Naturgy

Consolidated Directors' Report as at 30 June 2018

1. Company situation

Naturgy is an integrated gas and electricity company that operates in over 30 geographies and has a base of 20 million contracts in Europe and Latin America.

On 27 June 2018, a new Strategic Plan was approved whose primary goal is to orient the company towards value creation and lay the foundations for the Group's new industrial model in order to meet the challenges of the energy transition.

Naturgy's value-creation commitment rests on four basic pillars: simplicity and accountability, disciplined investment, optimisation, and shareholder remuneration.

At organisational level, changes have been made in corporate governance and in the organisation structure to facilitate decision-making and autonomy in the business units, always underpinned by oversight from headquarters.

The focus on simplicity is also reflected in the Group's strategic positioning to focus on Naturgy's core geographies and businesses. The positioning entails simplifying the business portfolio, which is being trimmed and rationalised so as restore the balance in the business mix and focus on the businesses and geographies in which Naturgy wants to strengthen its position or expand.

The Strategic Plan also steps up discipline in investing by setting hurdle rates and risk management criteria to ensure value creation and profitable growth in both organic and inorganic investments, always within the framework of the Group's industrial model and in pursuit of the objectives set in the strategic positioning.

This investment discipline will ensure that investments are optimised, but Naturgy has also made a firm commitment to optimise operating expenses, which will provide major savings with a visible impact on results.

The focus on value creation and increasing cash flow will make it possible to enhance shareholder remuneration within the period of the Strategic Plan and lay the foundations for growth, subject always to the requirement that value be created.

2. Business evolution and results

2.1. Milestones in the six-month period ended 30 June 2018

Ebitda amounted to Euros 2,004 million in the first half of 2018, a 1.3% reduction with respect to the same period of 2017. Exchange rate fluctuations in the period by all the currencies in which the group operates had a negative impact in the amount of Euros -106 million.

Net profit in the first half of 2018 amounted to Euros -3,281 million due to recognition of impairment following an exhaustive review of all the assets that might be impaired, as a result of the approval of the new Strategic Plan 2018-2022 on 27 June 2018. In recurring terms, net profit increased by 22.3% (Euros 532 million in the first half of 2018 vs. Euros 435 million in the first half of 2017).

On 22 February 2018, Repsol reached an agreement to sell its 20.072% stake in the capital of Naturgy Energy Group, S.A. to Rioja Bidco Shareholdings, S.L.U., a company controlled by funds advised by CVC. The transaction was completed on 18 May 2018, with the result that Repsol, S.A. ceased to be a shareholder of the company.

The following transfers were completed in the first half of 2018: i) the remaining 41.9% of the gas distribution business in Colombia for Euros 334 million, equal to its carrying amount, net of the dividends received; consequently, this did not have any impact on the consolidated income statement; ii) the gas distribution and supply business in Italy, as well as the transfer of the gas supply contract, for Euros 766 million, generating a capital gain of Euros 188 million after taxes which was recognised under "Profits from discontinued operations net of taxes" in the consolidated income statement; and iii) the sale of a 20% minority stake in the gas distribution business in Spain for Euros 1,500 million, which resulted in an increase of Euros 1,016 million in the "Reserves" caption in the consolidated balance sheet.

On 27 June 2018, Naturgy reached an outline agreement to sell its 70% stake in Kangra Coal Proprietary Limited (mining business in South Africa) to Menar Holding. Completion of the sale is subject to the execution of the pre-emptive acquisition right held by Izimbiwa Coal Inv., Naturgy's partner in Kangra, and owner of the remaining 30%, and to fulfilment of the established time periods and procedures. The transaction represents an equity value of Euros 28 million for Naturgy's 70% stake.

On 27 June 2018, Naturgy reached an agreement to sell its entire stake in Iberafrica Power Limited, in Kenya, to AEP Energy Africa Limited. The deal represents an enterprise value of USD 62 million. Completion of the transaction is subject to obtaining the necessary regulatory approvals and clearance from the competition authorities and is expected to take place in the fourth quarter of this year.

On 27 June 2018, the Shareholders' Meeting approved the distribution of income, consisting of allocating Euros 1,001 million out of 2017 income to dividends, the same amount as in the preceding year, representing a 73.6% payout. That is a dividend of Euros 1 per share, of which Euros 0.33 per share was paid as an interim dividend in cash on 27 September 2017 and a supplementary dividend 0.670 per share was paid, also in cash, on 5 July 2018.

On 27 June 2018, the Shareholders' Meeting approved the new Strategic Plan 2018-2022, which established a new industrial model and for the business units, and the activities and markets continuity in the future, and an update of the main assumptions and business projections in light of the new context variables for the next five years.

In the context of the new Strategic Plan 2018-2022 and as part of the new shareholder remuneration policy that includes a minimum dividend of Euros 1.30 per share out of 2018 earnings, the Board of Directors declared the first interim dividend for 2018 in the amount of Euros 0.280 per share, payable entirely in cash on 31 July 2018.

Following the approval of the new Strategic Plan 2018-2022, assets were impaired in the amount of Euros 4,851 million due to re-measurement of the estimated future cash flows on the basis of the Plan and for other factors that have occurred in the period; the impairment was recognised under "Depreciation and impairment of fixed assets" (Euros 4,279 million) and "Profit/(loss) of companies measured under the equity method" (Euros 572 million) in the consolidated income statement.

As of 30 June 2018, leverage stood at 44.8%, while the net financial debt/Ebitda ratio was 3.2, both metrics were lower than in 2017.

2.2. Main aggregates

Main financial aggregates

	2018	2017	%
Net sales	12,176	11,569	5.2
Ebitda	2,004	2,030	(1.3)
Operating income	(3,224)	1,172	-
Income attributable to equity holders of the parent company	(3,281)	550	-
Net capital expenditure	(1,429)	740	-
Equity (at 30/06)	15,220	18,246	(16.6)
Attributed equity (at 30/06)	11,442	14,609	(21.7)
Net borrowings (at 30/06)	12,362	15,818	(21.8)

Key financials & metrics

	2018	2017
Leverage	44.8%	46.4%
Ebitda/Cost of net financial debt	7.3x	6.5x
Net financial debt/Ebitda	3.2x	3.7x

Main stock market ratios and shareholder remuneration

	2018	2017
Average no. of shares ('000)	1,000,462	1,000,519
No. of shares outstanding at end of period ('000)	1,000,689	1,000,689
Share price at 30/06 (euro)	22.68	20.49
Stock market capitalisation at 30/06 (million euro)	22,696	20,504
Earnings per share (Euros)	(3.28)	0.55

Main physical aggregates

	2018	2017	%
Electricity Generation:			
Electric energy produced (GWh):	22,192	22,092	0.5
Spain:	13,279	13,161	0.9
Hydroelectric	2,335	737	216.8
Nuclear	2,060	2,185	(5.7)
Coal	1,203	2,832	(57.5)
CCGTs	6,251	6,141	1.8
Renewables and Cogeneration	1,430	1,266	13.0
International:	8,913	8,931	(0.2)
Hydroelectric	194	234	(17.1)
CCGTs	7,847	7,925	(1.0)
Oil – gas	510	466	9.4
Wind	362	306	18.3
Solar	67	-	-
Installed capacity (MW):	15,562	15,306	2.0
Spain:	12,718	12,716	-
Hydroelectric	1,954	1,954	-
Nuclear	604	604	-
Coal	2,010	2,010	-
CCGTs	7,001	7,001	-
Renewables and Cogeneration	1,149	1,147	0.2
International:	2,844	2,590	9.8
Hydroelectric	123	123	-
CCGTs	2,289	2,035	12.5
Oil – gas	198	198	-
Wind	234	234	-
Solar	68	-	-

	2018	2017	%
Supply			
Gas supply (GWh)	**126,587**	**123,024**	**2.9**
Europe wholesale	109,052	107,232	1.7
Spain retail	17,535	15,792	11.0
Electricity supply (GWh)	**18,328**	**17,524**	**4.6**
International LNG			
Sales (GWh)	**76,793**	**55,603**	**38.1**

	2018	2017	%
Gas distribution:			
Sales - TPA[1]:	**224,119**	**217,771**	**2.9**
Spain	102,730	98,913	3.9
Latin America	121,389	118,858	2.1
Gas distribution connections points (thousand) (at 30/06):	**10,586**	**10,345**	**2.3**
Spain	5,391	5,336	1.0
Latin America	5,195	5,009	3.7
Electricity distribution:			
Sales - TPA[1]:	**27,513**	**26,928**	**2.2**
Spain	16,294	15,977	2.0
Latin America	11,219	10,951	2.4
Electricity distribution connections (thousand) (at 30/06):	**7,510**	**7,388**	**1.7**
Spain	3,730	3,712	0.5
Latin America	3,780	3,676	2.8
ICEIT [2] (minutes)	**25**	**67**	**(62.7)**
Gas transportation – EMPL (GWh)[3]	**71,066**	**49,433**	**43.8**

[1] Third-Party Access (energy distributed). Includes TPA services in secondary transmission.
[2] Installed capacity equivalent interruption time in Spain.
[3] Maghreb-Europe gas pipeline.

