Rating of Public Sector Entities

Outside the United States

Sector-Specific Criteria Report

This criteria report updates and replaces *Ratings of Public Sector Entities* dated 5 March 2012

Scope

Five Key Areas: This criteria report details Fitch Ratings' approach to rating Public Sector Entities (PSEs) outside the United States. It is a sector-specific extension of Fitch's global Master Criteria Report, *Revenue-Supported Rating Criteria* and more specifically *Tax-Supported Rating Criteria*. It elaborates on five areas that determine Fitch's view on the likelihood of extraordinary support from the sponsor: Control, Ability, Legal Status, Strategic Importance, and Integration.

These key elements of Fitch's PSE rating criteria remain consistent with its prior criteria reports. Not all rating factors outlined in this report apply to each individual rating or rating action. Each specific Rating Action Commentary or rating report discusses those factors most relevant to the individual rating decisions.

Highlights

Wide Range of Entities: The legal status of PSEs varies from one country to another but they all have in common some form of public-sector ownership, public-sector role or specific public-sector legal status. The different legal forms of PSEs include government agencies, autonomous or non-autonomous public bodies, state-owned companies, companies with private legal status but with public-sector ownership and specifically created entities, both administrative and business oriented.

Variations in Extraordinary Support: Not all PSEs are likely to receive the same level of extraordinary support from upper tiers of government in case of financial stress. In some instances, the sovereign or local and regional government may be prohibited from directly supporting a particular category of PSE or a specific activity or business. Fitch has therefore classified PSEs as "dependent" where extraordinary support is highly likely and timely, and "non-dependent" where the likelihood and timeliness of extraordinary support is less certain.

Top-down Notching for "Dependents": If a PSE is highly integrated into the government apparatus, receives ongoing subsidies and capital injections, has tightly controlled activities and a public sector mission, Fitch considers it "dependent" on its stakeholder. Dependent PSEs are credit linked to the sponsor with a three-notch floor from the international rating of its public-sector stakeholder because Fitch considers that the likelihood of extraordinary support would be high.

Bottom-up Notching for "Non-Dependents": Where there is doubt about the timeliness and extent of financial support from its public stakeholder, Fitch classifies the PSE as "non-dependent" and follows a bottom-up approach to the rating. The focus is primarily on the standalone profile of the issuer. Fitch will not factor in extraordinary support from the sponsor but the link to it acts as a credit enhancement. However, the rating uplift would normally be limited to one rating category (ie, three notches).

National Rating-notching May Vary: For national ratings Fitch applies the corresponding internal mapping; in some instances a one-notch difference in the international rating could represent a wider notching differentiation in the national rating scale.

Related Research

French "Etablissements Publics" (June 2011)

Analysts

Fernando Mayorga
+34 93 323 8407
fernando.mayorga@fitchratings.com

Christophe Parisot
+ 33 1 44 29 91 34
christophe.parisot@fitchratings.com

Definition of a PSE

PSEs normally undertake a not-for-profit-maximisation mission and have a clear public sector mandate. They play strategic roles for the sovereign or local and regional government in a key sector. Fitch Ratings' definition of a PSE also covers not-for-profit private companies created to fulfil an important public social function, such as registered social landlords in the UK, and which are tightly regulated.

Assessment of Dependence

Fitch assesses whether it considers a PSE dependent or non-dependent on its stakeholders, as this determines whether it follows a top-down or a bottom-up rating approach. By dependence, Fitch not only means a financial or economic link but also one that is moral and legal between the PSE and its public-sector owner. This would result in regular financial support and timely extraordinary support in case of need. See Appendix A for a list of general factors Fitch looks at to determine whether a PSE is classified as dependent or non-dependent.

The assessment of economic/financial dependence is straightforward, as the flows from one entity to the other can easily be tracked or assessed. However, a moral link is more complicated, and Fitch assesses the purpose and role of the entity, its legal status, the necessity of the services provided and the control mechanisms in place.

This assessment is also dynamic — a PSE can shift from being considered dependent to non-dependent (and therefore subject to a change in the rating approach). For example, a weakening of state shareholding, change in legal status or a more commercial role for the PSE could result in Fitch re-classifying it from dependent to non-dependent and taking the appropriate rating action. A move in the opposite direction could also occur, although this would be rarer.

