

REGULATORY FRAMEWORK APPROVED BY THE CNMC FOR THE REMUNERATION OF NATURAL GAS DISTRIBUTION ACTIVITY

The National Commission on Markets and Competition (“CNMC”) has approved the Circular, which establishes the methodology for the remuneration for the regulated activity of natural gas distribution.

The Official State Bulletin (“BOE”) of 3 April 2020 published the CNMC Circular 4/2020, of 31 March, through which the regulatory body definitively approves the new regulatory framework for the remuneration of the natural gas distribution sector (the “Circular”), which will apply to the second regulatory period from 1 January 2021 to 31 December 2026.

The approval of this Circular follows two public consultation procedures and the publication of the relevant reports by the Ministry for the Ecological Transition (the “Ministry”) and by the State Council. The Circular was subject to an initial public consultation on 5 July 2019 and, on the basis of the submissions and reports which were received, to a second public consultation on 3 December 2019. The Ministry issued a report on both versions on 26 July 2019 and on 3 January 2020, respectively, and the Council of State decided on the draft Circular on 27 February 2020. Finally, the Circular was approved “*in accordance with the energy policy guidelines of the Ministry for Ecological Transition and the Demographic Challenge, and in compliance with that indicated by the Council of State*”¹, by the Plenary Session of the CNMC on 31 March 2020. The new Circular is part of the powers assumed by the CNMC following the approval of Royal Decree-Law 1/2019, of 11 January, on urgent measures to adapt the powers of the National Commission on Markets and Competition to the requirements necessitated by European law in relation with Directives 2009/72/CE and 2009/73/CE of the European

¹ Order TEC/406/2019, of 5 April, which establishes the energy policy guidelines for the National Commission on Markets and Competition.

Parliament and the Council, of 13 July 2009. This legislation deals with common rules for the internal market for electricity and natural gas².

The purpose of this note is to analyse the essential features of the Circular.

I. General considerations

The methodology approved by the CNMC updates the current³ remuneration model preserving the remuneration principles established in Law 34/1998, Law 18/2014, and their supporting provisions. Nevertheless, it introduces certain modifications that result in a reduction of the remuneration for natural gas distribution activity⁴.

In accordance with the Note (*Memoria*) to the Circular, the economic impact of the new methodology amounts to an average reduction in remuneration for natural gas distribution activity of 9.6% for the regulatory period between 2021-2026. Nevertheless, as discussed below, this impact (in individual terms) is very uneven for each of the companies that are engaged in natural gas distribution.

II. General aspects of the remuneration framework proposed by the Circular

The **purpose** of the Circular is to establish the methodology, applicable as of 1 January 2021, to determine the annual remuneration of the companies that are engaged in natural gas distribution for the costs incurred that are financed by the tolls and fees established for their use.

Regarding the **scope of application**, the Circular applies to:

- Facilities defined in Article 59.4 of Law 34/1998.
- Secondary transmission facilities which at the date of the entry into force of Royal Decree-Law 8/2014, of 4 July, adopting urgent measures for the growth, competitiveness, and efficiency, did not have an approved implementation project.

² Royal Decree-Law 1/2019, amended, regarding the natural gas sector, Law 3/2013, of 4 June, of the creation of the National Commission on Markets and Competition (“**Law 3/2013**”), Law 34/1998, of 7 October, of the Hydrocarbon Sector (“**Law 34/1998**”) and Law 18/2014, of 15 October, for the approval of urgent measures for growth, competitiveness, and efficiency (“**Law 18/2014**”).

³ Parametric model of remuneration by activity contained in Law 18/2014.

⁴ It should be noted that the first draft of the Circular submitted for public consultation, implied a substantial modification of the methodology provided for in Law 18/2014, whose impact was estimated by the Note that accompanied that draft, in an average reduction in the remuneration for natural gas distribution activity of 17.9% for the regulatory period between 2021-2026. Nevertheless, as with the current methodology, this impact was very uneven for each of the companies engaged in gas distribution, to the extent that it depended on the age and degree of depreciation of its assets.

- Facilities for the distribution of manufactured gases or propane other than natural gas and located on islands and non-mainland territories insofar as the twentieth transitional provision of Law 34/1998 is applicable or no single regulatory regulation is in place for the natural gas supply in those facilities⁵.

