

*Report on the process of
separating the roles of
Chairman of the Board
of Directors and Chief
Executive Officer at RED
ELÉCTRICA
CORPORACIÓN, S.A.*

June 9th, 2015

We offer added
value to **REC**

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Red Eléctrica Corporación, S.A.
Pº del Conde de los Gaitanes, 177
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For the attention of Mr. Rafael García de Diego

1. Purpose and scope of the Report

This document is in response to the request made by RED ELÉCTRICA CORPORACIÓN, S.A., hereinafter RED ELECTRICA or REC or the Company, as set out in our Engagement Letter dated June 6th, 2015 regarding the issuing of a **Report on the separation of the roles of Chairman of the Board and Chief Executive Officer (CEO) at the company**, to be presented at the next Nomination and Compensation Committee and Board of Directors meetings.

The report contains PwC's analysis of the separation of the roles of Board Chairman and CEO at the Company based on the review and analysis of the following information/documentation:

- “Report and proposal regarding the process of separating the roles of Chair of the Board of Directors and CEO at the Company”, June 2015, “REC Report”, prepared by RED ELÉCTRICA CORPORACIÓN S.A.
- Good governance regulation and recommendations existing in Spain: Spanish Companies Act¹, SCA and the Code of Good Governance², CGG.
- Codes of good governance, or equivalent, in countries with corporate governance models similar to Spain's: United States, France, Italy and United Kingdom.
- Existing trends regarding the separation of roles through an analysis of the most relevant organisations with influence on corporate governance.
 - Proxy advisors: ISS, Glass Lewis
 - Foreign institutional investors: Blackrock, F&C Management, BNP Paribas, Natixis and Amundi
 - Corporate governance rating agencies: Governance Metrics International (GMI)
 - Other organisations involved with corporate governance that have expressed an opinion regarding the separation of roles.
 - PwC Corporate Governance Reports

¹ Law 31/2014 (3 December) which amends the Spanish Companies Act to improve corporate governance (Ley 3/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo).

² Code of Good Governance for listed companies, February 2015. (Código de buen gobierno de sociedades cotizadas).

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- Development of RED ELECTRICA corporate governance model, analysing, among others, its internal regulation and corporate policies, shareholder structure, actions taken by the Company over the past years within good governance matters.

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2. Executive Summary

- The separation of the roles of Board Chairman and the CEO at listed companies has been, and continues to be, one of the most debated topics in corporate governance, while there is no empirical evidence³ that would allow for the conclusion that separating or combining roles is the best alternative for maximising the value of a company.
- The opinion of the most influencing corporate governance stakeholders, such as regulators/supervisors, proxy advisors, institutional investors or rating agencies, has evolved over the past few years from requiring the separation of roles in all cases, to taking into consideration the specific situation of each company on a case-by-case basis. The **corporate governance structure and model**, adopting **counterweight measures** to ensure a balance between supervision and management, as well as the existence of a reasonable **timeline** for the transition to the separation of roles, constitute the key aspects analysed by stakeholders when expressing an opinion regarding the separation of roles at a company.
- For years REC has positioned itself as a corporate governance pioneer in Spain, given its extensive history of voluntarily implementing good governance practices. REC's capital structure, with a heavy presence of foreign institutional investors (67%⁴), together with the Company's aim to define and adopt measures that are backed by its shareholders, led it to assume a series of commitments⁵ in 2012 that were intended to establish a transitioning that would lead to the formal separation of roles within a reasonable timescale.
- REC has currently met all of the commitments assumed in 2012 with its shareholders and other stakeholders with respect to the adoption of counterweight measures for the combination of both roles, which gives the governance system of REC prepared for a future formal separation of the roles of Board Chairman and CEO.
- Accordingly, in June 2015 REC prepared a report⁶ that covers, among other things, a proposal that analyses, develops and justifies the process for separating the roles of Board Chairman and CEO and indicating the reasons why such separation is proposed.
- As described throughout this document and in the light of the documentation analysed, the process for separating roles set out in the REC Report seems to be:
 - Timely, with the understanding that the decision to separate roles is the next natural step after the measures adopted by the Company over the past few years. The term of the process (between six and nine months) is in line with the approach of the main institutional shareholders and proxy advisors regarding

³ *Board Structure and agency costs*, Lasfer 2012; *The non-executive Chairman: Offering new solutions*, Spencer Stuart 2008; *Does independent Board of Directors really make a difference?*, Wang 2014

⁴ Information obtained from the Company's website. Information updated at 31 December 2014.

⁵ The commitments assumed by REC in 2012 are set out in the document "Statement on key issues of Red Electrica Corporación. A corporate Governance Approach".

⁶ "Report and proposal regarding the process of separating the roles of Chair of the Board of Directors and CEO at the Company".

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the existence of a certain, time-limited and, therefore, reasonable, period for implementing the separation.

