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CREDIT OPINION
29 September 2023

Update

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RATINGS

Basque Country (The)

Domicile	Spain
Long Term Rating	A3
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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The Basque Country (Spain)

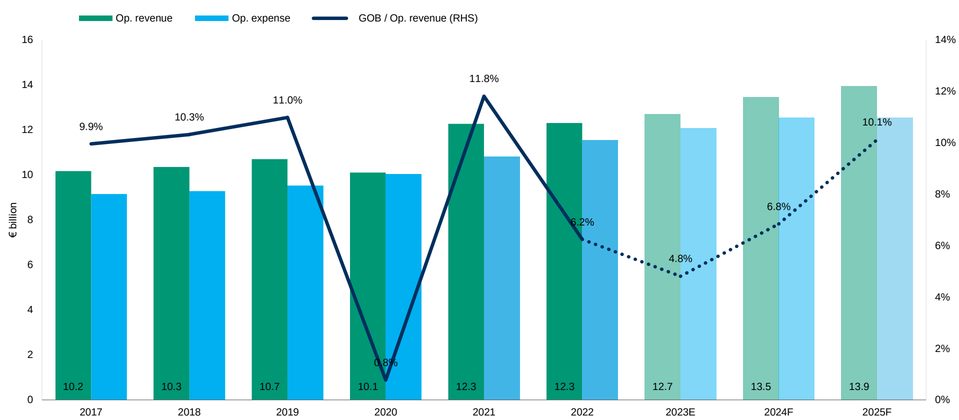
Update to credit analysis

Summary

The credit profile of the Basque Country (A3 stable) exceeds the Government of Spain's Baa1 rating by one notch, reflecting the region's unique and constitutionally protected tax regime, which provides it with a higher degree of fiscal flexibility than other Spanish regions under the so-called "Common Regime". Following a significant contraction in its gross operating balance (GOB) during the pandemic in 2020, the Basque Country's fiscal performance quickly recovered to pre-pandemic GOB levels in 2021 and 2022. We expect the region's operating performance to continue to improve until 2025.

Exhibit 1

Basque Country's operating margin is likely to grow through 2025



E = Estimate; F = Forecast. This represents Moody's forward view, not the view of the issuer.
Sources: Issuer and Moody's Investors Service

Credit strengths

» A high degree of fiscal flexibility derived from its unique legal status

» Strong fiscal performance

» A strong and diversified economic base

Credit challenges

» While improving still high debt burden

Rating outlook

The outlook on the Basque Country's rating is stable. This indicates our view that the region will continue to perform strongly, driving positive operating margins and a lower debt-to-operating revenue ratio over the next two to three years. In addition, the stable outlook reflects the stable outlook on the Spanish government's rating.

Factors that could lead to an upgrade

A strengthening of Spain's credit profile, leading to an upward adjustment in the sovereign rating, would likely have the same effect on the Basque Country's rating.

Factors that could lead to a downgrade

Large financing deficits, covered by a rapid increase in debt, would exert downward pressure on the region's rating. Any downgrade of Spain's rating would likely have similar implications for the Basque Country's rating.

Key indicators

Exhibit 2

The Basque Country

	2017	2018	2019	2020	2021	2022	2023E	2024F	2025F
Gross Operating Balance as a % of Operating Revenue	9.9	10.3	11.0	0.8	11.8	6.2	4.8	6.8	10.1
Capital Expenses as a % of Total Expenses	9.9	9.6	9.6	9.8	9.4	11.7	16.2	-	-
Self Financing Ratio	1.2	1.2	1.2	0.2	1.7	0.9	0.8	-	-
Financing Surplus(Deficit) as % of Total Revenue	1.6	2.2	2.3	-8.4	5.9	-1.0	-3.3	0.2	3.3
Interest Expenses as a % of Operating Revenue	1.8	1.7	1.7	1.4	1.2	1.2	1.7	1.7	1.8
Gross Borrowing Need as a % of Total Revenue	4.8	9.4	10.3	15.1	0.0	6.7	9.2	-	-
Net Direct and Indirect debt as a % of Operating Revenue	102.9	99.8	90.1	109.0	92.7	89.6	86.1	81.1	78.3

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Sources: Issuer and Moody's Investors Service

