Structured Finance Rating Methodology – Utility Cost Recovery Charges

1. Introduction

This methodology needs to be evaluated as a whole with the document "General Structured Finance Rating Methodology" published in February 2023.

The structured finance instrument's rating, as it happens with other financial products or entities, refers to creditworthiness or solvency of instrument. The rating must be considered as a dynamic element in continuous review and predictive character because it is based on future default probabilities.

The structured finance instrument payments will depend mainly on the underlying portfolio asset's payments as well as those structural improvements designed to protect the instrument bonds payments. Therefore, the bonds' credit risk will be linked not only to the counterparty risk of the Securitization Fund's financial agents, also and especially to the collateral assets' quality and their structure.

Structured finance product's Credit rating scale: EthiFinance Ratings has a set of scales designed to determine the credit rating of an entity, using an alphanumeric system with different levels. The issued ratings range from top solvency levels to more degraded levels with the possibility of insolvency. The long-term credit rating scale and the definition of each of the rating categories can be found in the *"Credit Rating Scale & Definitions"* document that appears on the EthiFinance Ratings website.

2. Scope

The methodology described in this document applies to all receivables that are derived from regulatory-based entitlement rights whose objective is to recover extra costs that have been incurred in the different public utilities Systems (i.e., water, gas, electricity, etc.). These excess costs are generated because regulated revenues of a particular System do not cover their corresponding costs. There are two categories of extra-costs that may be recovered which in turn contain different sub-types which by way of example are:

Stranded costs which include:

- Transitional costs derived from a system that changes from a regulated oligopoly to a fully competitive market.
- Nuclear Moratoriums.
- Special cost regimes applied to regions that are difficult to access.

Costs over-runs which include:

- Costs arising from supply contract disputes.
- Tariff Deficits.

These entitlement rights can be subject to securitization or can exist as a pool of receivables and usually have defined maturities.

Those receivables that are securitized will be analysed using this rating criteria in conjunction with the Trade Receivables Structured Finance Rating Methodology. Under equivalent conditions, securities backed by utility entitlement rights can attain a higher rating than the underlying receivables in cases where securities have a structure that includes different types of credit enhancements (i.e., subordinated tranches, first-loss reserves, excess spread, etc.).

3. Utility Cost Recovery Charges Assessment

EthiFinance Ratings uses five categories in order to analyse the credit risk associated to this asset class. Each category consists of a series of analytical factors that try to reflect the principal aspects that determine the creditworthiness of the asset.

An assessment between 1 and 10 is given to each of the factors that make up each of the categories where 1 is the best valuation and 10 is the worst in terms of credit quality. The assessment of each analytical factor and subfactor is given a weight which feeds into the final numeric rating which is the weighted average of the individual numeric scores. Lastly, the final numeric score is mapped into EthiFinance Ratings rating scale, using the agency's conversion table.

Although each category is given a numeric weight, the final rating outcome considers qualitative aspects.

3.1 Sovereign Risk

The rating of the country in which the Utility System operates acts as an anchor around which the rating of the entitlement right pivots. Depending on the scores assigned to the rest of the factors, the rating of the pool of receivables will be higher, equal or lower than the country's rating.

Normally, if the entitlement right is strongly entrenched from a legal point of view, regulation is very supportive and the other factors receive high scores, these types of assets can receive a higher rating than its country rating. This is so because the payment of the utility receivables does not directly depend on the financial situation of the sovereign but rather on the capacity of the final consumers within the service area to pay their utility bills.

EthiFinance Ratings understands that both residential and corporate consumers will give priority to paying their utility bills over other obligations because utilities cover non-discretionary basic needs and because a payment default entail having the service cut off. This justifies our view that utilities consumption is more robust than general consumer trends and that under a stress scenario of a sovereign default, utility clients would continue consuming water, gas and electricity.

This factor is related to the one that analyses the economic strength of the service area which will receive a higher score when the sovereign has a better rating.

This factor will be used as an anchor once the entitlement rights have been rated on a stand-alone basis without considering the country where the utility is located. In the case that the stand-alone rating is higher than its corresponding country ceiling, the final rating will be capped by the country ceiling. If this is not the case, the final assessment will be the same as the stand-alone rating.

The country ceiling defines the maximum rating that an issuer or an asset located in a specific country can achieve. The country ceiling is calculated adding three notches to the corresponding sovereign rating.

3.2 Economic Sustainability of the Utility System

The recovery of the entitlement rights is supported by all the final consumers of the corresponding utility and therefore, the repayment of the rights depends on the sustainability of the respective System.

The ratios that are used to measure the degree of the System's sustainability are:

- Outstanding accumulated deficits over system's annual regulated revenues.
- Outstanding accumulated deficits over deficit annuities.

System's accumulated deficits is the debt arising from the accumulated over-costs that are outstanding at a given date, in other words, the System's total debt.

Regulated revenues are those established by the Regulator in order to remunerate those activities that have not been liberalized and which include the transport and distribution networks and underground storage infrastructures in the case of natural gas.

The annuity is the amount that the System must collect annually in order to repay, within the time frame established by the Regulator, the System's total debt. The annuity has a principal component destined to repay the deficits and an interest component to remunerate the cost of financing the deficits borne by the system's operators who at the time did not receive all revenues due. This annuity becomes part of the System's total regulated costs.