- Coherent in form as it would be done in a transparent, ordered and progressive process by calling an Extraordinary General Shareholders' Meeting in 2015. The coexistence of two CEOs for a maximum of nine months should contribute to the correct transfer of power and responsibilities while assuring adequate coordination, continuity and stability for the business.
- Adequate for the current governance model, which is considered to be robust and mature after the measures adopted by the Company over the past few years.
- The process of separating the roles of Chairman of the Board of Directors and the CEO will be achieved at the General Shareholders' Meeting to be held in 2016 and at that time the definitive transfer of duties will take place. Shareholders at that meeting will have to appoint a new Chairman or re-elect the current Chairman/CEO with the responsibilities and duties inherent to the Board Chairman role. It should be noted in this respect that some of the most relevant stakeholders (ISS, F&C, OECD, etc.) have stated certain concerns regarding the role separation processes at those companies that elect the former CEO to the role of Chairman of the Board of Directors. For this reason, if REC wishes to re-elect the current Chairman/CEO as the new Chairman of the Board of Directors of REC, we consider it advisable for the Company to analyse the opportunity to reinforce some counterweight measures to help maximise support from shareholders for the re-election of Mr. José Folgado as non-executive Chairman while streamlining the Company's good governance practices. The following could be among those counterweight measures:
 - Maintain the Lead Independent Director (LID) and reinforce her role on the Board, in line with Recommendation 34 of the new CGG, regardless of the fact that this position is no longer required after the separation of the Board Chairman and CEO roles.
 - Reinforce the Board's role in the supervision of items associated with the sustainability of the Company by, for example, creating a temporary or permanent committee focusing on matters such as strategy, corporate social responsibility, etc.
 - Evaluate the possibility of the Board Chairman not forming part of the Audit and/or Nomination and Compensation Committees until the Chairman can be independent.
 - Include an evaluation of the Chairman and the CEO in the annual self-assessment of the Board of Directors, including financial and non-financial metrics.
 - Request an external advisor to prepare a suitability report on independence, absence of conflicts of interest and the contribution and impact of the Director

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- on Company sustainability issues during the Director nomination and/or re-election processes.
 - Reinforce the presence of independent Directors in the event that the Company wishes to increase the number of Board members.
 - Consider a possible reduction in the length of the term of members of the Board of Directors, which is currently established at four (4) years.
 - Reinforce the role of the Nomination and Compensation Committee when monitoring the evolution and potential of the second executive level that reports to the new CEO due to the importance that this has from the standpoint of succession plans.
 - Evaluate the advisability of making REC's Communications Policy with its main stakeholders public, thereby following Recommendation 4 of the CGG⁷ and the transparency practice in which the Company is immersed.
- The legal process applicable to the separation of roles proposed by REC is in line with the Company's internal regulations as well as current legislation for listed companies.
 - Finally, the compensation proposal for the new CEO prepared by REC as part of its report of June 2015 is in line with the recommendations set out in the new Code of Good Governance with respect to compensation components (fixed remuneration, as well as annual and multi-year variable remuneration) and the amount proposed falls within the compensation policy approved by Shareholders at the General Meeting held in 2015. It seems reasonable to gradually reduce the variable remuneration component currently in place for the Chairman/CEO, in line with the progressive transfer of the duties.

⁷ Recommendation 4 of the CGG establishes that a Company should define and promote a communications and contact policy with institutional investors and proxy advisors and that policy should be made public on its website, including information relating to the manner in which it has been implemented and identifying the contact persons or those responsible for the policy.

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3. Introduction

The separation or combination of Board Chairman and CEO roles at listed companies has been, and continues to be, one of the most debated topics in corporate governance. There is no empirical evidence that would allow for the conclusion that the separation or combination of roles is the best alternative to maximise the value of a company.

Those that propose a clear and differentiated separation of the Chairman of the Board of Directors and the CEO at a company consider that if the same person holds both roles an agency conflict⁸ could arise between the Chairman's supervisory and control duties and the CEO's management and administration duties. Conversely, those that push for the combination of both roles offer the defence that this governance structure provides a company with more solid leadership and avoids potential ambiguity as to who is ultimately responsible for taking decisions.

Perhaps this lack of unanimity is one of the main reasons why there is no regulation in this respect and only good governance recommendations are made that may be voluntarily applied by each company. Although it is true that the national and international trend is towards the separation of roles, there is no unanimous opinion regarding what the most appropriate model for large companies might be. As is set out in the accompanying table, what can be observed is that in those countries in which the Good Governance Codes, or equivalent, openly state the advisability of separating the Chairman and CEO roles (as is the case in the United Kingdom and Italy), the percentage of companies that separate those roles is higher.

	Spain**	United Kingdom	United States	France	Italy
Percentage of listed companies with separate Board Chair and CEO roles*	32%	100%	47%	32%	78%

*Calculation based on the information published in the *Spencer Stuart Spain Report - 2014 Edition*

**Information from the "Informe de Consejos de Administración de empresas cotizadas 2015" Report, published by PwC - Spain

In the case of Spain, there has been an evolution of the percentage of companies that have separated the roles of Chairman and CEO over the past few years, rising from 30% in 2010⁹ to 35% in 2014¹⁰. Although this percentage is still far below the situation in Italy or the United Kingdom, it should be noted that so far in 2015, and excluding REC, another Ibex-35 company has proceeded to implement the separation of the Board Chairman and CEO roles. This shows that there is starting to be higher awareness by companies to attempt to reinforce the balance between these supervisory and management duties within their organisations.

⁸ Jensen, M.C. and Meckling, W.H 1976 "Theory of the firm: Managerial behavior, agency costs and ownership structure". In accordance with the study, the Agency Theory establishes the need to ensure the convergence of interests between shareholders and executives.

⁹ Information from the "Listed Company Board of Directors Report 2010"- PwC

¹⁰ Information from the "Listed Company Board of Directors Report 2015"- PwC

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In any event, without ruling out any possible advantages or drawbacks of both models, the general trend of the main national and international stakeholders (regulators/supervisors, institutional investors, rating agencies, proxy advisors, etc.) has evolved over the past few years from requiring the separation of roles in all cases to currently taking into consideration the specific situation of each company on a case-by-case basis. This position is fundamentally based on the analysis of the corporate governance structure and model adopted by each company, compliance and the adoption of the necessary counterweight measures for the Chairman and CEO's powers, as well as the existence of a certain and limited timeline for transitioning to a separation of roles.

