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CREDIT OPINION
19 December 2022

Update

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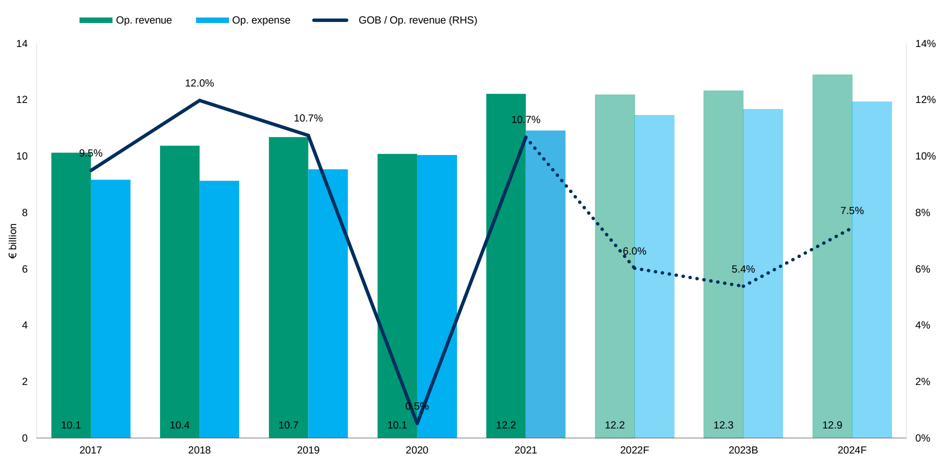
The Basque Country (Spain)

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”. Although the coronavirus pandemic has led to increased healthcare costs and lower tax revenue, weakening the region's gross operating balance (GOB) in 2020, the region's operating performance quickly recovered in 2021, with its GOB-to-operating revenue ratio reaching the pre-pandemic levels.

Exhibit 1
The pandemic significantly hurt the Basque Country's operating performance in 2020



B = Budget; 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 despite the pandemic-induced disruption

» A strong and diversified economic base

Credit challenges

» Increasing debt levels in recent years

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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Rating outlook

The outlook on the Basque Country's rating is stable. While the region's finances were significantly hurt in 2020 by lower tax revenue as a result of the pandemic, its performance quickly recovered in 2021, and we expect the tax revenue to remain higher than pre-pandemic levels over the next two 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	2022F	2023B	2024F
Gross Operating Balance as a % of Operating Revenue	9.5	12.0	10.8	0.5	10.7	6.0	5.4	7.5
Capital Expenses as a % of Total Expenses	9.9	9.6	10.8	9.6	9.4	13.1	13.4	-
Self Financing Ratio	1.1	1.4	1.1	0.2	1.5	0.7	0.8	-
Financing Surplus(Deficit) as % of Total Revenue	1.2	3.9	0.8	-8.4	4.6	-4.1	-3.2	-0.4
Interest Expenses as a % of Operating Revenue	1.8	1.7	1.7	1.4	1.2	1.1	1.7	1.6
Gross Borrowing Need as a % of Total Revenue	5.2	7.6	11.8	15.2	0.6	10.0	9.2	-
Net Direct and Indirect debt as a % of Operating Revenue	103.2	99.4	90.1	109.1	93.0	90.7	90.5	84.3

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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 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 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 next five years.

Strong fiscal performance despite the pandemic-induced disruption

After a weak GOB of €52 million reported in 2020 because of the pandemic, which resulted in lower tax revenue collection and higher healthcare expenditure, the Basque Country registered a high GOB of €1.3 billion in 2021, equivalent to 10.7% of its operating revenue (0.5% in 2020). This significant improvement was mainly explained by a 21% year-over-year growth in operating revenue, which outpaced the operating expenditure growth of 9%. The increase in operating revenue came on the back of a quick recovery in tax revenue collection as the regional economy recovered, and the contribution from central government grants of €645 million to help mitigate the impact of the pandemic on the region's finances (€568 million received in 2020). Including capital revenue and expenditure, the region reported a financing surplus of 4.8% of operating revenue in 2021 versus a deficit of 8.6% in 2020.

As calculated under the European System Accounts (ESA), the Basque Country reported a financing surplus of 0.9% of regional GDP in 2021, compared with a financing deficit of 0.8% in 2020. For 2022 and 2023, the central government set deficit-to-regional GDP reference rates for "foral" regime regional governments of 0.9% and 0.6%, respectively. These reference rates differ from the ones set for common regime regions of 0.6% and 0.3% for 2022 and 2023, respectively.

While the Basque Country's credit profile is better than that of other Spanish regions, the negative effects of the pandemic in 2020 and 2021 have been stronger for this region, mainly because of its fiscal autonomy, than for other regions of the common regime, for which transfers from the central government were guaranteed in both years.