2.3. Analysis of consolidated results

Net sales

	2018	% of total	2017	% of total	% 2018/2017
Gas & Electricity	9,908	81.4	9,002	77.8	10.1
Supply of gas, electricity and services	6,768	55.6	6,500	56.2	4.1
International LNG	1,795	14.7	1,124	9.7	59.7
Generation Europe	912	7.5	940	8.1	(3.0)
International generation	433	3.6	438	3.8	(1.1)
Infrastructure EMEA	1,196	9.8	1,217	10.5	(1.7)
Gas distribution Spain	612	5.0	638	5.5	(4.1)
Electricity distribution Spain	427	3.5	420	3.6	1.7
EMPL	157	1.3	159	1.4	(1.3)
Infrastructure LatAm South	2,493	20.5	2,876	24.9	(13.3)
Gas and electricity distribution Argentina	321	2.6	286	2.5	12.2
Gas distribution Brazil	735	6.0	803	6.9	(8.5)
Gas and electricity distribution Chile	1,435	11.8	1,787	15.4	(19.7)
Gas distribution Peru	2	-	-	-	-
Infrastructure LatAm North	654	5.4	688	5.9	(4.9)
Gas distribution Mexico	277	2.3	281	2.4	(1.4)
Electricity distribution Panama	377	3.1	407	3.5	(7.4)
Rest	129	1.1	129	1.1	-
Consolidation adjustments	(2,204)	(18.1)	(2,343)	(20.3)	(5.9)
Total	**12,176**	**100**	**11,569**	**100**	**5.2**

Net sales totalled Euros 12,176 million in the first half of 2018, a 5.2% increase with respect to the same period of 2017, due basically to higher volumes and prices in the gas business compared with the same period of the previous year, and to the currency effect.

Ebitda

	2018	% of total	2017	% of total	% 2018/2017
Gas & Electricity	595	29.7	549	27.0	8.4
Supply of gas, electricity and services	55	2.7	41	2.0	34.1
International LNG	233	11.6	163	8.0	42.9
Generation Europe	166	8.3	207	10.2	(19.8)
International generation	141	7.0	138	6.8	2.2
Infrastructure EMEA	891	44.5	878	43.3	1.5
Gas distribution Spain	432	21.6	432	21.3	-
Electricity distribution Spain	316	15.8	298	14.7	6.0
EMPL	143	7.1	148	7.3	(3.4)
Infrastructure LatAm South	362	18.1	407	20.0	(11.1)
Gas and electricity distribution Argentina	43	2.1	28	1.4	53.6
Gas distribution Brazil	110	5.5	126	6.2	(12.7)
Gas and electricity distribution Chile	211	10.5	256	12.6	(17.6)
Gas distribution Peru	(2)	(0.1)	(3)	(0.1)	(33.3)
Infrastructure LatAm North	123	6.1	139	6.8	(11.5)
Gas distribution Mexico	78	3.9	87	4.3	(10.3)
Electricity distribution Panama	45	2.2	52	2.6	(13.5)
Rest	33	1.6	57	2.8	(42.1)
Total	**2,004**	**100**	**2,030**	**100**	**(1.3)**

Consolidated Ebitda in the first half of 2018 amounted to Euros 2,004 million, 1.3% less than in the same period of the previous year.

Foreign currency fluctuations in consolidation by all the group's currencies had a negative impact on Ebitda in the first half of 2018 amounting to Euros 106 million with respect to the same period of 2017.

Ebitda from Naturgy's international activities accounts for 49.5% of the consolidated total, in line with the same period of last year (49.3%). Ebitda from operations in Spain maintained its share of the consolidated total at 50.5% (50.7% in the same period of 2017).

EBIT

	2018	% of total	2017	% of total	% 2018/2017
Gas & Electricity	(3,731)	115.7	200	17.1	-
Supply of gas, electricity and services	(6)	0.2	-	-	-
International LNG	197	(6.1)	139	11.9	41.7
Generation Europe	(3,981)	123.5	(17)	(1.5)	-
International generation	59	(1.8)	78	6.7	(24.4)
Infrastructure EMEA	598	(18.5)	595	50.8	0.5
Gas distribution Spain	284	(8.8)	280	23.9	1.4
Electricity distribution Spain	197	(6.1)	185	15.8	6.5
EMPL	117	(3.6)	130	11.1	(10.0)
Infrastructure LatAm South	184	(5.7)	281	24.0	(34.5)
Gas and electricity distribution Argentina	34	(1.1)	23	2.0	47.8
Gas distribution Brazil	78	(2.4)	91	7.8	(14.3)
Gas and electricity distribution Chile	120	(3.7)	170	14.5	(29.4)
Gas distribution Peru	(48)	1.5	(3)	(0.3)	-
Infrastructure LatAm North	76	(2.4)	98	8.4	(22.4)
Gas distribution Mexico	50	(1.6)	64	5.5	(21.9)
Electricity distribution Panama	26	(0.8)	34	2.9	(23.5)
Remainder	(351)	10.9	(2)	(0.2)	-
Total	**(3,224)**	**100**	**1,172**	**100**	**-**

Depreciation and amortisation and impairment charges as at 30 June 2018 amounted to Euros 5,165 million, including Euros 4,279 million in impairment of generation assets (Euros 3,929 million), computer software (Euros 171 million), and other non-viable projects (Euros 179 million) recognised after discounting future cash flows as a result of approving the Strategic Plan 2018-2022. They also include Euros 54 million in impairments recognised before the plan was approved.

Provisions for bad debts amounted to Euros 63 million, in line with the Euros 58 million booked last year.

EBIT in the first half of 2018 was negative in the amount of Euros -3,224 million as a result of the impairments.

Financial result

Net financial expenses amounted to Euros 306 million in the first half of 2018, 12.3% less than in the same period of the previous year (Euros 349 million in 2017).

The breakdown of the financial result is as follows:

	2018	2017	%
Cost of net financial debt	(274)	(315)	(13.0)
Other financial expenses/revenues	(41)	(41)	-
Financial revenues Costa Rica[1]	9	7	28.6
Net financial income	**(306)**	**(349)**	**(12.3)**

[1] The Costa Rica generation concessions are accounted for as finance leases in accordance with IFRIC 12.

The cost of net interest-bearing debt in the first half of 2018 was Euros 274 million, i.e. lower than in the same period of the previous year due to lower rates on new issues used to refinance maturing debt or redeem bonds, and cancellation of bank debt.

The average cost of gross financial debt is 3.0%, and 89% of the debt is at fixed rates.

Equity-accounted affiliates

Equity-accounted affiliates contributed -Euros 559 million in the first half of 2018 (Euros 7 million in the same period of 2017) due to recognising impairment of the holding in the Unión Fenosa Gas subgroup (Euros -538 million) and of the holding in Ecoeléctrica (Euros -34 million).

Income tax

The effective tax rate as of 30 June 2018, based on the best estimate of the effective tax rate for the full year, without taking into account all the non-recurrent impacts of the impairments and the decrease of the deferred taxes due to the Chile merges, was 21.7%, compared with 21.5% in the same period of the previous year.

Income from discontinued operations

In the first half of 2018, income from discontinued operations amounted to Euros -15 million (Euros 64 million in the first half of 2017), corresponding to Italy (Euros 194 million, including the Euros 188 million gain on the sale of the holdings), gas distribution in Colombia (Euros 7 million), electricity distribution in Moldova (Euros -61 million that includes a write-down of the investment amounting Euros 73 million), electricity generation in Kenya (-Euros 5 million that includes a write-down of the investment amounting Euros 7 million) and mining in South Africa (Euros - 150 million that includes a write-down of the investment amounting Euros 141 million).

Non-controlling interest

The main items in this account are the non-controlling interests in EMPL, International Electricity Generation (GPG), Nedgia (gas distribution in Spain), gas distribution companies in Chile, Brazil and Mexico, and the electricity distribution companies in Chile and Panama, as well as accrued interest on perpetual subordinated notes.

Income attributed to non-controlling interests amounted to Euros - 103 million in the first half of 2018 (Euros - 161 million in the first half of 2017).

Net income

Net profit amounted to Euros -3,281 million (Euros 550 million in the first half of 2017). Excluding the non-recurring effects in the period, net profit amounted to Euros 532 million, compared with Euros 435 million in the same period of the previous year, an increase of 22.3%.

2.4. Consolidated balance sheet

Investments

The breakdown of net investments by type is as follows:

	2018	2017	%
Investments in property, plant and equipment and intangible assets (Note 7)	1,145	737	55.4
Financial assets	35	27	29.6
Total gross investments	**1,180**	**764**	**54.5**
Divestments and others.	(2,609)	(24)	-
Total net investments	**(1,429)**	**740**	**-**

Investments in property, plant and equipment and intangible assets amounted to Euros 1,145 million in the first half of 2018, a 55.4% increase with respect to the same period of the previous year, basically because of the recognition of two new gas carriers under finance lease (Euros 380 million: one in March 2018 and the other in June 2018).

