service during 2013, and can be applied to 2013 expenses of projects placed in service during 2014.

Electricity and natural gas distribution

The New York tariff review, the New York Management Audit, the Internal Reorganization and the Maine transmission and distribution tariffs, the Maine 2010 major storm cost review and processes that affected Iberdrola USA, Inc. (hereinafter, Iberdrola USA) in 2012.

The revenues of Iberdrola USA are essentially regulated, being based on tariffs established in accordance with administrative procedures negotiated with the various regulatory bodies. The tariffs applied to regulated activities in the United States are approved by the regulatory

commissions of the different States and are based on service costs. The revenues of each regulated utility are set to be sufficient to cover all its operating costs, including energy costs, finance costs and the costs of equity, the last of which reflect the company's capital ratio and the "reasonable" return on equity.

Energy costs that are set on the New York and New England wholesale markets are passed through to consumers. The difference between energy costs that are budgeted for and those that are actually incurred by the utilities is offset by applying compensation procedures that result in either immediate or deferred tariff adjustments. These procedures apply to other costs, which are in most cases exceptional (effects of extreme weather conditions, environmental factors, regulatory and accounting changes, treatment of vulnerable customers, etc.) that generate credits and liabilities that are offset in the tariff process. Any revenues that allow a utility to exceed target returns (usually because of better-than-expected cost efficiency) are generally shared between the utility and its customers, resulting in future tariff reductions.

Each of the five supply companies in Iberdrola USA, which are between them active in four different states, must comply with regulatory procedures that differ in form but in all cases conform to the basic framework outlined above. As a general rule, tariff reviews cover various years (three in New York and five in Maine) and provide for reasonable returns on equity, protection and automatic adjustments for exceptional costs incurred and efficiency incentives.

New York tariff reviews

On 21 September 2010, the New York Public Service Commission ("**NYPSC**") approved the rates for the New York State Electric & Gas Corporation ("**NYSEG**") and Rochester Gas and Electric Corporation ("**RG&E**") for a three year and four month period. The rates approved allow for annual delivery tariff increases ranging on average between 3 to 7 per cent. for the different companies, based on 10 per cent. ROE applicable on a 48 per cent. equity ratio. In September 2012, NYSEG and RG&E put in place the third annual delivery tariff increase for each of the respective businesses. The rate term is extended until December 2013 with the right to continue for periods beyond 2013, with specific Earning Sharing Mechanisms rules giving clear incentives to the companies to introduce efficiency measures with strict quality targets. Rates also carry protection against uncontrollable cost variations and include a revenue decoupling mechanism.

New York management audit

In 2011, the NYPSC commenced a management audit of NYSEG, RG&E, Iberdrola USA and Iberdrola (with regard to its operations in the United States). The management audit was conducted pursuant to the requirements of the New York Public Service Law and affects all New York public service companies. The audit focused on the gas and electricity transmission and distribution operations including the corporate objectives, planning, budgeting, capital budget and personnel management. The final audit report was issued in July of 2012 and contained 75 recommendations. On August 28, 2012 the Commission issued an order on the management audit. The order required the Companies to supplement its reorganization petition in Case 12-M-0066, to address governance and structural issues contained in the audit report and to participate in a collaboration with parties. The order also required the Companies to file an Implementation Plan by October to address the audit recommendations. The Companies filed their Implementation Plan in October 2012 and is periodically filing progress to the regulator.

Internal Reorganization

In February 2012, IUSA filed Internal Reorganization petitions in New York, Maine, New Hampshire and FERC for approval to consolidate the Iberdrola subsidiaries in the United States

under one holding company. Specifically, Iberdrola Renewables Holdings and Iberdrola USA would be consolidated under a new Iberdrola USA holding company. A new intermediate holding company, Iberdrola USA Networks, would be created to hold all of Iberdrola's regulated electric and gas utilities in the United States (i.e. NYSEG, RG&E, CMP, Maine Natural Gas and New Hampshire Gas Corporation. The MPUC, New Hampshire PUC and FERC all issued orders granting the internal reorganizations in April and May 2012. The New York PSC required additional filings and information as part of its management audit as noted above. The Company anticipates NYPSC approval of the internal reorganization by the second quarter of 2012.

