


ISSUE RATING

Gas Deficit Entitlement Rights

Amount: EUR 684.4 MM

Coupon: 1.104%

Amortization frequency: monthly

 First rating date: 26/03/2020
 Review date: 05/04/2021

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Rating Action

Axesor Rating ("Axesor") has ratified its rating of AA-sf to the 2014 Gas Deficit Entitlement Rights held by Banco Santander, S.A. (Banco Santander).

Executive Summary

2014 Gas Deficit Entitlement Rights, are a pool of receivables that correspond to the deficits related to regulated activities accumulated up to 31st of December of 2014 recognized by the Order of the Ministry of Energy, Tourism and Digital Agenda which was published in the Official Gazette on the 29th of December of 2016 for a total amount of € 1.025 Bn. On the 1st of December 2017, Banco Santander acquired part of the 2014 deficit receivables that regulated gas players were entitled to vis a vis the Spanish Natural Gas System (the "System") for a nominal value of € 808,193,895 at a cost of € 812,621,990.

Asset Class	Rating	Legal Maturity	Collateral
Utilities Entitlement Rights	AA-(sf)	24/11/2031	2014 Gas Deficit Entitlement Rights

These rights are composed by payments that the market's regulator, Comisión Nacional de los Mercados y Competencia ("CNMC" or the "Regulator"), must make to the Gas operators that funded the accumulated deficits generated by the System up to 2014.

Banco Santander at close of 2020 held in its books entitlement rights recognized by Spanish Law, stemming from the 2014 natural gas deficit for a total consideration of € 362.44MM (vs. €684.43MM at close of 2019) . In november 2020 it was applied an early amortization payment of € 312.11MM (€ 200.3MM to the entitlement rights own by Santander), which decrease the total nominal value to an amount of € 339.25MM. This early amortization comes from a superavit from the 2019 period according to the order TEC/1367/2018

The receivables are paid monthly with a legal maturity date falling on the 24th of November of 2031 (fifteen years from the date of recognition of the entitlement rights). Subsequent deficits that may arise will be settled in a period of five years since their origination.

The 2014 Deficit rights were assigned to Banco Santander by part of their original owners who were: Enagás Transporte, S.A.U., Redexis, Madrileña Red de Gas, Naturgy and Nortegás through a true sale.

The annuities from these rights are charged as a regulated cost of the Spanish natural gas system to all final consumers. These charges are collected through the sector's billing system and final settlement and payment to the holders of the rights is made by market players following the instructions of the CNMC which, amongst other functions, is the Gas System's independent regulator.

Key Points

- **System Economic Sustainability:** Total Accumulated 2014 Gas Deficit closed at 392.2MM in 2020 (vs. 756.2MM at 2019) after an early amortization of 320.3MM, which improve both Economic Sustainability Metrics (Accumulated Deficits to Regulated Revenues and Accumulated Debt)

- ▶ **Sovereign Rating of the Kingdom of Spain:** On the 25th of September 2020 the Rating of the Kingdom of Spain was downgraded to an A- (stable) and as a result of the country ceiling established for this assetclass which is three notches above the sovereign rating, Axesor Downgraded the Rating to the 2014 Gas Deficit Entitlement Rights
- ▶ **Economic Strength of Service Area:** Service Area covers all of Spain and therefore with an economic strength commesurate with Spain´s Rating of A- Stable.
- ▶ **High Concentration in the main industry:** 22% of demand is concentrated in gas combined cycle electricity plants which add volatility to total demand
- ▶ **Regulatory Framework is remarkably robust:** the Law 18/2014 provides for recovery mechanisms should future deficits arise. Any future regulation that imposes an increase in the System's costs or a reduction in its revenues must include an equivalent reduction of costs or increase in revenues in order to maintain the System's financial equilibrium. Also, the CNMC publishes annually the annuity that will be added to the other regulated cost charged to final consumer in order to recover accumulated deficits.
- ▶ **Legal Status of Entitlement rights and their valid assignment:** The assignment of the 2014 deficit entitlement rights was performed according to Spanish law and is valid vis à vis third parties since the transfer contract was notarized