Excluding investment in gas carriers, capital expenditure increased by 3.8%.

Divestments and other items include the sale of the businesses in Italy for Euros 766 million, the proceeds from the sale of a 20% non-controlling stake in Holding de Negocios de Gas, S.A. (Euros 1,500 million) and the proceeds from the sale of the remaining 41.9% stake in the gas distribution business in Colombia (Euros 334 million).

The breakdown of investments in property, plant and equipment and intangible assets is as follows:

	2018	2017	% 2018/2017
Gas & Electricity	623	169	268.6
Supply of gas, electricity and services	35	25	40.0
International LNG	380	-	-
Generation Europe	109	54	101.9
International generation	99	90	10.0
Infrastructure EMEA	185	190	(2.6)
Gas distribution Spain	94	82	14.6
Electricity distribution Spain	90	106	(15.1)
EMPL	1	2	(50.0)
Infrastructure LatAm South	238	230	3.5
Gas and electricity distribution Argentina	27	21	28.6
Gas distribution Brazil	35	49	(28.6)
Gas and electricity distribution Chile	170	156	9.0
Gas distribution Peru	6	4	50.0
Infrastructure LatAm North	80	93	(14.0)
Gas distribution Mexico	35	41	(14.6)
Electricity distribution Panama	45	52	(13.5)
Remainder	19	55	(65.5)
Total	**1,145**	**737**	**55.4**

The gas business represented 54.4% of the consolidated total due to the addition of two new gas tankers under finance lease (Euros 380 million).

Infrastructure EMEA accounts for 16.2% of total consolidated capital expenditure, having declined by 2.6% year-on-year.

Infrastructure LatAm South accounted for 20.8% of the consolidated total, having increased by 3.5% year-on-year, basically because of higher investment in Chile.

Infrastructure LatAm North accounted for 7.0% of total consolidated capital expenditure, having declined by 14.0% with respect to the same period of the previous year.

Excluding the two gas tankers acquired under finance lease in 2018, capital expenditure in Spain increased by 18.5% and accounted for 45.2% of the total, compared with 38.4% the previous year. Capital expenditure outside Spain declined by 5.6% to account for 54.8% of the total (vs. 61.6% the previous year).

Maintenance capex in the first half of 2018 amounted to Euros 309 million, compared with Euros 345 million in the same period of the previous year, a 10.4% reduction. Growth capex amounted to Euros 836 million (Euros 456 million excluding the two gas carriers acquired under finance lease) compared with Euros 392 million, a 16.3% increase without considering the ships.

Additionally, in the first half of 2018 inorganic investments in two photovoltaic projects in Brazil have been made. Development of this projects, located in Minas Gerais State, would require an approximately investment of Euros 95 million and a capacity of 83 MW and are expected to start operations in the fourth quarter of 2018.

Equity and shareholder remuneration

The distribution of 2017 income proposed to the Shareholders' Meeting on 27 June 2018 entailed allocating Euros 1,001 million to dividends, the same amount as in the previous year. That represents a dividend of Euros 1 per share and a pay-out of 73.6%, i.e. a dividend yield of 5.2% based on the share price on 31 December 2017 (Euros 19.25).

An interim dividend amounting to Euros 0.33 per share out of 2017 earnings was paid entirely in cash on 27 September 2017, and the Euros 0.67 per share supplementary dividend was paid on 5 July 2018.

In the context of the new Strategic Plan 2018-2022 and as part of the new shareholder remuneration policy that includes a minimum dividend of Euros 1.30 per share out of 2018 earnings, the Board of Directors declared the first interim dividend for 2018 in the amount of Euros 0.28 per share, payable entirely in cash on 31 July 2018.

At 30 June 2018, Naturgy's shareholders' equity totalled Euros 15,220 million. Of that total, Euros 11,442 million is attributable to Naturgy.

Debt and finances

Net interest-bearing debt (Euros million)

	30/06/18	30/06/17	%
Net financial debt	12,362	15,818	(21.8)

At 30 June 2018, net interest-bearing debt amounted to Euros 12,362 million and leverage was 44.8% (Euros 15,818 million and 46.4% at 30 June 2017).

The net debt/Ebitda ratio was 3.2 and the Ebitda/interest ratio was 7.3 at 30 June 2018, evidencing an improvement in fundamentals with respect to the preceding year (3.7x and 6.4x, respectively).

Considering the estimated impact of applying IFRS 16, net interest-bearing debt would amount to Euros 14,000 million and the leverage ratio would be 47.9%. The net debt/Ebitda ratio would be 3.6.

Net interest-bearing debt is calculated as follows:

	30/06/18	30/06/17
Non-current borrowings	13,711	14,485
Current borrowings	2,217	2,857
Cash and cash equivalents	(3,492)	(1,455)
Derivatives	(74)	(69)
Net financial debt	**12,362**	**15,818**

Maturity of net debt (Euros million)

	2018	2019	2020	2021	Post 2022
Net debt maturities	240	438	731	1,696	9,257

The above table shows Naturgy's net debt maturities at 30 June 2018.

A total of 94.9% of net interest-bearing debt matures in or after 2020. The average term of the debt is 6.3 years.

Of the net interest-bearing debt, 4.2% is short term and 95.8% is long term.

The debt structure is mainly at fixed rate (89%) taking into account the impact of the derivatives on financial liabilities

The breakdown of the net borrowings by currency at 30 June 2018, in absolute and relative terms, is as follows:

(million euro)	30/06/2018	%
EUR	9,768	79.0
CLP	1,760	14.2
USD	262	2.1
MXN	311	2.5
BRL	234	1.9
Others	27	0.3
Total net financial debt	**12,362**	**100.0**

Main financial transactions

In January 2018, Naturgy Euros 850 million in 10-year bonds paying 1.5%, the proceeds from which were used to tender for Euros 916 million in bonds maturing between 2019 and 2023. Additionally, two bonds totalling 1,099 million with an average coupon of 4.59% matured in the first quarter of 2018.

In March 2018, Gas Natural México issued Euros 153 million in 3-year bonds with a variable coupon of TIIE plus 0.40% and 7-year bonds with a coupon of 8.89%.

In the first half of 2018, issues under the Euro Commercial Paper (ECP) programme totalled Euros 3,044 million (Euros 2,133 million in the same period of 2017). The outstanding balance of issues under the ECP programme stands at Euros 500 million (there were no outstanding issues at 31 December 2017).

On 1 July 2018 an ING credit facility has been renewed amounting to Euros 300 million.

Credit rating

The credit ratings of Naturgy's short- and long-term debt are as follows:

Agency	Short term	Long term
Fitch	F2	BBB+
Moody's	P-2	Baa2
S&P	A-2	BBB

On 18 July 2018, S&P ratified the long-term credit rating (BBB) and stable outlook after the presentation of the new Strategic Plan.

Liquidity and capital

At 30 June 2018, cash and cash equivalents together with available bank finance totalled Euros 10,686 million, providing the company with sufficient liquidity to cover its debt maturities for more than 24 months, with the following breakdown:

Liquidity source	Limit	Drawn	Available
Committed credit lines	6,973	213	6,760
Uncommitted credit lines	548	114	434
Cash and cash equivalents	-	-	3,492
Total	**7,521**	**327**	**10,686**

Additionally, at 30 June 2018, the company had Euros 6,815 million available in the form of shelf registrations for financial instruments, including Euros 4,960 million in the Euro Medium Term Notes (EMTN) programme; Euros 500 million in the Euro Commercial Paper (ECP) programme; and a combined Euros 1,355 million in the stock market certificates programmes on the Mexico Stock Exchange, the commercial paper programme on the Panama Exchange and the bond lines in Chile.

2.5. Analysis of results by segment

Gas & Electricity

2.5.1 Supply of gas, electricity and services

This business includes wholesale gas procurement and supply in the Spanish liberalised market, the supply of gas and electricity and of other products and services related to retail supply in the Spanish liberalised market, supply of gas at the last resort tariff (TUR) in Spain and supply of electricity at the small consumer voluntary price (PVPC) in Spain.

Results

	2018	2017	%
Net sales	6,768	6,500	4.1
Procurement	(6,457)	(6,190)	4.3
Net personnel expenses	(64)	(54)	18.5
Other revenues/expenses	(192)	(215)	(10.7)
Ebitda	**55**	**41**	**34.1**
Depreciation, amortisation and impairment expenses	(31)	(13)	138.5
Allocation to provisions	(30)	(28)	7.1
EBIT	**(6)**	**-**	**-**

Net sales amounted to Euros 6,768 million, a 4.1% increase with respect to last year. Ebitda amounted to Euros 55 million, 34.1% more than in the same period of the previous year due to improved retail margins.

The Euros 17 million increase in depreciation and amortisation charges in the period is due mainly to the application of IFRS 5.