Maine

The transmission tariffs of Central Maine Power ("**CMP**") are set by the FERC through a regulated tariff and are administered by ISO New England. The transmission tariffs are set annually using the formula authorised by the FERC which permits the recovery of the direct operating and maintenance expenses assigned to transmission, and the return on the investment in transmission assets. The FERC offers a Return on Equity ("ROE") and additional incentives applicable to the assets based on age, voltage and other factors. The formula also includes provisions for the tariff to include the budgeted investments in facilities, subject to reconciliation the following year. In accordance with the FERC's tariff incentive order, CMP receives an ROE of 12.89 per cent. (11.14 per cent. base ROE, 50 basis point NETO added, and 125 basis point incentive) and its tariffs are allowed to include the construction work relating to the Maine supply security programme (USD 1,400 million were invested in CMP for the transmission project from 2011 to 2015), subject to an annual reconciliation.

In September 2011, the Massachusetts Attorney and other state officials filed a complaint with the FERC stating that the base return on equity of ISO New England for the owners of the transmission facilities in New England was too high and should be lowered. CMP is a member of the New England Transmission Owners ("**NE-TO**"). The current base return on equity is 11.14 per cent. The complaint requests that the FERC reduce the NE-TO's allowed base ROE by 1.94 per cent. to a value of 9.2 per cent.. The NE-TOs disagree with the complaint and requested dismissal. In May 2012 the FERC issued an order setting a hearing for the complaint and directing the matter to the settlement judge procedure. Following designation of a settlement judge, an initial settlement conference was convened, and settlement discussions ensued. In August 2012 the FERC settlement judge declared the parties to be at an impasse and terminated settlement proceedings. A litigation schedule to resolve the complaint has been established and a decision by the FERC is expected in late 2013 or early 2014.

CMP customer charge-offs: Under Maine electric restructuring law, Maine electric delivery utilities are required to bill customers for delivery and supply service. This includes managing delivery and supply accounts receivables and uncollectibles. On 25 January, 2013, the MPUC issued its written order confirming the $4.1 million credit to the standard offer retainage account. After PUC denied CMP's Request for Reconsideration, the company has filed appel with Maine Supreme Judicial Court on 4 June, 2013.

CMP Storm Costs: Under its distribution service 2008 Alternative Rate Plan ("ARP 2008"), CMP is allowed to recover restoration costs for extraordinary storms meeting established qualification criteria. In 2011 the MPUC staff raised concerns regarding $4.9 million of storm costs associated the qualification of the November 2010 storm as an extraordinary storm event, as well as the prudence of certain restoration costs incurred in the February 2010 storm. In June 2012, the MPUC concluded that all of CMP's 2010 storm restoration costs were prudently incurred and qualified for rate recovery under the terms of ARP 2008.

CMP's distribution tariffs are set under the **ARP 2008** approved by the Maine Public Utilities Commission ("**MPUC**") for a five-year period commencing 1 January 2009. Under the ARP 2008, CMP's distribution tariffs are adjusted on 1 July each year in line with an inflation index less a productivity factor of 1 per cent. The tariff plan also includes changes in prices for the recovery of unexpected significant costs, including those arising from changes in the law, capital gains or losses, environmental expenditure and major storms On 14 March 2012, CMP submitted its request for the fourth annual price change under ARP 2008. On June 21, 2012, the MPUC approved a stipulation resolving all matters relating to the annual price change on 1 July 2012 resulting in a net distribution price increase of 2.15 per cent. In June 2013, distribution price stipulation was approved with the 6.5% distribution tariff increase effective July 1, 2013. The MPUC also approved the audit of the CMPs AMI program.

CMP has filed Direct Testimony on 5 May 2013 as regards ARP 2014 to define distribution remuneration framework over next 5 years. First data request have been submitted to company and hearings and technical conferences already scheduled starting in July 2013.

Industry Regulation in Brazil

The electricity distribution activities carried out by subsidiaries consolidated using proportionate consolidation, being Companhia de Eletricidade do Estado do Bahía, S.A. ("Coelba"), Companhia Energética do Río Grande do Norte, S.A. ("Cosern") and Companhia Energética do Pernambuco, S.A. ("Celpe"), are subject to the regulations of the countries in which they operate.

On 27 April 2011 ELEKTRO was acquired by a distribution company which operates in Sao Paulo and Moto Grosso do Sul, therefore, it is subject to the same regulation.

