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Analysis
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Contact	Phone
<i>Madrid</i>	
Carlos Winzer	34.91.310.14.54
<i>London</i>	
Jeremy Hawes	44.20.7772.5454
<i>Paris</i>	
Eric de Bodard	33.1.53.30.10.20

Corporación de Reservas Estratégicas de Productos Petrolíferos

Corporate Profile

CORES' Aaa RATING REFLECTS ITS STRATEGIC IMPORTANCE TO THE SPANISH ECONOMY AND ITS SPECIAL LEGAL STATUS AS A PUBLIC ENTITY

Madrid-based Corporación de Reservas Estratégicas de Productos Petrolíferos (CORES, rated Aaa) is the organisation responsible for managing the strategic oil reserves and controlling compulsory reserves (petroleum products and natural gas) in Spain.

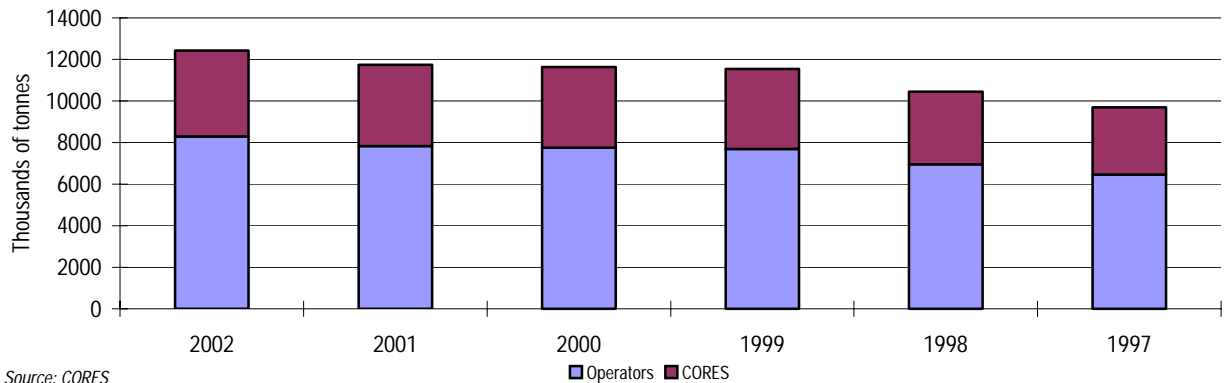
Countries in which oil is structurally in high demand as an energy resource but which cannot guarantee supplies due to a lack of domestic production consequently need to hold certain amounts of crude oil and petroleum products in reserve. This is certainly the case for Spain, given that (1) oil accounts for 51% of total energy resources consumed in the country and (2) 99.5% of Spain's oil needs are covered by imports. CORES was created to take responsibility for the strategic oil reserves as well as for controlling the compulsory reserves to be kept by operators.

Strategic oil reserves are set at one-third of the minimum security reserves—that is, 30 days of sales/consumption of oil products. CORES is also responsible for ensuring that the oil companies operating in Spain maintain 60-days minimum security reserves.

CORES holds approximately 4.5 million metric tons of oil products. By product category, 12.2% of CORES' stocks are held in the form of gasoline, 5.7% as heavy fuel oils, 38.8% in middle distillates and the remaining 43.3% in crude oil. CORES endeavours to keep its reserves in crude oil as high as possible, given its preference for greater flexibility and lower maintenance costs for crude oil.

CORES is entitled to lease up to 50% of its oil requirements although it has not so far leased any of its reserves designed for covering strategic reserves. The corporation's 30-day minimum reserves cannot be pledged or sold except for exceptional circumstances stipulated by law, namely: (1) in the event of a supply shortage, (2) in the event of an excess of strategic reserves beyond legal requirements, (3) by means of a sale aimed at maintaining the quality of the products. Any decision to sell the strategic reserves has to be made by the government.

