



## RATING ACTION COMMENTARY

# Fitch Revises Outlook on Puy-de-Dôme to Negative; Affirms at 'AA'

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[Department of Puy de Dome - Rating Action Report](#)

Fitch Ratings - Paris - 26 May 2020: Fitch Ratings has revised the Outlook on Puy-de-Dôme's Long-Term Foreign-and Local-Currency Issuer Default Ratings (IDRs) to Negative from Stable and affirmed the IDRs at 'AA'. Fitch has also affirmed the Short-Term Foreign Currency IDR at 'F1+'. A full list of rating actions is below.

The revision of the Outlook on Puy-de-Dôme reflects the revision of the Outlook on the French state (AA/Negative) to Negative from Stable on 15 May 2020.

Under EU credit rating agency (CRA) regulation, the publication of local and regional governments' reviews is subject to restrictions and must take place according to a published schedule, except where it is necessary for CRAs to deviate from this in order to comply with their legal obligations. Fitch interprets this provision as allowing us to publish a rating review in situations where there is a material change in the creditworthiness of the issuer that we believe makes it inappropriate for us to wait until the next scheduled review date to update the rating or Outlook/Watch status. The next scheduled review date for Fitch's rating

on Puy-de-Dôme is 12 June 2020, but Fitch believes that developments in the country warrant such a deviation from the calendar and our rationale for this is laid out below.

## KEY RATING DRIVERS

The rating action reflects the following key rating drivers and their relative weights:

### HIGH WEIGHT

#### Sovereign Cap

The revision of the Outlook on Puy-de-Dôme reflects the revision of the Outlook of the French state to Negative from Stable on 15 May 2020.

French local and regional governments (LRGs) may not be rated above the French state. This reflects the high influence the French state has on French LRGs' responsibilities and finances. As a result, a downgrade of the sovereign would result in a downgrade of Puy-de-Dôme.

### LOW WEIGHT

#### Risk Profile: High Midrange

Fitch assesses Puy-de-Dôme's risk profile at High Midrange, reflecting a mix of Stronger and Midrange Attributes on the six key risk factors. The High Midrange risk profile reflects the limited risk that the department's cash flow available for debt service will contract beyond reasonable downturn expectations.

#### Revenue Robustness: Stronger

Puy-de-Dôme benefits from robust revenue, mainly made up of stable transfers and predictable tax items. This includes the property tax, which is based on the fiscal value of properties, the tax on insurance contracts, which has a low volatility through the economic cycle, and the fuel tax whose proceeds are mostly guaranteed by the French state with low counterparty risk. The counterparty risk of transfers is also low as most of them are made by the French state, which benefits from a high rating.

Property transfer duties (13% of estimated operating revenue) are the main source of potential volatility as they are linked to real estate transactions. The latter grew by 25% between 2015-2019, but we expect them to significantly decrease in 2020 due to the coronavirus pandemic and containment measures. We factor the drop in proceeds and the potential volatility of this tax item into our rating case scenario. We also expect CVAE proceeds (6%) to be significantly hit by the pandemic in 2021-2022 as they are driven by local companies' value-added, recorded one or two years earlier.

The replacement of the share of property tax by a share of nationally collected VAT as of 2021, as included in the Finance Bill for 2020, will increase the share of tax items linked to GDP growth (national GDP in the case of VAT versus local GDP for CVAE). However, the departments will still benefit from a minimum level of proceeds guaranteed by the French state (amount of property tax received in 2020). This change in revenue breakdown will increase the potential volatility of revenue, but should not lead to a lower assessment of the department's revenue robustness.

#### Revenue Adjustability: Midrange

As a result of the replacement of the property tax with VAT proceeds, Puy-de-Dôme will lose almost all its rate-setting power and tax flexibility as of 2021, like other French departments.

However, Fitch believes that French departments benefit from cost pass-through mechanisms with the French state as their counterparty: they are responsible for public policies decided at the national level, especially for social spending, and tend to receive greater financial support from the French state when cost increase. Fitch expects the French state to continue supporting the departments if the latter face a sustained increase in social spending, and the full removal of their fiscal flexibility would make support from the French state even more likely, in our view.

The support mechanisms from the French state have not been sufficient to cover the increase in spending in the past and do not benefit from a constitutional guarantee. A Stronger assessment of the rating factor is therefore ruled out. However, the track record of financial support and our expectation that such support would continue in case of need justify, in our view, a Midrange assessment of the factor for all French departments.

