Utility Credit Rights Securitisation Rating Criteria

Sector-Specific

Scope

This report describes Fitch Ratings' methodology for analysing credit risk in utility credit rights securitisations in Portugal, Spain and Chile. The assumptions are used for rating new and existing utility credit rights securitisation transactions. Utility credit rights are regulatory assets established by law, offering the owner the right to a future cash flow stream sourced from a largely diversified obligor base, for the delivery of basic services like electricity, gas or water.

The ratings address the relative vulnerability to a default of the notes, with regards to the receipt of interest and principal, in accordance with the terms of the notes' documentation. The following key rating drivers are analysed and are equally important within the overall rating assessment.

Key Rating Drivers

Sovereign/Subnational Risk: The maximum rating of utility credit rights securitisations is three notches over the sovereign or subnational Issuer Default Rating (IDR). The delivery of essential services, such as electricity, gas or water, is dependent on the economic strength of a country and its legal framework; therefore, delinking the credit profile of utility cash flow from the IDR is possible only to a limited extent. Fitch may use a subnational IDR as an alternative, if the obligor base and the governance of the sector relates to a specific region.

Utility System Sustainability: The repayment of utility credit rights is an obligation of the utility system as a whole, and therefore the ratings of utility credit rights securitisations are influenced by the long-term economic profile of the respective industry. If Fitch considers the industry to be exposed to material financial imbalances, FX volatility and/or regulatory uncertainty, utility credit rights securitisation ratings could be lower than the sovereign or subnational IDR.

By 'utility system' we mean the group of public and private companies, institutions and activities involved in the production, transmission and distribution of utility services, as well as the entire base of present and future utility consumers, considered jointly in a given country or region.

Regulatory Environment: The powers and the independence of the industry regulator are critical factors in determining whether the securitisation ratings can be higher than the sovereign or subnational IDR. This is because the repayment of the securitisation notes also depends on the regulatory framework supporting the utility credit rights.

Legal Analysis of Credit Rights: Adequate legal recognition, transferability and ring-fencing of the utility credit rights is often established under applicable law. Utility credit rights are typically not exposed to set-off or commingling risk in the event of obligors or suppliers defaulting, and, in some instances, their repayment schedule is prescribed by law. Structural mitigants within a securitisation proposal should mitigate these risks, if not fully addressed by the legal framework.

Payment Interruption Risk: Fitch believes most utility suppliers can be replaced in an orderly manner, even in stress scenarios, because continuity of service is a national interest. However, the replacement could produce temporary cash flow mismatches and payment interruption risks, which may be mitigated by the securitisation structure.

Table of Contents

This report updates and replaces the *Utility Credit Rights Securitisation Rating Criteria*, dated *16 December 2020*.

Related Criteria

Global Structured Finance Rating Criteria (October 2021)

Single- and Multi-Name Credit-Linked Notes Rating Criteria (February 2021)

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Sovereign/Subnational Risk

Fitch considers that regulated utility credit rights and their associated cash flow are supported and influenced (ie, positively and negatively) by the economic strength of a country and the stability or volatility of its legal and institutional framework. The agency believes these factors are expressed by the sovereign Foreign-Currency (FC) or Local-Currency (LC) IDR, depending on the currency of the rated notes, as a starting point, given the sensitivity of the sovereign IDR to recessionary factors, such as high unemployment rates, decreasing consumption, private and public leverage and fiscal policy tightening. A subnational IDR would be taken into account in those instances when the obligor base and the governance of the utility sector relates to one specific region or municipality.

Because the supply of utility services like water, electricity and gas is an essential service and its continuity and affordability ranks as a national interest, Fitch believes its governance and operating environment is influenced by policy makers when designing short-, medium- and long-term strategies.

Utility credit rights securitisations will be ultimately repaid if the respective service (eg, electricity, gas or water) is made available to end-consumers at an affordable price, while allowing the sector regulator to enforce tariff charges that fully cover system costs, inclusive of past shortfalls (if any). These shortfalls are caused when regulated revenues do not cover regulated costs.

