Research Update:
Spain's Autonomous Community of The Basque Country 'A-' Rating Affirmed; Outlook Remains Stable

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Overview
- The Basque Country is performing in line with our base case, in which we assume a gradual reduction in the region's deficit, roughly in line with official deficit targets.
- In our view, the Basque Country's high fiscal autonomy and sound financial management make it more resilient in a stress scenario than Spain. We consequently rate the Basque Country two notches higher than Spain.
- We are affirming our 'A-' long-term rating on the Basque Country.
- The stable outlook on the Basque Country reflects that on Spain.

Rating Action

Rationale
Our long-term rating on the Basque Country is two notches higher than the long-term rating on Spain (BBB/Stable/A-2). According to our criteria for rating above the sovereign, a local and regional government (LRG) can be rated up to two notches higher than its sovereign if the LRG can maintain credit characteristics that are more resilient than the sovereign's in a stress scenario, despite a high sensitivity to country risk.

We believe the Basque Country meets the above-mentioned conditions and therefore apply a two-notch differential to the ratings, reflecting our view of:
- The region's export-oriented and competitive industry, focused on internationally diverse markets, which partly mitigates its high concentration on Spain's economy.
- Its special constitutional status, which isolates the region from negative intervention by the sovereign.
- Its financing system, with high fiscal autonomy that does not rely on transfers from the central government to any meaningful degree. As a result, we estimate that the impact of a sovereign stress scenario would come from a fall in GDP and tax collection.
A track record of sound financial management and our view that the region's management shows a strong credit culture.

We also think that the Basque Country could withstand a stress scenario, as defined in our criteria, and continue to service its debt after a sovereign default. However, we believe that the Basque Country has high sensitivity to country risk.

In addition, we have revised our assessment of the Basque Country's stand-alone credit profile (SACP) upward, to 'aa-' from 'a+', based on the region's improved liquidity. The SACP is not a rating but a means of assessing the intrinsic creditworthiness of an LRG under the assumption that it is not constrained by the sovereign credit rating. The SACP results from the combination of our assessment of an LRG's individual credit profile and the institutional framework in which it operates.

The Basque Country's SACP is underpinned, in our opinion, by the region's very strong economy in an international context, its strong financial management and budgetary flexibility, and its low contingent liabilities. In assessing the SACP, we also take into account the evolving but balanced institutional framework in which the Basque Country operates, as well as the region's adequate liquidity, with a higher debt-service coverage ratio than in our previous assessment.

Although we expect budgetary consolidation over our 2014-2016 forecast horizon, the Basque Country's SACP remains constrained by average budgetary performance in an international context. We expect the Basque Country to post a small operating surplus and deficits after capital accounts. The region's creditworthiness is also constrained by its moderate debt burden. Our assessment of Spain's institutional framework as evolving but balanced reflects our view of the Basque Country's high fiscal autonomy, which is tempered by our expectation of only limited extraordinary support from Spain's central government if needed.

The Basque Country--along with Spain's other special-status LRGs, such as the Autonomous Community of Navarre and the Historical Territory of Bizkaia--has unique taxing powers compared with the rest of Spain's LRGs, including legislative power over personal income and corporate taxes. The three Basque Country provinces, one of which is Bizkaia, collect taxes and transfer a portion of them to Spain's central government in compensation for the services it provides in the Basque Country. Any remaining resources are then redistributed among the Basque Country's regional government, provinces, and municipalities, according to their respective areas of responsibility.

The Basque Country does not participate in Spain's equalization system for funding regions. As a result, it can benefit fully from the strength of its economy and resulting large tax bases. In our opinion, the Basque Country's economy is wealthier, more competitive, and more export-oriented than Spain's.

We view the Basque Country's financial management as strong, as defined in our
criteria. In our opinion, the region's financial management is professional, clearly identifies the region's main external risks, and shows a strong credit culture. The region's minority nationalist government, with the support of the socialist party, was able to approve the budget for 2014. The budget for 2015 is under discussion in the regional Parliament. We understand that the government intends to take all necessary measures to reduce its deficits to avoid intervention from the central government.

The Basque Country's budgetary performance in 2013 was in line with our base-case scenario, and it complied with the official deficit target. Although in 2013 the region posted an operating deficit of 1.2% of operating revenues, after an operating surplus of 1.4% in 2012, it reduced the deficit after capital accounts to 8.2% of total revenues from 8.4%.

Under our base-case scenario, we anticipate that the region's budgetary metrics will improve, although we do not expect the region to return to balanced budgets over our 2014-2016 forecast horizon. We project that the region will post an operating surplus of 4.8% of operating revenues and a deficit after capital accounts of 2.7% of total revenues in 2016, slightly better than our previous assessment of an operating surplus of 4.3% and a deficit after capital accounts of 3.1%.