Main aggregates

The main aggregates in the supply activity are as follows:

	2018	2017	%
Gas sales (GWh)	**126,587**	**123,024**	**2.9**
Europe wholesale	109,052	107,232	1.7
Retail Spain	17,535	15,792	11.0
Electricity sales (GWh)	**18,328**	**17,524**	**4.6**
Retail contracts (Spain) ('000, at 30/06)	**11,655**	**11,740**	**(0.7)**
Energy contracts	8,796	8,856	(0.7)
Energy services contracts	2,859	2,884	(0.9)
Contracts per customer (Spain)	1.52	1.52	-
Gas contract market share (Spain)	53.8	55.0	1.2 p.p.

Gas supply

In June, Sonatrach and Naturgy strengthened their relationship by extending the contracts for the purchase of Algerian gas until the end of the next decade; their alliance ensures a stable supply of gas to Spain.

The renewal of the contracts enables Naturgy to maintain a very large volume and ensures an optimal mix of natural gas (NG) and liquefied natural gas (LNG) in its inputs.

The first shipment of LNG under the long-term contract signed with the Russian company Yamal LNG was unloaded on 21 June 2018. This is the first of a total of 37 shiploads that will reach south-western Europe each year until 2041. This contract expands Naturgy's portfolio of strategic suppliers and reinforces the diversity of supply in this region of Europe with the first long-term contract for the supply of LNG from Russia.

Wholesale supply

Wholesale supply in Spain totalled 75,728 GWh, a 1.2% increase with respect to the same period of the previous year.

Naturgy has a strong position in natural gas supply in Europe, with a presence in France, Belgium, Luxembourg, the Netherlands, Germany, Ireland and Portugal. Its customers are mainly industrial and services companies and the public sector.

Sales in France totalled 20.1 TWh in the first half. Sales in Belgium, Luxembourg, the Netherlands, Germany and Ireland amounted to 9.9 TWh in the same period.

Naturgy is still Portugal's second-largest operator (and its largest foreign operator), with a market share of approximately 14%, and it sold 3.2 TWh there in the first half of 2018.

Retail supply

In the retail market, Naturgy focuses on meeting its customers' energy needs. With a range of quality products and services, it has 11.7 million active gas, electricity and maintenance contracts.

Naturgy provides a comprehensive service by integrating the supply of both energies (gas and electricity) with maintenance services to achieve efficiencies and enhance customer satisfaction; it supplies both energies to over 1.5 million homes, a large percentage of which have a maintenance contract in place.

With a strong focus on continued growth in the retail business, the company sells products and services throughout Spain, having signed 745 thousand new contracts in the first half of 2018.

The offering of services for residential and SME customers has enabled the company to increase the number of active contracts to 2.8 million, managed through the group's own operating platform with 121 associated firms connected via a mobile online system. As a result of this performance, the portfolio of energy and services contracts in the retail segment increased in value.

Naturgy continues to focus on developing natural gas service stations that are open to the public. In the first half of 2018, the company had 49 natural gas service stations, supplying both compressed and liquefied natural gas. A total of 30 stations are open to the public and 19 are private. Additionally, Naturgy is running four special projects developed to encourage the vehicular natural gas use.

As for electricity supply, 18,328 GWh were sold in the first half of 2018, including sales in the liberalised market and under the last resort tariff, a 4.6% increase. The electricity supply portfolio is in line with Naturgy's strategy of maximising margins, optimising market share, and hedging against price variations in the electricity market.

2.5.2 LNG International

This includes trading of liquefied natural gas in international markets and maritime transportation.

Results

	2018	2017	%
Net sales	1,795	1,124	59.7
Procurement	(1,555)	(952)	63.3
Net personnel expenses	(2)	(3)	(33.3)
Other revenues/expenses	(5)	(6)	(16.7)
Ebitda	**233**	**163**	**42.9**
Depreciation, amortisation and impairment expenses	(36)	(24)	50.0
Allocation to provisions	-	-	-
EBIT	**197**	**139**	**41.7**

Ebitda in the LNG business amounted to Euros 233 million in the first half of 2018, a 42.9% increase year-on-year.

Main aggregates

	2018	2017	%
Gas sales (GWh)	76,793	55,603	38.1
Shipping fleet capacity (m^3)	1,463,149	1,095,532	33.6

LNG trading in the international market increased by 38.1% in the first half to 76,793 GWh. This increase was due to the availability of larger volumes under Naturgy's long-term procurement contracts, as well as the completion of a larger number of LNG optimisation and trading transactions.

The company continues to diversify into international markets, having sold gas in the Americas and Asia. This strengthens the company's presence in the main international LNG markets, providing it with a medium-term position in growing countries and new markets.

The shipping fleet expanded with the addition of two new vessels under long-term charter to handle the larger procurement volume.

The main gas price indices performed as follows:

	2018	2017	%
Brent (USD/bbl)	70.6	51.8	36.3
Henry Hub (USD/MMBtu)	2.8	3.2	(12.5)
NBP (USD/MMBtu)	7.7	5.4	42.6
TTF (EUR/MWh)	19.5	17.4	12.7

2.5.3 Generation Europe

Includes power generation in Spain, also conventional and renewable.

Results

	2018	2017	%
Net sales	912	940	(3.0)
Procurement	(465)	(458)	1.5
Net personnel expenses	(56)	(60)	(6.7)
Other revenues/expenses	(225)	(215)	4.7
Ebitda	**166**	**207**	**(19.8)**
Depreciation, amortisation and impairment expenses	(4,147)	(224)	-
Allocation to provisions	-	-	-
EBIT	**(3,981)**	**(17)**	**-**

Net sales in the electricity generation business in Spain amounted to Euros 912 million, 3.0% less than in the same period of the previous year, while Ebitda amounted to Euros 166 million, 19.8% less than in the same period last year.

Depreciation and amortisation charges and impairment losses amounted to Euros 4,147 million, including Euros 3,929 million of impairments as a result of discounting future cash flows following approval of the Strategic Plan 2018-2022.

Market situation

Electricity demand in mainland Spain amounted to 126.4 TWh in the first half of the year, an increase of 1.2% with respect to the same period of 2017. Adjusting for temperatures and the calendar effect, growth would have been 1.1% in 2018.

Peak capacity usage in one hour was registered on 27 June: 36,927 MW, i.e. below the 39,017 MW attained in the same quarter of the previous year (22 June 2017) and well below the all-time summer record of 40,934 MW reached in July 2010.

The balance of physical international interchanges amounted to 6,033 GWh in the first half of 2018, 18.7% more than the 5,081 GWh registered in the same period of the previous year.

Year-to-date consumption for pumped storage amounted to 2,243 GWh, i.e. 7.5% more than in 2017 due to lower market prices in comparison with last year.

Net generation in Spain increased by 0.6% overall in the first half of 2018.Renewable output increased by 23.3% year-on-year and covered 44.6% of demand, compared with 36.6% the previous year.

Wind output in the first half amounted to 27,779 GWh (+10.4% year-on-year) and covered 22.0% of demand, two points more than in the same period of 2017.

In terms of hydroelectric energy capability, the second quarter of 2018 was rated as wet, with an exceedance probability of 20% when compared with the historical average; i.e. statistically, 20 out of every 100 years would be dryer. The trend during the quarter was similar.

Non-renewable output declined by -13.0%. The thermal gap narrowed by -22.6% in the first half of the year, achieving coverage that was 6 points lower than in the same period of 2017 (19.6% vs. 25.6%).

Nuclear output decreased by -10.7%, coal-fired output by -31.0%, CCGT output by -8.5% and output from other non-renewable thermal, cogeneration and energy-from-waste increased by 1.6% at the end of the first half, compared with the same period of last year.

Year-to-date, the weighted average price in the electricity pool was Euros 50.92/MWh, i.e. 1.97% less than in the same period of 2017.

Movements in the main electricity and related market price indices (in addition to the indices mentioned in point 2.5.2.) are set out below:

	2018	**2017**	**%**
Arithmetic mean daily market price (€ /MWh)	50.1	51.3	(2.3)
Coal API 2 CIF (USD/t)	88.0	78.9	11.5
CO_2 EUA (€/ton)	12.1	5.0	142.0

Main aggregates

The key figures of Naturgy's generation business in Spain are as follows:

	2018	**2017**	**%**
Installed capacity (MW):	12,719	12,716	-
Generation:	11,569	11,569	-
Hydroelectric	1,954	1,954	-
Nuclear	604	604	-
Coal	2,010	2,010	-
CCGTs	7,001	7,001	-
Renewable and cogeneration output:	1,150	1,147	0.3
Wind	982	979	0.3
Small hydroelectric	110	110	-
Cogeneration and other	58	58	-
Electric energy produced (GWh):	13,280	13,161	0.9
Generation:	11,849	11,895	(0.4)
Hydroelectric	2,335	737	216.8
Nuclear	2,060	2,185	(5.7)
Coal	1,203	2,832	(57.5)
CCGTs	6,251	6,141	1.8
Renewable and cogeneration output:	1,431	1,266	13.0
Wind	1,079	987	9.3
Small hydroelectric	316	240	31.7
Cogeneration and other	36	39	(7.7)
Market share of generation	16.8	16.5	0.3 p.p.

Naturgy's output in the first half of 2018 amounted to 13,280 GWh, a 0.9% increase with respect to same period of the previous year.