The maximum achievable rating of utility credit rights securitisations is three notches higher than the sovereign or subnational IDR, as long as the assessments of both the utility system's sustainability and the regulatory environment meet the criteria for a three-notch uplift.

However, in instances in which Fitch assesses, as described below, that the sustainability of the system, regulatory environment and/or legal framework has weaker attributes, a notching differential of zero to negative notches from the relevant IDR may be applied. The significance of the above-mentioned factors to the ultimate notching decision will vary according to the specifics of the transaction; but, for those transactions with a combination of multiple weak attributes, Fitch may apply a wider differentiation from the sovereign or subnational IDR or even decline to rate the transaction. Therefore, the final notch differential between the securitisation rating and the anchor IDR is dependent on the combined assessment of the utility system's sustainability and the regulatory framework, as described in the sections below.

Fitch's central expectation is that macroeconomic trends and regulatory policies have a direct impact on the equilibrium of the utility systems and in turn, on the payment of utility credit rights. Additionally, in some jurisdictions, where end-users bills are denominated in local currency while the utility rights are denominated in a foreign currency, as in the case of Chile the equilibrium might also be affected by FX volatility. Fitch also considers that the governance of the utility sector and its legal framework are exposed to political and fiscal intervention. For example, a sovereign under stress might decide to increase tariffs to a point where demand could suffer, or on the contrary, it could maintain artificially low end-user tariffs to support a specific political interest.

In most cases, Fitch views utility system revenues as more robust and less volatile than the overall pattern of consumption in the economy. This is based on the assumption that individuals and companies will make timely payments on their utility bills ahead of many other financial commitments, even in periods of stress, as users defaulting on their payments run the risk of disconnected by the utility supplier. Nevertheless, utility system revenues are not immune to recessionary headwinds and are affected by weaker demand volume and increasing credit write-offs, as shown by sector statistics and the financial statements of domestic utility companies.

When there are explicit third-party guarantees on utility credit rights securitisations, the guarantor's credit profile can be considered a rating floor. This also applies for non-guaranteed securitisations when Fitch considers the guarantor of other similar securitisations to have a strong incentive, such as reputational and or legal risk, to ensure system stability by avoiding the hypothetical default of non-guaranteed obligations. Fitch will only consider this incentive to exist when the non-guaranteed obligations represent a residual amount over total system debt, typically below 10%.

Fitch may elect not to rate Securitisations of utility credit rights exposed to refinancing risk without the appropriate structural mitigants. A transaction is exposed to refinancing risk when there are cash flow mismatches between assets and liabilities. In cases in which there is refinancing risk and the notes benefit from an irrevocable and first demand guarantee, the ratings will be linked to the rating of the guarantor, in line with our Single- and Multi-Name Credit-Linked Notes Rating Criteria.

Utility System Sustainability

The economic profile of the utility system influences its ability to repay utility credit rights, even if not exposed to volumetric or price volatility risks. A long-term assessment is relevant because utility cash flow has repayment horizons of typically between five and 15 years, with utility credit rights securitisations defining legal maturities that fall a couple of years after the scheduled maturity date of the credit rights. For securitisations with a shorter time to maturity, Fitch focuses on the expected evolution in the short term.

Fitch analyses the long-term system sustainability of each respective industry by formulating base case and stress scenarios, mainly by comparing forecasted regulated revenues and regulated costs of the utility industry and assessing key performance indicators (KPIs).

Quantitative Assumptions – Base Case Scenario

Regulated revenues are typically forecasted based on Fitch's macroeconomic projections (particularly GDP), the utility system principles that inform the tariff calibration process, third party independent consultant reports and the historic year-on-year evolution of regulated revenues. In addition, the agency accounts for expected consumption patterns, typically influenced by technological developments and demographic trends, and price forecasts linked to guidelines collected from research from relevant sector players or associations or official indications.

