1. SIGNIFICANT EVENTS IN 2012

IBERDROLA's results during the period were achieved in a complex operating environment characterised by the adverse macroeconomic climate worldwide and regulatory amendments that led to a drop in revenues mainly in Spain.

The most noteworthy factors affecting performance during the period were weak demand for electricity and slightly lower energy prices given the trend in commodity prices.

The following should be mentioned in relation to the Group's operating trajectory:

- In Spain, the year has been characterised by much lower water availability in comparison to the previous year (-39.9%) and a 1.4% dip in mainland electricity demand – factors affecting all segments of the market.

- In the United Kingdom, electricity demand recovered slightly by 0.2%, while demand for gas rose sharply as a result of climatic conditions.

- In Iberdrola USA's area of operations in the United States, electricity demand grew 1.2%, while gas demand dropped 6.3% due to more benign climatic conditions than in the previous period.

- Demand in Brazil, meanwhile, climbed 4.6% year on year.

Within this context, total output by the IBERDROLA Group in the course of the year fell by 7.4% to 134,396 GWh. By geographical areas, these figures include: 57,127 GWh generated in Spain (-10.3%), 18,703 GWh in the United Kingdom (-17.7%), 16,722 GWh in the United States (+7.9%), 39,255 GWh in Latin America (-4.2%), and 2,589 GWh from renewables in other countries (+17.2%).

At the 2012 close, IBERDROLA boasts 46,039 MW of installed capacity (excluding the capacity of the wind farms in Germany and France that were sold off at year end), 59.4% of which produces emissions-free energy at low variable cost.

The average trend of the euro against IBERDROLA's reference currencies has been as follows: the Pound sterling and the US dollar strengthened by 6.6% and 7.7% respectively, whereas Brazilian Real weakened by 7.8%.

The most significant events during the period were as follows:

- Royal Decree-Law 13/2012 was enacted, reducing the remuneration for distribution activities in Spain by EUR 234 million (compared to the provisional remuneration recognised for 2012 in Order IET 3586/2011) and lower capacity payments in the generation business in Spain.

- Several tax effects, which are described later in this report.

- Write-offs of wind farm development costs and the Alberta Hub project portfolio, raising provisions by EUR 95 million, and of the GAMESA's portfolio, resulting in a negative impact of EUR 203 million on the result of companies accounted for using the equity method.

- One-off effects of climatic conditions in Brazil and the United States in the last quarter, generating a non-recurring expense of EUR 122 million.

- Positive impacts of income tax, primarily due to the reduction in the tax rate in the United Kingdom, reversals of tax provisions subsequent to the agreements reached with the tax authorities in the United States, and the deductibility of the goodwill of ELEKTRO (Brazil), which led directly to a lower income tax expense compared to 2011.

1.1 Income statement highlights

The main results in 2012 were as follows:

Millions of euros	*At 31 December 2012*	*Change against 2011*
Revenue	34,201	8.1%
Gross margin	12,578	4.6%
EBITDA	7,727	1.0%
EBIT	4,377	-2.8%
Net profit	2,841	1.3%

1.1.1 Gross margin

The gross margin was EUR 12,578 million, an increase of 4.6% on the same period in 2011 (EUR 12,026 million). This improvement is due to higher sales (+8.1%), greater international activity, and favourable exchange-rate fluctuations.

By business areas:

- **Regulated Business**

The regulated business increased its contribution by 2.2% to EUR 5,668 million (EUR 5,544 million in 2011).

- In Spain, the gross margin shrank by 8.2% to EUR 1,857 million (EUR 2,022 million in 2011) because of the impact of the measures approved by the Government on 30 March cutting the revenues recognised by distribution companies (Royal Decree 13/2012). The impact amounts to EUR 233 million.

- In the United Kingdom, a 14.3% rise to EUR 1,152 million (EUR 1,008 million in 2011) following the increase in the remuneration basis after application of the new DCPR5 distribution regulation from April 2010 to March 2015, and the strenghtening of the Pound sterling (6.6%).

- The contribution of the United States during the year stood at EUR 1,422 million (EUR 1,293 million in 2011). The 10% rise is due to higher prevailing tariffs and the strengthening of the US dollar (+7.7%), despite lower gas demand and adverse climatic conditions in the fourth quarter.

- The gross margin in Brazil climbed 1.3% to EUR 1,237 million (EUR 1,221 million in 2011), spurred on by the addition of ELEKTRO during the entire year. In contrast, the gross margin was negatively affected by reductions in ELEKTRO's tariffs as from August, higher energy generation costs directly due to the drought in Brazil, and a 7.8% weakening in the value of the Brazilian real compared to 2011.

- **Deregulated Business**

The deregulated business increased its contribution to the gross margin by 9.7% to EUR 4,417 million (EUR 4,045 million in 2011, once the Gas businesses in US and Canada were reclassified, in order to make both periods comparable, as in 2011 they were included under the Renewable Business and Other Businesses).

- In Spain, the gross margin rose by 1.4% to EUR 2,781 million (EUR 2,744 million in 2011). This improvement is due to a higher unit margin, despite lower output (-10.3%), particularly hydroelectric output (-39.9%).