Conventional hydroelectric output increased by 216.8% to 2,335 GWh. The first quarter of 2018 was average in terms of precipitation, and this situation was maintained in the second quarter, ending June with an exceedance probability of 39%, i.e. in statistical terms, 39 out of every 100 years would be wetter.

Reservoirs in the Naturgy watersheds were at 54% of capacity, twenty points higher than at the end of 2Q17 and 37 points higher than at the beginning of the year.

Nuclear output declined by -5.7% while coal-fired output was down -57.5%, and overall utilisation stood at 14%.

CCGT output increased by 1.8% year-on-year to 6,251 GWh. CCGT utilisation year-to-date was 21%, more than double that of the industry as a whole.

Emissions of CO_2 in the first half of 2018 from Naturgy's coal-fired power plants and CCGTs that are affected by the regulation governing greenhouse gas emissions trading totalled 3.6 million tons (-1.4 million tons with respect to the same period of 2017). That decrease was mainly due to coal-fired power plants, caused by lower utilisation as a result of greater precipitation and the use of renewable sources in the first half of 2018 in comparison with the previous year.

Naturgy applies a comprehensive approach to its portfolio of CO_2 emission rights for the post-Kyoto (2013-2020) period, acquiring the necessary emission rights and credits through active participation in auctions and the secondary market.

Naturgy's share of conventional output was 16.8% in the first half of 2018, 0.3 points more than in the same period of 2017.

As for renewable generation and cogeneration, during the second quarter of 2018 Naturgy Renovables commissioned its first wind farm in the Canary Islands: the Haria 2.35 MW wind farm on Gran Canaria is among the projects that the group registered in 2015 under the 450 MW quota opened by the Canary Islands Regional Government.

2.5.4 Generation International (GPG)

This area encompasses the international generation assets and holdings in Brazil (commercial operation in September 2017), Mexico, Puerto Rico, Dominican Republic, Panama and Costa Rica and the power generation projects in Australia and Chile, as well as assets operated for third parties via group company O&M Energy.

Results

	2018	**2017**	**%**
Net sales	433	438	(1.1)
Procurement	(243)	(247)	(1.6)
Net personnel expenses	(19)	(18)	5.6
Other revenues/expenses	(30)	(35)	(14.3)
Ebitda	**141**	**138**	**2.2**
Depreciation, amortisation and impairment expenses	(82)	(60)	36.7
Allocation to provisions	-	-	-
EBIT	**59**	**78**	**(24.4)**

GPG's Ebitda in the first half of 2018 amounted to Euros 141 million, up 2.2% year-on-year due basically to a higher Ebitda contribution from O&M Energy, Costa Rica and Brazil (which was not operational in 1H17), and despite an adverse currency effect (Euros -17 million, basically because of USD).

Ebitda in Mexico declined by -5.4% as a result of the exchange rate effect offset with the higher contribution margin, due basically to higher surplus output.

The Bii Hioxo plant performed better than last year because of a higher wind index.

Ebitda in the Dominican Republic increased by 8.3% year-on-year due to higher output and a higher margins in spot prices, higher demand, lower precipitation and the withdrawal of competitors from the system.

Brazil, which came into operation in September 2017, contributed Euros 4.4 million in Ebitda in the first half of 2018.

Ebitda in Costa Rica increased by over 100% as a result of the recovery of water dispatching revenues (not paid in previous periods) and the penalty imposed by ICE in the second quarter of 2017 due to the delayed entry into commercial operation of the Torito plant.

Main aggregates

The key physical aggregates in this business are as follows:

	2018	2017	%
Installed capacity (MW):	2,912	2,590	12.4
Mexico (CC)	2,289	2,035	12.5
Mexico (wind)	234	234	-
Brazil (solar)	68	-	
Costa Rica (hydroelectric)	101	101	-
Panama (hydroelectric)	22	22	-
Dominican Republic (oil-fired)	198	198	-
Electric energy produced (GWh):	8,980	8,931	0.5
Mexico (CC)	7,847	7,925	(1.0)
Mexico (wind)	362	306	18.3
Brazil (solar)	67	-	-
Costa Rica (hydroelectric)	154	196	(21.4)
Panama (hydroelectric)	40	38	5.3
Dominican Republic (oil-fired)	510	466	9.4
Availability factor (%)			
Mexico (CC)	90.8	95.6	-4.8 p.p.
Costa Rica (hydroelectric)	99.3	96.8	2.5 p.p.
Panama (hydroelectric)	81.8	90.1	-8.3 p.p.
Dominican Republic (oil-fired)	93.9	92.1	1.8 p.p.

Output from the CCGT plants in Mexico decreased year-on-year as a result of the longer maintenance shutdowns at Tuxpan. This effect was partly offset by the sale of larger surpluses, mainly by Norte Durango. The capacity increase year-on-year was due to the recognition of additional capacity in the CCGT plants and the high fogging process implemented in Norte Durango and Tuxpan. Differences in maintenance calendars between years resulted in lower availability than in 2017.

Wind power output by Bii Hioxo increased as a result of the higher wind index.

Hydroelectric output in Costa Rica was impaired by lower precipitation. As discussed in section 2,3, the Costa Rica concessions are accounted for as finance leases in accordance with IFRIC 12.

Output in Panama increased slightly year-on-year as a result of greater precipitation this year in the areas where the plants are located. The reduction in availability year-on-year is attributable to the damage to Unit 2 of the La Yeguada hydroelectric plant.

Output in the Dominican Republic increased year-on-year due to higher demand, lower precipitation and the withdrawal of more efficient plants from the system.

Naturgy's first photovoltaic power project in Brazil entered commercial operation in September 2017: the Sobral I and Sertao I solar farms, with an installed capacity of 68 MW, are located in the Piauí region in northern Brazil.

Infrastructure EMEA

2.5.5 Gas distribution Spain

This area includes remunerated gas distribution and transportation as well activities that are charged for outside the regulated distribution system (meter rental, customer connections, etc.), and the piped liquefied petroleum gas (LPG) business.

Results

	2018	2017	%
Net sales	612	638	(4.1)
Procurement	(41)	(50)	(18.0)
Net personnel expenses	(43)	(44)	(2.3)
Other revenues/expenses	(96)	(111)	(13.5)
Ebitda	**432**	**433**	**(0.2)**
Depreciation, amortisation and impairment expenses	(146)	(148)	(1.4)
Allocation to provisions	(2)	(4)	(50.0)
EBIT	**284**	**281**	**1.1**

Net sales in the gas distribution business amounted to Euros 612 million, i.e. Euros 26 million less than the previous year due to the lower meter rental revenues due to application of the price reduction under Order ETU/1283/2017, of 22 December 2017, in force since January 2018.

These factors, coupled with the positive impact of efficiency measures on operating expenses, resulted in a 0.2% reduction in Ebitda.

Main aggregates

	2018	2017	%
Sales – TPA (GWh)	102,730	98,913	3.9
LPG sales (ton)	54,166	85,223	(36.4)
Distribution network (km)	55,871	53,042	5.3
Increase in connection points (thousand)	20	23	(13.0)
Connection points (thousand) (at 30/06)	5,391	5,336	1.0

Regulated gas sales increased by 3.9% (+3,817 GWh).

Demand growth was concentrated in the residential market. Growth far outstripped the same period of the previous year: +15% (+3,839 GWh) due to favourable weather conditions in March, which was the coldest in 15 years.

The decline in LPG sales was due to a reduction in the number of consumers using this fuel as a result of the shift to natural gas.

2.5.6 <u>Electricity distribution Spain</u>

The electricity distribution business in Spain includes regulated distribution of electricity and network services for customers, basically connections and hook-ups, metering and other actions associated with third-party access to Naturgy's distribution network.

Results

	2018	2017	%
Net sales	427	420	1.7
Procurement	-	-	-
Net personnel expenses	(39)	(53)	(26.4)
Other revenues/expenses	(72)	(69)	4.3
Ebitda	**316**	**298**	**6.0**
Depreciation, amortisation and impairment expenses	(119)	(113)	5.3
Allocation to provisions	-	-	-
EBIT	**197**	**185**	**6.5**

The Ministerial Order on electricity tolls for 2018 (ETU/1282/2017) establishes that, until the approval of the remuneration for transmission and distribution for 2018 under the provisions of Royal Decree 1047/2013, of 27 December, and Royal Decree 1048/2013, of 27 December, the remuneration established in Order IET/981/2016 and Order IET/980/2016, which established the remuneration for electricity transmission and distribution companies for 2016, will be paid pro rata.

Net revenues amounted to Euros 427 million, i.e. slightly higher than in the same period of 2017, due to application of the aforementioned Ministerial Orders and to the accrual of investments that were brought into operation, considering also the adjustment to the finance percentage of the base, as published in the draft ministerial order covering the remuneration for distribution.

Ebitda amounted to Euros 316 million in the first half of 2018, a 6.0% increase with respect to the same period of 2017, due to the positive impact of the reduction in personnel expenses (-26.4%) as a result of business efficiency measures implemented in 2017.

