

CREDIT OPINION

29 April 2019

Update

 Rate this Research

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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Basque Country (The) (Spain)

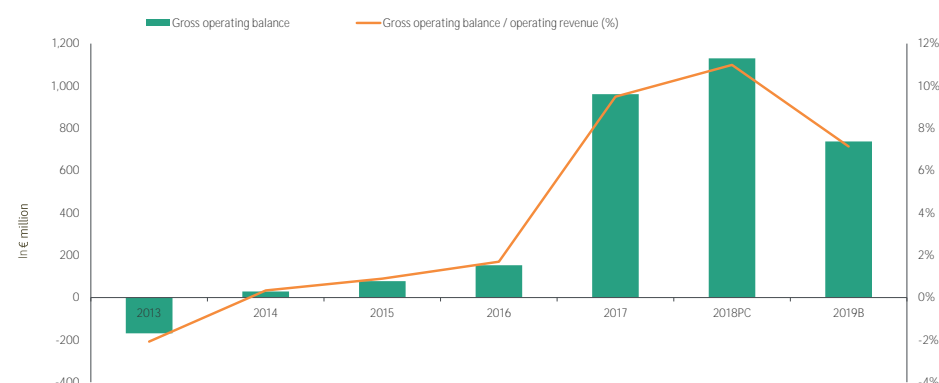
Update to credit analysis

Summary

The credit profile of the [Basque Country \(A3 stable\)](#) exceeds the Spanish sovereign rating by one notch, reflecting the region's unique and constitutionally protected tax regime, which provides it with a higher degree of fiscal flexibility compared with that of other Spanish regions, as well as its improved fiscal performance in recent years. The Basque Country benefits from good access to capital markets. Its debt stock was equivalent to 100% of operating revenue as of year-end 2018, and the region has always complied with the deficit limit targets set by the central government; it posted a surplus in European System Accounts terms in 2018 for the second consecutive year.

Exhibit 1

The Basque Country continues to improve its operating performance



PC= Pre-closing; B=Budget.
Source: Moody's Investors Service

Credit strengths

- » A high degree of fiscal flexibility because of the region's unique legal status
- » Good access to capital markets
- » Strong fiscal performance
- » A strong and diverse economic base

Credit challenges

- » Rapid increase in direct debt levels during the economic crisis

Rating outlook

The outlook is stable, reflecting the stable outlook on the [Government of Spain's \(Baa1 stable\)](#) rating.

Factors that could lead to an upgrade

A strengthening of Spain's sovereign 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 implications for the Basque Country's rating.

Key indicators

Exhibit 2

The Basque Country

	2013	2014	2015	2016	2017	2018PC	2019B
Gross Operating Balance as a % of Operating Revenue	-2.1	0.3	0.9	1.7	9.5	11.0	7.1
Capital Expenses as a % of Total Expenses	11.6	10.7	8.7	9.4	9.9	9.8	10.2
Self Financing Ratio	0.3	0.4	0.4	0.5	1.1	1.3	0.8
Financing Surplus(Deficit) as % of Total Revenue	-8.6	-6.9	-6.0	-5.3	1.2	2.7	-1.6
Interest Expenses as a % of Operating Revenue	2.7	2.9	2.6	2.2	1.8	1.8	2.3
Gross Borrowing Need as a % of Total Revenue	10.9	12.2	13.7	11.4	5.2	8.9	12.0
Net Direct and Indirect debt as a % of Operating Revenue	108.8	110.6	113.8	114.4	103.2	100.4	101.5

PC= Pre-closing; B=Budget.

Sources: Moody's Investors Service, issuer

Detailed credit considerations

The credit profile of the Basque Country, as expressed in the region's A3 rating, combines (1) a Baseline Credit Assessment (BCA) of a3, and (2) a very high likelihood of receiving extraordinary support from the three Basque provinces in the event the entity faces acute liquidity stress.

Baseline Credit Assessment

A high degree of fiscal flexibility derived from the region's unique legal status

The region and its three constituent provinces (Guipuzcoa, Alava and Biscay) benefit from a unique tax regime under 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 between 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 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, and is set according to the Basque Country's administrative workload. Generally, the region receives 70% of 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. We are not aware of any indications that this arrangement is likely to change in the near future.

The Basque Country benefits from good access to capital markets

The Basque Country benefits from a good relationship with financial institutions, and it easily covered its funding needs in 2018. The region has financed 76% of its requirements via bond issuances, raising €966 million in 2018 (44% or €326 million in 2017), including its first sustainable bond of €500 million in June 2018.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

In 2019, the Basque Country has to raise €831 million, a large proportion of which have already been covered by bond issuances. The Basque country successfully issued a sustainable bond issuance of €600 million on 25 April 2019, the highest bond issuance in the region's history. This 10-year issuance benefited from high international demand, including 71% of non-domestic investors. In addition, the region has also issued a private placement bond of €150 million due in 30 years.