We expect the region's operating revenues to increase by 6.2% in 2014 and by 3.7% in 2015, due to better economic prospects in Spain and the Basque Country and the full effect of the tax reform passed in 2013, which includes the suppression of several personal income tax deductions, and an increase in the rates for real estate transaction taxes, among other measures. The region will also benefit from the introduction of new taxes in the Basque financing framework, such as on bank deposits, lottery prizes, electricity production, and greenhouse gases.

Our base-case forecast reflects our expectation that the Basque Country will adapt its expenditures as needed to post deficits in line with, or only slightly above, the official targets. In our view, the Basque Country could absorb some potential revenue deviations by using its budgetary flexibility, which is greater than that of most Spanish regions. This is owing to its special fiscal regime and wealthier economy. The Basque Country's GDP per capita is 135% the Spanish average, based on data from INE, the Spanish national statistics office.

The Basque Country's continued deficit will further increase its moderate tax-supported debt. However, because we assume revenues will increase, we foresee the region's tax-supported debt stabilizing, in relative terms, at about 100% of operating revenues in 2015 and 2016, which is slightly better than our previous estimate of 105%. Our tax-supported debt figure includes the debt of the region's non-self-supporting public-sector companies, as well as some guarantees the region provides to third parties. Together, these items represent about 10% of the region's tax-supported debt.

Still, we believe the Basque Country has low contingent liabilities because we
include most of the debt of the companies it owns in our calculation of its
tax-supported debt. We expect the region to continue restructuring and
streamlining its companies.

We could revise our SACP assessment to 'a+' from 'aa-' under our downside
scenario if, contrary to our expectations, the Basque Country posted
higher-than-expected deficits after capital accounts. This would likely lead
us to take a more negative view of its budgetary flexibility or financial
management.

Liquidity
We now assess the Basque Country's liquidity as adequate, compared with less
than adequate previously. This reflects our view of the region's adequate
debt-service coverage ratio and satisfactory access to external liquidity.

The debt-service coverage ratio reflects our estimate of the region's internal
cash generation capacity and available credit lines. We project coverage to be
about 85% of the Basque Country's debt service over the next 12 months, which
we estimate at €960 million. In our view, the debt-service coverage ratio has
strengthened, thanks to the region's policy of taking advantage of improved
market conditions to refinance part of its loan portfolio (about €870 million
as of November 2014). Consequently, the region has reduced its average debt
cost, lengthened the average tenor of its debt, and smoothed its debt
repayment profile. We expect the region to continue with this policy in the
coming months.

The region benefits from satisfactory access to external sources of liquidity,
in our view. So far in 2014, the region has borrowed €1.05 billion, which
covers 95% of its funding needs for the full year.

Outlook
The stable outlook on the Basque Country reflects that on Spain. Given our
stable outlook on Spain, we currently see a lower than one-in-three
probability of an upgrade or downgrade of Spain over our 2014-2016 forecast
horizon.

Given the region's SACP, currently at 'aa-', and our view of its credit
strengths, we do not see a realistic scenario under which the Basque Country's
SACP would weaken to 'bbb+' or lower. If this were to occur, however, we would
downgrade the Basque Country, all other factors remaining unchanged.

We could also downgrade the Basque Country if we believed that it no longer
met our conditions to be rated above the sovereign. However, we consider this
scenario to be highly unlikely.

We would upgrade the Basque Country by one notch if we upgraded Spain by one
notch and the region continued to perform in line with our current base case, all other factors remaining unchanged.