Main aggregates

	2018	2017	%
Sales – TPA (GWh)	16,294	15,977	2.0
Connection points (thousand) (at 30/06)	3,730	3,712	0.5
ICEIT (minutes)	25	67	(62.7)

Energy supplied increased by 2% in the first half with respect to the same period of 2017. The increase was 0.9% in year-on-year terms. Domestic demand amounted to 124,605 GWh in the first half of 2018, a 1% increase, according to figures from Red Eléctrica de España (REE).

The number of supply connections increased in the first half of 2018, by 9,952.

Despite the improvement with respect to the first half of 2017, outage statistics (ICEIT) were penalised in the first half of 2018 by storms in March. The same period of 2017 was also affected by major storms in Galicia (Jurgen, Kurt and Leiv) which had a very significant impact on figures in the first half.

As of 30 June 2018, smart meters accounted for 97.5% of the total, and 95.9% of meter readings are performed on a remote basis. The plan is to achieve 100% smart meters and remote readings in the residential market by 31 December 2018, as required by law. Nevertheless, in accordance with Order ETU 1282/2017, from 1 January 2019, electricity distribution companies are allowed to have up to 2% of their meters without upgrading provided that this is due to causes not attributable to the companies themselves, which must be supported and accepted by the National Markets and Competition Commission.

2.5.7 EMPL

This area refers to operation of the Maghreb-Europe gas pipeline.

Results

	2018	2017	%
Net sales	157	159	(1.3)
Procurement	-	-	-
Net personnel expenses	(2)	(2)	-
Other revenues/expenses	(12)	(9)	33.3
Ebitda	**143**	**148**	**(3.4)**
Depreciation, amortisation and impairment expenses	(26)	(18)	44.4
Allocation to provisions	-	-	-
EBIT	**117**	**130**	**(10.0)**

Net revenues in the Infrastructure business totalled Euros 157 million in the first half of 2018, a 1.3% decline year-on-year.

Ebitda declined by 3.4% year-on-year to Euros 143 million due to the negative impact of the USD exchange rate (Euros -17 million) offset with the increase in the transported volume and for the 3% increase in the transportation fee.

Main aggregates

The main aggregates in international gas transportation are as follows:

	2018	2017	%
Gas transport-EMPL (GWh):	71,066	49,433	43.8
Portugal-Morocco	20,398	20,441	(0.2)
Spain (Naturgy)	50,668	28,992	74.8

The gas transportation activity conducted in Morocco through companies EMPL and Metragaz represented a total volume of 71,066 GWh, 43.8% more than in the same period last year. Of that figure, 50,668 GWh were shipped for Naturgy through Sagane and 20,398 GWh for Portugal and Morocco.

Naturgy owns 14.9% of Medgaz, the company that owns and operates the Algeria-Europe subsea gas pipeline connecting Beni Saf with the Almería coast in Spain (capacity: 8 bcm/year). That capacity is associated with a supply contract amounting to 0.8 bcm/year. A total of 4,023 GWh were shipped via the Medgaz pipeline for Naturgy in the first half of 2018.

Infrastructure Latin America South

This refers to the regulated gas distribution business in Argentina, Brazil, Chile and Peru and the electricity distribution in Argentina and Chile. In Chile also includes the gas supply activity and the electricity transmission activity.

2.5.8 Gas and electricity distribution Argentina

Results

	2018	2017	%
Net sales	321	286	12.2
Procurement	(203)	(178)	14.0
Net personnel expenses	(17)	(22)	(22.7)
Other revenues/expenses	(58)	(58)	-
Ebitda	43	28	53.6
Depreciation, amortisation and impairment expenses	(2)	(2)	-
Allocation to provisions	(7)	(3)	-
EBIT	34	23	47.8

Ebitda of Gas and electricity distribution in Argentina amounted to Euros 43 million, with an increase of 53.6% in respect to the same period of the previous year, following the full application of the tariff review process, whose final stage was approved in April 2018 and despite the impact of the argentine peso devaluation (Euros -24 million).

Main aggregates

The main aggregates in this area are as follows:

	2018	2017	%
Gas activity sales (GWh)	34,576	34,880	(0.9)
Gas sales	14,138	13,860	2.0
TPA	20,438	21,020	(2.8)
Distribution network (km)	25,965	25,749	0.8
Increase in connection points (thousand)	8	10	(20.0)
Connection points (thousand) (at 30/06)	1,659	1,642	1.0
Electricity sales (GWh)	998	977	2.1
Electricity sales	830	810	2.5
TPA	168	167	0.6
Connection points (thousand) (at 30/06)	231	224	3.1

Gas sales volumes in the first half were in line with the previous year's figures, however, in operating segments there is a notable 9% increase in sales in the deregulated industrial market and higher sales to residential-commercial customers due to lower average temperatures than last year, though this was offset by lower sales of automotive gas and lower TPA.

2.5.9 Gas distribution Brazil

Results

	2018	2017	%
Net sales	735	803	(8.5)
Procurement	(563)	(603)	(6.6)
Net personnel expenses	(20)	(21)	(4.8)
Other revenues/expenses	(42)	(53)	(20.8)
Ebitda	**110**	**126**	**(12.7)**
Depreciation, amortisation and impairment expenses	(30)	(33)	(9.1)
Allocation to provisions	(2)	(2)	-
EBIT	**78**	**91**	**(14.3)**

Brazil’s Ebitda decrease a 12.7%, affected, with a negative impact of Euros -23 million. Dispatching and TPA for thermal power plants was 8.9% lower than in the first half of 2017. In contrast, sales of automotive natural gas increased by 9.6% year-on-year as it proved more competitive than liquid fuels; industrial market sales declined by 4.2%, while gas sales in the residential-commercial market were in line with the previous year.

The Ebitda evaluation performance is due to higher gas margins in the automotive and residential markets, mainly because higher volumes offset lower sales in other market segments. Additionally, tariffs increased due to retroactive updates and inflation adjustments.

Main aggregates

	2018	2017	%
Gas activity sales (GWh)	35,461	37,197	(4.7)
Gas sales	28,850	31,579	(8.6)
TPA	6,611	5,618	17.7
Distribution network (km)	7,627	7,382	3.3
Increase in connection points (thousand)	19	21	(9.5)
Connection points (thousand) (at 30/06)	1,109	1,058	4.8

Sales declined by 4.7%: power generation and TPA sales fell by -8.9% due to lower thermal power plant utilisation, while industrial sales declined by 4.2% because of the crisis, as the macroeconomic situation is still recovering. Sales in the residential and commercial market declined slightly, by 0.3%, mainly as a result of lower consumption by large retailers. In contrast, automotive gas sales increased by 9.6% as it proved more competitive than liquid fuels and because of the larger demand for vehicle conversion in the period.

2.5.10 Gas and electricity distribution Chile

Includes the activities of gas distribution, gas supply and the electricity transmission and distribution activities.

Results

	2018	2017	%
Net sales	1,435	1,787	(19.7)
Procurement	(1,009)	(1,350)	(25.3)
Net personnel expenses	(73)	(77)	(5.2)
Other revenues/expenses	(142)	(104)	36.5
Ebitda	**211**	**256**	**(17.6)**
Depreciation, amortisation and impairment expenses	(79)	(74)	6.8
Allocation to provisions	(12)	(12)	-
EBIT	**120**	**170**	**(29.4)**

Chile contributed Euros 211 million in Ebitda, basically as a result of non-recurring expenses related to tree felling and pruning, fire prevention, fines and penalties in the electricity distribution area, and the costs of litigation with gas producers.

Main aggregates

The key physical aggregates in this business are as follows:

	2018	2017	%
Gas distribution sales (GWh)	5,222	5,166	1.1
Gas commercialization sales (GWh)	3,102	3,404	(8.9)
TPA (GWh)	15,664	15,040	4.1
Distribution network (km)	7,358	7,092	3.8
Increase in connection points (thousand)	12	9	33.3
Connection points (thousand) (at 30/06)	614	593	3.5
	-	-	
Electricity sales (GWh):	7,675	7,446	3.1
Electricity sales	6,377	6,842	(6.8)
TPA	1,298	604	114.9
Connection points (thousand) (at 30/06)	2,893	2,824	2.4
Electricity transmitted (GWh)	7,573	7,396	2.4
Transmission network (km, at 30/06)	3,528	3,528	-

- In gas distribution in Chile, the number of gas supply connections increased by 22 thousand, including growth in the residential-commercial (3.7%) and industrial (0.3%) segments with respect to the first half of 2017. As for gas sales and TPA, the strongest growth was observed in the TPA (4.1%) and industrial (4.1%) segments, while there was a decline year-on-year in sales for power generation (-8.7%) and to residential-commercial customers (-3.1%).

- In electricity distribution in Chile, there was a 2.4% year-on-year increase in electricity transmission, mainly due to greater activity in the first half. The transmission grid is 3,528 km long, the same as last year.

Infrastructure Latin America North

This refers to the regulated gas distribution business in Mexico and the electricity distribution business in Panama.