- In the United Kingdom, the gross margin grew by 37.1% to EUR 1,083 million (EUR 790 million in 2011). Procurement improvements, better prices obtained and higher sales offset the decline in output over the period. The customer base increased by 7.7% to EUR 5.6 million.

- In Mexico, the gross margin rose by 9.5% to EUR 496 million (EUR 453 million in 2011), caused by improved plant performance and the devaluation of the Mexican dollar.

- The United States and Canada improved its gross margin by 47% compared to 2011, which rose from EUR 38 million to EUR 56 million due to higher margins on private sales and fluctuations in the US dollar.

- **Renewable Business**

The gross margin of the renewables business climbed by 10.5% to EUR 2,285 million (EUR 2,067 million in 2011, once the US Gas Business has been reclassified to Deregulated Business from the Renewable Business) due to greater output (+10.7%), robust wind power output in all areas (26.3% on average) and higher prices (+2%).

- **Other Businesses**

Other businesses contributed EUR 258 million (EUR 435 million in 2011, as the Canada Gas Business has been reclassified from Other Businesses to Deregulated Business) chiefly due to the lower engineering margin and activity.

1.1.2 Basic margin

The basic margin (gross margin plus assigned emission rights) for the period is up 3.5% to EUR 12,699 million.

1.1.3 EBITDA

Consolidated EBITDA rose 1% to EUR 7,727 million (EUR 7,650 million in 2011). In addition to the improvement in the basic and gross margins, net operating expense rose by 7.7% due to expenses incurred on boosting efficiency, primarily in Spain (EUR 160 million), the fruits of which will be born in future periods, the addition of ELEKTRO, and exchange-rate fluctuations.

Net operation expense is therefore broken down as follows:

- **Net personnel expenses**

Net personnel expenses rose by 11.9% to EUR 1,840 million (EUR 1,643 million in 2011).

- **Net external services**

Net external services increased by 4% to EUR 1,949 million.

- **Taxes other than income tax**

Taxes other than income tax rose by 6.9% to EUR 1,182 million (EUR 1,107 million in 2011). The following are the most noteworthy items:

- The impact on the generation business in the United Kingdom during 2012 of accelerated CERT/CESP expenditure in order to comply with the Government's CO_2 emission reduction targets focusing on improving home insulation and energy efficiency. This led to higher taxes of EUR 134 million.

- The Supreme Court's ruling on 7 February exempted generation companies from financing the social tariff (*'bono social'*), and recognised the right to reimbursement of the considerations paid out for the social bonus. This generated a positive tax effect of EUR 161 million in 2012.

- The rise in local and regional taxes and duties in Spain over recent years. Notably, however, the "Ecotax" in Castile-La Mancha was deemed to be unconstitutional according to an October 2012 court ruling, resulting in lower taxes of EUR 27 million.

1.1.4 EBIT

EBIT stood at EUR 4,377 million, a 2.8% decrease on the EUR 4,505 million recognized in the same period in 2011.

- **Depreciation/amortisation and provisions**

Depreciation/amortisation and provisions rose by 6.5% to EUR 3,350 million (EUR 3,145 million in 2011). The key factors behind this increase were:

- Depreciation/amortisation rose by 7.6% to EUR 2,816 million (EUR 2,617 million in 2011). The increase is due to the growth of the business (higher number of assets put into operation thanks to the Group's investment activity and the addition of ELEKTRO), partially offset by lower depreciation resulting from a lengthening of the useful lives of wind turbines (EUR 66 million), which since 1 July 2011 are depreciated over 25 years (previously 20 years).

- Provisions amounted to EUR 534 million (+1.1%) (EUR 528 million in 2011). The largest variations were due to the write-offs of development costs associated with the renewables pipeline (EUR 144 million) and gas assets in the US (EUR 49 million), and non-recurring allowances in Brazil on recognising hidden bad debts.

1.1.5 Financial results

Net financial loss was EUR 1,100 million, 3.6% higher than the previous year. The main causes of this were as follows:

- An increase of EUR 19,8 million in interest expense due to the increase in the average net debt, partially offset by the reduction of the borrowing costs to 4.51% (-7 bp).

- An increase of EUR 54.9 million, mainly consequence of the exchange rate impact on results' hedging derivatives. The Group's policy is to parcially hedge results in other currencies. Doing so, as US dollar and Great Britain pound weakened in 2011, important unrealised gains based on the exchange rate were realised last year and these returns no longer exist in 2012, as both currencies have strenghtened in 2012.

- An increase of EUR 85 million due to the reversal of the provision related to 2008 revenue shortfall, which is not applicable this year.

- A decrease of EUR 20.1 million due to the reversal of provisioned funs associated to a fiscal contingency on Renewables USA.

- A decrease of EUR 105 million associated to the unrealised gain obtained by registering IBERDROLA's interest on Medgaz at its market value.

1.1.6 Results of companies accounted for using the equity method

Results of companies accounted for using the equity method stood at EUR -188 million (EUR -34.5 million in 2011), mainly due to GAMESA’s contribution (Note 11.a).