Regulated costs are approximated; subsidies are forecasted taking into account both existing subsidies and new subsidies that would be payable. Other regulated items, such as distribution and transmission costs, are forecasted in accordance with recent trends, regulatory framework and adjusted if additional planned investments are incorporated.

Quantitative Assumptions – Scenarios of Stress

When formulating scenarios of stress commensurate with the ratings of the securitisation notes, Fitch focuses on the key cash flow items of the utility system most affected by prolonged recessions, such as regulated revenues (affected by price and volume patterns). The most important stresses are disclosed in relevant rating communications; the magnitude of such stresses is decided on a case-by-case basis and influenced by the following factors:

- Ability of the industry regulator to apply corrective price measures: system imbalances and cash flow deficits may not be immediately compensated by a corresponding increase in regulated revenues or cost reductions, especially if the industry regulator lacks full independent powers to set access tariffs. In such situations, the stress scenario implies flat access tariffs, so regulated revenues do not adjust.

- Utility consumption: stresses are calibrated considering base case consumption forecasts and real GDP growth, as utility consumption is highly correlated to GDP patterns. For example, if consumption levels are expected to decrease in periods of economic recession, additional stresses are accommodated in the order of a 0.5-1.0 percentage point further contraction a year on a sustained manner.

- Volatility of historical data: stresses are greater if the record on regulated revenues and costs shows significant volatility, as this suggests the utility system is more vulnerable to economic downturns and changes in sector policies. This assessment is focused on regulated revenues, utility subsidies and the financing costs of potential deficits.

- The most influential components of regulated cash flow: specific stresses can be introduced to the most influential drivers affecting regulated revenues or costs. For example, sporadic utility system cash surpluses (if any) can be ignored if no certainty was available with regards to the application of such monies.

- Rating level: stresses are commensurate with the ratings of the notes. Therefore, the level of stress increases as the ratings of the notes denotes higher credit quality.
- Additionally, the interest rate of the new debt is stressed in accordance with our Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria. The base case coupon rate, which is derived from recent comparables, is stressed upwards and downwards in line with the stress described in the criteria for the highest rating notes of the transaction.

Fitch evaluates system sustainability in the base case and stressed scenarios, considering the KPIs listed in the table below.

KPIs Used to Assess System Sustainability

	Category		
	Leverage	Liquidity	Convergence
Sustainable	Outstanding utility imbalances relative to annual regulated revenues below 100%. Outstanding utility imbalances relative to annual total system revenues below 50%.	Annuities to repay imbalances relative to annual regulated revenues below 10%.	Hard deadline exists for the elimination of utility imbalances. Outstanding imbalances decreasing.
Unsustainable	Outstanding utility imbalances relative to annual regulated revenues equal or above 100%. Outstanding utility imbalances relative to annual total system revenues equal or above 50%.	Annuities to repay imbalances relative to annual regulated revenues equal or above 10%.	No credible hard deadline exists for the elimination of utility imbalances. Outstanding imbalances increasing.

Source: Fitch Ratings

The thresholds shown above for leverage and liquidity are indicative, rather than hard rules. The KPIs are not reviewed in isolation, but are complemented with the qualitative analysis of other aspects, such as regulatory independence or legal framework stability.

New utility imbalances are typically financed in the first instance (and over the short term) by the utility companies, as is the case of electricity tariff deficits. However, the long-term credit worthiness of the utility credit rights is not reliant on utility companies, as the payment of utility credit rights rests on the utility system as a whole.

Fitch analyses the utility system KPIs in the base case and stressed scenarios over the next three to five years. The impact on the notes relative to that of the sovereign rating or the subnational IDR can be summarised as follows.

- Three notches above the sovereign or subnational IDR, if the leverage and liquidity KPIs indicate a sustainable system from a fundamental economic perspective.
- One or two notches above the sovereign or subnational IDR when the overall assessment implies unsustainable KPIs, compensated for by regulatory independence and a clear and stable credit rights' legal framework.
- Zero or negative notches if the overall economic profile of the utility system is assessed to be materially undermined or exposed to factors such as FX volatility which ultimately can impact system sustainability.