Detailed credit considerations

The credit profile of the Basque Country, as expressed in the region's A3 stable rating, combines a Baseline Credit Assessment (BCA) of a3 and a high likelihood of receiving extraordinary support from the Government of Spain in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

A high degree of fiscal flexibility derived from its unique legal status

The region and its three constituent provinces (Guipuzcoa, Alava and Biscay) benefit from a unique tax regime outlined in the Spanish Constitution and the Basque Country's Statute of Autonomy. The three Basque provinces set and collect their own taxes, and redistribute the bulk of the proceeds to the Basque Country and its municipalities under pre-established agreements with the central government. Close relationships among the three Basque provinces and the Basque Country are formalised through the Basque Financial Council (Consejo Vasco de Finanzas Públicas).

The three Basque provinces make an annual payment, or cupo, to the central government in recognition of the services provided by the Spanish state. The cupo is set through negotiations between the central government and the region every five years, and is independent of the Basque Country's annual financial performance.

The share of tax revenue transferred to the region is usually negotiated for a five-year period. Generally, the region receives around 70% of the total tax revenue raised in the Basque provinces. The methodology for calculating this share has changed little since its inception in 1985, ensuring a relatively stable and predictable revenue stream. This arrangement is unlikely to change in the medium term.

Strong fiscal performance

The Basque Country has demonstrated its strong fiscal framework by quickly recovering its financials from the negative effects of the pandemic in 2020. In 2022, the region posted a positive GOB of €767 million, or 6.2% of its operating revenue, which compares with a GOB of €1.4 billion or 11.8% of operating revenue in 2021. The decrease in the region's GOB was mainly because of a modest 0.3% year-over-year growth in operating revenue, which was insufficient to compensate its operating expenditure growth of 6.7%. The rise in operating expenditure was mainly driven by a 10% year-on-year increase in personnel costs (mainly because of an increase in salaries).

Including capital revenue and spending, the region reported a financing deficit of €127 million, equivalent to around 1% of its operating revenue in 2022, versus a surplus of 6% in 2021.

As calculated under the European System Accounts (ESA), the Basque Country reported a financing deficit of 0.1% of regional GDP in 2022 (with a deficit-to-regional GDP reference rate of 0.9% for 2022), compared with a financing surplus of 0.87% in 2021. An indicative deficit of 0.6% of regional GDP has been set for 2023. We expect the Basque Country to close 2023 with a break-even financial result, as its economy rebounds. This expectation is corroborated by the fact that tax revenue collection for the three Basque provinces from January to June 2023 has already been 6% higher than in 2022.

We expect the Basque Country to continue to record positive GOBs of 5%-10% of operating revenue in the next two to three years and comply with the deficit limit targets established by the central government, mainly supported by Spain's positive economic prospects and the region's strong budget management, which is reflected in the Governance score (G-1) in its ESG Credit Impact Score.

In addition, the Basque Country will receive around €1.6 billion of NextGenerationEU funds until 2026, of which around €1 billion were received as of May 2023.

A strong and diversified economic base

Situated on the north coast of Spain, the Basque Country has 2.2 million inhabitants (4.6% of the country's population in 2022) and is the country's second-wealthiest region (after Madrid), with a GDP per capita of €32,925 in 2021 (latest available data at the regional level), well above the Spanish average of €25,498.

The Basque Country's economy is diversified and has traditionally benefited from a strong export-oriented industrial base, led by the automotive sector, which is mainly exposed to the trading between France and Germany. Also, other relevant economic activities include energy, railway and shipbuilding industries. In 2021, the industrial sector accounted for 22.9% of the regional GDP, well above the national average of 15.3%. According to estimations from the Basque Country's statistical institute, the region's real GDP grew to around 4.4% by year-end 2022, recovering towards the pre-pandemic levels, mainly supported by the still-improving industry sector. In addition, the region forecasts a real GDP growth of 1.6% in 2023 and 2.1% in 2024.

As of year-end 2022, the Basque Country registered an unemployment rate of 8.6%, the lowest in last decade as well as among those of other Spanish regions we rate, and far below the national average of 12.9% in 2022. The region has also recovered the number of job positions that were lost during the pandemic (equivalent to a total of 1 million of full time job positions).