Obtaining all of these prior safeguards for stakeholders is a basic and essential part of the responsible management of a company.

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4. Situation of RED ELÉCTRICA

REC has a Chairman/CEO since 2008 who was re-elected in 2012, when the main foreign institutional investors and proxy advisors asked for the separation of roles in order to avoid the risk of excessive concentration of power. For a company such as REC, in which 67%¹¹ of share capital is represented by foreign institutional investors, the opinion of this group of stakeholders was fundamental for adopting adequate measures.

In this context, in 2012 REC issued the “*Statement on key issues of Red Electrica Corporación. A Corporate Governance Approach*”, which served as support for the backing of stakeholders of the re-election of the Chairman and as a Company Director and in which it assumed a series of commitments.

These commitments were intended to establish a transition path that would lead to the formal separation of roles within a reasonable timeline through the adoption of a series of measures or counterweights against the combination of duties. These measures were assumed by REC as challenges in subsequent years and translated into the following actions taken by the Company:

4.1. Regarding the Governance Structure:

- **Composition of the Board of Directors and Committees:** REC's Board of Directors currently consists of 11 members which is in line with CGG Recommendation 13¹². It has 7 independent Directors (64% of the total) and a single Executive Director, the Chairman-CEO, thereby complying with Recommendations 15, 16 and 17 in the new CGG¹³.

The Audit and the Nomination and Compensation Committees are composed only of external Directors and, in both cases, the Chairman is an Independent Director, in line with the provisions of the SCA and the new CGG. It should also be noted that there is no Executive Committee at REC, which is a positive aspect with respect to the assuming competencies and responsibilities within the Company's Board.

The composition of the Committees has been reinforced to ensure the proper exercising of their duties.

- **Diversity:** During the past few years REC has been one of the companies with the largest percentage of female Directors, and in 2014 five (50%) of its external Directors were

¹¹ Information obtained from the Company's website. Information updated at 31 December 2014.

¹² CGG Recommendation 13 states that it is advisable to have a minimum of 5 and a maximum of 15 Directors.

¹³ These CGG recommendations establish: (Rec. 15) that the outside proprietary and independent Directors should represent a broad majority and there should be as few Executive Directors as is necessary; (Rec. 16) that the number of proprietary and independent Directors reflect the proportion between Company share capital represented by the proprietary Directors and the rest of the share capital; (Rec. 17) that the number of independent Directors represent at least one half of all Directors.

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women. This percentage is far above the 16%¹⁴ average at companies listed on the Ibex, and also meets the standards established in CGG Recommendation 14¹⁵.

Together with gender diversity, over the past few years REC has also reinforced the diversity of technical and industry profiles when appointing members of the Board.

4.2. Regarding good governance practices:

- **Authorities that cannot be delegated by the Board of Directors:** In line with good market practices and for the past several years, REC's internal regulation define areas reserved for the Board which, as a result, cannot be delegated to the CEO or to Committees. They consist of essential responsibilities for the Board of the Company that were established in Recommendation 8 of the old Unified Code of Good Governance, which the SCA has established under Article 529 ter.
- **Lead Independent Director:** in line with good corporate governance practices and anticipating the current legal obligation introduced by the SCA to appoint an Lead Independent Director (hereinafter LID) when a Company has a Board Chairman with executive authority, REC appointed Mrs. Carmen Gómez de Barreda Tous de Monsalve to that position. Several of the duties granted to the Board of Directors by REC's internal regulation are those set out in Recommendation 34¹⁶ of the new CGG.
- **Length of term:** In accordance with Article 20 of REC's bylaws, the maximum term for Directors is 4 years and the Company anticipated the legal obligation established by the SCA regarding the term limitations applicable to listed companies. REC's Board of Directors has undergone a significant process of changing its Directors over the past few years and the average length of service of external Directors is 2.8 years. There is no Independent Director that has been in the position for more than 12 years, as is stipulated by the SCA.
- **Training and information:** REC's Board of Directors has a training program so that Directors may optimally fulfil their responsibilities. In accordance with the results of the self-assessment process for 2014, this program is very positively regarded by Directors and it is also in line with CGG Recommendations 29 and 30¹⁷, relating to companies providing their Directors with the advisory services that are necessary to comply with the duties that have been assigned to them.

¹⁴ Information from the "Listed Company Board of Directors Report 2010"- PuC and the "Annual Corporate Governance Report on IBEX 35 Companies" – CNMV.

¹⁵ CGG Recommendation 14 suggests that in 2020 female Directors should represent 30% of all members of the Board.

¹⁶ Recommendation 34 of the CTG establishes new authorities for the LID: She will preside over the Board in the absence of the Chair and Vice Chair, receive any concerns expressed by non-executive Directors, maintain contacts with investors and shareholders and coordinate the succession plan for the Chair.

¹⁷ These CGG recommendations establish: (29) That a Company establish adequate channels so that Directors may obtain the required advice so that they may comply with their duties including, if required by the circumstances, outside advisory services for which the Company will make payment; (30) That, regardless of the knowledge required of Directors to carry out their duties, companies must also offer knowledge programs to Directors when circumstances so advise.