Dependent Public Sector Entity

A dependent PSE is an entity directly or indirectly majority-owned or tightly controlled by the sovereign/subnational (the stakeholder), or with equivalent special public status. Its activities fulfil a public-sector mandate in a non-competitive sector, where forms of state subsidy or grant from the stakeholder comprise most revenue for the PSE, or the PSE receives on-going capital injections. The likelihood of ongoing and extraordinary support by the sponsor would be considered very high to ensure that the PSE is able to service its financial obligations on time. Such entities do not usually maximise profit, with profitability often determined by grants or subsidies.

For a PSE to be considered dependent it needs to be highly integrated into the government apparatus, with its activities tightly controlled by the latter. It must undertake key public-service activities (normally falling under the responsibility of the sovereign or the regional/local government) and must have a clear public-sector status without any immediate plans for privatisation. Such a PSE can either be rated at the same level as its public-sector owner or notched down from the rating of the stakeholder.

Statutory or specific guarantees would result in the rating of a PSE or its debt instruments being automatically equalised with that of its public-sector guarantor.

Statutory Guarantee

A statutory guarantee (normally covering all the issuer's obligations) is usually included either in the PSE's statute or in certain laws passed by its public sector owner in relation to its PSEs.

Specific Guarantee

The equalisation of a PSE's rating with that of its stakeholder is also possible where there is a specific debt guarantee rather than a statutory guarantee.

Related Criteria

Revenue-Supported Rating Criteria (June 2012)
Tax-Supported Rating Criteria (August 2012)

An explicit guarantee would need to include the following characteristics:

- enforceable – it is not ultra vires (ie, that it is within the powers of the stakeholder);
- irrevocable — it cannot be changed or cancelled once it has been granted;
- unequivocal — it specifies the guaranteed amount;
- unconditional — it has a clear definition of the extent of the guarantee;
- on demand — there is no question about timeliness;
- general — it must cover all obligations (present and future); and
- indefinite — it should have no time limit (unless it is a guarantee for a specific bond issue).

Fitch also assesses the track record of the sovereign/subnational in honouring past guarantees and the legal environment in which it operates.

Rating Not Automatically Equalised with Stakeholder

For dependent PSEs that do not benefit from a statutory or specific guarantee, the key rating factors are the analysis of the owners' ongoing and potential extraordinary support, whether through a written commitment or not, and the PSE's standalone fundamentals.

The assessment of dependence (and therefore rating differentiation) is based on the strength of the factors mentioned below. Fitch views control and ability to lend financial assistance as the two key areas in deciding whether to align the rating of the PSE with that of its stakeholder — the tighter the control, the narrower the rating differential. This is followed by legal status, strategic importance and integration.

Control

This is a key rating issue and includes factors such as management appointments, the controlling ministry (whether it is the finance ministry, or any other ministry or sub-ministry), financial supervision (including the approval of accounts and borrowing and budget reporting), board control, policy design, strategic direction and implementation, and official audits. The tighter the control by the sovereign/subnational of the PSE's decision-making process, the closer the link between the rating of the PSE and that of its stakeholder.

Ability

A subnational may have a strong moral obligation or willingness to support a PSE but it may not be able to do so on a timely basis because of financial constraints. For example, if the liabilities of the PSE are significant in relation to the GDP of the sovereign/subnational, it may be difficult for the sovereign/subnational to provide extraordinary support to the PSE in a timely manner. Although Fitch factors in the indirect debt of the dependent PSEs in the rating of the stakeholder, it normally considers these liabilities subordinated (ie, the sponsor would pay its direct obligations first, before those of its dependent bodies).

The ease of access of the sovereign/subnational to either bank funding or the capital market is important for Fitch to assess the level of actual financial support that can be raised at short notice. Where the debt of the PSE is significant relative to that of its stakeholder, the rating differentiation is likely to be wider in countries where the capital or financial sector is less developed and in those instances where the rating of the stakeholder is not investment grade. An assessment of the liquidity position of the sponsor would also be necessary to judge the timeliness of extraordinary support

Legal Status

Fitch believes that the less corporate the legal status of the PSE, the closer the link with the stakeholder. For example, a ministerial department or a government agency would be rated closer to the stakeholder than a public company. A 100%-owned public company would be more likely to have a narrower rating differentiation with the stakeholder than a majority-owned public company. Where public ownership is under 40%, it is unlikely that Fitch would consider the PSE as dependent.