The Brazilian regulatory framework is based on a system of maximum tariffs (Price-Cap) that is revised every three, four or five years, depending on each company`s concession contract. Coelba, Celpe and Cosern have a five-year term and Elektro has a four-year term. The tariffs are updated annually by the Brazilian National Energy Agency ("ANEEL"), through the annual adjustment process that considers inflation, an ex-ante efficiency factor and variations on the non-manageable costs components, such as energy and transmission.

The tariffs have two components:

Component A, which corresponds to energy purchases and to other costs that are extraneous to the distributor and passed through to the end tariff.Component B, which corresponds to costs relating to the distributor's system of remuneration and which factor in operating and maintenance expenses, a return on investment (determined by applying a rate of return to the value of the distribution assets) and an efficiency-related factor.

As explained above, the aim of the annual revision is to ensure that component A costs are passed on and that component B costs perform in line with inflation and with the pre-determined efficiency factor.

In November 2011, ANEEL approved the rules applying to the third cycle of Periodic Tariff Reviews ("**RTP**") for the distribution companies in Brazil.

With regard to the rules prevailing in the previous regulatory period, the main changes were:

- *WACC (actual after tax)*: reduced from 9.95 per cent. to 7.5 per cent.;

- *Benchmark company*: the methodology was changed from a *benchmark company* to a benchmark model relating to operating costs;

- *Other income*: other items invoiced to customers were included in the base tariff, particularly penalties applied to customers (surplus demand, surplus reactive power, etc.);

- *Base remuneration*: there were no significant methodological changes (assets are taken into consideration at the beginning of the second cycle plus the investments incurred in the regulatory period, less depreciation and amortisation, plus accumulated inflation);

- *X factor*: a service quality component was added based on specific indices (frequency and duration of service interruptions). A "route factor" is also taken into account. This sets a destination route for operating costs until the end of the third regulatory period, depending on each distribution company's benchmark model; and

- *Transfer of SUDENE tax incentives to customers*: this item is the subject of litigation and the transfer was suspended by the judge until a final decision has been taken.

The third RTP will be fully operational in April 2013 for the distribution companies of Neoenergía (Coelba, Cosern and Celpe). In ELEKTRO's case, the third tariff cycle scheme began to apply in August 2012 with retroactive effect from August 2011.

For the electricity generation business, the new model for the Brazilian electricity sector introduced in 2004 made the Government responsible for guaranteeing adequate expansion of the supply of energy to the system, eliminating the risk of further rationing. This expansion is being pursued via the public tendering of generation projects in which the successful bidder is the supplier that offers the lowest price in Brazilian reals per MWh generated, in exchange for which the bidder is awarded a concession or permit for between 15 and 30 years (depending on the technology) to operate a power station under a sales contract and at a price that is predetermined at the time of the tender.

Brazil faced some important structural changes to its electricity regulation during the last year.

In September 2012, the president Dilma Roussef announced a “Provisional Law” (MP 579) cutting some of the regulatory encumbrances of the electricity sector and setting the rules for the option to extend expiring concession terms. Regarding the sector encumbrances, two of them will be fully extinct from the tariffs - RGR and CCC – and another one will be partially funded by the Brazilian Treasury. Besides, the anticipation of the end of concession terms for many generation plants and transmission lines (those who agreed on the conditions) from 2015-2017 to 2012 allows further reduction. Altogether, these effects represent around an 18 per cent. reduction for low voltage customers and up to 32 per cent. reduction for medium and high voltage customers. Energy prices for the renewed concessions (previously defined by auctions) were calculated by the government and ANEEL. The new revenues of renewed concessions of both generation and transmission shall include only O&M costs and a specific operational profit depending on how efficient the assets are in comparison to the sector average. Existing non-depreciated investments will be compensated by governmental funds.

Tariff reductions have taken place as promised though the lack of support of several generators to the new regulations left short of cheaper long term generation contracts to the Brazilian supply. This expanded short position together with a worsening in hydro conditions at 2013 led to a significant increase in energy costs to be supported by distributors. Government provided public funds through Conta de Desevolvimento Energetico in order to mitigate financial stress to distributors and soften requirements for a new tariff adjustment.

Also in 2012, ANEEL has proposed to establish short term tariff adjustments by means of determining triggers in the energy cost component transferred to the final customers – the "tariff flag". The Green Flag will mean low costs based on the hydro power domination, the Yellow Flag will indicate generation costs are increasing due to the increasing use of thermal power in the hydrothermal matrix and the Red Flag will indicate situations where the energy supply is taking even higher costs. The methodology will also start operating in 2014 (starting in June 2013 for information purposes) and may reduce the energy cost variation accumulated in a year to date way, which is currently supported by the power distribution companies' cash flow before being considerated in the Component A during the annual tariff adjustments.