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There is an information platform consisting of a Director Portal which has been designed in order to improve the operation of the Board of Directors. Through that Portal REC makes available to Directors all necessary information and relevant documentation so that before meetings are held Directors have sufficient information that will allow them to take adequate decisions. REC is thus aligned with Recommendation 31¹⁸ of the new CGG.

- **Dedication:** An adequate level of dedication by the Board of Directors serves as a counterweight as it allows Directors to be more prepared and, therefore, contribute more value to the decisions adopted by the Company. REC therefore limits the number of other Boards to which an independent Director may pertain to two (2) which is one of the most restrictive in its sector and of most Ibex-35 companies.

Another indicator that helps to measure the Director dedication level is the number of meetings held by the Board. In 2014 REC's Board held thirteen (13) meetings, which is above the average number of meetings held by the "Oil and Energy" sector¹⁹ in 2014 (12 meetings). Based on that frequency of meetings, REC is in line with CGG Recommendation 26²⁰.

- **Senior Management attendance to Board meetings:** As a result of the self-assessment processes carried out by REC's Board of Directors over the past few years, PwC has a high level of knowledge regarding the interaction between the Board of Directors and Senior Management. The positive evaluation by Directors of the availability of executives is notable, together with the depth and preparation of their appearances, particularly in 2014 when the effectiveness of those appearances particularly stood out according to the Directors due to their high degree of specialisation and the technical quality.
- **Self-assessment of the Board of Directors:** In accordance with Recommendation 36²¹ of the new CGG, as well as the recommendations established by several international stakeholders, REC has been performing a self-assessment of Governing Bodies since 2006. As a result of its desire for continuous improvement, since 2011 that process has been supported by the participation of external advisors in order to provide a more objective and independent view. Based on the results of that process, REC prepares an action plan that includes improvements that it will implement the following year, in line with the SCA and CGG Recommendation 36. REC also publishes and reports the most relevant points of the self-assessment process to its stakeholders in a transparent manner.
- **Compensation:** REC has been one of the pioneer Ibex-35 companies to submit the annual compensation for the Board of Directors (since 2007) and the Annual Report on Directors Compensation (since 2010) to a binding vote of shareholders at a General meeting through separate points of the agenda. In 2014 the Company also reviewed its

¹⁸ CGG Recommendation 31 establishes that those points of the agenda for which a decision or resolution will be adopted must be clearly indicated so that Directors may previously obtain all relevant information they consider necessary.

¹⁹ The "Oil and Energy" sector consists of the following companies: Enagás, Endesa, Gas Natural, Iberdrola, Red Eléctrica and Repsol.

²⁰ CGG Recommendation 26 establishes that a Board of Directors should meet at least eight times per year.

²¹ CGG Recommendation 36 establishes that the annual assessment of the Board will result in an action plan to correct any detected weaknesses. Every three years the Board will be assisted by an external consultant to perform the assessment and the consultant's independence will be verified by the Nomination Committee.

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compensation policy in accordance with the good practices and recommendations established in the CGG, such as providing only fixed compensation to outside Directors (Recommendation 57), or the review of the compensation system for the Executive Director by establishing fixed and short and long-term variable components that are aligned with key and strategic objectives at the Company (Recommendation 58), and limiting indemnities due to the termination of the contractual relationship with the Chairman to one year's compensation (Recommendation 64).

- **Transparency:** REC is committed to its stakeholders and has always adopted a transparent policy for communicating and reporting its Corporate Governance Reports. REC was given numerous awards and recognition in 2014, and it was notably included among listed companies that have adopted some of the five best good governance practices identified in the report from the Commitment and Transparency Foundation ("Fundación Compromiso y Transparencia"). REC was specifically chosen due to the transparency and exhaustiveness of the corporate governance information offered on the Company's corporate website.

The Company also uses its corporate website to publish numerous policies²² that inform its stakeholders of its practices in various areas.

In the area of shareholder relations, REC usually organises informational meetings -road shows- in the main financial centres in Spain and abroad where there is a large presence of institutional investors, to provide information regarding its activities and performance of its business in an attempt to get closer to that group of investors. This is particularly relevant considering the high percentage of foreign investors that are present in REC's share capital. Over the past few years the Chairman of the Nomination and Compensation Committee participated in several road shows with proxy advisors and the Company's intention is to involve the Lead Independent Director in these areas.

For the first time REC broadcast a live stream of its 2015 General Shareholders' Meeting on its corporate website in line with CGG Recommendation 7²³.

²² Among them we note: Corporate Governance Policy, Corporate Responsibility Policy, Integral Risk Management Policy, Excellence and Quality Policy, Environmental Policy, etc.

²³ CGG Recommendation 7 establishes that a Company should provide a live broadcast of the General Shareholders' Meeting on its website.

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4.3. Regarding REC's financial performance:

Over the past few years REC has seen very positive economic-financial development as is reflected in the metrics for the period 2011-2014²⁴ set out below:

- **EBITDA:** The Company obtained gross operating profits totalling €1,385 million in 2014, which is 14% higher than in 2011.
- **Stock market evolution:** REC's capitalisation in the stock market rose from €4.5 billion in 2011 to nearly €10 billion in 2014, which is a 121% increase over the period 2011-2014.
- **Shareholder return:** In 2014, REC distributed a €3 dividend per share, 36% higher than that distributed in 2011 (€2.2 per share).

²⁴ Information from the Chair's addresses to the General Shareholders' Meetings held in 2012 and 2015.