Figure 1 – Strategic Oil Reserves in Spain



Source: CORES

Legal Framework

CORES was created in October 1994 by means of Royal Decree 2111, which granted the corporation a mandate to constitute, maintain and manage Spain's strategic oil stocks. Under this Royal Decree and the later Law 34/1998, CORES is considered as a corporation governed by Public Law, but with a legal personality and capacity to act under Private Law. Although CORES is subject to private commercial laws, its strategic role means that it is subject to the supervision of the Public Administration, in particular the Ministry of Economy.

CORES has specific characteristics that differentiate it from a private company. Firstly, it has no share capital given that, in accordance with its by-laws, the financial resources that enable it to carry out its activities are contributed by member fees. Secondly, the corporation cannot be liquidated unless a specific law to that effect is approved by Parliament. Finally, CORES is partially exempt from corporate taxes given that it does not have to pay Corporate Income Tax on fees received or on any income earned from the disposal of strategic reserves.

Key Rating Considerations

Business Risk Factors

ALTHOUGH CORES HAS NO EXPLICIT GUARANTEE FROM THE KINGDOM OF SPAIN (Aaa), ITS ISSUER RATING RELIES ENTIRELY ON ITS CLOSE RELATIONSHIP WITH AND SUPPORT FROM THE GOVERNMENT

The Aaa rating assigned to CORES by Moody's is based on the entity's legal status as a *corporación de derecho público*, which cannot be privatised under existing legislation, as well as on the fact that there are no plans for this status to be changed. In addition, a key factor in our rating assessment is our understanding and assumption that CORES will remain a key instrument for the Spanish government's strategic oil reserve policy and therefore instrumental for the Ministry of Economy.

CORES' linkage to the State is based on the obligation that the latter imposes on operators to pay a fee to the corporation and the legal threat of their operating licence being withdrawn if the fee is not paid, which makes very unlikely that an operator will default in the payment of the fee even in a distressed scenario.

HOWEVER, THE LEGAL NATURE OF CORES IS NOT AS STRONG AS THAT OF OTHER SPANISH STATE – OWNED QUASI-CORPORATE ENTITIES (SQES)

CORES is a hybrid entity in terms of its legal nature, which is arguably not as strong as that of other rated state-owned quasi-corporate entities (SQEs) in Spain such as RTVE (Aaa) or SEPI (Aaa). The State does not grant an explicit guarantee on CORES' liabilities, the company does not receive direct subsidies from the Spanish government (whereas RTVE does) and there is no liquidity assurance mechanism in case of financial stress. By law, only CORES' members (which are all oil distributors in Spain) are responsible for the entity's financial sustainability and the timely repayment of its debts.

Nevertheless, the Aaa rating assigned to CORES is supported by (1) the importance of the strategic reserves for the Spanish economy, (2) the clear and specific framework established by law under which CORES operates, and (3) the close relationship and support from the Government, which is materialised through the approval of the fees by the Ministry of Economy and the publication of the fees in the Official State Gazette (Boletín Oficial del Estado).

The legal mandate which CORES has been granted to ensure compliance with obligations under Spanish law and international regulations with respect to the strategic stockholding of oil products could in theory be performed directly by the companies themselves, as in the case in some other countries. However, the operators support the existence of entities such as CORES because it is more efficient, there are greater economies of scale and the financing costs are much lower. In addition, the operators are not burdened by the large liability which would otherwise sit on their balance sheets as a result of financing the acquisition of oil reserves.

CORES’ OPERATIONS AND FINANCIAL ACTIVITIES BENEFIT FROM A FEE-BASED FUNDING SYSTEM THAT PROVIDES THE ENTITY WITH A PREDICTABLE AND FLEXIBLE FINANCIAL PROFILE

CORES is funded through the monthly fees that it receives from its members (published each year in the Official State Gazette). Moody's derives comfort from the fact that all oil operators and importers in Spain are required by law to pay fees to CORES, and that failure to do so can ultimately result in a termination of the operator's activities. In the event of delayed payments by any of the member companies, CORES charges a penalty of 300 basis points over the legal Spanish interest rate for the duration of the payment moratorium. By law, failure to settle the fee within a period of 45 days is considered a serious infraction and could result in a termination of the operator's licence.