In April of the same year, ANEEL issued the Normative Resolution 482/2012, determining the conditions for a customer to produce its own power and connect it to distribution grids – so called "micro and mini distributed generation". Distributed Generation regulation in Brazil used to be restricted to small power plants connected to the medium voltage grid (13,8kV – 69kV), from whom DSOs can fulfil up to 10 per cent. of their captive markets buying through public bids. From now on, ANEEL has defined the access methodologies for these micro and mini generators, ratified by the agency in December 2012. A micro generator is classified as up to 100kW, while the mini generator is classified as up to 1000kW and they must operate based on renewable sources only (for example, solar or wind). The energy volumes exported to the grid are "priced" at the same local tariff and can be compensated as credits for up to 36 months subsequently.

Industry Regulation in Mexico

General Framework, CFE and CRE

The Mexican electricity sector has been regulated for more than 30 years by the Electricity Public Service Act ("**LSPEE**") which, in accordance with the Political Constitution of the United States of Mexico, establishes that it corresponds "*(…) exclusively to the Nation, to generate, transmit, transform, distribute and supply electricity that is intended to be used to provide a public service (…). In this field, concessions will not be awarded to individuals and the Nation, via the Federal Electricity Commission, will exploit the assets and natural resources that are necessary for such purposes*".

The same law charges the aforesaid Federal Electricity Commission ("**CFE**"), which has the legal status of a decentralised public sector institution, with responsibility for the planning of the national electricity system, generation, transmission, transformation, distribution and sale of electricity, and the realisation of all civil engineering, installations and other work that may be necessary to planning, overseeing, operating and maintaining the national electricity system (directly or through subsidiaries).

Since October 2009 the CFE distributes and sells electricity throughout the country. Before that date, the CFE area of distribution had a significant exception representing about 30 per cent. of the national consumption: the metropolitan Federal District and portions of the surrounding area (the states of Mexico, Morelos, Puebla and Hidalgo), were managed by Luz y Fuerza del Centro ("**LyFC**"), which until its decommissioning in the last quarter of 2009 was another public sector body that entered into a Zone Delimitation Agreement with the CFE in 1982 until its decommissioning presidential decree. CFE operates and does the planning and expansion of the entire National Electricity System (*Sistema Eléctrico Nacional* or *SEN*) and is subject to regulation by the Energy Regulating Commission (*Comisión Reguladora de Energía* or *CRE*).

Established in 1995, the CRE has as its principal duties:

- Participating in the process of setting tariffs for electricity supply;

- Approving the criteria used to determine the contributions of the Government and other federal bodies to the execution of work necessary for the supply of electricity; checking the efficiency, quality, safety and stability of the service; granting and revoking the licences and permits that are required, pursuant to applicable law, to perform regulated activities.

Issue permits for all types of power generation not intended for public service: Independent Power Producer, self generation, Cogeneration, Renewable energy generation, import and export of power and "Small Independent Power Producer". These forms of privately owned power generation mechanisms are explained below.

The Energy Secretariat ("**SENER**"), meanwhile, is responsible for planning and guiding national energy policy, for guaranteeing efficient supply and for undertaking the technological developments necessary for promotion of the use of innovative energy sources.

The LSPEE was amended in 1993 to specify the activities not considered a "public service" and in which the participation of other private companies was therefore permitted.

As a result, there are now six ways in which private investors (licensees) can participate in the electricity sector, provided they have first obtained a CRE licence. Pursuant to the LSPEE, these are:

(a) **Self-supply**: own-use of electricity generated by the generators themselves or by their partners.

(b) **Cogeneration**: electricity generated in this way must be used to satisfy the needs of establishments associated with co-generation. In this case, as with self-supply, consumers or partners sign an interconnection agreement with the CFE for support, transport and other services.

(c) **Independent production**: this is the option most frequently used in Mexico and allows for the establishment of an independent generator provided the power its plants generate is sold exclusively to the National Electricity System or to the export market through a public tender. The LSPEE Regulations also require that companies thus established are domiciled in national territory and that their plants have a minimum capacity of 30 MW. These licences are granted for a term of 30 years, while all other types of licence are granted for indefinite terms.