Regulatory Environment

Reliability of sector rules and independence of the utility industry regulator are key aspects within Fitch's rating analysis. The agency considers the independence of the utility industry regulator to be of great importance for system sustainability and for the repayment of outstanding utility credit rights. Typically, regulators are empowered and mandated by law to ensure the financial sustainability of the utility system and the recovery of tariff deficits.

Independent regulators are expected to systematically adjust access tariffs for the use of the utility infrastructure, in order to recover system costs and prevent or reduce the risk of financial imbalances. An independent regulator acts without interference from any government body.

Fitch analyses the following factors when determining the degree of independence and empowerment, and the duties of the utility system regulator.

- Its mandate and independence from the government.
- Its ability to monitor and assess all utility system operators on an on-going basis, covering a variety of topics, such as:
  - compliance with the obligations defined by specific utility sector legislation and regulation;
  - compliance with the obligations defined by the concession/licences agreements in respect to the specific utility regulated activities; or
  - operational and financial performance.
- Its ability to ensure that the costs of regulated activities are covered by regulated system revenues, securing the full pass-through of costs into the tariffs, even in scenarios of weak demand. Fitch considers permanent imbalances to be symptoms of insufficient regulatory effectiveness. On the contrary, we regard occasional deviations as compatible with adequate regulatory management, as multiple risk factors can influence the functioning of the system, e.g. adverse weather conditions.

Fitch decides on the degree of rating notching differential from the sovereign or subnational IDR, depending on its assessment of the utility system and credit rights regulatory framework and the regulator's position as an independent body able to address potential system imbalances. In this sense, the impact of the regulatory environment on the distance between securitisation ratings and the anchor IDR is summarised below:

- Three notches of uplift if the regulator is regarded as truly independent and has sufficient powers to address system imbalances. The regulatory framework is assessed to be stable and predictable.
- One or two notches of uplift if the regulator is regarded as an independent body but has limited powers to effectively address system imbalances, such as inability to set access tariffs. The regulatory framework is robust but does not offer the highest levels of predictability.
- Zero or negative notches if the regulator is not regarded as an independent body and the regulatory framework is lacking stability and predictability. A very weak regulatory and governance framework could trigger extreme sector imbalances that could be subject to unconventional management strategies, such as debt restructurings, which in turn could be considered a default by Fitch. Regulatory risk becomes political risk when government interference is manifested through legislative provisions that overrule the regulation of the sector, like a retrospective change of law that jeopardises the recoverability of system costs. Political risk also materialises in systems where recurring tariff increases are required to maintain system equilibrium given macroeconomic or FX pressures, or when funds available for the payment of utility regulated costs are redirected to cover other public finance needs.

Credit Rights Legal Analysis

Because utility credit rights are created and recognised by national or subnational legislation, Fitch carefully analyses such legal provisions to assess the adequacy of the establishment and ring-fencing of the assets.

Legal recognition of the utility credit rights should be very transparent, establishing for example, outstanding balances, repayment mechanisms and deadlines, and payable interest rates, if any. The agency's analysis also considers the track record of legislative and regulatory changes, especially if adverse effects have resulted for utility credit rights or sector governance as a whole.

Legislation typically establishes that the repayment of utility credit rights is an obligation of the utility system until full amortisation. Therefore, Fitch believes the repayment of such credit rights is protected from typical sources of default risk, such as the non-performance of end-users and suppliers. In addition, the fact that the repayment is an obligation of the 'utility system' rather than of individual consumers also mitigates set-off and commingling risks.

Securitisation ratings could be lower than, or linked to, the sovereign or subnational IDR if the legal framework is affected by persistent or potential regulatory uncertainties. Moreover, if legal recognition and repayment definitions are vague or uncertain, Fitch would most likely decide not to assign a rating to the securitisation transaction.

Payment Interruption Risk

Utility suppliers act as indirect collateral servicers of utility credit rights securitisations, as they collect bill payments, in addition to supplying services to customers. Fitch's central expectation is that an orderly replacement upon the default of a supplier is possible because the supply of utility services is typically considered a key national interest and the sector regulator would manage the situation to ensure the service remained available.