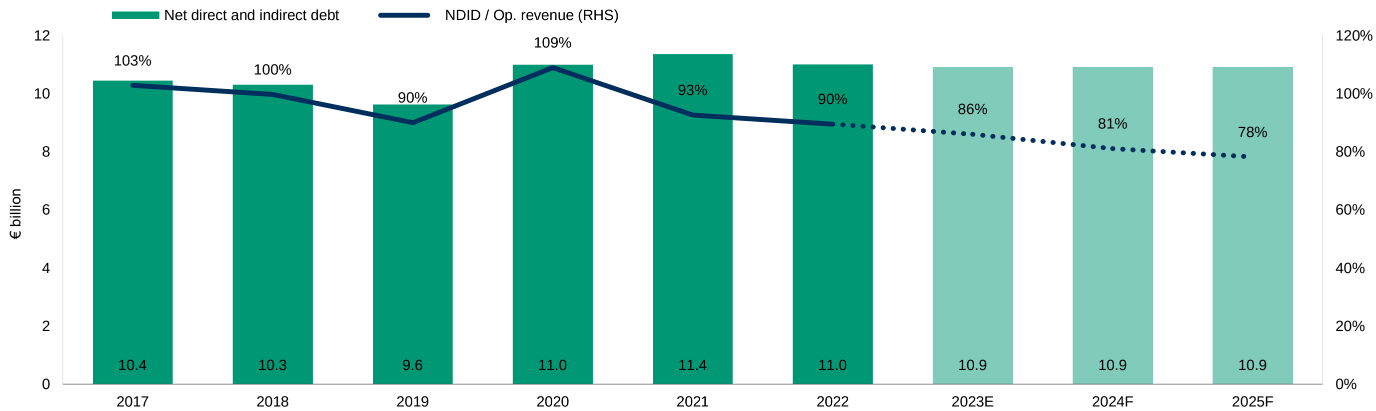
While improving still high debt burden

Although the region's net direct and indirect debt (NDID) stock has been historically low, it increased rapidly in the last decade, rising to a record-high of €11 billion in 2022 from €7.8 billion in 2012. Despite this increase, the region's direct debt decreased by €247 million in 2022 to €10.4 billion, on the back of an agreement with the central government to reduce the debt raised to cover pandemic-related spending, which was ultimately not used.

The Basque Country's indirect debt in 2022 also decreased because of lower indirect debt from its public sector and decreasing guarantees of €286 million (€305 million in 2021). These guarantees were largely provided directly to the public administration or through mutual-guarantee companies (Sociedades de Garantía Recíproca), which pose very low risk to the region's finances.

As a result of the Basque Country's lower NDID, its debt-to-operating revenue ratio decreased to 90% in 2022 from 93% in 2021, remaining well below the average for rated regions of around 176% in 2022. Following the abovementioned agreement on the region's debt reduction with the central government, we expect further debt reduction of around €104 million in 2023. We forecast the region's debt-to-operating revenue ratio to decrease to around 86% in 2023, on the back of lower NDID and higher tax revenue collection expected for the year. We also believe the region's debt levels will stabilise from 2024 onward, with the debt burden declining to around 78% by 2025, as Spain's positive economic prospects boost operating revenue.

Exhibit 3
The Basque Country's debt burden will continue to decrease in the next three years



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Sources: Issuer and Moody's Investors Service

In addition, the region's prudent debt management is reflected in its low average debt cost of 1.75% and an average debt life of 8.4 years as of year-end 2022. Also, all of its debt is euro denominated and most of its debt stock is contracted at fixed rates, with moderate exposure to variable-rate debt of 18% as of year-end 2022.

Since 2018, the Basque Country has been a regular issuer of sustainable bonds in capital markets, which has fostered positive relationships with financial institutions. In 2022, the region covered part of its annual funding needs of €1.2 billion via bond issuances, including a sustainable bond of €500 million issued in April 2022. In 2023, the Basque Country will cover its annual funding needs of around €1.2 billion by both its own resources and debt from the financial market. In February 2023, the Basque Country successfully raised €700 million via a sustainable bond issuance with strong demand from a diversified investor base. We do not expect the region to contract more debt in this year.