(d) **Small-scale production**: generation at plants with capacity of less than 30 MW.

(e) **Exports**: via the cogeneration, independent production and small-scale production models.

(f) **Imports**: the CRE may authorise import agreements between foreign suppliers and domestic consumers.

The regulatory framework for the development of power plants using renewable energy sources by private companies envisages four distinct models:

(a) **Independent Power Producer ("PIE"):** generation capacity of more than 30 MW. The CFE puts the contract for the construction and operation of a plant out to public tender, on the undertaking that it will acquire the energy thus generated under long-term contracts at a price determined in the tender process. All required investment is made by the winner of the tender.

(b) **Self-supply**: exclusively for shareholder consumption.

(c) **Small-scale producer**: capacity of less than 30 MW; the CFE acquires the energy generated at a regulated price.

(d) **Exports**: a licence is required to export energy outside the country.

Renewable Energy Regulatory Framework

Recently, the CRE has been charged with the implementation of the Renewable Energy Law, designed to create a framework for the promotion of wind energy, mini-hydro, biomass and efficient cogeneration by private investment, yet not by subsidies.

To promote generation from renewable sources, the Interconnection Agreement for renewable sources, intended to provide the framework for interconnection to the SEN networks has been adapted.

The benefits of the Interconnection Agreement for Renewable sources are:

- a banking mechanism of the electricity for a period up to 12 months
- wheeling studies are not required
- a fixed reduced wheeling tariff to send the electricity to remote customers (estampilla postal)
- credit of the user's demand charges based on average generation in peak hours during each month
- waiver on charges such as "connection services, permitting charges and backup

In addition, investments in these plants are eligible for accelerated tax depreciation of up to 100 per cent. during the first 10 years. During 2010, the CRE passed a resolution to extend the benefits of the Interconnection Agreement for Renewable sources to the Efficient Co-generation plants, and issued the efficiency criteria to qualify.

April 2008 saw the launch of a set of seven proposals aimed at reforming the Mexican energy sector in two areas: reform of the oil industry and the introduction of a legal framework for energy efficiency and the development of renewable energy.

In the area of renewable energy, two proposals were passed in 2008 whose implementation was carried out during 2009:

- Draft Decree enacting the Law on Sustainable Energy Usage.
- Draft Decree creating the Law on Renewable Energy Usage and funding of the Energy Transition.

These are two of the seven energy proposals approved by the Senate on 23 October 2008 and which have been submitted to the Federal Executive for the relevant constitutional purposes.

In the summer of 2009 the Special Renewable Energy Usage Programme was published, which establishes non-binding targets for different renewable technologies until 2012. The programme aims to increase electricity generation capacity from 3.3 per cent. of the total in 2008 to 7.6 per cent. in 2012. Wind generation is designed to reach 4.3 per cent. of the total in 2012 compared

to 0.15 per cent. in 2008. This programme is within the framework of a broader CO_2 emission reduction strategy (Special Climate Change Programme), which could amount to 200 Mton in the entire period.

Since the CFE sets the growth plan for the National Electricity System ("**SEN**") only on the basis of economic and reliability criteria, the CRE has imposed on the CFE the application of a cost criterion that is added to fossil fuel generation: the cost of CO_2 emissions must be considered to form part of energy costs (which are calculated on the basis of the CO_2 emissions´ certificates), which provides an opportunity for renewable energies. This new cost criterion should be included in the Power Sector Construction and Investment Programme ("**POISE**"), which is the CFE's vehicle for presenting its SEN expansion plan to the SENER and it sets a framework for the Board to approve investments. On 2 February 2011, the CRE issued a methodology for calculating electricity co-generation efficiency and the criteria for determining efficient cogeneration. This ruling states that for a system to be efficient and receive the benefits of renewable sources, the facility must comply with a higher level of efficiency than that indicated by the CRE, depending on the electricity power grid, altitude and the reference values. The benefits from meeting this regulation are those indicated in the Interconnection Agreement for renewable energies: lower transmission tariffs, electricity balance and a capacity benefit equal to the average of peak-time generation.

During 2012, the CRE passed a resolution with the procedure and rules to grant "qualified certifier" status to institutions and specialized companies which in turn will be entitled to provide the service of metering and reporting to CRE the information of any prospective efficient cogeneration plants.