Results of non-current assets

Results of non-current assets amounted to EUR -14 million, having fallen by EUR 59.7 million compared to the 2011 close. The most significant transactions during the year were the sale of renewables assets in Germany and France, and the sale of deregulated companies in the US.

1.1.7 Net results

As a result of the above, pre-tax profits totalled EUR 3,075 million, down by 11% from the 2011 figure of EUR 3,454.4 million.

Taxes amount to EUR 206 million (EUR 549 million in 2011). The tax expense is down EUR 343 million due, inter alia, to:

- The reversal of tax provisions relating to the US renewables business of EUR 259 million subsequent to a favourable ruling.

- Deductibility in Brazil of the goodwill generated from the acquisition of ELEKTRO, with a positive impact of EUR 275 million.

- The 1% cut in the UK tax rate, increasing the result by EUR 164 million in 2012.

These tax items partially offset the EUR 429 million impact of the asset write-offs corresponding to the revaluation of GAMESA, the development costs of renewables projects that will not be carried out, the Alberta Hub project portfolio, etc.

As a result, net profit stood at EUR 2,841 million, up by 1.3% from 2011 (EUR 2,805 million).

1.2 Operating highlights

1.2.1 Grid Business

- **Spain**

IBERDROLA has more than 10.85 million supply outlets in Spain and total energy distribution is 94,522 GWh, 1.9% down from the previous year (96,336 GWh in 2011).

The installed power equivalent interruption time indicator (TIEPI) showing supply quality in 2012 stood at 58 minutes, equal to the all-time record in 2011 and reiterating the levels reached after years of significant improvements in this indicator. Supply was available for 99.99% of the time.

- **United Kingdom**

IBERDROLA has more than 3.4 million supply outlets in the United Kingdom. The volume of energy distributed in 2012 was 35,521 GWh, having risen by 0.2% from 35,434 GWh in 2011.

During the 2011-2012 regulatory year, Scottish Power Distribution and Scottish Power Manweb improved their service levels and therefore received a bonus. The mechanism rewarding grid reliability changed on 1 April 2012, incorporating various customer service indicators affecting the entire grid business.

- **United States**

- Distribution

  IBERDROLA has 1.86 million electricity supply outlets in the United States. The volume of energy distributed in 2012 was 31,573 GWh, up by 2.1% from 31,201 GWh in 2011.

Companies ended the year with all their service quality indicators within the thresholds established by the relevant Commission.

- Transmission

  Work continues to construct the transmission line in Maine, which will cost a total of USD 1,400 million. USD 340 million of the total investment earmarked for this project was completed during the year.

- Gas

  The number of gas users in the United States at 31 December was 0.56 million, and supply during the period totalled 28,130 GWh, a decrease of 6.3% from the 2011 figure of 30,030 GWh.

- **Brazil**

Demand at Brazil's three distributors, Coelba, Cosern, Celpe and ELEKTRO, increased by 17% to 49,006 GWh (41,872 GWh in 2011).

At year end, the number of managed users totalled 12 million.

1,595 MW of regulated electricity generating capacity was in operation at the 2012 year end (584 MW in IBERDROLA). Work on the Belo Monte, Teles Pires and wind farm projects continued as planned, and therefore the expected commissioning dates remain unchanged.

1.2.2 Deregulated Business

- **Spain and Portugal**

Installed capacity in Spain (excluding renewables) stood at 19,382 MW.

The energy balance of the Iberian Peninsula showed a 1.4% reduction in electricity demand, while demand for ordinary regime output fell by 3.0%.

In 2012, IBERDROLA's output earmarked for the ordinary regime and cogeneration dropped by 14.8% to 44,916 GWh (52,716 GWh in 2011).

Performances during the year by technologies were as follows:

- Hydroelectric output stood at 9,039 GWh (15,043 GWh in 2011), a fall of 39.9% against the same period the previous year. Hydraulic reserves were at 34.1% (equivalent to 3,846 GWh).

- Nuclear output stood at 26,026 GWh, up by 7.1% from the 2011 figure of 24,290 GWh.

- Coal-fired thermal power plants showed an increase of 63.5% to 4,396 GWh (2,689 GWh in 2011).

- Combined-cycle output fell by 64.6% to 2,831 GWh (8,007 GWh in 2011).

- Finally, combined heat and power (CHP) output fell by 2.4% to 2,624 GWh (2,690 GWh in 2011).

Energy supplied (electricity and gas) has reached 65,579 GWh. Electricity output supplied on the deregulated market in 2012 has been 41,625 GWh, a 1% increase from the 41,271 GWh supplied in 2011.

The situation of the Group's natural gas procurements in 2012 has been as follows:

- The Spanish system showed slightly lower demand for natural gas than in 2011 in the industrial, residential and electricity production segments.

- IBERDROLA has brought deliveries through its procurement contracts into line with current needs, and has taken several steps to optimise its gas portfolio through various sales on the wholesale market.

- BP and DONG ENERGY were supplied with the volumes of gas set forth in the long-term sales agreements entered into.

In Portugal, IBERDROLA supplied 5,730 GWh in 2012, compared to the 5,118 GWh in 2011, positioning itself as the second-largest supplier to medium-voltage industrial customers and SMEs, and having entered the residential sector.