The first ratio measures the size of the accumulated over-costs on a given date relative to the annual regulated revenues of the System. The ratio indicates the number of years that the System would take to repay the total debt if it dedicated 100% of the regulated revenues to that end. This is a good measure of the sustainability of the System in the medium term and can be equated to the solvency of the System. A high ratio would indicate that the System is highly burdened (i.e., would take many years to repay the debt) and the solution would likely entail a hike in the utility's tariffs which could be politically unjustifiable, especially if current tariffs are already high in relation to neighbouring countries.

The second ratio indicates the average years that it takes to repay the System's debt. In principle, the repayment of a debt becomes more uncertain the longer its amortizations extend in time and therefore, higher values of this ratio indicate a higher risk and therefore a weaker rating.

3.3 Economic Strength of the service area and consumer granularity

Recovery charges are billed to the final utility consumer and therefore payments of the entitlement rights will depend on the economic strength and the granularity of the consumers who, as a whole, make up the Service Area and who ultimately must finance the System's charges.

The economic strength of an area is defined as the capacity of its inhabitants and corporates to attend the timely payment of their utility bills in full. In order to measure this sub factor, EthiFinance Ratings uses the rating of the country where the utility is located as a reference.

Regarding granularity, analysis will be performed on the degree of concentration of the client base since a highly concentrated base implies that there is a risk that a few of the largest consumer industries could relocate or go bankrupt. This is in turn would lead to a fall in demand and of the total billed revenues of the service area, reducing its capacity to remunerate its regulated costs. This sub factor will be measured calculating the weight over GDP of the largest industry in the country.

In most of the cases, when the service area extends to a whole country, its granularity will be scored between 1 and 2. Lower scores will be assigned to countries that depend significantly on a specific industry (i.e., mining, petroleum, etc.). Also, service areas that belong to a region within a country have higher probabilities of receiving lower granularity scores.

3.4 Regulatory Framework

The regulatory framework is critical in order to determine the credit quality of the entitlement rights precisely because the obligation to honor these rights is established through regulation. A high score of the regulatory framework will facilitate the pool of receivables to be rated above the sovereign rating.

In this section various factors are analyzed:

- Rank of the legal instrument that recognizes the entitlement right.
- Mechanisms designed to recuperate future payment deficits that may arise when revenues collected from the final consumer do not cover the System's costs.
- Mechanisms that protect existing rights from future regulations that could financially endanger the full repayment of the rights.
- Regulation that annually establishes the annuity that the System must collect in order to cover the recovery charges.
- Seniority of payment of the entitlement rights being rated over other regulated charges.
- Entitlement rights that are not directly subject to demand volatility but rather are pre-set at the beginning of the year as a fixed charge.

3.5 True Sale Analysis

In the case that the original owner of the entitlement rights transferred those rights to the current holder, such a transfer must be classified as a true sale that can be upheld vis à vis a third party.

Factors that are analyzed in this section include:

- Full ownership-transfer of the rights executed according to law.
- Effectiveness of the ownership transfer vis à vis a third party (transfer contract is private o is notarized).
- Ownership transfer is communicated to the regulator in charge of payment of the rights and said payer acknowledges payment instructions and pays into the accounts of the assignee of the rights.

For more detail consult the sections Qualitative Assessment, Quantitative Assessment and the section Review and Monitoring from the "General Structured Finance Methodology".

4. Factor weighting in the Final Rating

Weights of Analytical Factors	
Economic sustaintability of the Utility System	20%
Accumulated Deficits / Annual Regulated Revenues	10%
Accumulated Deficits / Annuity Amount	10%
Economic strength of the service area and granularity	20%
Creditworthiness of the service area	15%
Consumer granularity	5%
Legal Framework	40%
Rank of the legal instrument acknowledging the rights	5%
Mechanisms that recover the rights	5%
Mechanisms that protect the rights from future imbalances	5%
Annuities established yearly by the Regulator	5%
Seniority of payments over other regulated costs	10%
Payment of rights not directly subject to demand risk	10%
True sale of the rights with irrevocable legal status	20%
Transfer of rights executed according to law	5%
Transfer is firms vis a vis third parties	5%
Transfer is communicated to payer and acknowledged by him	10%

Source: Ethifinance Ratings.

5. Conversion of numeric rating to EthiFinance Ratings Scale

Once the weighted average of all the analytical factors is calculated, the final numeric ratings are then translated into EthiFinance Ratings grid as shown in the following table with the whole numbers corresponding to the highest rating of each category (i.e., a rating of 2 corresponds to a AA+ and a rating of 3 corresponds to a A+).

Ethifinance Ratings	Numeric Rating
AAA	1 - 1.99
AA+ AA AA-	2 - 2.99
A+ A A-	3 - 3.99
BBB+ BBB BBB-	4 - 4.99
BB+ BB BB-	5 - 5.99
B+ B B-	6 - 6.99
CCC+ CCC CCC-	7 - 7.99
CC	8 - 8.99
CC	9 - 9.99
C	10

*Source: Ethifinance Ratings.

This document updates the previous version while preserving its original methodological criteria; therefore, all existing ratings remain unchanged. In this version, the format has been updated and includes a higher level of detail.