Strong fiscal performance

The Basque Country's gross operating balance (GOB)-to-operating revenue ratio fell to an average of -3% between 2011 and 2013, weighed down by the economic crisis. However, the region's GOB has improved significantly since 2014, coming back to the pre-crisis levels and reaching an estimated surplus of €1.1 billion, or 11% of operating revenue in 2018, up from 9.5% in 2017. The improvement was largely the result of a 1.6% increase in taxes collected by the three Basque provinces, the proceeds of which were redistributed to the Basque Country. The increase in tax collection was a consequence of the far-reaching fiscal reform adopted by the provinces in 2014. At the same time, operating expenditure decreased by 0.2% in 2018, supporting the GOB improvement for the year.

The improvement in the GOB counteracted the 13% decrease in capital revenue during the year, together with a 1.6% decrease in capital spending, leading to an estimated financing surplus of €283 million, or 2.8% of operating revenue in 2018 (a surplus of 1.2% in 2017); this is a second consecutive surplus since the onset of the financial crisis in 2007.

As calculated under the European System Accounts, the Basque Country had a surplus-to-GDP ratio of 0.68% in 2018 (1.5% in 2017). As one of the five regions that posted a surplus in 2018, it complied amply with the 2018 deficit target of -0.4% of GDP. The deficit ceiling for 2019 has been set at 0.1%, and we believe the Basque Country is unlikely to need further consolidation efforts to achieve this target.

A strong and diverse economic base

Situated on the north coast of Spain, the Basque Country is the country's second-wealthiest region (after Madrid), with a GDP per capita of €33,088 in 2017 (last available data), well above the Spanish average of €24,999.

The Basque Country's economy is diverse and has traditionally benefitted from a strong industrial base. The economy is driven by automotive sector exports to the rest of Europe and is home to one of the world's leading shipyards. In 2017, the regional GDP grew by 3.1%, in line with the national average of 3.1%. As in other Spanish regions, economic improvement has led to a fall in unemployment. The Basque Country's unemployment rate stood at 9.6% as of year-end 2018, down from 10.6% in 2017. This was the lowest among those of the Spanish regions, and far below the national average of 14.5% (16.6% in 2017).

Rapid increase in direct debt levels during the economic crisis

Although the region's net direct and indirect debt stock has historically been low, it has increased rapidly since the onset of the euro area sovereign debt crisis, rising to €10.3 billion in 2018 from €0.5 billion in 2008. However, direct debt only increased by €52 million in 2018, increasing the total direct debt stock to €9.1 billion.

In 2018, the Basque Country reported indirect debt incurred by non-self-supporting entities equivalent to 8% of operating revenue, a decrease of 9% from that in the previous year. Guarantees also decreased to €377 million in 2018 from €451 million in 2017 and were largely provided directly to the public administration or through mutual-guarantee companies (Sociedades de Garantía Recíproca), which we believe pose very limited risk.

The region's ratio of net direct and indirect debt to operating revenue saw a reversal in 2017, and continued to do so in 2018, decreasing to 100% from 103% in 2017, as the economic recovery led to faster operating revenue growth. The Basque Country's debt burden remained well below the regional sector average of around 200% in 2018. We expect this trend to continue in 2019 on the back of higher operating revenue and lower funding needs.

The Basque Country has a strong cash position, with cash reserves of around €1.4 billion as of year-end 2018, reaching the pre-crisis levels for the first time. The region also had €800 million in credit line facilities available, which were not drawn as of year-end 2018. These reserves and credit lines would allow the Basque Country to cover all its financing needs for the next 12 months (including annual debt repayments of €1.1 billion in 2019). It has a substantially stronger position than that of its national peers.

Extraordinary support considerations

We view the Basque Country as having a very high likelihood of receiving extraordinary support from the three Basque provinces (Guipuzcoa, Alava and Biscay) in the event that the Basque Country faces acute financial distress. The very high likelihood of support reflects the unique institutional framework of the Basque Historical Territories (Territorios Forales), as the three provinces are also known. Given the three province's atypical fiscal regime in Spain, we view reputational risk as an incentive for them to provide support to the Basque Country in the event of financial distress.

Rating methodology and scorecard factors

The assigned BCA of a3 is above the scorecard-indicated BCA of baa1. The matrix-generated BCA of baa1 reflects (1) an Idiosyncratic Risk score of 3 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) 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, 16 January 2018.

Exhibit 3

The Basque Country Regional and Local Governments

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	99.31	70%	5	20%	1.00
Economic volatility	5		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	2	20%	0.40
Financial flexibility	3		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	9.23	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	3	1.84	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	100.44	25%			
Short-term direct debt / total direct debt (%)	3	13.30	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.75(3)
Systemic Risk Assessment						A2
Suggested BCA						baa1

The above scorecard includes 2018 pre-closing figures.

Source: Moody's Investors Service

Ratings

Exhibit 4

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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