- **United Kingdom**

At 31 December 2012, installed capacity in the United Kingdom (excluding renewables capacity) was 6,036 MW.

Output from traditional generation fell 20% in 2012 to 16,426 GWh from the 20,584 GWh from the previous year.

The most noteworthy features by technologies were as follows:

- Coal-fired power plant output rose by 9.3% to 11,214 GWh (10,257 GWh in 2011).

- Gas combined-cycle output fell by 53.4% to 4,429 GWh (9,513 GWh in 2011).

- Hydroelectric output went up 24.7% to 689 GWh (553 GWh in 2011).

- CHP output fell to 94 GWh, down by 64% from the 261 GWh generated in 2011.

In 2012, 22,859 GWh of electricity and 32,248 GWh of gas were sold to customers, as against the 22,019 GWh of electricity and 28,392 GWh of gas sold during the previous year.

ScottishPower had 3.4 million electricity customers and 2.2 million gas customers at 31 December 2012.

- **Mexico**

IBERDROLA is Mexico's leading private electricity producer. Installed capacity has totalled 4,987 MW.

During 2012, installed capacity in operation at La Laguna, located in Gómez Palacios (Durango), has increased by 20 MW, while the 37-MW extension to the Enertek CHP plant in Altamira (Tamaulipas) has begun and is expected to enter service in 2014.

34,971 GWh of electricity was supplied in 2012, not including electricity generated using renewables; 29,204 GWh of which were supplied to the Federal Electricity Commission and 5,767 GWh to partner consumers in the private self-supply regime.

- **Gas storage in the US and Canada**

In total, the Company's gas storage facilities handled a total of 2.41 bcm in 2012. The Company also boasted 2.20 bcm of contracted and managed capacity.

1.2.3 Renewable Business

At the 2012 close, 14,034 MW of renewable capacity has been installed (excluding the capacity of the wind farms in Germany and France that were sold at year end).

At the back end of 2012, the Company has also agreed the sale of its operating assets in France and Germany amounting to 366 MW of capacity, subject to obtaining the relevant regulatory permits. As a result of the aforementioned additions and divestments, installed capacity rose by 344 MW during the year, up by 2.5% from 2011.

At year end, 296 MW of renewable projects were under construction.

Operating capacity rose by 2.5% to 13,735 MW, not taking into account the divestments' capacity.

Renewable output has increased by 10.7% to 31,784 GWh (28,721 GWh in 2011).

- **Onshore wind power**

After installing an additional 344 MW over the 12 months, IBERDROLA boasts 13,619 MW of installed onshore wind capacity. The geographical spread of this capacity is as follows: Spain (5,735 MW), the US (5,443 MW), the UK and Ireland (1,234 MW) and the rest of the world (1,207 MW).

- **Offshore wind power**

The renewable business is currently developing a total of 6,300 MW of offshore wind capacity, primarily in the United Kingdom (76%), Germany (16%) and France (8%).

In the United Kingdom, the Company is developing the West of Duddon Sands wind farm in the Irish Sea, with installed capacity of 389 MW. IBERDROLA is constructing this wind farm in partnership with Dong Energy.

In December 2009, under the "Round 3" Offshore Wind power UK program, the Crown Estate (the agency owning the property) awarded the joint venture owned by IBERDROLA and Vattenfall (50:50) the exclusive rights to develop offshore wind farms in the area of East Anglia in the North Sea (Zone 5), with estimated total capacity of 7,200 MW.

IBERDROLA continues to develop the Wikinger offshore wind farm in the Baltic Sea (Germany), with construction scheduled to commence in 2015. It is estimated that this wind farm could boast capacity of approximately 400 MW. During 2012, detailed geotechnical engineering work has been performed having commenced the offshore geotechnical surveying campaign.

In April 2012, the consortium comprising IBERDROLA and the French company EOLE-RES was awarded exclusive rights by the French government to construct and operate the 500-MW Saint-Brieuc offshore wind farm. It will be sited in Saint-Brieuc Bay in the department of Côtes d'Armor, 20 kilometres from the shore. During 2012, work started on analysing the environmental and technical conditions of the site.

1.3 Financial resources

The most significant financing transactions performed by the IBERDROLA Group in 2011 are described in Note 24 to the consolidated financial statements.

1.4 Impact of changes in Spanish regulation

Royal Decree-Law 6/2009 of 30 April established a new model to eliminate the tariff deficit in 2013. However, in recent years, IBERDROLA's business continued to be affected by considerable regulatory uncertainties; one of the most significant being the deficit problem both in terms of the accumulated deficit and the measures designed to contain the tariff deficit moving forward.

The charge imposed arbitrarily on certain electricity companies, including IBERDROLA, to finance the tariff deficit could become impossible to assume if appropriate regulatory measures are not imposed by the relevant authorities to guarantee a solution to the deficit.

In 2012, IBERDROLA defended its interests by instigating several legal and administrative proceedings aimed at ensuring adequate compliance with the regulatory provisions designed, on the one hand, to limit the impacts of the said deficit and, on the other, to promote the securitisation process that was put on hold for several months for no reason.