2.5.11 Gas distribution Mexico

Results

	2018	2017	%
Net sales	277	281	(1.4)
Procurement	(159)	(160)	(0.6)
Net personnel expenses	(16)	(13)	23.1
Other revenues/expenses	(24)	(21)	14.3
Ebitda	**78**	**87**	**(10.3)**
Depreciation, amortisation and impairment expenses	(20)	(17)	17.6
Allocation to provisions	(8)	(6)	33.3
EBIT	**50**	**64**	**(21.9)**

In the first half of 2018, ebitda in Mexico amounted to Euros 78 million, i.e. Euros - 9 million less than in the same period of 2017, basically because of devaluation of the Mexican peso.

Main aggregates

	2018	2017	%
Gas activity sales (GWh)	27,343	28,787	(5.0)
Gas sales	10,379	10,843	(4.3)
TPA	16,964	17,944	(5.5)
Distribution network (km)	22,204	21,385	3.8
Increase in connection points (thousand)	31	58	(46.6)
Connection points (thousand) (at 30/06)	1,804	1,716	5.1

The commercial strategy was redesigned in the first half to focus efforts on the most profitable areas, such as Mexico City and some areas of Monterrey. This strategy led to a reduction in new customer additions but they were of better quality.

As part of this refocus, stricter criteria were adopted for retaining customers with bad debt problems. This, coupled with the aggressive customer acquisition drive in recent years, increased customer churn in the period.

At the end of June 2018, there were 1,804 thousand customers (1,802 thousand residential-commercial), a 5.1% increase year-on-year, while the sales volume stood at 27,343 GWh, 5.0% less, due to performance by the TPA and industrial markets. Residential-commercial sales, which have higher margins, increased by 7%.

Affected by the new commercial policy, the distribution network increased by 3.8%, i.e. slightly more slowly than in the previous year (4.2%).

2.5.12 Electricity distribution Panama

Results

	2018	2017	%
Net sales	377	407	(7.4)
Procurement	(305)	(324)	(5.9)
Net personnel expenses	(6)	(6)	-
Other revenues/expenses	(21)	(25)	(16.0)
Ebitda	**45**	**52**	**(13.5)**
Depreciation, amortisation and impairment expenses	(17)	(16)	6.3
Allocation to provisions	(2)	(2)	-
EBIT	**26**	**34**	**(23.5)**

Ebitda in the Panama business in the first half of 2018 amounted to Euros 45 million with a 13.5% decrease, basically because of higher energy losses in the period. It is expected that part of this effect can be recovered in the remainder of the year.

Main aggregates

	2018	2017	%
Electricity sales (GWh):	2,545	2,527	0.7
Electricity sales	2,434	2,477	(1.7)
TPA	111	50	122.0
Connection points (thousand) (at 30/06)	656	628	4.5

Electricity sales increased slightly year-on-year, though by less than the average increase of recent years. Temperatures year-to-date have been below the historical average, with the result that energy sale volumes have expanded by less than projected.

The number of supply connections increased by 4.5%, in line with the pace of growth in the previous year.

3. Main risks and uncertainties

3.1. <u>Operating risks</u>

3.1.1. Regulatory risk

Naturgy and its subsidiaries are required to comply with legislation governing the natural gas and electricity sectors. In particular, gas and electricity distribution are regulated activities in most of the countries in which Naturgy performs them.

Legislation applicable to the natural gas and electricity sectors in the countries in which Naturgy operates is generally revised on a regular basis by the competent authorities. Any amendments may affect the current remuneration system for regulated activities, adversely impacting Naturgy's business, profits, grants and financial position.

In the event that competent public or private bodies interpret or apply such regulations based on criteria that differ from those of Naturgy, its compliance might be questioned or appealed and, in the event that an infringement were proven, there might be a material adverse impact on Naturgy's business, prospects, profits, grants and financial position.

Regulatory risk management is founded on smooth communication between Naturgy and regulators. Additionally, in the course of its regulated activities, Naturgy ensures that its costs and investments are aligned with the rates of return recognised for each business.

3.1.2. Gas and electricity volume risk

Most purchases of natural gas and liquefied natural gas (LNG) are made under long-term contracts containing clauses whereby Naturgy is obligated to purchase certain annual volumes of gas ("take-or-pay" clauses).Under such contracts, even if Naturgy does not need to acquire the committed volume of gas at a given time, it is contractually obligated to pay for the minimum volume committed in the take-or-pay clauses.

The contracts stipulate gas volumes in line with Naturgy's estimated needs. However, actual needs may be below the volumes estimated when the contracts were arranged. In the event of significant departures from the estimates, Naturgy will be obligated to purchase a large volume of gas than is actually needed or, failing this, to pay for the minimum volume of gas committed, irrespective of whether or not it acquires the volume that exceeds its needs; this could have a significant adverse effect on Naturgy's operating costs.

In the electricity business, Naturgy's results are exposed to a reduction in the amount of electricity generated, which is shaped by trends in demand for electricity. Additionally, in view of the major role played by CCGT technology in Naturgy's generating fleet, the amount of power generated might be reduced because of the growing importance of power generation from renewable sources. Business results may also be affected by the levels of hydroelectric output, which may impact the production mix and costs.

A decrease in the volume of electricity generated would increase uncertainty as regards the achievement of generation/supply objectives and the variability of the results.

Naturgy manages contracts and assets on a globally integrated basis to optimise energy balances, enabling it to correct any deviation in the most profitable manner possible.

3.1.3. Operational risk

a) Insurable risks

Naturgy's activities are exposed to a variety of operational risks such as faults in the distribution network, in electricity generation facilities and in gas carriers, explosions, polluting emissions, toxic spillage, fire, adverse weather conditions, contractual breaches, sabotage or accidents affecting the gas distribution network or electricity generation assets, and other damage and force majeure circumstances that might cause bodily harm and/or material damage, affecting or destroying Naturgy's facilities or property. Events such as these, or similar events, are unforeseeable and may interrupt the supply of gas and generation of electricity. In such situations, although coverage is provided by risk insurance policies, such as policies covering loss of profit and material damage, Naturgy's financial situation and results could be affected to the extent that any losses are not insured, coverage is insufficient, or economic losses are generated due to coverage limits or an increase in the excess, as well as potential increases in premiums paid to insurers.

Naturgy might also have to respond to third-party claims for bodily harm and/or other damage caused in the ordinary course of business. Such claims could result in the payment of indemnities under legislation applicable in the countries in which Naturgy operates, which could have a material adverse impact on the business, prospects, financial position and results if the its third-party liability insurance policies not cover the amount of the indemnities.

Naturgy prepares continuous improvement plans to reduce the frequency and severity of potential incidents. Specific asset supervision units have been created to intensify preventive and predictive maintenance, among other measures. Additionally, the approach to insurance coverage is based on optimising the total cost of risk.

b) Image and reputation

Naturgy is exposed to opinions and perceptions of a variety of stakeholders. Such perceptions may be adversely impacted by events caused by the Company or by third parties over which the Company has little or no control, impacting its own reputation or that of the industry. Such impacts might cause medium-term financial damage by increasing regulatory demands or funding costs or by requiring additional expenditure to win customers.

Naturgy is engaged actively in identifying and monitoring potential reputational events and the stakeholders affected. Transparency also forms part of our communication policy.

c) Environment

Naturgy's activities are subject to extensive legislation on environmental protection.

Naturgy and its subsidiaries must comply strictly with extensive environmental protection regulations requiring, among other aspects, the preparation of environmental impact analyses, obtainment of authorisations, licences and permits, and fulfilment of certain requirements. Considerations include:

- Environmental authorisations and licences might not be granted or might be revoked due to failure to comply with the attached conditions;
- The regulatory framework or its interpretation by the authorities might be amended, resulting in higher costs or deadlines for compliance with the new requirements.

In order to mitigate this risk, Naturgy has adopted an integrated environmental management system and has emergency plans for facilities where there is a risk of accidents with an environmental impact. Specific insurance policies have also been arranged to cover this type of risks.

d) Climate change

Demand for electricity and natural gas is related to the weather. A significant part of gas consumption during the winter months is driven by seasonal needs for space heating in the residential segment, as well as to enable the CCGT plants to support production in the electricity system. In summer, consumption is driven by power generation basically for air conditioning. Naturgy's revenue and results from natural gas distribution and supply activities might be adversely affected in the event that the autumn months become warmer or winters become milder. Demand for electricity might also fall if summers become milder, due to a decline in demand for air conditioning. Additionally, hydroelectric generation plant utilisation depends on rainfall in the plant locations and might be affected by drought.

European policies and measures to combat climate change could affect Naturgy's results in the event that the competitiveness of the Company's generation mix is altered.