Pemex and Natural Gas

On 4 December 2009, the National Hydrocarbons Commission ("**CNH**") issued a resolution on technical provisions to prevent or reduce the burning and venting of gas in oil and gas exploration and operations, which is obligatory for PEMEX. It establishes, inter alia, the procedures PEMEX must follow to present the CNH with a programme that includes targets, investment timetables and commitments to reduce gas flaring to the lowest technical and economically viable volume. This resolution gives rise to investment opportunities in Mexico in natural gas storage and usage.

In November 2011, the president of Mexico unveiled an ambitious investment programme of over USD 10,500 million to increase the expansion process of natural gas from public and private investments. The projects will increase the transmission network by 38 per cent. (4,374 km more for the current network) and the distribution network by 125 per cent. (56,568 km more for the current network).

Gas distribution will increase from 22 to 26 states in the country, doubling the number of users from 2 million to over 4 million. The strategy envisages developing 8 gas pipelines which will contribute mainly to:

- boosting the current transport system through the construction of a new network of gas pipelines and new gas compression infrastructure;
- developing new gas distribution and supply infrastructure by road to meet the needs of industrial, commercial and domestic customers; and
- strengthening natural gas regulation.

Until last year, under the tariff scheme for gas transport in Mexico any new gas pipeline installed had to be paid for by its new users, regardless of whether they were connected to the National Gas Pipeline System ("**SNG**") of PEMEX. However, to prevent discrimination among users, the CRE has implemented a new tariff scheme that recognises the benefits to the consumers from each new infrastructure in an Integrated National Transport System ("**STNI**").

All natural gas transport and storage systems joining the new integrated tariff system must meet certain general characteristics, i.e. they must:

(a) be part of an interconnected system;

(b) provide benefits, enhance security, continuity, duplicity and efficiency of the integrated systems; and

(c) standardise the integrated systems with the current conditions for providing services.

Furthermore, the CRE has already made adjustments to the Natural Gas Regulations in order to develop the STNI using integrated tariffs.

Lastly, in December 2011, the CFE published an agreement approving an amendment to the tariffs for supplying and selling electricity. The agreement took effect on 1 January 2012.

During 2012, some new gas pipeline projects were launched under CFE bidding processes, particularly in the northwest (close to the Pacific Ocean), based on the projected power plants to switch from bunker C fuel oil to gas. The gas consumption has increased to the point at which several critical alerts of the system caused interruptions to gas based industrial and power generation.

The programme unveiled in 2011 to expand the gas system is urgently required, and it is expected that the PRI new government will give a significant push to it based on CFE biddings.

Electricity Rates

Until January 2008, tariffs were changed every six years. However, the new proposal of the Secretariat of Finance and Public Credit ("**SHCP**") is for a new change to be made in January 2012 and, thereafter, in April each year. In January 2008, this adjustment gave rise to a flow of income to the tariffs and there is reason to believe that the same effect could occur again in 2012.

The yearly adjustment of rate structure based on the previous year's basket of fuels is in effect, and due to the gas restrictions, a slight rate increase was applied in April 2012 due to a higher utilization of bunker C fuel oil in the basket. The adjustment in April 2013 is expected to be similar, due to the continuation of critical alerts of the system.

Other European regulation

On 3 March 2011, the third legislative package entered into force to ensure internal gas and electricity markets. It entails:

a) Two directives, one for gas and one for electricity, which reform the previous directives designed to create the respective internal markets. Among the main changes are the greater separation of transmission and deregulated activities, increased powers and independence of the national regulators, and greater protection for small consumers.

b) Two rules on access to gas and electricity transport networks which reform the previous regulations. The main changes include the constitution of a European Network for Transmission System Operators and the establishment of a community-wide technical code.

c) A regulation to establish the Agency for the Cooperation of National Energy Regulators for the purpose of promoting cooperation among national regulators to establish a single market. Currently, this agency is working on the development of technical guidelines and codes in order to bring the internal energy market into operation in 2014.

In March 2011, three new European Institutions were constituted (ACER and ENTSO-E and G).

In December 2011, the European Commission adopted the Communication "**Energy Roadmap 2050**". It explores the challenges to deliver the EU's decarbonisation objective, ensuring security of energy supply and competitiveness. The EU is committed to reducing greenhouse gas emissions to below 80-95 per cent. of the 1990 levels, by 2050.