In the regard, IBERDROLA contacted the Ministry of Industry, Energy and Tourism and the Cabinet Commission on the Tariff Deficit on several occasions to highlight the severe problems associated with funding the deficit, the worrying high level of the deficit in 2012, and the need to adopt urgent measures to tackle this serious problem. It also called for the securitisation of the deficit that has already been funded to be restarted as market conditions warrant.

Despite these actions, the tariff deficit securitisation process has remained on hold for most of 2012, whereby the maximum placement period of a year laid down in Royal Decree 437/2010 was not achieved, with IBERDROLA reserving the right to take the pertinent action to defend its interests.

The unexpected enactment of Royal Decree-Law 29/2012 of 28 December laying down amendments to certain areas of electricity sector regulation led to a substantial change in the regulatory framework prevailing to date.

This law annulled the statutory requirement previously in place to eliminate the tariff deficit as from 2013 and to guarantee sufficient revenues to assume the regulated costs of the Spanish electricity system, and generated uncertainty regarding when the tariff deficit financed in 2012 would be recovered. All this not only has represented a step backwards in resolving the problem, but also involved a sudden shift in what had been a predictable environment until then, and a clear breach of the principles of legitimate expectations and legal certainty.

The Government has recently instigated a new reform of electricity sector regulation, passing provisions (such as Royal Decree-Law 2/2013 of 1 February) designed to cut electricity system costs, and announced measures to include these costs within the Spanish central government budget, although the outcome of these measures is still unknown.

The situation arising from the enactment of Royal Decree-Law 29/2012 and other new laws has generated considerable uncertainty in 2013 surrounding, inter alia, actual revenues from the new taxes, actual revenues from the sale of emissions rights, final approval of the extraordinary credit facility of EUR 2,200 million, and funding of non-mainland costs incurred in 2013 through the Spanish central government budget for that year.

Against this backdrop, IBERDROLA will continue to take the necessary steps to defend its interest as far as possible, and may have to consider additional measures to avoid the negative consequences of having to settle the tariff deficit if it cannot be contained.

Despite the robustness of IBERDROLA's business structure, the Company's credit rating was downgraded in 2012, partly in response to worsening market conditions in Europe and also the impact on net debt of the tariff deficit securitisation programme being frozen throughout most of the year (credit ratings are disclosed in Note 19 to the consolidated financial statements).

2. MAIN RISK FACTORS ASSOCIATED WITH THE ACTIVITIES OF THE IBERDROLA GROUP

The IBERDROLA Group is exposed to various inherent risks in the countries, industries and markets in which it operates and the businesses it carries out, which could prevent it from achieving its objectives and implementing its strategies successfully.

2.1 Business and market risks

The activities of the IBERDROLA Group are subject to a range of business risks related to the uncertainty of the main variables affecting it, such as demand for electricity and gas, changes in hydroelectric and wind power output (both the Group's own output and that of the domestic markets in which it operates) and changes in the price of fuel and CO_2 emission rights. In the case of fuels and CO_2 emission rights, these risks are evident in:

- The electricity generation and retailing business, in which the IBERDROLA Group is exposed to variations in the price of CO_2 emission rights and in the selling price of electricity, in addition to variations in and volatility of fuel costs (mainly gas and coal).

- The gas retailing business, in which a large portion of the IBERDROLA Group's operating expenses relate to the purchase of gas for customer supplies. The IBERDROLA Group is therefore exposed to the risk of changes in gas prices.

- Energy transactions (discretionary trading).

Exposure to these risks is managed and mitigated by monitoring positions, arranging derivatives, diversifying the agreements and various clauses in these sale and purchase agreements.

Gas and electricity generation and supply in Europe

In both the Spanish market and the UK, IBERDROLA's main markets, the current generating mix across a range of generating technologies furnishes a substantial natural hedge against the market and business risks associated with supplying, producing and selling energy to end customers.

The remaining risk is mitigated through appropriate diversification and management of supply contracts, taking into account:

- Indexation of price, as far as possible, against indices which replicate the changes in revenue on the demand side.

- Inclusion of revision and re-opener clauses which help prices keep pace with market changes.

- Complementary financial hedging operations, to maintain risk within established global limits, mainly in the short and medium term.

- Establishment of thresholds on the size of open positions and their sensitivity to underlier price fluctuations.

In terms of the gas supply risk, IBERDROLA will ensure its global basket is as balanced as possible in terms of the number of countries supplied and the type of supply (piped gas or LNG).

Electricity generation and supply in Mexico

In the case of the Mexican market, the IBERDROLA Group does not have a significant commodity price risk because the main contracts are instrumented as pass-through. In the regulated electricity and gas business, there is a limited risk of price changes since the regulatory systems allow the cost to be passed on to the end customer.

Gas transport and storage in the United States and Canada

The gas transport and storage business in the United States mitigates market and business risk by limiting exposure to unsold inventories at a certain time and through an overarching VaR limit calculated to a 99% confidence interval and a holding period of five days.

Renewable business

The renewable energy business in Spain and the United Kingdom deflects the market risk associated with energy that is not sold at tariff onto the deregulated businesses in these countries through specific internal arrangements, so that it is combined with other positions.