#### Expenditure Sustainability: Midrange

Puy-de-Dôme exercises good control of its operating expenditure. Between 2015 and 2019, operating expenditure increased by 1% a year on average, below the pace of operating revenue (1.3%). The department has implemented cost-cutting measures since 2016, which partly offset growing social spending.

The department also aims to respect aims to comply with the prudential rules set by the French state, under the Finance Programming Bill for 2018-2022, which cap the department's current expenditure growth at 1.2% a year. However, these rules have been put on hold in the context of the coronavirus crisis and include some exceptions relative to social spending.

Puy-de-Dôme has responsibilities over some cyclical expenditure items, especially social benefits (16% of estimated operating expenditure in 2019), which are likely to increase in case of an economic downturn. We expect this spending item to increase significantly in 2020-2021 due to the economic recession triggered by the coronavirus pandemic.

#### Expenditure Adjustability: Midrange

Puy-de-Dôme's operating expenditure is mainly made of rigid mandatory transfers, especially social benefits, social subsidies to elderly (10%) and disabled (3%) and social accommodations fees (24%). The department has limited ability to cut social transfers as policies are decided at the national level. Staff costs (22% estimated) are also a rigid spending item as most of the department's employees have the status of civil servants. However, cost-cutting measures remain possible, as evidenced by the good control the department has exercised over operating spending in recent years.

The department has more flexibility on its capital expenditure programme (13% of total expenditure estimated in 2019) as a share may be postponed in case of need. Overall, we estimate the share of inflexible expenditure to be between 70% and 90%.

We consider that the level of service and investment within the department is high, and that the affordability to reduce it is strong in an international perspective.

#### Liabilities and Liquidity Robustness: Stronger

Puy-de-Dôme operates under a robust national and individual debt management framework. Its liabilities carry little risk. At end-2019, 50% of debt was fixed rate and 99% was considered risk-free by national regulation. Debt service is

structurally well covered by the operating balance (2019: 1.5x) and the department's amortisation profile is smooth.

Off-balance sheet liabilities (guarantees plus public-sector entities' debt) are significant as they represented a high 7.6x the operating balance in 2018. However, 92% was related to the low-risk social housing sector.

#### Liabilities and Liquidity Flexibility: Stronger

Fitch believes that a solid framework applies to French LRGs regarding the allocation of emergency funding by the French state. LRGs' cash is deposited at the national treasury and there is therefore a "cash pooling" mechanism between LRGs and the French state. In this context, the French state may provide cash advances to LRGs. The counterparty risk of this mechanism is low due to the high sovereign rating.

The department has also abundant access to liquidity under various forms, including EUR44 million from committed lines contracted with counterparties rated in the 'A' category. Like other French LRGs, the department has also access to some institutional lenders, especially Caisse des Depots et Consignations (AA/Negative), which may support them in case of problems with commercial banks.

#### Debt Sustainability: 'aa' category

Fitch assesses Puy-de-Dôme's debt sustainability in the 'aa' category. In our rating case scenario, we expect the payback ratio (net adjusted debt / operating balance) to exceed the 7.5x threshold only in the last year and be close to 8x (2019e: 3.3x), the debt service coverage (operating balance debt service; Fitch's synthetic calculation) to be above 1.5x, and the fiscal debt burden to be around 60%.

Puy-de-Dôme's payback ratio improved in recent years to 3.3x estimated in 2019, from 5.4x in 2016. The operating balance improved to EUR93 million estimated in 2019, from EUR77 million in 2016, driven mostly by property transfer duties, while operating spending remained largely contained. In our rating case scenario, which factors in prudent assumptions, including a sharp decline in real estate market transactions and growing social benefits spending, we expect the department's operating balance to be close to EUR55 million per year in the coming years.

In our rating case scenario, Puy-de-Dôme's net adjusted debt will grow to around EUR410 million at end-2024, from EUR309 million at end-2019. This reflects our expectation that the capital balance (capital expenditure minus capital revenue; Fitch's adjusted) will be negative, at close to -EUR70 million a year on average in 2020-2024 (2019: -EUR69 million estimated). The operating balance would not be sufficient to cover both the capital balance and the financial charges.

Puy-de-Dôme is a French department located in the central part of the country. Its main city is Clermont-Ferrand, and has 0.7 million residents. Its main responsibilities are social spending, education (middle schools) and road maintenance. It is classified by Fitch as a Type B LRG, meaning that it is required to cover debt service from cash flow on an annual basis.