Strategic Importance

The more important the PSE's role in fulfilling public services on behalf of, or mandated by, the sovereign or the subnational, the greater the likelihood that it will be supported. For example, if the interruption or suspension of a public service (such as public transport or social housing) would have social/political consequences, the likelihood and timing of support would be higher than if the services provided by the PSE were of secondary importance.

Fitch assesses the intention and track record of the government regarding continuing services and protecting creditors. for example, whether an essential service can still be provided even if a default has occurred. Fitch would also consider whether the default of a major PSE could have negative consequences for the creditworthiness of its public stakeholder, reducing its access to funding from the capital markets.

Integration

Fitch considers that the tighter the level of consolidation (both budgetary and financial), the more likely the rating will be equalised with that of the sovereign/subnational. The greater the level of ongoing funding of the PSE from the stakeholder, the more dependent it will be and therefore the narrower the rating differentiation. In addition, the size of the public sector is important. For example, in countries where the public sector is wide the likelihood of extraordinary support for one PSE would be lower than in those countries where there are only few key PSEs.

Notching Policy for Dependent PSEs

There is no rating differential between the PSE and its public-sector stakeholder where there is a clear statutory or specific guarantee. But if the guarantee is implicit and Fitch has doubts about the timeliness of support, the PSE's rating is likely to be lower than that of its owner, unless its standalone credit fundamentals are strong and in line with those of its guarantor.

Where there is no guarantee Fitch analyses the following parameters: the legal and institutional framework; any written commitment of support; the degree of integration with the stakeholder; the level of management/financial control; the record of timely support and the likelihood of privatisation in the short term. The assessment is dynamic and does not only focus on past experience. Fitch looks ahead, assessing whether these conditions are likely to change in the short to medium term (including any change of status, privatisation or weakening in financial support). In most cases this involves discussions with the PSE's owners and other institutions.

The agency applies a top-down approach, with the possibility that up to three notches could be subtracted from the international local and foreign currency ratings of the stakeholder, depending on Fitch's assessment of the level and timeliness of extraordinary support from the sponsor. In most situations the rating of a dependent PSE is likely to be higher than the standalone profile of the entity because of its not-for-profit-maximisation role.

Where Fitch publishes a sector view, it may decide to assign a broader notching policy (ie, greater than one rating category for dependent entities), as their aggregate link will be weaker than the link between one single PSE and its public-sector stakeholder. For national ratings, the rating differentiation could be wider than three notches.

Figure 1

Notching From Local and Foreign Currency Ratings for Dependent PSEs

Likelihood of extraordinary support	Notching
Very strong	0–1
Strong	1–2
Moderate	2–3
<Moderate[a]	n.a.

n.a. — Not applicable
[a]Use “non-dependent” notching policy
Source: Fitch

Figure 1 illustrates the notching policy (ie, how many notches would be subtracted from the rating of the sovereign/subnational), taking into account the different assessments of support. In most cases Fitch will have a public rating on the sponsor; however, in those rare situations that Fitch does not rate the sponsor(s), the agency would have to undertake an internal rating of the subnational.

The rating of the PSE would usually not be higher than that of the stakeholder, even if the credit metrics of the former are significantly better than those of its public-sector owner.

When the sponsor is composed of more than one local or regional government, Fitch would normally use a weighted average of the credit profile of the sponsors based on their controlling stakes and/or funding involvement in the PSE. However, if there are a large number of sponsors, the agency may conclude that there are not sufficiently strong links to any members of the group, and may decide not to consider the PSE as a dependent entity.

Non-Dependent Public Sector Entity

PSEs in this category include those that are operating autonomously and whose control by the sovereign or subnational is more subtle than direct. The sponsor may only have a minority stake in the company. The PSE may have a profit maximisation function and operate to all intents and purposes as a commercial entity, or there may be short-term prospects of privatisation. Extraordinary financial support may be constrained or even prohibited through regulations such as EU competition policy, or it cannot be relied on.