However, Fitch believes that a replacement of the utility provider could produce temporary cash flow mismatches and payment interruption risks; therefore, utility credit rights securitisations may include mitigants to potential liquidity shortfalls in stress scenarios.

When Fitch's assessment concludes the replaceability of suppliers and distributors to be unlikely or uncertain, an impact analysis would be conducted to assess whether the transaction incorporates structural arrangements to mitigate any potential loss of cash flow. Fitch will consider payment interruption stress, as the longer of three months, or one payment period of the securitisation.

The agency analyses the allocation mechanism of utility system revenues to determine if any form of priority of payments or seniority is embedded in the utility credit rights. In cases when the repayment of credit rights is senior to other system-regulated costs and the system regulator continues operating independently under a scenario of stress, this seniority is considered as a mitigant to payment interruption risk.

However, when legal provisions indicate that full repayment of existing utility credit rights should be ensured, even by creating new imbalances, the agency believes such an arrangement does not provide for reliable seniority/subordination in the long term, notably in scenarios of financial instability. Hence, this form of subordination would not be considered as credit protection.

Transaction Expenses

Utility credit rights securitisations are typically structured with no credit enhancement nor excess spread protection to the notes, with cash collections being sufficient to meet transaction expenses and payments due on the notes.

When rating utility credit rights securitisation transactions, Fitch expects adequate structural mitigants to be in place (such as dedicated reserves) to cover lifetime expenses, which could be impacted for instance when a counterparty is replaced at a higher cost than initially estimated.

Rating Assumption Sensitivity

Key factors that can trigger a rating change in a utility credit right securitisation transaction include: changes to the respective sovereign or subnational rating, and/or the economic profile of the utility system; sector regulator independence and powers; the legal framework affecting the utility credit rights; and the structural arrangements of the transaction.

The following table shows rating sensitivities on a securitisation transaction assumed to be rated 'Asf', three notches above the sovereign IDR. Each sensitivity denotes the potential rating impact on the transaction from each individual parameter.

Rating Assumption Sensitivity to Individual Parameters

	Implied Rating
Defined sensitivities: stresses to the assumptions that could reduce the ratings by one full category, to non-investment grade and to 'CCCsf' or below	
i) Sovereign IDR is downgraded by one rating category	BBBsf
ii) Economic profile of the utility system is forecasted to be materially undermined	BB+sf
iii) Distressed exchange: payment terms on utility credit rights are substantially diminished	Dsf
Defined stresses	
i) The independence of the industry regulator is undermined and the regulatory framework becomes unpredictable	BBBsf
ii) Leverage and coverage KPIs are assessed to be unsustainable	BBB+sf
iii) Unexpected litigation claims imply a one-off increase in regulated costs by 50%	A-sf

Source: Fitch Ratings

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment, exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process, while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating when appropriate. A variation can be approved by a ratings committee when the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but when the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch's Ratings Definitions, available at https://www.fitchratings.com/products/rating-definitions. In addition, ratings within the scope of these criteria are subject to the limitations listed in Fitch's Global Structured Finance Rating Criteria.

Disclosures

Fitch expects to disclose the following items in its initial transaction reports and/or RAC s:

- Most important stresses linked to quantitative assessment.
- Variations to this criteria report.

Appendix: Data Sources

Criteria Development

The following data has been used in the development of the criteria assumptions:

- Performance of rated electricity tariff deficit securitizations;
- Electricity system legal framework;
- Various Fitch credit reports on EMEA and LatAm utilities; and
- Key revenue and cost items of the electricity systems.

Criteria Application

Sources of Data

Key data on the Spanish, Portuguese and Chilean electricity systems is typically sourced from the sector regulators, such as Comisión Nacional de los Mercados y la Competencia (CNMC), Entidade Reguladora dos Serviços Energéticos (ERSE) and Chilean National Energy Commission (CNE).