We expect higher inflation and energy costs, caused by the Russian military invasion of Ukraine, to exert pressure on the region's operating expenditures, but the Basque Country will likely continue to record positive GOBs of 6%-8% of operating revenue for the following two to three years, mainly supported by the region's strong budget management, which is reflected in the Governance score (G-1) in its ESG Credit Impact Score. This expectation is corroborated by outstanding tax revenue collection for the three basque provinces from January to September 2022, which was already 9.5% higher year over year.

In addition, the Basque Country will receive around €1 billion of Next Generation EU funds for 2021-23, of which around €401 million were received as of year-end 2021.

A strong and diversified economic base

Situated on the north coast of Spain, the Basque Country has 2.1 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 €30,401 in 2020 (latest available data at the regional level), well above the Spanish average of €23,693.

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 2020, the regional GDP growth was -10.9%, similar to the national GDP growth of -10.8%. According to the Basque Country's statistical institute, the region's real GDP grew to around 5.9% by year-end 2021, mainly driven by outperforming exports. Despite the current geopolitical situation affecting its main trading partners' economic activity, the Basque Country expects the regional economy to continue to recover, recording around 4.3% of GDP growth in 2022 but decelerating in 2023 to around 2.1%.

Similar to that in many other regions, economic recovery after the pandemic led to a reduction in unemployment. As of September 2022, the Basque Country reported an unemployment rate of 8.3%, down from 9.9% a year earlier. Basque Country's unemployment rate was the lowest among those for other Spanish regions, and far below the national average of 12.7% in Q3 2022 (14.5% in 2021).

Increasing debt levels in recent years

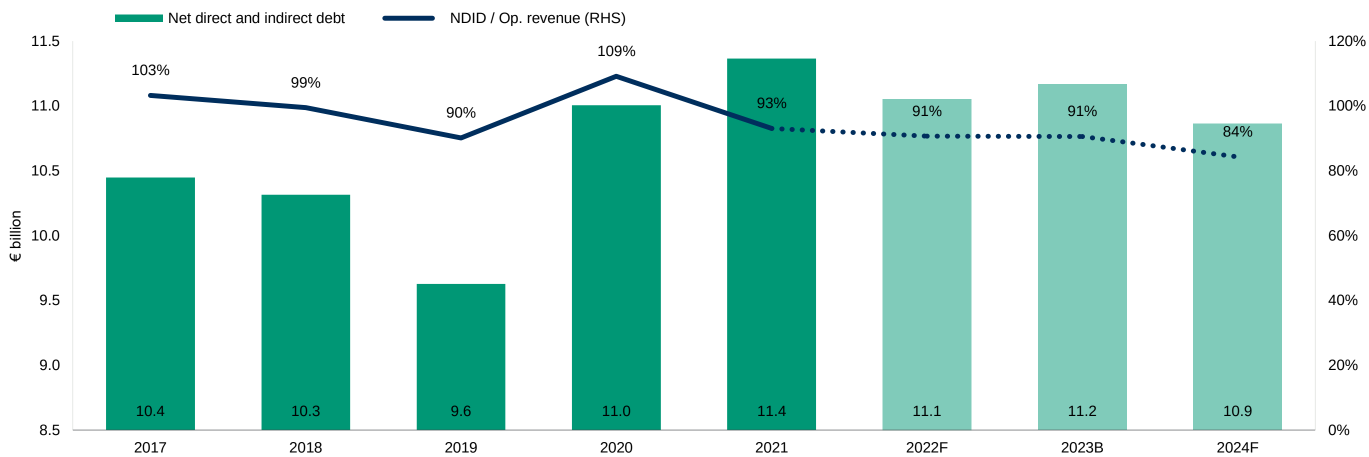
Although the region's net direct and indirect debt stock has historically been low, it has increased rapidly in the last decade, rising to a record-high of €11.4 billion in 2021 from €6.4 billion in 2011. The region's direct debt increased by €535 million as of year-end 2021 on the back of higher allowed deficit target for the region to fund the pandemic-related spending.

In 2021, the Basque Country reported lower indirect debt incurred by non-self-supporting entities of €584 million, equivalent to around 5% of operating revenue (€745 million in 2020). Guarantees continued to decrease, reaching €305 million in 2021 from €326 million in 2020 (€875 million in 2011), 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.

As of year-end 2021, the region's ratio of net direct and indirect debt to operating revenue decreased to 93% from 109% in 2020, on the back of a quick recovery in its revenue collection. The Basque Country's debt burden remained well below the regional sector average of around 167% in 2021. We expect the region's debt burden to continue to decrease over the next two years to around 91% as of year-end 2022 and around 84% in 2024. In 2020 and 2021, the central government authorized the Basque Country to issue higher debt than its real funding needs for the year to mitigate the impact of the pandemic in its finances, and the region ended up with a debt excess of €1.6 billion. As agreed with the central government, the region will start reducing its debt in the next five years by raising less debt than its funding requirements and early amortizations (€315 million in 2022).