The renewable energy businesses in other countries sell their energy preferably at a fixed price, tariff or through long-term power purchase agreements (PPAs) to mitigate exposure to market risk and guarantee returns on the investments made.

Discretionary trading transactions

Discretionary trading of electricity, gas, emissions rights and other fuels and associated products performed by some of the Group's businesses is residual and the overall risk thereof is mitigated using individual stop-loss limits, the aggregate total of which cannot exceed 2% of consolidated Net Profit for the period, pursuant to the market risk policy approved by Iberdrola, S.A.'s Board of Directors.

2.2 Credit risk

The IBERDROLA Group is exposed to credit risk in which counterparties (customers, suppliers, financial institutions, partners etc.) may default on their contractual obligations. Exposure may arise with regard to unsettled amounts, the cost of substituting products not supplied and also, in the case of dedicated plants, outstanding amounts.

Credit risk is managed and limited in accordance with the type of transaction and the creditworthiness of the counterparty. A specific corporate credit risk policy is in place which establishes criteria for admission, approval systems, authorisation levels, scoring tools, exposure measurement methodologies etc.

With regard to credit risk on trade receivables, the historical cost of defaults has remained moderate and stable, close to 1% of total turnover of this activity, despite the current difficult economic environment. Regarding other exposure (counterparties in transactions with derivatives, placement of cash surpluses, energy sales, procurements and guarantees received from third parties), no significant defaults or losses were incurred in 2012 and 2011.

2.3 Financial risk

Information concerning financial risk is set out in Note 5 to the consolidated financial statements.

Turbulence in the global financial markets has affected spreads on Spanish debt, which the regulator claims has led to the delay in the securitisation of a portion of the tariff deficit in Spain, breaching the commitment to complete this process by the end of 2012. It is, however, hoped that the process will be completed during 2013.

2.4 Regulatory risk

Energy companies in the IBERDROLA Group are subject to laws and regulations concerning prices and other aspects of their activities in each of the countries in which they operate. The introduction of new laws and regulations or modifications to those already in existence may have an adverse effect on the Group's financial situation and the results of its operations.

Risk policies include continuous analysis and monitoring of regulatory changes, together with decision-making based on reasonable assumptions concerning regulatory behaviour, both domestically and internationally.

The most noteworthy developments in Spain were the new regulatory measures enacted in 2012 and at the beginning of 2013 to eliminate the tariff deficit, affecting the Group's entire energy business (networks, renewables and deregulated businesses).

In the United Kingdom, the on-going review of the present energy model could affect future yields of the IBERDROLA Group's business assets in the country.

2.5 Operational risk

During all IBERDROLA Group's activities, direct or indirect losses may arise as a result of inadequate internal procedures, technical failures, human error, or external events.

Specifically, the IBERDROLA Group is exposed, among other risks, to malfunctions, explosions, fire, toxic spillages or polluting emissions at its gas and electricity distribution networks and generating plants. It could also be adversely affected by sabotage, adverse meteorological conditions or force majeure. Any of these risks could cause damage or destruction to the IBERDROLA Group's facilities, as well as injuries to third parties or damage to the environment, along with the ensuing lawsuits, especially in the event of power outages caused by accidents at our distribution networks and possible penalties imposed by the authorities.

Although many of these risks are unpredictable, the IBERDROLA Group mitigates them by carrying out the necessary investment, conducting operation and maintenance procedures and programmes (supported by quality control systems), planning appropriate employee training, and taking out the required insurance covering both material damages and civil liability.

However, this insurance does not completely eliminate operational risk, since it is not always possible to pass such risk on to insurance companies and, in addition, cover is always subject to certain limitations.

The IBERDROLA Group's nuclear plants in Spain are also exposed to risks relating to their operations and risks arising from the storage and handling of radioactive materials.

- Current Spanish law caps the liability of nuclear plant operators in the event of a nuclear accident at EUR 700 million. This liability for a nuclear accident must be insured by the operator of Spanish nuclear power stations. The IBERDROLA Group meets this obligation by taking out Nuclear Civil Liability insurance policies for each plant. However, Law 12/2011 of 27 May concerning civil liability for nuclear damage or damage caused by radioactive materials will increase the operator's liability ceiling and the consequent ceiling on mandatory insurance to EUR 1,200 million for nuclear plants. The law will be introduced when all signatories of the Paris and Brussels Conventions ratify the 2004 amendment protocols.

- Some mention must likewise be made of the indirect economic risk to which these plants are exposed following a potential serious international incident in relation to such plants, with a possible impact on regular renewals of operating licences and increased outlay on safety investment. It should also be said, however, that the incident at the Fukushima nuclear plant in Japan finally had only a minor effect on our facilities.

Market trading conducted by the Group's various energy trading desks and treasury dealers is also exposed to operational risk due to possible inappropriate processes, technological faults, human error, fraud or any other external or internal event.

This risk in mitigated by following the operational risk policy when trading on the market, the cornerstones of which are as follows:

- Robust risk control culture.
- Proper segregation of duties.
- Publication of clear processes and policies.
- Secure and flexible information systems.