Such a threat makes it highly unlikely that an operator will not pay the fee. In fact, members regularly comply with payment obligations and since CORES’ creation, defaulted payments have been negligible. In 2003, there were no overdue fees recorded.

By law, the fees paid to CORES – which constitute its main cash inflow – must be calculated so as to ensure that they cover the following: (1) financial costs, which are mainly debt interest payments; (2) all operational costs derived from the constitution, storage and maintenance of the strategic reserves; (3) administrative costs; and (4) the allocation of the Statutory Financial Reserve.

CORES’ Board of Directors decides whether any excess fees that are left over after these costs have been covered are to be paid back to CORES members, and it allocates the remaining surplus to the Statutory Financial Reserve.

Independently of these extraordinary fees, exceptionally, the government can oblige CORES’ members to pay set an extraordinary fee at any time. To date, a conservative budgeting policy has resulted in fee surpluses arising in every year since CORES started to operate.

Moody's expects that the current funding mechanism through fees paid by all member companies will remain in place and that the current legal status of the entity will also remain unchanged.

THERE IS SOME CONCENTRATION RISK, AS CORES SIGNIFICANTLY RELIES ON REPSOL AND CEPESA, THE TWO LARGEST OIL COMPANIES IN SPAIN

We note a certain concentration risk given that CORES’ two largest contributors together represent 62% of its fees – Repsol-YPF S.A. (Repsol, Baa1) accounts for 39% and Compañía Española de Petróleos S.A. (Cepsa, not rated) for 23%. However, these fees represent only a minimal proportion of these companies’ total annual expenses. In addition, as the Spanish oil market becomes more competitive, these two operators’ share in CORES’ fee income should decline gradually.

CORES’ ASSET BASE IS HIGHLY MARKETABLE

One of CORES’ specific characteristics is the marketability of its asset base, given that oil stocks represent 98% of its total assets. The company's oil stock was purchased at significantly lower prices than current market prices and CORES therefore has a cushion in terms of valuation of its stock of around €300 million. It is also worth noting that, in the event of a supply crisis (in which case CORES would have to sell its reserves if the Spanish government so decides), the market price would be considerably higher than the acquisition cost of strategic reserves.

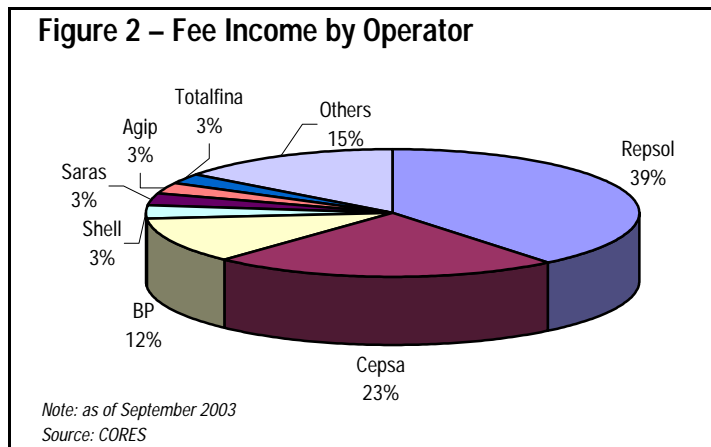
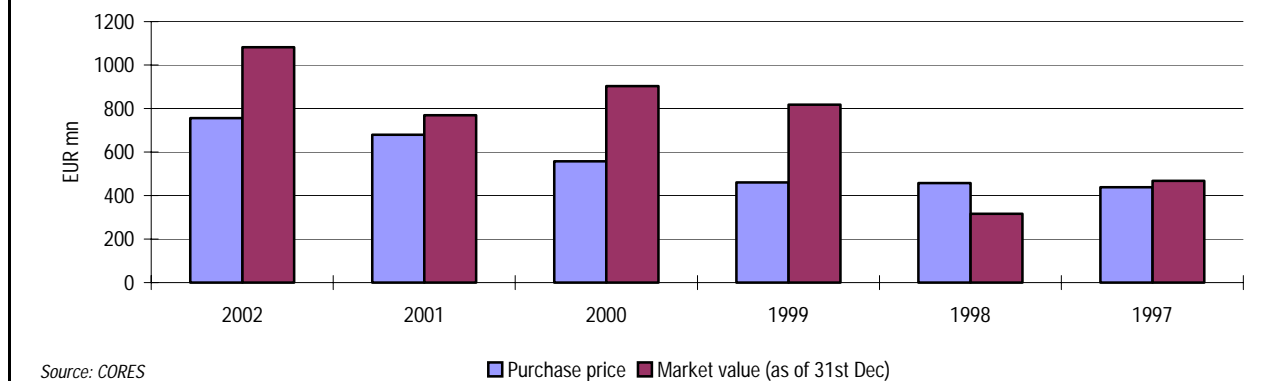