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5. Analysis of the process of separating roles

As has been indicated throughout this report, REC has met all of the commitments assumed in 2012 with its shareholders and other stakeholders regarding the adoption of counterweight measures that has led it to a robust governance system and, therefore, to finally implement a formal separation of roles. The Company's transparency with respect to the issue of information and maintaining dialogue with the various groups of shareholders and proxy advisors over the past few years has been notable, and has been recognised by international organisations and institutions.

In the light of the information that has been analysed, the current organisational model allows REC to continue advancing towards the implementation in the near future of a separation of roles expected by the different stakeholders.

The separation process established in the REC report seems to be timely, coherent in form and adequate for the current governance model of the Company. It also positions REC as an organisation that anticipates international corporate governance trends as it is among the first companies in Spain to implement a separation role process in response to the expectations of its shareholders and investors.

- It is timely, with the understanding that the decision to separate roles is the next natural step after the measures adopted by the Company over the past few years. This transition, which will last between six and nine months, is in line with the approach of the main institutional shareholders and proxy advisors regarding the existence of a certain, time-limited and, therefore, reasonable, period for implementing the separation. Finally, the execution of the new Group Strategic Plan (2014-2019) from the start with the new governance structure implemented by REC is considered as positive.
- It is coherent in form since it will be done in a transparent, organised and progressive way by calling an Extraordinary Shareholders' Meeting in order to obtain support from shareholders for this process. Taking into account the relevance of the CEO role, the coexistence of two CEOs for nearly a year will guarantee the proper transfer of power and responsibilities while assuring adequate coordination, continuity and business stability, as is necessary to effectively separate the roles at the General Shareholders' Meeting 2016.
- It is adequate for the current governance model, as it is considered to be solid and mature after the measures adopted by the Company over the past few years.

The process of separating the roles of Chairman of the Board of Directors and the CEO will be achieved at the General Shareholders' Meeting to be held in 2016 and at that time the definitive transfer of duties will take place. Shareholders at that meeting will have to appoint a new Chairman or re-elect the current Chairman/CEO with the responsibilities and duties inherent to the Board Chairman role. It should be noted in this respect that some of the most relevant stakeholders (ISS, F&C, OECD, etc.) have stated certain concerns regarding the role separation processes at those companies that elect the former CEO to the role of Chairman of the Board of Directors. Some of its arguments are based on the risk that the former CEO may control the planning and the definition of

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the Board's agenda, that the new CEO may be influenced by the presence of his/her predecessor with respect to decisions taken in the past or it may simply involve a loyalty factor towards the former CEO. In any event, once more the consideration is that this is a matter that must be approached on a case-by-case basis since the situation will depend on the actual circumstances at each company and the measures that are adopted to support the re-election of the former CEO as the Chairman.

For this reason, if REC wishes to re-elect the current Chairman/CEO as the new Chairman of the Board of Directors of REC, we consider it advisable for the Company to analyse the opportunity to reinforce some counterweight measures to help maximise support from shareholders for the re-election of Mr. José Folgado as non-executive Chairman while refining the Company's good governance practices. Those counterweight measures include the following, some of which have already been indicated by the Company in its report:

- Maintain the LID not only during the transition process but even after it ends, reinforcing its role on the Board, regardless of the fact that it is not required after the separation of the Chairman and CEO roles takes place. This position would be even more necessary in the event that REC wishes to re-elect the Chairman-CEO as the new Board Chairman at the Shareholders meeting in 2016. As REC has stated in its report, the LID's role during the latest self-assessment process was highly valued and continues to serve as a counterweight. The responsibilities of this role could be reinforced, in line with Recommendation 34 in the new CGG.
- Taking into account that the design proposed by REC calls for the Chairman to focus on "driving and encouraging approval by the Board of Directors of the Strategic Plan for the Company and the Group, as well as adequate supervision of its execution", it could be advisable for REC to reinforce the role of the Board with respect to the supervision of items associated with the Company's sustainability in the medium and long-term such as, for example, the temporary or permanent creation of a committee in which the Chair would participate focusing on areas such as strategy and corporate social responsibility, among other issues.
- In order to reinforce independence and until the role may be deemed to be independent, evaluate the possibility that the Chairman will not form part of the Audit and/or Nomination and Compensation Committees.
- Analyse the possibility of including an evaluation of the Chairman and the CEO in the annual self-assessment of the Board of Directors, including previously defined financial and non-financial metrics.
- To reinforce the independence of the Board, when making proposals to appoint the new Independent Directors and when requested at the time of their re-election, the Nomination and Compensation Committee should request the preparation of a suitability report regarding the candidate and covering his/her independence, absence of conflicts of interest and the contribution and impact the proposed Director may have on the improvement and supervision of medium and long-term sustainability elements at the Company (strategy, corporate social responsibility, risk, etc.).

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- In the event that the Company plans to increase the number of the members of the Board in the future, it may consider that this take place for the purpose of reinforcing the presence of independent Directors.
- Evaluate a possible reduction in the length of term for members of the Board of Directors, currently established at four (4) years, thereby following the requirements of the proxy advisors and institutional investors and the practice of 29% of Ibex-35 companies that have a term of three (3) years²⁵.
- Reinforce the role of the Nomination and Compensation Committee when monitoring the evolution and potential of the second executive level that reports to the new CEO due to the importance that this has from the standpoint of succession plans.
- Evaluate the advisability of making REC's Communications Policy with its main stakeholders public, thereby following Recommendation 4 of the CGG²⁶ and the transparency practice in which the Company is immersed.