Other regulations of interest in 2011:

a) Regulation on wholesale energy market integrity and transparency (**REMIT**), published in December 2011, which establishes rules prohibiting abusive practices affecting the wholesale energy markets in the European Union;

Over the course of 2012, relevant legislation and initiatives to the energy sector were adopted:

- Directive 27/2012 on Energy Efficiency aimed to use energy more efficiently from the generation to the final consumption by establishing measures at EU level to achieve energy savings of 20% in 2020. Among other, renovation of the Central Government buildings or systems to reduce energy consumption of suppliers or distributors (or alternative measures with similar results).

- *Regulation on OTC derivatives, central counterparties and trade repositories* (also known as EMIR Regulation). Its aim is to increase transparency and reduce risk in OTC operations.

- Communication on renewable energy, which proposes four areas for improvement: (i) integration in the electricity market, (ii) support schemes, (iii) cooperation between Member States, and (iv) cooperation with third countries.

- Proposal for a revised Directive or Environmental Assessment. In parliamentary procedure.

- Communication on the internal energy market which raises several issues to be addressed and proposes a roadmap for this operation in 2014.

The European Union Emissions Trading System (EU ETS) for the period 2013 – 2020 came into operation at the end of 2012.

To date in 2013, it has been published the following documents and initiatives:

- “Regulation 347/2013 on guidelines for trans-European energy infrastructure”, published on April 2013, which is part of the Commission “Energy Infrastructure Package”. It is targeted at ensuring that strategic energy networks and storage facilities are completed by 2020. The Commission has identified 12 priority corridors and areas covering electricity, gas, oil and carbon dioxide transport networks. A funding Regulation ““Connecting Europe Facility” (CEF) is also part of the Package. It has been agreed but it has yet to be formally adopted by the EU Council and the Parliament.

- Electricity and gas Network codes, in compliance with the Third Package, continue its development.

- ETS initiatives: A proposal for amending ETS Directive 87/2003 to postpone (“back-load”) the auctioning of some allowances of greenhouse gases from the beggining of the period 2013-2020 to its end is being processed.

- Green Paper on "A 2030 framework for climate and energy policies" opens a debate on the nature and level of potential climate and energy targets for 2030 and other important aspects of EU energy policy in a 2030 perspective.

- Communication on “Energy Technologies and Innovation” setting out a strategy to enable the EU to have a world-class technology and innovation sector fit for coping with the challenges up to 2020 and beyond.

Document Incorporated by Reference

Interim condensed consolidated financial statements of the Guarantor

On 24 July 2013 Iberdrola published a statement of its interim condensed consolidated financial statements and interim consolidated management report for the period ended June 30, 2013, which were approved by the Board of Directors of Iberdrola held on 23 July 2013. By virtue of the Supplement, such statement of its interim condensed consolidated financial statements and interim consolidated management report, together with the explanatory notes to the interim condensed consolidated financial statements and the auditor’s report on limited review of the interim condensed consolidated financial statements, is incorporated in, and forms part of, the Supplement.

Cross Reference List

The information set out in the table below, which is required by Commission Regulation (EC) No.809/2004, of 29 April 2004, is contained in the documents incorporated by reference:

Information incorporated by reference	**Page number**
Iberdrola, S.A.	
Interim Condensed Consolidated Financial Statements	i
Report on limited review by auditor	ii-iii
Balance sheet	3
Profit and loss account	5
Consolidated Statements of Cash Flows	8
Accounting policies and explanatory notes	9
Interim consolidated management report	43

Any information not listed in the cross reference list above but included in the document incorporated by reference is given for information purposes only.

Copies of the Supplement and the document incorporated by reference in the Supplement can be obtained, free of charge, from the registered office of the Issuer, the registered office of the Guarantor and from the specified offices of the Paying Agents for the time being in London and Luxembourg. The Supplement will be available on the Central Bank of Ireland's web site (www.centralbank.ie) for 12 months and the document incorporated by reference is electronically published at:

https://www.iberdrola.es/webibd/gc/prod/en/doc/InformeConsolidado1S13.pdf

Save as disclosed in the Supplement, no other significant new factor, material mistake or inaccuracy relating to information included in the Offering Circular has arisen or been noted, as the case may be, since the publication of the Offering Circular.

Investors who have already agreed to purchase and subscribe for the Notes before the Supplement is published have the right, exercisable within two working days after the publication of the Supplement, to withdraw their acceptances.

The date of this Supplement is 8 August 2013