Notching Policy for Non-Dependent PSEs

For these entities, Fitch uses a bottom-up rating approach and the analysis focuses primarily on the PSE’s standalone profile for the assessment of its rating. Fitch will not factor in extraordinary support from the sponsor but the link to its public sector sponsor would act as a credit enhancement.

This includes aspects such as discretionary funding and subsidies (such as those allowed under EU competition policy), the role of any regulator of the sector, the regulatory framework and ongoing monitoring (for a more exhaustive list see Appendix C).

However, Fitch normally limits the rating enhancement (uplift) to one rating category (no more than three notches) from the standalone assessment of the PSE. This is because if the enhancement is considered significant, by definition the entity would be dependent on the stakeholder and a top-down rating approach would be more appropriate.

Appendix A

Characteristics of Dependent and Non Dependent PSEs – Not All Aspects Have to be Present

Dependent

- The PSE falls under a separate legal regime, which does not allow it to be liquidated or made bankrupt.
- The sovereign/subnational dictates the strategic policy of the PSE.
- The PSE has a not-for-profit-maximisation mission
- There is a strong economic/financial link between the sovereign/subnational and the PSE.
- The PSE is tightly monitored by the sovereign/subnational.
- The PSE is policy oriented and responsible for providing important public services.
- There is a precedent of support of similar types of PSE by the sovereign/subnational.
- A default by the PSE would have considerable negative repercussions for the credit perception of the sponsor.

Non-Dependent

- The PSE operates in a commercial environment.
- It is profit oriented.
- The status of the PSE is likely to change in the short term to a more commercial orientation.
- Full or, at least, part privatisation is imminent.
- Public-sector aid/bail-out is prohibited (either by the EU or other bodies).
- The sovereign/subnational has stated publicly that it will not financially support the PSE.
- There is a precedent of non-support of similar types of PSEs by the sovereign/subnational.

Appendix B

Checklist for Assessment of Dependency for Dependent Entities

Legal Status and Political Framework

- Proximity or legal link to the sovereign/subnational, such as government department, government agency, public entity (non-corporate), fully owned public company, majority-owned public company or minority-owned public company.
- Past level of support, or extraordinary support for troubled PSEs.
- Assessment of the likelihood of extraordinary support and ongoing financial support by the sponsor.
- Political remarks on support.
- Overall size of the public sector.

Integration

- Degree of consolidation of the budget/accounts of the PSE with the sovereign/subnational.
- Whether debt is considered part of the financial liability of the sponsor or the overall general government sector.
- Status of employees (eg, civil servants).
- Level of ongoing funding of the PSE by the sponsor and the proportion of total revenue that this represents.

Strategic Importance

- Nature of the public services provided by the PSE.
- Impact of the disruption of services on the sovereign/subnational.
- Importance of dividend payments to the sovereign/subnational.

Control

- Appointment of management of the PSE.
- Level of board representation and control.
- Decision-making process of the PSE.
- Debt authorisation requirement.
- Planning and strategic direction decision-making.
- Intervention of the stakeholder in tariff-setting policies.
- Official and unofficial audits and reporting requirements.

Ability

- Size of the liability of the PSE in relation to the overall GDP of the sovereign/subnational.
- Rapid access by the sovereign/subnational to funding (eg, financial institutions or the capital markets) in case of extraordinary support.
- Formalisation of requirements for extraordinary support by the sovereign/subnational (ie, approval from upper tiers of government).

Appendix C

Checklist for Assessment of Credit Enhancement for Non-Dependent Entities

- The percentage of minority ownership by the sovereign or subnational.
- The freedom of the PSE management in governance and decision-making.
- Whether the stakeholder can inject capital to the PSE in the event of need.
- The PSE operates in a commercial but highly regulated environment.
- The role of the regulator in terms of funding.
- Whether the regulator monitors the financial situation of the entities in its sector and has the ability and funding to provide extraordinary support or to re-structure entities.
- The proportion of the business of the PSE that is public service related and the time horizon of such public service provision by the PSE.
- The discretionary funding available to the PSE from its stakeholder, taking into account the mechanisms available and conditionality for providing these funds.
- Whether the stakeholder is willing to instil a commercial and responsible operating strategy for the PSEs.
- The sector the PSE is operating in and the other players, for example whether it consists of both public and private operating entities.
- The importance of the service provided by the PSE.
- The time horizon for the PSE to be fully privatised.