### Key Statistics

**Table 1**

**Autonomous Community of The Basque Country Financial Statistics**

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014bc</th>
<th>2015bc</th>
<th>2016bc</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenues</td>
<td>8,617.9</td>
<td>8,142.8</td>
<td>8,650.0</td>
<td>8,974.0</td>
<td>9,208.3</td>
</tr>
<tr>
<td>- Operating expenditures</td>
<td>8,493.4</td>
<td>8,238.1</td>
<td>8,554.2</td>
<td>8,777.3</td>
<td>8,767.3</td>
</tr>
<tr>
<td>= Operating balance</td>
<td>124.5</td>
<td>(95.3)</td>
<td>95.8</td>
<td>196.7</td>
<td>441.0</td>
</tr>
<tr>
<td>Operating balance (% of operating revenues)</td>
<td>1.4</td>
<td>(1.2)</td>
<td>1.1</td>
<td>2.2</td>
<td>4.8</td>
</tr>
<tr>
<td>+ Capital revenues</td>
<td>494.1</td>
<td>441.8</td>
<td>483.7</td>
<td>456.5</td>
<td>468.4</td>
</tr>
<tr>
<td>- Capital expenditures</td>
<td>1,386.0</td>
<td>1,053.0</td>
<td>1,259.9</td>
<td>1,236.4</td>
<td>1,174.6</td>
</tr>
<tr>
<td>= Balance after capital accounts</td>
<td>(767.3)</td>
<td>(706.5)</td>
<td>(680.4)</td>
<td>(583.3)</td>
<td>(265.2)</td>
</tr>
<tr>
<td>Balance after capital accounts (% of total revenues)</td>
<td>(8.4)</td>
<td>(8.2)</td>
<td>(7.4)</td>
<td>(6.2)</td>
<td>(2.7)</td>
</tr>
<tr>
<td>- Debt repaid</td>
<td>174.5</td>
<td>199.9</td>
<td>469.5</td>
<td>711.3</td>
<td>934.5</td>
</tr>
<tr>
<td>+ Gross borrowings</td>
<td>1,086.9</td>
<td>1,175.3</td>
<td>1,149.9</td>
<td>1,294.6</td>
<td>1,199.7</td>
</tr>
<tr>
<td>= Balance after borrowings</td>
<td>145.1</td>
<td>268.9</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Direct debt (outstanding at year-end)</td>
<td>6,088.5</td>
<td>7,087.7</td>
<td>7,768.1</td>
<td>8,351.4</td>
<td>8,616.6</td>
</tr>
<tr>
<td>Direct debt (% of operating revenues)</td>
<td>70.6</td>
<td>87.0</td>
<td>89.8</td>
<td>93.1</td>
<td>93.6</td>
</tr>
<tr>
<td>Tax-supported debt (outstanding at year-end)</td>
<td>6,883.7</td>
<td>7,935.4</td>
<td>8,641.7</td>
<td>9,204.7</td>
<td>9,433.4</td>
</tr>
<tr>
<td>Tax-supported debt (% of consolidated operating revenues)</td>
<td>78.5</td>
<td>95.6</td>
<td>98.1</td>
<td>100.7</td>
<td>100.6</td>
</tr>
<tr>
<td>Interest (% of operating revenues)</td>
<td>2.3</td>
<td>2.7</td>
<td>2.9</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>Debt service (% of operating revenues)</td>
<td>4.3</td>
<td>5.2</td>
<td>8.3</td>
<td>10.7</td>
<td>12.9</td>
</tr>
</tbody>
</table>

The data and ratios above result in part from Standard & Poor’s own calculations, drawing on national as well as international sources, reflecting Standard & Poor’s independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc—Base case reflects Standard & Poor’s expectations of the most likely scenario.

**Table 2**

**Autonomous Community of The Basque Country Economic Statistics**

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population on Jan. 1 (000s)</td>
<td>2,172</td>
<td>2,178</td>
<td>2,185</td>
<td>2,193</td>
<td>2,192</td>
</tr>
<tr>
<td>Population growth (%)</td>
<td>0.7</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
<td>(0.1)</td>
</tr>
<tr>
<td>Nominal GDP (mil. €)</td>
<td>63,298</td>
<td>63,353</td>
<td>64,857</td>
<td>63,614</td>
<td>62,780</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>29,652</td>
<td>30,101</td>
<td>30,480</td>
<td>30,051</td>
<td>29,959</td>
</tr>
<tr>
<td>GDP (real) growth (%)</td>
<td>(4.2)</td>
<td>1.5</td>
<td>0.2</td>
<td>(1.3)</td>
<td>(1.9)</td>
</tr>
</tbody>
</table>

The data and ratios above result in part from Standard & Poor’s own calculations, drawing on national as well as international sources, reflecting Standard & Poor’s independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. Sources typically include national statistical offices, and Eurostat.
Ratings Score Snapshot

Table 3

Autonomous Community of The Basque Country Ratings Score Snapshot

<table>
<thead>
<tr>
<th>Key rating factors</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional framework</td>
<td>Evolving but balanced</td>
</tr>
<tr>
<td>Economy</td>
<td>Very strong</td>
</tr>
<tr>
<td>Financial management</td>
<td>Strong</td>
</tr>
<tr>
<td>Budgetary flexibility</td>
<td>Strong</td>
</tr>
<tr>
<td>Budgetary performance</td>
<td>Average</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Adequate</td>
</tr>
<tr>
<td>Debt burden</td>
<td>Moderate</td>
</tr>
<tr>
<td>Contingent liabilities</td>
<td>Low</td>
</tr>
</tbody>
</table>

*Standard & Poor's ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the rating.

Key Sovereign Statistics

- Ratings On Spain Affirmed At 'BBB/A-2'; Outlook Stable, Nov. 14, 2014

Related Criteria And Research

Related Criteria
- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013

Related Research
- Ratings On Spain Affirmed At 'BBB/A-2'; Outlook Stable, Nov. 14, 2014
- Autonomous Community Of The Basque Country Upgraded To 'A-' After Spain Upgrade; Outlook Remains Stable, June 13, 2014
- Institutional Framework Assessments For International Local And Regional Governments, Jan. 14, 2014
- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been...
distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

**Ratings List**

**Ratings Affirmed**

The Basque Country (Autonomous Community of)
Issuer Credit Rating: A-/Stable/--
Senior Unsecured: A-

**Additional Contact:**
International Public Finance Ratings Europe; PublicFinanceEurope@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.