In relation to the general **principles and criteria** of the remuneration methodology, the following should be highlighted:

- During each regulatory period, no automatic updating formulas shall be applied to the values of the parameters used to calculate the remuneration of the companies.
- The remuneration parameters and values established in the Circular may be reviewed by the CNMC before the beginning of the following regulatory period. Nevertheless, in the event that no review is carried out, these parameters and values shall be understood to be extended for the following regulatory period⁶.
- The required information that affects the calculation of the remuneration, will be subject to an external audit, notwithstanding additional information requirements, subsequent inspections or a possible subsequent audit.
- The regulatory period will be of 6 years, with the first regulatory period in which the new methodology will be applicable starting on 1 January 2021 and continuing until 31 December 2026⁷.
- Each regulatory period will be divided into full “gas years”, or fractions thereof⁸
⁹.

III. Remuneration of the distribution activity

The annual remuneration for costs incurred in the activity of distribution¹⁰ will be the sum of the following items:

⁵ As set out in Article 60.5 of Law 34/1998, of 7 October.

⁶ See Article 63.2 of Law 18/2014, of 15 October.

⁷ It should be noted that, in accordance with the eighth additional provision, the CNMC must carry out an evaluation of the remuneration model before the end of the regulatory period, which will be reflected in the corresponding report. An eventual modification of the remuneration model established in the Circular for the following regulatory periods will depend on the result of this report.

⁸ To allow the temporary coordination of remuneration with the periods of application of tolls and fees, by extension and integration with those determined for transmission in accordance with Regulation (UE) 2017/460 of the Commission, of 16 March 2017, establishing a grid code on the harmonisation of gas transmission tariff structures.

⁹ In general, the gas year “a” for which the remuneration of a distribution company is determined is considered to be between 1 October of year “a-1” and 30 September of year “a”, both included. In exceptional circumstances in accordance with the second additional provision of the Circular, the gas year of 2021 will start on 1 January 2021 and end on 30 September 2021.

¹⁰ Excluding connections or other facilities or services with regulated prices resulting from the application of Law 34/1998 and its supporting regulations.

- **Base remuneration (“RDE”)**: is the remuneration for the distribution activity corresponding to the existing market as of 31 December 2020. Its value is determined for each company for the regulatory period 2021-2026 and is the result of deducting from the remuneration calculated in accordance with the methodology set out in Annex X of Law 18/2014, for the facilities and supply points existing in 2020 (“RD”), a remuneration adjustment of the distribution activity (“AAD”) applicable to the company during the regulatory period 2021-2026.^{11 12 13}

This AAD, whose calculation formula is contained in Article 6 of the Circular, is one of the main innovations introduced by the Circular and is an adjustment in relation to the remuneration corresponding to the distribution activity carried out during the year 2000. For this reason, it has been stated above that the impact of the remuneration reduction introduced by the Circular will be different for each company, depending on the activity carried out by each of them during the year 2000.

As will be explained below, the application of this adjustment will be carried out gradually during the period 2021-2025.

- **Remuneration for market development (“RDM”)**: this consists of remuneration for the use of the distribution facilities brought into service from 1 January 2021 to 30 September of the gas year “a” and for the performance of functions assigned to the distribution of the company “e” by an efficient and well-managed company. In this way, RDM becomes linked to the new supply points that will be established as of 2021.

¹¹ In accordance with the Note to the Circular, “*the economic adjustment is made to remunerate the natural gas supply points and demand for natural gas existing in the year 2000 at the latest with the remuneration currently established in the Market Development Remuneration (RDM) for the new supply points and demand*”.

¹² In accordance with Article 6.3 of the Circular, the CNMC “*will make the information requirements and will approve the necessary resolutions to determine the remuneration adjustment to the current owners of the grids in view of the changes that have taken place as a result of the corporate operations that have occurred in the companies included in Order ECO/31/2003, of 16 January. The aforementioned resolutions may include calculations and distributions that take into account the physical information on the facilities and their start-up date, as well as the evolution of demand and the supply points associated with these facilities*”.

¹³ In accordance with Article 6.4 of the Circular, the CNMC will approve, after a hearing process, the resolutions establishing for each distribution company “e” the remuneration adjustment for the distribution activity and the base remuneration provisionally based on the data available when establishing the remuneration for the year 2021 and, on a definitive basis, from the data of the definitive settlement for the year 2020.

The value of the different parameters taken into consideration for the calculation of the RDM is defined in a CNMC resolution¹⁴.

For the purposes of calculating the RMD, it is specified that a municipality will be considered as recently regasified (*regasificación reciente*) during the first five gas years "a" in which a distribution grid is developed for the first time in its territory whose first entry into service takes place after 31 December 2020. The remuneration for market development accrued for the gas year "a" in a municipality of recent gasification may be equal, at most, to the value of the revenue obtained from the invoicing of gas distribution tolls in that municipality during the said gas year "a"¹⁵.