The separation of roles proposed by REC in its report complies with the Company's internal regulation as established in its current bylaws, General Meeting Regulations and Board of Directors Regulations, as well as the Spanish Companies Act and the Recommendations set out in the new Code of Good Governance. The formal process for transitioning to the separation of roles will be carried out through:

- The approval of an increase in the number of members of the Board and the appointment of a new CEO by the shareholders at an Extraordinary Meeting that will foreseeably be held in July 2015.
- Delegation of authority to the new CEO by the Board of Directors.
- Approval by the Board of Directors of the contract between the new CEO and the Company through a two thirds majority vote of the Board of Directors.
- Election of a new non-executive Chairman by shareholders at an Ordinary General Meeting in 2016 or, if appropriate, the re-election of the current Chairman as a non-executive Director in the category of "Other external Directors".
- Revocation by the Board of Directors of the executive authority delegated to the preceding Executive Chair.
- At that time the Board Chairman will not have any duties other than those arising from the Chairman role.

²⁵ Information updated at 31 December 2014.

²⁶ Recommendation 4 of the CGG establishes that a Company should define and promote a communications and contact policy with institutional advisors and proxy advisors and that policy should be made public on its website, including information relating to the manner in which it has been implemented and identifying the contact persons or those responsible for the policy.

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Finally, the compensation proposed by REC for the new CEO is in line with the recommendations of the new CGG regarding compensation components (fixed compensation and annual and multi-year variable compensation). The amount of the proposed compensation falls within the compensation policy approved by shareholders at the General Meeting in 2015. It seems reasonable to gradually reduce the variable remuneration component currently in place for the Chairman/CEO, in line with the progressive transfer of the duties.

The legislation, main recommendations and national and international trends regarding the separation of roles are identified in Section 6 as support for all of the above mentioned:

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6. Legislative framework and recommendations regarding the separation of roles

6.1. Spain: SCA and CGG

The Spanish Companies Act (SCA) was published in the Official State Journal this past 4th of December. This law introduces significant amendments relating particularly to General Shareholders' Meetings and Boards of Directors at listed companies.

Among the amendments affecting the Board of Directors, the new Article 529 septies²⁷ allows the role of Chairman of the Board of Directors to be held by an Executive Director but in those cases a reinforced majority is required to appoint the Chairman as the favourable vote of two thirds of the members of the Board will be required.

In such cases, it is mandatory for the Board of Directors, with the abstention of Executive Directors, to necessarily appoint a Lead independent Director from among Independent Directors that will be specifically authorised to call a meeting of the Board of Directors or to include new points in the agenda for a Board meeting that has already been called, coordinate and meet with non-executive Directors and perform, if appropriate, a regular evaluation of the Chairman of the Board of Directors.

Principal 16 of the new CGG approved this past 18th of February, indicates the concern regarding the difficulty of deciding whether it is appropriate for the role of Chairman of the Board of Directors to be held by a Company Executive Director, since both solutions offer advantages and disadvantages.

In these circumstances, and in the light of an absence of uniformity in international practices, the CGG maintains the criterion of not expressing an opinion regarding the advisability or not of separating both roles, and adopts a neutral position.

However, this neutrality must be understood in its just terms given that the CGG considers it necessary that when the roles are held by the same person, corrective measures should be implemented to avoid the risk of excessive concentration of power. The CGG therefore recommends that in order to consolidate performance and make it more effective, the duties of the Lead Independent Director must extend to additional areas such as company shareholder relations regarding corporate governance or the management of the succession plan for the Chairman of the Board.

²⁷ Article 529. septies: "1. Unless stipulated otherwise in enabling regulations, the position of Chair of the Board of Directors may be held by an Executive Director. In such cases the appointment of the Chair will require the favorable vote of two thirds of the members of the Board of Directors.

2. In the event that the Chair is an Executive Director the Board of Directors, with the abstention of Executive Directors, must necessarily appoint a Lead Independent Director from among Independent Directors that will be specifically authorised to call a meeting of the Board of Directors or to include new points in the agenda for a Board meeting that has already been called, coordinate and meet with non-executive Directors and perform, if appropriate, a regular evaluation of the Chair of the Board of Directors".

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6.2. Main countries of reference with respect to Corporate Governance:

The opinion adopted with respect to the separation of roles in countries such as the United States, France, Italy and the United Kingdom are analysed below as they are countries with Corporate Governance models that are most similar to that in Spain and are the most advanced in this area.

- In the **United States**, the *Dodd-Frank Act (July 2010)* requires companies to reveal whether the roles of Chairman and CEO are held by the same person and, if so, an explanation be provided with the reasons or motivation for doing so.
- In **France**, the “*Code de Gouvernement D’entreprise des Sociétés Cotées*”(June 2013), permits companies to choose whether or not they will separate roles but in the case that the roles are held jointly the duties that will be exercised by the Board Chairman must be clearly specified (in addition to those duties that are established by law).
- In **Italy**, the *Codice di Autodisciplina (July 2014)* supports the separation of roles between the Chairman and CEO. The Code recommends following the best international practices and indicates that the accumulation of roles destabilises the balance of power on the Board and if Chairman and CEO roles are held by the same person, a Lead Independent Director role must be created.
- In the **United Kingdom** the *Corporate Governance Code (September 2014)* indicates that the roles of Chairman and CEO cannot be held by the same person and the responsibilities of each role must be clearly established and approved by the Board.