Sensitivity Analysis

Individual or Collective factors that could have an impact on the assigned rating

▶ **Positive Factors (↑):**

Any upgrade on the Sovereign Rating of the Kingdom of Spain would benefit the current Rating of the Entitlement Rights

▶ **Negative Factors (↓):**

A downgrade on the sovereign Rating of the Kingdom of Spain could trigger further downgrades to Rating due to the Asset Class Country Ceiling. Also, a worsening of the economic sustainability of the gas system such as an increase in the accumulated gas tariff deficit, or a change in the regulation of the system.

Main Figures

Main Figures	Issuance Data
Holder	Banco Santander, S.A.
Purpose	Natural gas system deficit 2014
Type of Vehicle	N/A
Asset Class	Receivables purchase
Entitlement Date	01/12/2017
Payment Date	The last day of each month
Interest payment frequency	Monthly
Principal payment frequency	Monthly
First payment dates	31/12/2017
legal maturity date	24/11/2031

*Source: Banco Santander, S.A.

Participants

Participants	Role
Enagás Transporte, S.A.U., Redexis, Madrileña Red de Gas, Naturgy and Nortegas	Original Owners of the Deficits
Comisión Nacional de los Mercados y la Competencia	Independent Regulator
Entitlement Rights Owner	Banco Santander, S.A.
*Source: Banco Santander, S.A.	

1. Assets Overview

1.1. The Spanish Gas System

The Spanish Gas System has historically enjoyed a stable regulation under the Ley 34/1998, de 7 de octubre, del Sector de Hidrocarburos (the “Hydrocarbon Sector Law”). This stability allowed the expansion of the Gas Sector, growing at a remarkable pace of +17% compound annual growth rate (CAGR) between 2002 and 2008, a period during which natural gas demand increased by 85%, reaching the figure of 449 TWh. To support this increment, in demand investments in Gas infrastructures were executed, including transport assets (Gas pipelines and LNG Regasification plants), distribution assets and underground gas storage capacity.

1.2. Gas System Deficit

During 2008 demand started to shrink at a considerable pace (-6% CAGR2008-13) as a result of the economic crisis, leading to a fall in tariff revenues which were insufficient to cover the System’s regulated costs. This imbalance generated a growing tariff deficit

This deficit was caused by a fall in the natural gas demand of the two major segments combined with a continuing rise in the regulated costs during the 2008-2013 period: Combined Cycle Plants (CCP) that used gas for the production of electricity reduced their gas consumption by 131 TWh (-21%), due to a fall in electricity demand coupled with the public subsidies for renewable energies and the use of domestic carbon for thermal plants both of which displaced electricity produced by the CCP plants.

In order to offset the fall in demand and the continued increase in regulated costs, the regulator increased the Systems’ revenues through significant hikes in the access tariffs which placed the prices paid by the end-consumer above the European Union average. Despite the increase in regulated revenues, tariff deficits continued to grow, reaching a total accumulated amount of € 1,025 MM at the close of 2014. This figure represented 34% of total 2013 regulated costs while the average annual tariff deficit charge represented 5,7% of total 2013 regulated costs.

1.3. Regulatory Measures aimed at ending the Gas Deficit

On July 2014 a Royal Law Decree 8/2014 was enacted. The purpose of this Law was to contain future tariff deficits and to recover accumulated shortfalls up to 2014. This Royal Decree was ratified by Law 18/2014 which was published on the 17th of October 2014. Measures that were enacted by the law to allow the economic rebalancing of the Gas System included.

1. 1. A reduction of €238 MM of regulated costs paid to the infrastructure assets with transport assets (-97 MM) and distribution assets (-€110 MM) absorbing a major part of the costs reductions.
2. Suppression of the automatic upward inflation adjustment of the Systems’ costs and RAB (Regulated Asset Base).
3. Payments to the transport, regasification and gas deposits infrastructures are partially indexed to the demand partially mitigating impacts from future decreases in demand on the System’s financial balance.
4. Six-year regulatory periods are established during which the parameters used to calculate the Systems’ regulated costs cannot be changed giving stability to the payment regime of regulated assets. However, should significant deviations arise during the period, adjustments can be made in three-year periods.