- **Transitional Distribution Remuneration ("RTD"):** this remuneration concept aims to carry out, over the 2021-2026 regulatory period, a gradual application of the AAD (remuneration adjustment for the distribution activity). The RTD is calculated as a percentage of the AAD for each gas year, which will be gradually reduced over the 2021-2025 period (in 2026 it will amount to 0%)¹⁷.
- **Loss settlement incentive ("IM"):** this is the positive or negative incentive for the settlement of gas losses for each year and company, determined in accordance with the provisions contained in Order IET/2446/2013, of 27 December, establishing the tolls and fees associated with the access of third parties to gas facilities and the remuneration of regulated activities, apart from other components.

Once the annual remuneration has been determined provided the sum of the four abovementioned items, the following remuneration adjustments will be made, where appropriate:

- **Adjustment for related products and services:** A remuneration adjustment is planned for the use of regulated assets in related products and services,

¹⁴ The specific value of these parameters for the 2021-2026 regulatory period is established in the fourth additional provision of the Circular.

¹⁵ According to the Note to the Circular, this mechanism is considered to comply with the energy policy guideline, which consists of not providing incentives for the expansion of natural gas grids when the revenues from new supply points do not cover costs.

¹⁶ In accordance with the third transitional provision, relating to the remuneration of municipalities with recent gasification prior to 1 January 2021, "*For those municipalities which, for the purpose of section 2 of Annex X to Law 18/2014, of 15 October, were considered to be municipalities with recent gasification, the unit remuneration per supply point established in this circular shall continue to be applied to them until the end of the five year period from the year in which they first came into service*".

¹⁷ According to Article 8 of the Circular, the aforementioned percentages account for 85% for gas year 2021 (actually $\frac{3}{4}$ of 85% as the duration of the gas year in 2021 is shorter), 70% for gas year 2022, 50% for gas year 2023, 35% for gas year 2024, 15% for gas year 2025, and 0% for gas year 2026.

related activities are understood to be those activities, other than the ones with a regulated economic regime that are carried out by the regulated company and whose exercise involves the use or consumption of resources from activities with a regulated economic regime¹⁸.

For each related product or service, the CNMC will determine by means of a resolution, after a hearing, the methodology for the remuneration adjustment¹⁹.

Each year, the CNMC will establish by resolution the amount of the lesser remuneration to be received in the gas year “a+1”, for each company and for each related product and service carried out during the previous calendar year.

- **Penalty for financial prudence²⁰:** a negative economic incentive is envisaged, which may reach a maximum value of 1% of the company's overall remuneration, for the holders of regulated natural gas assets that lie outside the recommended values of ratios²¹ defined by the CNMC in its Communication 1/2019, of 23 October, defining certain ratios for assessing the level of indebtedness and the economic/financial capacity of the companies that carry out regulated activities in the electricity and gas sectors²².

The value of the penalty for each calendar year for each company will be determined by resolution of the CNMC.

IV. Additional issues

Additionally, the Circular regulates the following matters:

- It establishes the procedure for the inclusion of a new distributor in the remuneration regime and the remuneration criteria for the distribution facilities subject to transfer of ownership.

¹⁸ In accordance with the provisions of Article 9 of the Circular, companies that provide third parties with related products or services for the provision of which they use the facilities and resources paid for under the economic regime established in the Circular shall declare to the CNMC before 1 July of each year the related products and services corresponding to the previous calendar year and their forecast for the current year.

¹⁹ Until this resolution is approved, 50% of the annual income obtained from the making of related products or the provision of related services will be considered for the purposes of reducing the annual value of the remuneration. However, this adjustment will be adjusted if a lower percentage of income results from the aforementioned resolution.

²⁰ In accordance with the fifth additional provision of the Circular, the penalty will not be applicable until 2024, the fourth year of the first period of application of this methodology, on the basis of an IGR based on the financial statements of the year 2022.

²¹ IGR (“*Overall Ratios Index*” defined in the Communication) below 0.90%.

- It establishes the general aspects regarding the accrual of the remuneration, information requirements and inspections.
- It provides for the supervision of companies' investment plans and the closure of the plants.
- It provides for a system of cost regulatory information. It refers to a subsequent approval, by means of a Circular, of the relevant provisions for the development of the regulatory cost information and for the collection of all the information necessary to determine whether distribution companies are receiving adequate remuneration for their natural gas distribution activity.

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²² The penalty shall not apply if the company is part of a group of companies in which the parent company of that group also holds gas system assets and, at the aggregate or consolidated level of that parent company and its subsidiaries holding grid assets, the IGR is greater than or equal to 0.90.