6.3. Opinion of the main stakeholders regarding the separation of roles

a) Proxy Advisors and proxy solicitors

- **ISS**²⁸ generally recommends voting against the (re) election of the Chairman and CEO in the case where the roles are unified. However, when the company guarantees that the Chairman-CEO will only play a joint role on a provisional basis (no more than two years), with the intention of separating the roles within a certain period, these exceptional circumstances should be taken into consideration. The vote recommendation will be made on a case-by-case basis in this respect. In order for ISS to consider recommending a favourable vote with respect to the combination of the Chairman-CEO roles on a provisional basis, the Company would need to provide adequate control mechanisms on the Board (i.e. a lead independent director, a high general level of independence on the Board and a high level of independence for Board committees).

In general, it recommends voting against the election or re-election of the former CEO as the Chairman of the Board of Directors, particularly by companies in Germany, Austria and Holland.

²⁸ Europe Summary Proxy Voting Guidelines. Effective for Meetings on or after February 1, 2015.

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- Although the combination of roles is common in Spain, **Glass Lewis**²⁹ recommends voting against the Chair of the Nomination Committee when the roles are unified and the Director is not sufficiently independent or when the Board of Directors has not applied adequate counterweight measures to avoid potential conflicts of interest deriving from the combination of roles, such as the appointment of a lead independent director for the adoption of other leadership structures.
- In its Report “Corporate Governance and Institutional Investments-2015 Edition” **Georgeson**³⁰ indicates the opinion of 75 international institutional investors regarding several topics relating to corporate governance. Of those investors, 92% require the separation of the Chairman and CEO roles. However, 50% accept counterweight measures in cases of combination, and 37% of them only accept such measures on a temporary basis and 13% do not support any type of measure. An independent Chairman is demanded by 69% of investors.

b) Foreign institutional investors

- **BlackRock**³¹ supports the separation of the Chairman and CEO roles. In the event that both roles are held by the same person, the Board must implement counterweight measures to prevent the concentration of power by the Chairman-CEO. The measures to be implemented must be at least:
 - Majority of independent members of the Board of Directors.
 - Majority of independent directors on the various Board Committees.
 - Appointment of a Lead Independent Director.
 - Reduction of the length of term for Directors.
- **F&C Management Ltd.**³² argues that the roles of Chairman and CEO are substantially different and, accordingly, should be separate. F&C states that only when both roles are separate can an adequate balance of authority and responsibility be assured between the Board and Executive Management. If for some reason the roles are held by the same person (for example, during a transition period) an explanation and justification must be provided in the Corporate Governance Report and the annual accounts and, in all cases, a Lead Independent Director must be appointed.

F&C does not support a former CEO assuming the role of Chairman. In the event that such a situation arises, the Company must have a significant reason since it understands that this is a violation of good practices.

²⁹ Guidelines 2015 Proxy Season. An overview of the Glass Lewis approach to Proxy advice.

³⁰ Georgeson is the world leader in Proxy Solicitation and Corporate Governance advisory services, working with listed companies to strengthen their relationships with shareholders.

³¹ Proxy voting guidelines for European, Middle Eastern and African securities

³² Global Corporate Governance Guideline, F&C Management Ltd. (January 2015).

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- **BNP Paribas**³³, supports the separation of roles and argues that either the roles must be separate or there must be sufficient power counterweight measures in place and, in any case, a Lead Independent Director must be appointed.
- **Natixis**³⁴ favours the separation of the Chairman and CEO roles. The Board must guarantee counterweight measures and sufficient independence to exercise effective control over Executive Directors. In the event that both roles are combined, a case by case analysis would be performed depending on criteria such as:
 - Reasons that led the Company to unify the roles.
 - The Company's corporate governance practices.
 - The power counterweight measures that have been implemented.
 - Measures put into place to manage conflicts of interest that result from the combination of those duties.

An independent Vice-Chairman with a series of duties and certain authorities that will be defined in the Company's bylaws must be appointed.

- **Amundi**³⁵ argues that the duties and responsibilities deriving from the Chairman and CEO roles are different and also carry substantial workloads and therefore it considers that both roles should be separate and an independent Chairman should be appointed.

c) Corporate governance rating agencies

- **Governance Metrics International (GMI)** clarifies its opinion regarding the separation of roles in its report *The Costs of a Combined Chairman/CEO (June 2012)*. It performs a study regarding the combination of Chairman and CEO roles and reaches the conclusion that this system is more costly for the company, involves more risk for investors and provides fewer benefits to shareholders over the long-term than the separation of roles.

d) Other organisations that have expressed an opinion regarding the separation of positions.

- **Director-Administrator Institute ("Instituto de Consejeros-Administradores (IC-A)", Spain**

In the document "Principles of Good Corporate Governance-August 2011 Edition" the IC-A expresses its opinion regarding the separation of positions and states that the Chairman of listed companies should not be an Executive Director and there should be a clear, explicit,

³³ *Governance and Voting Principles*, BNP Paribas Asset Management (2015).

³⁴ *Proxy voting and Engagement policy*, Natixis Asset Management (March 2015)

³⁵ *Voting Policy*, Amundi Group (2015).

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written and approved separation of the duties, tasks and responsibilities of the non-executive Chairman of the Board from those of the CEO as the top executive.

- **Organisation for Economic Cooperation and Development (OECD)**

In its report *"Corporate Governance and the Financial Crisis"*, the OECD indicates that there is an emerging consensus that the separation of the CEO and Chairman roles is a good practice, but not an obligation.

It also indicates that it is important for the Board Chairman to play a key role to guarantee an effective Board through the establishment of the agenda and guaranteeing that the most important matters are covered. When the roles of CEO and Chairman are not separate, it is important that large corporations explain the measures that have been adopted to prevent conflicts of interest and to ensure the integrity of the Chairman's duties.