Specific thresholds and guidelines are applicable to all trades performed, in accordance with the principle of proportionality.

3. ENVIRONMENT AND SUSTAINABILITY

IBERDROLA accepts that the environment places constraints on all human activities and is a factor of companies' competitiveness, and it is committed to promoting innovation in this field and also eco-efficiency, to gradually reducing the environmental impact of its activities, facilities, products and services, and striving to ensure that its activities are congruent with future generations' legitimate right to an appropriate environment.

The Group undertakes and promotes this commitment through its policies. IBERDROLA currently has three specific policies in place to manage environmental issues: its environmental policy, its anti-climate change policy and its biodiversity policy, which set forth the principles through which the Company will continue to improve its environmental management.

IBERDROLA has also been included, for the twelfth consecutive year, on the global Dow Jones Sustainability Index, a worldwide benchmark for recognition of companies' contributions to sustainable development and on other prestigious international sustainability indexes. It is the only utility to have earned this distinction since the index was created in 1999.

4. RESEARCH AND DEVELOPMENT ACTIVITIES

IBERDROLA promotes research, development and innovation (R&D and innovation) as a major tool to optimise and manage its assets, operations and processes in order to boost the sustainability and reliability of supply, contributing new, more efficient products and services.

The Company's innovative strategy involving R&D and innovation projects across all its business lines is laid out in the new 2012-2014 R&D and Innovation Plan. In 2012, the Group invested EUR 145 million in its R&D and innovation activities, spread across its international subsidiaries and comprising a portfolio of over 150 projects in areas that help to position IBERDROLA as a technology leader in its sector.

IBERDROLA innovates through an international R&D and innovation model, which is open and decentralised and gives priority to partnerships with technology providers and encourages innovation among its staff. In keeping with the commitment to excellence, these systems are AENOR certified in the businesses in Spain pursuant to the UNE standard 166.002.

IBERDROLA has begun construction of its smart grid R&D and innovation centre in Qatar. Research will be conducted in partnership with the Qatari utility company, Kahramaa, to analyse the feasibility of rolling out a network of smart grids and a pilot project will be launched to prepare for the definitive roll-out of smart grids in Qatar.

Some of the most innovative ventures by major area are as follows:

Renewable energies

R&D and innovation projects to boost the efficiency of assets in operation and development, and improve generating technologies. These include the European TWENTIES project, the aim of which is to demonstrate the possible wide scale grid integration of wind power through a demo project at various wind farms in southern Spain.

The Company is at the forefront of offshore wind worldwide, where it is developing the most innovative, cutting-edge projects leading to applications for patents related with this segment. The most notable projects are: the INNPACTO EMERGE and Etorgai FLOTTEK projects to develop deep water floating platforms; the CENIT AZIMUT project aimed at deepening technical knowledge to optimise offshore wind farm development; and the EERA DTOC project in which the Company is helping to develop tools to design large offshore wind farms. The Offshore Wind Accelerator (OWA) project is particularly noteworthy. This special programme is being promoted by the Carbon Trust (United Kingdom) and brings together the efforts and knowledge of specialised engineering firms and utilities to find solutions to cutting the cost and risks of offshore wind in order to accelerate its roll-out in UK waters.

In the ocean energy field (wave and tidal), the demo projects under way at the European Marine Energy Centre (EMEC) in Scotland stand out. These projects involve full-scale demos of the PELAMIS wave energy converter and the HAMMERFEST tidal energy converter. In the area of research, the CENIT OCEAN LIDER project headed up by Iberdrola Ingeniería y Construcción, S.A.U. for the development of ocean energy generation technologies, where significant outcomes for planning and installing offshore energy and their impacts on the environment have arrayed. In the field of wind resource, the Company has completed the SOFTCOMPUTING project and is leading the OPENFOAM project, both of which aim to improve wind resource predictions and analysis by optimising wind series modelling and analysis. Major projects to develop, evolve and improve operational tools include: CORE, DOMINA and METEOFLOW, which off the back of their success have been rolled out in the United Kingdom and the United States through technology transfer agreements.

Clean generation technologies

IBERDROLA's R&D and innovation work in the area of generation focuses on optimising operating conditions, improving safety and reducing environmental impact by cutting emissions or using more efficient generating plants. The ECRIGEN and SIRO projects focus on managing life cycles and the use of materials. The former aims to boost the reliability of critical components in generating plants, which are subject to very demanding operating conditions. The latter project centres around developing an innovative robot that can rapidly, flexibly and reliably inspect the condition of the whole fleet of electricity generators. In the nuclear field, the AUTONUC project (integration of new control systems technology) and PREVENCIÓN DE ACCIDENTES (new models and methodologies to prevent accidents at nuclear plants) stand out. Fusion technologies are also being developed as part of the Company's effort to develop clean and sustainable energy generation. IBERDROLA remains firmly committed to reducing the environmental impact of its generating plants in Spain and Scotland. In this regard, it is carrying out the COEBEN II project to adapt the Group's facilities to comply with prevailing NOx emission requirements and the SIGMA and VIDA projects related with CO_2 capture and storage. The ARRANCADOR project is most noteworthy in the hydroelectric segment and involves developing pure pumped storage at the Gabriel y Galán hydro plan on the Tajo River, which will facilitate the integration of renewable energy.