Figure 3 – Purchase Price vs. Market Price of Strategic Reserves



On the operational side, CORES requires the government's authorisation to release strategic oil reserves if the sale price is below the average acquisition cost and/or if there is an imminent or existing disruption in the supply of oil products. In such a crisis scenario, the government would decide by legal decree how to use and release both CORES' strategic stocks and the operator's security reserves. By law, the proceeds from the disposal of reserves would be applied first to the redemption of debts contracted by the corporation.

CORES DOES NOT OWN STORAGE CAPACITY ALTHOUGH THERE IS A PLAN TO BUILD SOME

To date the storage of the crude oil and the petroleum products owned by CORES has taken place in facilities rented out by third parties. On the one hand, renting storage capacity provides the corporation with operational flexibility. However, the increasing need to build up strategic reserves in light of the persistent growth in consumption – combined with the existence of market pressure in terms of the availability of rented storage – prompted CORES to decide, at the end of 2002, to explore the possibility of using its own facilities, either by building them directly or by means of any other option allowing their long-term use.

As a result, three projects are currently at a relatively advanced stage aimed at making available to CORES storage capacity of its own totalling a volume of around 650,000 cubic metres of finished products and 200,000 cubic metres of crude oil. At the date of conclusion, scheduled for 2005, these projects would provide storage capacity for approximately 12% of the corporation's total requirements.

Financial Risk Factors

PREDICTABLE REVENUE AND MARGIN EVOLUTION DUE TO FEE-BASED FUNDING SYSTEM

As mentioned earlier, by law, the fees paid to the corporation are calculated so as to cover all of its operating, financial, and administrative costs. Rental expenses and financing costs comprise the largest components of CORES' cost base (72% and 25%, respectively) while central costs are marginal (only 3% of costs) given the lean structure of the corporation.

The entity's operating and financing costs are fully matched by the fees received from the operators and in the event of an operational deficit the government can order the operators to make an extraordinary contribution in order to cover such a deficit, making revenues and margins highly predictable.

Figure 4 – Revenues and Profitability

(In € million)	Dec-00	Dec-01	Dec-02
Revenues	136	125	102
Revenue growth	99.2%	-7.9%	-18.7%
EBIT	52	37	29
Operating margin	38.3%	29.6%	28.4%
Net interest	-21	-26	-25
Net income	32	10	4

Source: CORES' Annual Reports/Moody's

LEVERAGE IS HIGH AND IS EXPECTED TO INCREASE OVER THE MEDIUM TERM

CORES' high level of leverage reflects the acquisition cost of the oil reserves, which have been financed with external debt. In addition, it rents storage capacity from third parties as it does not (as yet) own any storage capacity of its own. Adjusting debt for operating leases provides an even higher financial leverage position. The corporation's plans to build own storage capacity (see above) represents a capex requirement of around €57 million, which will be financed with debt.

