Methodological Assumptions
SUB-SOVEREIGN RATING

1. Methodological Framework

This document describes the methodology developed by Axesor Rating for the issuance of sub-sovereign ratings (SMRs), as well as the long and/or short-term debt instruments issued by these types of issuers.

The credit rating assigned by Axesor Rating measures the capacity and willingness of the sub-sovereign government to meet its financial obligations in a timely fashion.

For the evaluation we use macroeconomic, social, financial and political information (as well as any other information that we consider necessary for the rating of the RLG), from regional, national and international statistical offices of recognized prestige, as well as information provided by the sub-sovereign government itself (in the case of solicited rating).

The rating process described consists of two pillars:

- **Quantitative factors**: which assesses the socio-economic conditions and the intrinsic financial situation of the SMR (budgets, debt and liquidity) that determine its ability to meet its financial obligations in a time and form.

- **Qualitative factors**: with which we evaluate the institutional framework, the governmental situation of the SMR, the supervision and control mechanisms, the relationship of the SMR with the rest of the levels of government that, in short, determine the willingness to attend to its obligations in time and form.

The explanatory factors for each pillar are measured by scales that evaluate the quality of each metric, giving a score ranging from 10 (worst) to 1 (best).

Both pillars provide a preliminary score (PS) that can be adjusted (up or down) depending on our future forecasts, the outlook for the management team and/or the level of sovereign support in the event of financial stress.

Finally, this methodology will map the numeric rating resulting from the analytical process into the scale “Axesor Long-Term Sovereign and Sub-Soveign Credit Scale” (available for consultation on the website). In addition, the rating is accompanied by an outlook (over the next year) depending on the prospects of both the sector and the performance of the company (Outlook Methodological is available on the website).

The methodology has been developed considering the influence of environmental, social and governance (ESG) criteria on the capacity and willingness of LGNs to meet their financial commitments in time and form. To this end, and within both the quantitative and qualitative pillars, we include various metrics with which we assess the progress of the LGN in these aspects.

Given the interdependence between the sovereign and sub-sovereign governments, the sovereign rating acts as a ceiling, with certain exceptions. The exceptions, although few, are rare and refer to those SMRs with broad fiscal powers that have been devolved, excellent levels of liquidity and/or autonomy to access alternative sources of financing, among others. In these cases, the final rating could be up to one notch above the sovereign rating.

Finally, it should be noted that the methodology described should be understood in a flexible manner given the dynamic nature of the segment it addresses. Therefore, the importance of the factors described throughout this methodology may vary in order to adapt the analysis to these changes, including new factors if necessary.

2. Scope

We consider regional and local governments to be sub-levels of sovereign government that are entrusted with a certain level of public services (mainly education, health, transport and waste management), and for whose financing have resources that are legally recognised (basically taxes, fees and transfers received from other government units), including the power to establish certain regional and/or municipal taxes or fees.

Decentralised bodies, instrumental entities and independent companies are excluded from the scope of this methodology, although for the definitive rating of the SMR we consider the existing relations between them.

3. Quantitative factors analysis

In the quantitative pillar we measure the capacity of the LGN to meet its financial obligations based on a quantitative analysis of several factors (KPIs) which are grouped into the following categories:

- **Economic environment**: Within this category we evaluate the behaviour of its main macro-magnitudes, mainly the Gross Domestic Product (GDP), with which we not only measure the size of the RLG, but also the evolution and stability of its economy, identifying its main productive activities and comparing it with the evolution presented by the national economy and its main regional or municipal peers.

- **Social environment:** This category is part of the ESG criteria considered in our methodology. We analyse the wealth per inhabitant and the situation of the labour market, both of which condition the tax collection potential of the RLG, as well as the expenditure needs associated with the public services directly entrusted. We also evaluate the demographic situation and the degree of population ageing.

- **Public finances:** We value the ability of the RLG to meet its financial obligations. To this end, we evaluate budgetary stability, its dependence on resources from higher levels of government, the evolution of the main expenditure items, the level of investment and the tax burden of the territory. We also consider their level of debt, structure (instruments and terms), commercial debt and liquidity levels, all in the context of any regulatory restrictions that may exist.

Each category has an established weight in the final score of the business profile, as indicated in the table below:

Economic risk profile (Quantitative pillar)	
	Weight/ total
Macroeconomic environment	**20%**
Economic environment	*10%*
Social environment	*10%*
Public Finances	**60%**
Fiscal situation	*20%*
Public Debt	*20%*
Liquidity	*20%*

4. Qualitative factor analysis

Within this pillar we assess the political risk, i.e. the willingness of the SMR to meet its financial obligations.

We also evaluate the institutional structures that underlie the economic system of the SMR, which are particularly important in promoting economic growth, as well as their relationship with higher levels of government.

Specifically, the analysis of this pillar focuses on two categories:

- **Institutional framework**: in which we evaluate the strength of its institutions and relations with higher levels of government, the powers ceded and the fiscal powers of the SMR, with a special interest in evaluating the capacity of the SMR to adapt its sources of income to the different phases of the economic cycle. We also review the existing supervision and control instruments and the compliance of the SMR with the established regulatory requirements (e.g. budgetary stability objectives and debt limits).

- **Government:** We assess the government's situation, its stability, the capacity to prepare, approve and execute budgets, as well as transparency and consistency in the publication of information, among others. In this regard, we observe the parliamentary composition of the RLG, whether there is a majority or stable government through government agreements with the rest of the political parties, or whether on the contrary it is a minority or unstable government, since this situation could lead to a non-confidence vote that would end up raising the level of uncertainty and distancing itself from compliance with the established budgetary plan.

Each category has an established weight in the final score of the business profile, as indicated in the table below:

Political risk profile (Qualitative pillar)	
	Weight/ total
Institutional framework	**15%**
Government	**5%**

This document updates the previous version while preserving its original methodological assumptions; therefore, all existing ratings remain unchanged.