Naturgy forms part of a number of work groups at European level, enabling strategy to be adapted to new regulations in advance. The company also forms part of clean development projects designed to reduce CO_2 emissions.

e) Geopolitical exposure

Naturgy has interests in countries with different political, economic and social environments; in this regard, two main areas are particularly relevant:

- Latin America

  A large part of Naturgy's operating profits are generated by its Latin American subsidiaries. Operations in Latin America are exposed to a range of risks inherent to investment in the region. Of the risk factors linked to investment and business in Latin America, the following should be noted:

  - Considerable influence of local governments on the economy;
  - Significant fluctuation in the economic growth rate;
  - High inflation;
  - Devaluation, depreciation or overvaluation of local currencies;
  - Controls or restrictions on the repatriation of earnings;
  - Fluctuating interest rates;
  - Changes in financial, economic and fiscal policies;
  - Unexpected changes to regulatory frameworks;
  - Social tensions and
  - Political and macroeconomic instability.

- Middle East and Maghreb

  Naturgy has both its own assets and major contracts for the supply of gas from various Maghreb countries and the Middle East, particularly Egypt. Political instability in the zone may result in physical damage to the assets of Naturgy's investee companies or the obstruction of the operations of those or other companies, interrupting the Group's gas supply.

Naturgy has a diversified portfolio both in the countries in which it carries on energy distribution activities (Latin America, Europe) and the countries that supply gas (Latin America, Africa, Middle East, Europe). Diversification minimises the risk of expropriation and of supply interruption due to the knock-on effect of political instability in neighbouring countries. Specific insurance policies have also been arranged for these risks.

3.2. Financial risks

Financial risks (interest rate, exchange rate, commodity price,credit and liquidity risk) are detailed in Note 17 to the 2017 Consolidated Annual Accounts.

3.3. Main opportunities

- Generation mix: Naturgy’s generating fleet, consisting mainly of CCGT facilities, has the necessary flexibility to adapt to different market circumstances, based optional dispatching; it is thus a valuable asset to leverage opportunities related to price and demand volume volatility in the gas and electricity markets. Despite the transition to renewable energy, the CCGTs' operational flexibility mean that this technology is well placed to make a meaningful contribution in the future.

- International generation: Increase renewable capacity internationally, given that renewable energies are cost-competitive and Naturgy's presence in growth markets.
- Portfolio of natural gas and LNG procurements: Management of gas pipelines, investment in plants and the fleet of gas carriers enable the Company to meet its business needs in a flexible, diversified manner, optimising its approach to different energy scenarios. Specifically, the fleet of gas carriers makes Naturgy one of the world's leading LNG operators and a principal in the Atlantic, the Mediterranean and Asia.
- A balanced structural position in terms of businesses and geographies, many with stable flows, irrespective of commodities prices, making it possible to take the maximum advantage of growth in energy demand and of new business opportunities in new markets.

4. Subsequent events

Events after the closing date, i.e. 30 June 2018, are described in Note 22 to the condensed interim consolidated financial statements.

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Glossary of terms

Naturgy's' financial disclosures contain magnitudes and metrics drafted in accordance with International Financial Reporting Standards (IFRS) and others that are based on the Group's disclosure model, referred to as Alternative Performance Metrics (APM), which are viewed as adjusted figures with respect to those presented in accordance with IFRS.

The chosen APMs are useful for persons consulting the financial information as they allow an analysis of the financial performance, cash flows and financial situation of Naturgy, and a comparison with other companies.

Below is a glossary of terms with the definition of the APMs. Generally, the APM terms are directly traceable to the relevant items of the interim consolidated balance sheet, interim consolidated income statement, interim consolidated statement of cash flows or notes to the interim financial statements of Naturgy. Terms which cannot be directly cross-referenced are reconciled in the Glossary below.

Alternative Performance Metrics	Definition and terms	Reconciliation of values at 30.06.2018	Reconciliation of values at 30.06.2017	Relevance
Ebitda	"Operating profit"(2)	Euros 2,004 million	Euros 2,030 million	Measure of earnings before interest, taxes, depreciation and amortisation and provisions
Net capital expenditure	"Investment in intangible assets" (4) (Note 7) + "Investment in property, plant and equipment"(4) (Note 7) + Financial investments – Receipts for divestment of property, plant and equipment and intangible assets – Other investing receipts/(payments) (6)	Euros - 1,429 million = 121 + 1,024 + 35 – 2,609	Euros 740 million = 137 + 600 + 27 - 24	Total investments net of the cash received from divestments and other investing receipts
Gross financial debt	"Non-current financial liabilities"(1) + "Current financial liabilities"(1)	Euros 15,928 million = 13,711 + 2,217	Euros 17,342 million = 14,485 + 2,857	Current and non-current financial debt
Net financial debt	Gross financial debt(5)– "Cash and cash equivalents"(1) – "Derivative financial assets"(4) (Note 8)	Euros 12,362 million = 15,928 - 3,492 – 74	Euros 15,818 million = 17,342 - 1,455 - 69	Current and non-current financial debt less cash and cash equivalents and derivative financial assets
Leverage (%)	Net financial debt(5) / (Net financial debt(5) + "Net equity"(1))	44.8% = 12,362 / (12,362 + 15,220)	46.4% = 15,818/(15,818 + 18,246)	The ratio of external funds over total funds
Cost of net financial debt	"Cost of financial debt"(4) (Note 17) – "Interest revenue"(4) (Note 17)	Euros 274 million = 286 - 12	Euros 315 million = 330 - 15	Amount of expense relative to the cost of financial debt less interest revenue
Ebitda/Cost of net financial debt	Ebitda(5)/ Cost of net financial debt(5)	7.3x = 2,004 / 274	6.5x = 2,030 / 315	Ratio between Ebitda and net financial debt
Net financial debt/Ebitda	Net financial debt(5) / Ebitda in the last four quarters(5)	3.2x = 12,362 / 3,889	3.7x = 15,818 / 4,237	Ratio between net financial debt and Ebitda
Market capitalisation	No. of shares ('000) outstanding at end of period(6) * Market price at end of period(6)	Euros 22,696 million = 1,000,689 * Euros 22.68	Euros 20,504 million = 1,000,689 * Euros 20.49	Measure of the company's total value based on its share price
Earnings per share	"Attributable income in the period"(2) / Average No. of shares in the period (in thousands)(6)	Euros - 3.28 = -3,281 / 1,000,462	Euros 0.55 = 550 / 1,000,519	Ratio between the income attributed to the parent company and the number of shares
Personnel expenses, net	Personnel expenses – "Own work capitalised" (Note 14)(4)	Euros 464 million = 520 - 56	Euros 469 million = 524 - 55	Personnel expenses recognised in the income statement
Other revenues/expenses	"Other operating revenues"(2), "Other operating expenses"(2) "Recognition of fixed asset grants and other"(2)	Euros - 801 million = 83 - 905 + 21	Euros - 807 million = 107 -935 + 21	Other revenues and expenses recognised in the consolidated income statement

(1) Consolidated balance sheet line item.
(2) Consolidated income statement line item.
(3) Consolidated statement of cash flows line item.
(4) Figure detailed in the notes to the consolidated financial statements.
(5) Figure detailed in the APMs.
(6) Figure detailed in the Directors' Report.

Naturgy Energy Group, S.A.

Condensed interim directors' report as of 30 June 2018

Naturgy Energy Group, S.A.

Directors' report for the six-month period ended 30 June 2018

Nota 1. Business performance

Naturgy Energy Group, S.A. is a holding company whose main ordinary activity is the administration and management of holdings in subsidiaries. As a result, its earnings arise fundamentally from dividends and revenues from finance provided to companies in the Naturgy group. It also has contracts to supply gas to other Naturgy companies and, in the electricity area, it acts as representative of the Naturgy generation and supply companies before the Electricity Market.

Nota 2. Significant events in the first half of 2018

Key figures from the income statement

Earnings performance in the first half of 2018 can be explained by the sale of a 20% stake in the gas distribution business in Spain, through Group company Holding Negocios Gas, S.A (Note 3), and the impairment recognised on financial instruments following adaptation to the new Strategic Plan 2018-2022 (Note 2.3.3).

Revenues in the six-month period ended 30 June 2018 amounted to €2,164 million, of which €1,581 million were basically from the sale of gas and electricity, €326 million were dividends collected from group companies and associates, and €257 million were from finance provided to Naturgy group companies.

The €158 million reduction in revenue is the net result of:

- Revenues increased by €87 million, basically due to good performance in the gas business.
- Dividends from subsidiaries declined by €281 million in the half-year, mainly from the companies Gas Natural Comercializadora, S.A., Gas Natural Servicios SDG, S.A. and Sagane, S.A.
- Financial revenues from providing finance to subsidiaries increased by €36 million.

Procurements amounted to €1,585 million in the year, basically for the purchase of gas and electricity, with an €86 million increase, in line with revenue performance.

Other operating revenues amounted to €189 million, net personnel expenses to €122 million, operating expenses to €151 million, depreciation and amortisation to €48 million, and impairment and gain/loss on fixed asset disposals to €5,450 million, with the result that EBIT in the period amounted to €5,897 million, a €5,197 million increase with respect to same period of the previous year.

Financial income was negative in the amount of €265 million, compared with €290 million in the same period of 2017. This reduction was due basically to the cancellation of loans to Naturgy group companies.

Income before taxes amounted to €5,632 million and income tax to €35 million, with the result that net profit for the period was €5,597 million, compared with €449 million in the same period of the previous year.

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