Smart grids

The Group's R&D and innovation work in connection with electricity distribution focuses on improving the distribution network, with close attention paid to occupational safety, environmental aspects, and better supply quality. IBERDROLA is dedicated to rolling out smart grids through a number of projects focusing on constructing a modern electricity grid based on remote management. In Europe, Iberdrola Distribución Eléctrica, S.A.U. is leading the GRID4EU and iGREENGrid projects to develop more precise methodologies for integrating renewable energy into electricity distribution grids. Other recently approved European projects include DISCERN which will compare various smart grid solutions and search for the optimal combination of grid architectures, and ADVANCED, continuing the work performed in the Address project aiming to find a solution to active demand management in Europe. In Spain, the Company saw in the 2013 by rolling out smart grids in seven self-governing regions (Castile-La Mancha, Castile Leon, Extremadura, Madrid, the Basque Country, Murcia and Navarre) off the back of completing the first phase of the STAR project in Castellón (Valencia). The Bidelek-Sareak project in the province of Vizcaya and the PRICE project in the Corredor del Henares (in the east of the region of Madrid and Guadalajara) are working along the same lines. IBERDROLA is also close to completing its first smart grid projects in the United States, where it has installed 550,000 smart meters across Maine; and in Scotland where 30,000 customers in Glasgow will also benefit from this technology.

Electric vehicles

In 2012, IBERDROLA has continued to conduct several projects through agreements entered into with various public administrations (primarily town and city councils), and several R&D and innovation programmes. Significant knowledge on e-mobility has been gleaned from these projects primarily in relation to charging technologies and systems, and they have prompted several agreements with providers of charging systems, information technology and electric vehicle manufacturers, among others.

In parallel and thanks to the experience gained from the demo and pilot projects conducted, work has continued on developing commercial solutions targeting the various potential users of private and corporate fleet electric vehicles, car parks, motorcycles, etc. to enable these users to benefit from zero-emission charging at a competitive price and of the highest quality.

This work is being conducted against the backdrop of a gradual improvement in standardisation of charging systems, and the interoperability agreements entered into by the various parties to drive business models forward and lay the foundations for the imminent roll-out of e-mobility.

Energy markets

In light of an increasingly globalised and competitive market, the INTEGRA project has been launched, which is being led by Global Energy Management to standardise decision-making criteria by developing cutting-edge tools for the management of energy trading and deepen knowledge of how international markets work to help take decisions on investing in energy technologies.

PERSEO – Technology to open up new business opportunities

PERSEO is IBERDROLA's development capital fund geared towards innovative technology generating renewable electricity and reducing the environmental impact of the existing production systems.

The main areas of technology are as follows:

- Renewable energies: solar (photovoltaic and thermal), wind (e.g. offshore), ocean (tidal and wave);

- Energy efficiency: energy management systems, green mobility;

- O&M technologies: new operations and maintenance technologies; and

- Other energy technologies: emissions reduction, energy storage, etc.

Over EUR 25 million have already been earmarked to underpin the future of our investments to develop the technology value chain and IBERDROLA's position within it.

The following partners are working on PERSEO: ocean energies (Oceantec and Hammerfest Strom), solar energy (Morgan Solar) and CO_2 applications in industry (AlgaEnergy and WESTEC Environmental Solutions).

In order to preserve and reinforce the PERSEO programme, an agreement was entered into in July 2012 with the Centre for the Development of Industrial Technology (CDTI for its initials in Spanish) as part of the Spanish government's INNVIERTE project, in which we will invest a further EUR 25 million or more in new energy technologies over the next five years.

5. TREASURY SHARES AND CAPITAL REDUCTION

In their General Meeting of 26 March 2010, shareholders expressly agreed to delegate powers to the Board of Directors, with powers of substitution, pursuant to the provisions of the Spanish Corporate Enterprise Act, to carry out derivative acquisition of shares in Iberdrola, S.A. Acquisitions may be carried out directly by Iberdrola or indirectly through its subsidiaries. The process excludes any subsidiaries carrying out regulated business pursuant to the provisions of the Electricity Sector Act and the Hydrocarbons Act.

Acquisitions may be made up to the maximum legal threshold (i.e., 10% of share capital).

The authorisation was granted for a maximum five-year period.

On this authorisation, in 2012 the IBERDROLA Group purchased 80,964,694 treasury shares (of which 80,030,417 were purchased by IBERDROLA) for a total of EUR 300,002 thousand, with nominal value EUR 60,724 thousand. Additionally, 32,692,750 treasury shares were sold off (of which 32,023,813 were sold by IBERDROLA) for the sum of EUR 164,967 thousand.

Finally, at year-end 2012, treasury stock stood at 85,723,586 shares (83,188,438 shares in IBERDROLA) and four swaps were outstanding on 24,969,751 treasury shares.

6. SUBSEQUENT EVENTS

Subsequent events to 2012 close are described on Note 49 to the Consolidated financial statements.