In addition, the government is currently studying the possibility of increasing the number of days of sales/consumption of oil products for which CORES is responsible from 30 days to around 45 days. If this change is approved, CORES will need to raise additional debt in order to increase its reserves to meet the new requirements.

Figure 5 – Leverage			
(In € million)	Dec-00	Dec-01	Dec-02
Debt due<1 year	16	5	22
Debt due>1 year	497	624	672
Total Debt	513	629	694
Operating lease x 8	411	475	554
TOTAL ADJ DEBT	924	1103	1248
CASH & ST INVS	6	12	12

Source: CORES' Annual Reports/Moody's

STRONG LIQUIDITY PROFILE, WITH NO DEBT MATURITIES UNTIL 2007

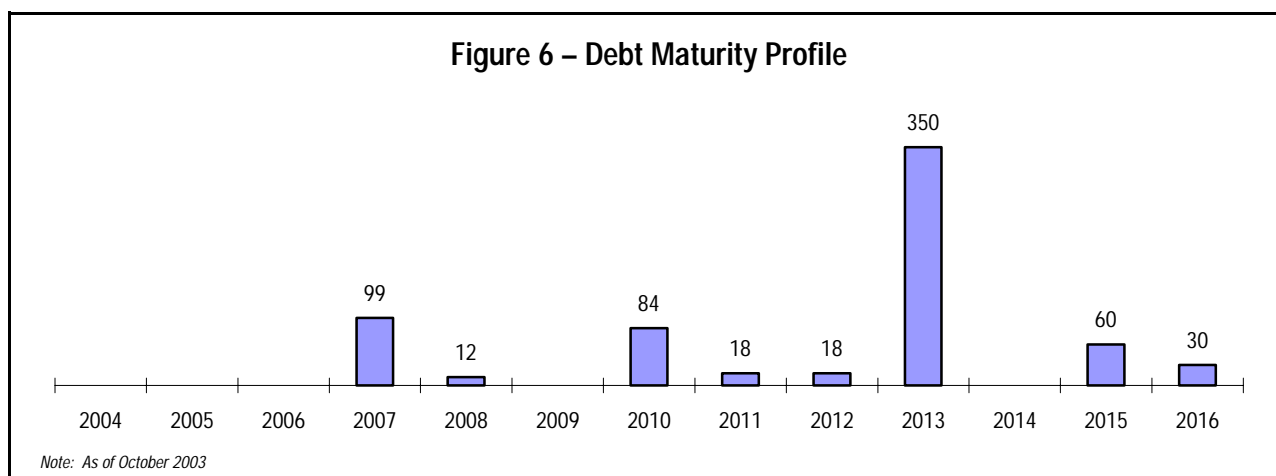
The corporation's liquidity profile is strong, as it has no debt maturities until 2007.

In June 2003, CORES issued a 10-year bond for a total amount of €350 million and used the proceeds to repay part of its existing bank loans.

CORES has a €30 million one-year committed bank facility, and the intention is to maintain availability of around 70% under this line at all times.

The corporation executes all of its transactions in euros in order to avoid any exchange rate risk, although it is exposed to the fluctuation in oil prices given that these are denominated in US dollars. CORES does not trade in the commodities futures market.

Moody's has factored that CORES will retain an adequate liquidity management policy in order to avoid any future liquidity constraints.



Related Research

Analysis:

[Ente Publico Radio Television Española, February 2003, \(77469\)](#)

Special Comment:

[State-Owned Quasi-Corporate Entities \(SQEs\): Moody's Rating Approach, May 2003 \(78031\)](#)

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<u>Author</u>	<u>Editor</u>	<u>Senior Associate</u>	<u>Senior Production Associate</u>
Carlos Winzer	Justin Neville	Iván Palacios	Mark A. Lee

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