5. Should new deficits arise in excess of 10% of total regulated revenues in a given year, the Regulator must increase tariffs the following year in order to compensate the costs overruns above the 10% level. Similarly, should the new annual deficit together with accumulated past shortfalls exceed 15% of System's regulated revenues the Regulator must also increase tariffs the following year to compensate excesses past the 15% level. The part of the deficit that remains below the 10% and 15% levels will be defined as a temporary shortfall and must be recovered in the following five years.
6. The 2014 accumulated deficit and the temporary deficits that were generated after 2014 are senior in payment to the other regulated costs (except for the Algerian supply contract debt established through an international arbitration). However, should there be any revenue surplus, it will be applied to pay the temporary deficits with preference over the 2014 accumulated deficit.
7. The law recognizes the existence of an accumulated tariff deficit at the close of 2014 of €1,025 MM which must be repaid in 15 years starting in November 2016. Possible future deficits will be repaid in the next 5 years.

1.4. Future trend of the Gas System's Deficit

Regulatory Period (2014 to 2020)

During this period, regulated costs will decrease due to the fact that the financial yield paid to the regulated assets will be applied to their net value which will fall over time. Additionally, at close of 2019, the debt stemming from the Algerian Gas Arbitration ruling has been paid-off, which will bring annual savings for the Gas System of up to approximately €33 MM

Regulatory Period (2021 to 2026)

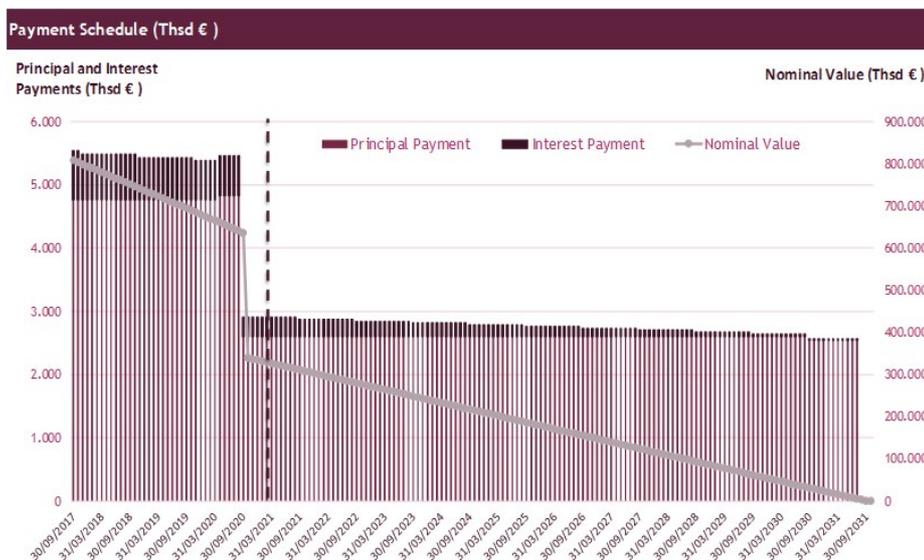
As mentioned, the CNMC is the institution in-charge of setting the System's regulated costs that are ultimately paid to the regulated activities. On the 23rd of December of 2019 the CNMC published the new methodology to be applied during the 2021-2026 period for calculating the revenues that must be paid to the regulated activities of Gas Transport and regassification from liquefied natural gas (LNG). In the memorandum that accompanies the regulation, the CNMC justifies the proposed reductions in System's costs:

1. During the period 2009-2014, regulated tolls were increased in a cumulative 33.5% which led to Spanish households paying on average 17,2% more than their European counterparts during the period 2007-2018 (excluding taxes).
2. The return on equity of the transport of gas has yielded financial returns well above yields commensurate with a low-risk activity.
3. Although the measures contained in the Law of 2014 contributed to largely contain past deficits, they were insufficient as deficits have continued to be generated, albeit in lower amounts during the years 2015 to 2017.
4. The reduction in the System's regulated costs will be applied gradually and will represent an average annual reduction of €117 MM of which €106 MM will be borne by the transport assets and €11 MM will be supported by the regassification activity.
5. The decrease in the System's regulated costs, given stable or slightly increasing revenues, will lead to the appearance of net surplus revenues. The Regulator clearly states that these surpluses will be applied to pay-off accumulated deficit charges and to lower the tolls paid by consumers.