## **DERIVATION SUMMARY**

Puy-de-Dôme's Standalone Credit Profile (SCP) is assessed at 'aa' reflecting a combination of a 'High Midrange' risk profile and debt sustainability metrics assessed in the middle of the 'aa' category under Fitch's rating case scenario. The rating is not capped by the sovereign rating. However, the Outlook has been revised to Negative to mirror that on the sovereign. There is no other rating factor affecting the rating.

## **KEY ASSUMPTIONS**

Qualitative assumptions and assessments and their respective change since the last review on 13 December 2019 and weight in the rating decision:

Qualitative Assumptions and assessments:

Risk Profile: High Midrange, unchanged with low weight

Revenue Robustness: Stronger, unchanged with low weight

Revenue Adjustability: Midrange, unchanged with low weight

Expenditure Sustainability: Midrange, unchanged with low weight

Expenditure Adjustability: Midrange, unchanged with low weight

Liabilities and Liquidity Robustness: Stronger, unchanged with low weight

Liabilities and Liquidity Flexibility: Stronger, unchanged with low weight

Debt sustainability: 'aa' category, unchanged with low weight

Support: N/A, unchanged with low weight

Asymmetric Risk: N/A, unchanged with low weight

Sovereign Cap: Yes, lowered with high weight

Quantitative assumptions - issuer specific

Fitch's rating case scenario is a "through-the-cycle" scenario, which is based on the 2015-2019 figures and 2020-2024 projected ratios. It incorporates a combination of revenue, cost and financial risk stresses in case of economic slowdown. Fitch revised its rating case scenario's assumptions to reflect the economic consequences of the coronavirus on French departments' debt sustainability metrics.

The revised key assumptions for Puy-de-Dôme include:

yoy 1.3% increase in operating revenue on average in 2020-2024, including a sharp reduction in property transfer duties proceeds in 2020 by 25% and drop in CVAE proceeds of 6% in 2022;

yoy 2.0% increase in operating spending on average in 2020-2024;

net capital balance of close to -EUR70 million on average in 2020-2024;

2.2% cost of debt and 15-year maturity for new debt.

Quantitative assumptions - sovereign related

Figures as per Fitch's sovereign actual for 2018 and forecast for 2021, respectively:

GDP per capita (US dollar, market exchange rate): 42,764; 40,632; low weight

Real GDP growth (%): 1.7; 4.1; high weight

Consumer prices (annual average % change): 2.1; 0.7; low weight

General government balance (% of GDP): -2.3; -6.8; high weight

General government debt (% of GDP): 98.3; 115.5; high weight

Current account balance plus net FDI (% of GDP): -3.1; -3.9; low weight

Net external debt (% of GDP): 36.3; 48.4; low weight

IMF Development Classification: EM

CDS Market Implied Rating: AA-

Material changes in revenue and cost profiles are occurring across the French LRGs' sector and likely to worsen in the coming weeks and months as economic activity suffers and some forms of government restrictions are maintained. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised rating case qualitative and quantitative assumptions based on performance expectations and assessment of key risks.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The Outlook would be revised back to Stable if the Outlook on the sovereign was revised to Stable, all other things unchanged.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Puy-de-Dôme's long-term ratings could be downgraded if the department's net payback ratio exceeds 7.5x on a sustained basis in our rating case scenario. This could notably happen if the drop in tax revenue resulting from the pandemic is larger than currently expected and not matched by a decrease in expenditure. A downgrade of the sovereign would also be reflected in the ratings.

For Puy-de-Dôme, a prolonged COVID-19 impact and much slower economic recovery lasting until 2025 would pressure net revenues. Should the issuer be



unable to proactively reduce expenditure or supplement weaker receipts from increased central governments transfers, this would lead to a downgrade.

## COMMITTEE MINUTE SUMMARY

Committee date: 25 May 2020

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

## BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## SUMMARY OF FINANCIAL ADJUSTMENTS

Puy-de-Dôme's accounts are consolidated with those of the fire brigades as the latter is mostly financed through a transfer from the department (EUR33 million in 2019).

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING		
Puy-de-Dôme, Department of	LT IDR	AA	Affirmed
●	ST IDR	F1+	Affirmed
●	LC LT IDR	AA	Affirmed
● senior unsecured	LT	AA	Affirmed
● senior unsecured	ST	F1+	Affirmed

[VIEW ADDITIONAL RATING DETAILS](#)

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## **APPLICABLE CRITERIA**

[Rating Criteria for International Local and Regional Governments \(pub. 13 Sep 2019\) \(including rating assumption sensitivity\)](#)

## **ADDITIONAL DISCLOSURES**

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Puy-de-Dome, Department of

EU Issued

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