Exhibit 3

The Basque Country's debt burden will slowly decrease in the following years



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Sources: Issuer and Moody's Investors Service

The region's prudent debt management is reflected in its low debt cost of 1.26% on average and a growing average debt life of 8.45 years in 2021. In addition, all its debt is euro denominated and most of its debt stock is contracted at fixed rates, with 21.9% of variable-rate debt as of 2021.

Being a frequent sustainable bond issuer in capital markets since 2018, the Basque Country benefits from good relationships with financial institutions. The region easily covered its 2021 funding needs of €1.2 billion via bond issuances — by extending an existing bond of €200 million in March 2021 and issuing an 11-year sustainable bond of €1 billion in April 2021. The Basque Country raised €500 million through a sustainable bond issuance in April 2022, supported by the good international demand of the region's sustainable securities.

The Basque Country has a very strong cash position, with cash reserves of around €4.5 billion as of year-end 2021. The region also had an additional €1.2 billion in available credit facilities, which were not drawn as of December 2021. Because of its large cash buffer, these credit facilities were reduced to €800 million in 2022. We expect the region to continue to retain a high volume of cash on hand, at close to €3.8 billion by year-end 2022 (€3.7 billion as of September 2022).

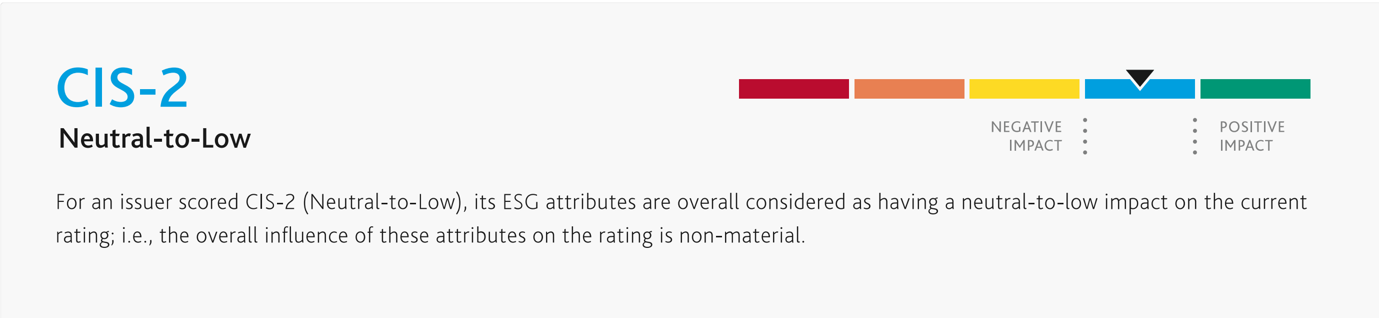
Extraordinary support considerations

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

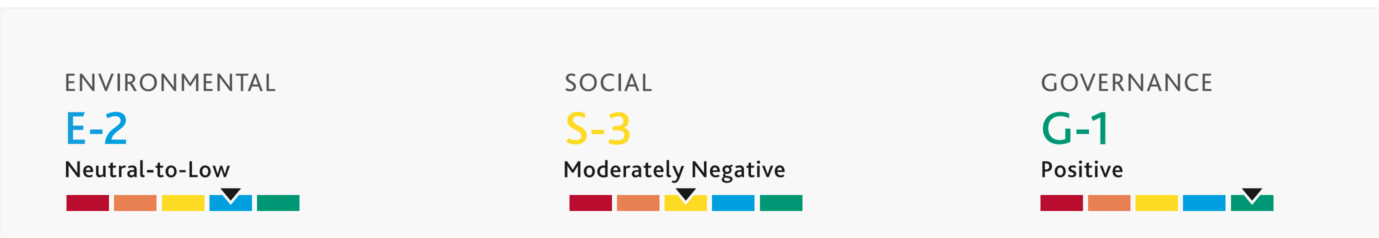
Exhibit 4
ESG Credit Impact Score



Source: Moody's Investors Service

The Basque Country's ESG Credit Impact Score is neutral-to-low (**CIS-2**), reflecting 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



Source: Moody's Investors Service

Environmental

The Basque Country's exposure to environmental risks is low across all categories. Its overall E issuer profile score is therefore neutral-to-low (**E-2**).

Social

We assess The Basque Country's social issuer profile score as moderately negative (**S-3**), reflecting good housing availability, education, health & safety, and access to basic services. However, the region faces moderate negative risks 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. The coronavirus pandemic has also affected to the region's credit profile through negative economic growth and higher healthcare expenses in 2020.

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	128.64%	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	7.79%	12.5%			
Interest Burden [3]	3	1.34%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	5	93.03%	25%			
Debt Structure [5]	1	6.30%	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**
Scorecard-Indicated BCA Outcome						**a3**
Assigned BCA						**a3**

[1] Local GDP per capita as % 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 2021

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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