In conclusion, it is our opinion that the recovery of the tariff deficits under the new regulation has been consolidated, limiting the possibility of future deficits from arising. Also during 2019 there was an important superavit in the period, which caused an early amortization of the Deficit Rights of the system as seen below.

1.5. Payments Schedule

The graph below, illustrates the monthly principal and interests paid by the System to the holders of the deficit entitlement rights (left-hand scale) and the total outstanding value of the rights on each of the corresponding dates (right-hand scale). In terms of the deficit rights held by Banco Santander, the early amortization led to a prepayment in favor of the Bank of € 200.3MM, reducing the total outstanding deficit rights held by Banco Santander to an amount of € 339.25MM in November 2020.



* Source: Banco Santander, S.A.

2. Analytical Rating Factors

2.1. Sovereign Risk

The sovereign rating of the Kingdom of Spain (A- by Axesor) in which the Natural Gas System operates acts as an anchor around which the rating of the Deficit receivables rights pivot. Depending on the scores assigned to the rest of the factors, the rating of the pool of gas receivables will be higher, equal or lower than the sovereign rating. In any case, final rating will be constrained by Spain’s country ceiling (AA-) which is placed 3 notches above the sovereign rating.

Normally, if the entitlement right is strongly entrenched from a legal point of view, regulation is very supportive and the other analytical 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 gas 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 natural gas bills.

In our opinion, both residential and corporate consumers will give priority to paying their gas bills over other obligations because utilities cover non-discretionary basic needs and because a payment default entails having the service cut off. This justifies our view that natural gas consumption is more robust than general consumer trends and that under a stress scenario of a sovereign default, consumers would continue consuming gas albeit in lower quantities.

2.2. Economic Sustainability of the Gas System

During the regulatory period 2021 to 2026, the costs of the System are expected to be reduced annually by €117 MM on average. Given a stable gas consumption, this will contribute to the generation of tariff surpluses after a period of continued deficits since 2006.

Compared to the electric tariff deficit, the gas deficit is much smaller and therefore relatively easier to recover: Recovery annuity charges for 2019 went up to €107 MM which represented a 3,45% of total regulated revenues of the Gas System while accumulated deficits pending recovery at the close of 2018, including payable interests, represented 33% of total regulated revenues

Economic Strength of the Service Area

Service Area covers all of Spain and therefore with an economic strength commensurate with Spain's sovereign rating of A (Axesor). Consumer granularity is strong although 20% to 22% of demand is concentrated in gas combined cycle electricity plants which add volatility to total demand. During 2018, for example, demand from this segment fell by 21% although total natural gas demand only fell by 0.3% thanks to demand increases in the industrial and domestic/commercial segments which grew by 3.3% and 12.7%, respectively.

2.3. Regulatory Framework

Regulatory Framework is remarkably robust:

1. Entitlement rights have been recognized by Law 18/2014.
2. The Law 18/2014 provides for recovery mechanisms should future deficits arise. Any future regulation that imposes an increase in the System's costs or a reduction in its revenues must include an equivalent reduction of costs or increase in revenues in order to maintain the System's financial equilibrium. Additionally, while deficits remain outstanding, the regulator cannot lower the System's tariff revenues and new temporary deficits that exceed certain thresholds automatically lead to tariff increases the following year.
3. Annually the CNMC publishes the annuity that will be added to the other regulated costs charged to final consumers in order to recover accumulated deficits.
4. Tariff deficits are senior to the rest of regulated costs with the exception of the Algerian gas supply surcharge which represent annuities of €32.7 MM, the last of which has been payed off in December 2019. However, should the System generate surpluses (as in 2018), these amounts will be applied to repay temporary deficits over the 2014 accumulated deficit, which is held by Banco Santander.
5. Tariff deficits are recovered through predefined annuities that do not directly depend on the demand of gas. However, it must be noted that if real gas demand continually falls below CNMC's estimates, new deficits can arise.