The Basque Country has a very strong cash position, with cash reserves of around €4.1 billion as of year-end 2022, equivalent to 33% of its operating revenue and 39% of the region's direct debt in 2022. The region also had an additional €800 million in available credit facilities, which were not drawn as of December 2022. We expect the region to continue to retain a high volume of cash on hand of close to €3.4 billion as of year-end 2023.

Extraordinary support considerations

We view the Basque Country as having a high likelihood of receiving extraordinary support from the Government of Spain in the event that it faces acute financial distress, reflecting our assessment of the risk to the government's reputation if the region were to default. The region's role in providing crucial services, such as healthcare and education, and its presence in the capital markets are further incentives for the central government to provide support, if necessary. This assessment is corroborated by the consistent track record of central government support for Spanish regions in recent years, as illustrated by the launch of the regional liquidity facilities, the Fondo de Liquidez Autonomico and the Fondo de Facilidad Financiera, as well as the extraordinary transfers from the central government to mitigate the effects of the coronavirus pandemic on the regions' finances in 2020 and 2021.

ESG considerations

The Basque Country's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 4
ESG Credit Impact Score

CIS-2
Neutral-to-Low

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

Source: Moody's Investors Service

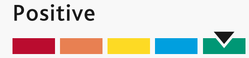
The Basque Country's ESG considerations do not have a material impact on the current rating. Its ESG Credit Impact Score (**CIS-2**), reflects low exposure to environmental risks, moderate exposure to social risks and very strong governance and in general strong capacity to respond to shocks.

Exhibit 5
ESG Issuer Profile Scores

ENVIRONMENTAL
E-2
Neutral-to-Low

SOCIAL
S-3
Moderately Negative

GOVERNANCE
G-1
Positive



Source: Moody's Investors Service

Environmental
The Basque Country's exposure to environmental risks are not material in differentiating credit quality.

Social
The Basque Country has a moderate credit exposures to social risks. We have assigned an issuer profile score of (**S-3**), reflecting good housing availability, education, health & safety, and access to basic services. However, the region faces moderate credit exposure with regards to population ageing, which puts pressure on healthcare and social spending. Spanish regions are responsible for healthcare, which typically represents around 40% of their expenses.

Governance
The Basque Country's governance profile is captured by a positive G issuer profile score (**G-1**). This is underpinned by its strong budget management by implementing budgetary control plans. The region also provides transparent and timely financial reports. This contributes to its relatively strong resilience to S risks, along with very high wealth levels.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Rating methodology and scorecard factors

The assigned BCA of a3 is in line with the scorecard-indicated BCA. The matrix-generated BCA of a3 reflects an Idiosyncratic Risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and a Systemic Risk score of A2. In the case of the Basque Country, the Systemic Risk of A2 exceeds the sovereign bond rating by two notches, which reflects the fiscal flexibility derived from its unique institutional framework.

For details about our rating approach, please refer to our Regional and Local Governments rating methodology, published on 16 January 2018.

Exhibit 6
The Basque Country
Regional and local governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals				**2.20**	**20%**	**0.44**
Economic Strength [1]	1	121.79%	70%			
Economic Volatility	5		30%			
Factor 2: Institutional Framework				**2**	**20%**	**0.40**
Legislative Background	1		50%			
Financial Flexibility	3		50%			
Factor 3: Financial Position				**2.50**	**30%**	**0.75**
Operating Margin [2]	3	7.05%	12.5%			
Interest Burden [3]	3	1.21%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	5	89.56%	25%			
Debt Structure [5]	1	7.21%	25%			
Factor 4: Governance and Management				**1**	**30%**	**0.30**
Risk Controls and Financial Management	1					
Investment and Debt Management	1					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						**1.89 (2)**
Systemic Risk Assessment						**A2**
Suggested BCA score						**a3**
Assigned BCA						**a3**

[1] Local GDP per capita as a percentage of national GDP per capita.
[2] Gross operating balance/operating revenue.
[3] Interest payments/operating revenue.
[4] Net direct and indirect debt/operating revenue.
[5] Short-term direct debt/total direct debt.
Source: Moody's Investors Service (fiscal 2022)

Ratings

Exhibit 7

Category	Moody's Rating
BASQUE COUNTRY (THE)	
Outlook	Stable
Issuer Rating	A3
Senior Unsecured -Dom Curr	A3

Source: Moody's Investors Service

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