The OECD considers that if the new Chairman is the former CEO, that person will continue to be associated with management and, therefore, may not be sufficiently objective and independent. It also may generate confusion as to who is the leader of the company.

- **European Economic and Social Committee (EESC)**

The report from the European Economic and Social Committee regarding the already mentioned Green Paper "Corporate Governance Legislation in the EU" shows that the EESC supports the separation of duties and responsibilities falling to the Chairman of the Board of Directors and the CEO since this guarantees that the Board of Directors will be organised in a more effective manner, it creates a better control system and impedes the concentration of power. However, it considers that the decision to separate these duties and responsibilities or not falls to the Company (shareholders and the Board of Directors) and it does not support European regulations that impose such separation. The EESC considers that the final decision should be left to the sovereign corporate governance policy of the Company concerned since some small or medium-sized companies have very small Boards. At the European Union level such separation is recommended.

- **European Fund and Asset Management Association (EFAMA), Europe**

In response to question 3 in the Green Paper (*"Corporate Governance Legislation in the EU"* dated 5 April 2011 (*Should the EU attempt to ensure that the duties and responsibilities of the Chair of the Board of Directors and CEO be clearly separated?*)) most members of the EFAMA believe that the duties and responsibilities of a Board Chair and CEO should be clearly separated since they consider that only a clear separation of roles ensures independent control by the Chairman and avoids the accumulation of power by a single person. Members of EFAMA indicated that there may be situations in which the combination of roles is required, for example at small companies and in those cases a "comply or explain" approach should be considered.

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- **Council of Institutional Investors (CII)³⁶, United States**

The document “*Corporate Governance Policies*”, April 2015, considers that a Board should be led by an Independent Director and the roles of CEO and Chairman should only be combined in very limited circumstances.

- **National Association of Corporate Directors (NACD)³⁷, United States**

In the “Annual Survey of Board Leadership” (2014 Edition), the NACD shows that the trend towards separate roles has increased over time and it considers that the Chairman must meet several criteria in order to be classified as Non-Executive or Independent. It considers that in order for a Chairman to be Independent, that person cannot perform any executive duties (CEO), cannot have assumed executive duties previously at the company and must not be a founder or member of the founder's family. The idea of an Independent Chairman is that he/she may provide an impartial and objective perspective to the Board. In accordance with that report, founders, the members of the founder's family and ex-executives tend not to have that objectivity.

- **Global Network of Director Institutes (GNDI)³⁸**

In its report “*Guiding principles of good governance*” the GNDI states, in principle 5, that the roles of Chairman and CEO must be separate and the Chairman independent from management. However, it also defends that in some jurisdictions, particularly when the independence of the Board is already safeguarded, there may be legitimate circumstances under which a Board chooses to unify those roles, in which case a Lead Independent Director should be appointed and would have the authority to call meetings and represent independent directors. .

e) **PwC Corporate Governance Reports**

PwC has published several research and position documents regarding trends in several areas of corporate governance, among which are reports relating to the separation of roles, some of which are mentioned below:

- *PwC's 2014 Annual Corporate Directors Survey*, presents the opinion of 863 directors in the US market. The information reflected in that report shows that 51% of Directors consider that their company already has a separation of the Chairman and CEO roles and a

³⁶ This not-for-profit association created by US institutional pension funds focuses on encouraging good corporate governance practices.

³⁷ NACD is a US Association with more than 35 years of experience. It establishes guidelines and good practices for Boards of Directors.

³⁸ GNDI is an international network that shares corporate governance and Board of Directors experiences. It represents more than 100,000 directors and professionals associated with corporate governance.

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further 11% of Directors are evaluating implementing the separation of roles at their companies.

- The report *ProxyPulse Third Edition 2014* analyses the results of the 4,113 Shareholder Meetings held by US companies between January 1st and June 30th 2014. The report detected trends towards the separation of roles since during the meeting season in 2014 up to 62 proposals were presented to separate the Chairman and CEO roles compared with the 53 proposals presented for the same purpose the preceding year.
- The report *What matters in the Boardroom Edition 2014* compares the responses that were given by directors and investors in the main US companies relating to various areas of corporate governance at their companies. The opinion that the Chairman and CEO roles must be separate is held by 94% of investors while 23% of directors support the separation of roles.
- In the report “*Should the Chair be the CEO?*” PwC Spain 2011, presents an evaluation of the advantages and disadvantages of recommending the separation or combination of the Chairman of the Board of Directors and CEO roles, concluding that it is not realistic to impose the separation of roles without assuming certain risks for listed companies. In those cases in which separation does not exist, the adequate offset of powers within the Board may be deepened.

This report only constitutes the conclusions regarding the analysis that we have performed with respect to the separation of the Chairman and CEO roles at the company based on a review of the information provided by the Company and a comparative analysis of trends of reference at listed companies in countries with a longer tradition of good corporate governance practices. Under no circumstances does this report constitute a legal opinion or replace the evaluation process that is inherent to a legal opinion and should not be interpreted or considered to be such an opinion.

This report is issued solely for the purpose established in section 1 and for your information. Our maximum liability to Red Eléctrica Corporación, S.A. for any damages deriving from fault or negligence on our part when rendering these services has been established in our engagement letter dated June 6th, 2015. We will not accept any liability whatsoever with respect to third parties other than the recipients of this Report.

Landwell-PricewaterhouseCoopers Tax & Legal Services, S.L.

Mario Lara Sanz

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