The assignment of the 2014 deficit entitlement rights was performed according to Spanish law and is valid vis à vis third parties since the transfer contract was notarized. Furthermore, the transfer of the rights was communicated to the CNMC and CNMC acknowledged the assignment, in its regulation of the 20th of December 2019, where it establishes the recovery annuities that must be paid to the holders of 2014 deficit entitlement rights, mentioning Banco Santander as one of the owners of said rights.

Rating Scorecard

Entitlement rights on 2014 Gas Deficits		
Sovereign Risk		A-
FACTORS	Weight	Assessment
System Economic Sustainability		20,0%
Accumulated Deficits/Regulated Revenues	10,0%	AAA
Accumulated Deficit/Annual Deficit Payments	10,0%	BBB+
Diversification and Economic Strength of Service Area		20,0%
Creditworthiness of the Service Area	15,0%	AA-
Consumer granularity (Peso 1a Industria / PIB)	5,0%	BB+
Legal Framework		40,0%
Rank of the legal instrument that acknowledges the rights	5,0%	AAA
Mechanisms that recuperate future deficits	5,0%	AA
Mechanisms that protect the rights from future regulation	5,0%	AA
Annuities established annually by the Regulator	5,0%	AAA
Seniority of payment over other regulated charges	10,0%	AA
Payment of rights not directly subject to demand risks	10,0%	A+
True Sale of the rights and their irrevocable legal status		20,0%
Transfer of rights executed according to the law	10,0%	AAA
Transfer is firm vis á vis third parties	5,0%	AAA
Communication and Acknowledgment by Payer	5,0%	AAA
Total Weighted Score		AA
Sovereign Risk		A-
TOTAL RATING		AA-

Regulatory information

Sources of information

The credit rating assigned in this report has been requested by the holder of the rated entitlement rights, who has also taken part in the process. It is based on private information as well as public information. The main sources of information are:

1. Regulation applicable to the entitlement rights.
2. Reports from the Regulatory Bodies.
3. Information provided by the holder of the rights.
4. Public information from public access sources, mainly official statistics institutes, central banks, and other government sources, in addition to the OECD, Eurostat, World Bank, European Central Bank, among others.
5. Information published in the Official Bulletins.

In the case that the entitlement rights are securitized the rating will also be based on the information provided by the management company, the originator or any other participant in the transaction including but not limited to:

1. The quality of the Collateral.
2. The level of credit enhancement.
3. Counterparties.

The information was thoroughly reviewed to ensure that it is valid and consistent, and is considered satisfactory. Nevertheless, Axesor Rating assumes no responsibility for the accuracy of the information and the conclusions drawn from it.

Additional information

- The rating was carried out in accordance with Regulation (EC) N°1060/2009 of the European Parliament and the Council of 16 September 2009, on credit rating agencies, and in accordance with the Structured Finance Rating Methodology that can be consulted on www.axesor-rating.com/en-US/about-axesor/methodology and according to the Structured Finance Rating scale available at www.axesor-rating.com/en-US/about-axesor/rating-scale.
- Axesor publishes data on the historical default rates of the rating categories, which are located in the central statistics repository CEREP, of the European Securities and Markets Authority (ESMA).
- In accordance with Article 6 (2), in conjunction with Annex I, section B (4) of the Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009, it is reported that during the last 12 months axesor has provided ancillary services to related third parties of the rated entity, but not to the rated entity. However, according to our Conflict of Interest Policy, it does not involve a conflict of interest, since the aggregate sale does not exceed 5% of net turnover.
- The issued credit rating has been notified to the rated entity, and has not been modified since.

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