

Date of Issue: 02/12/2026	Validity: 02/11/2028	Code: PCR-OR-ANA-MET-RE-002	Version: 02	Page: 1 of10
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Risk Rating Methodology for Provincial, Municipal, and Public Entity Bonds Under Such Jurisdictions

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CHANGE LOG

Change Log				
No .	Section and Page Number Modified	Description of Change	Date of Modification	Version No.
1	N/A	Not applicable, as this is the first version of the document	12/04/2017	1
2	Section 2, Scope, Page 4	The scope of the document was updated to take a more general approach	02/12/2026	2

1. OBJECTIVE

To describe the methods and criteria used by PCR to rate the risk of provincial, municipal, and public entity bonds under such jurisdictions.

2. SCOPE

This document describes Pacific Credit Rating's (PCR) methodology for rating provincial, municipal, and public entity bonds, focusing on the entity's ability to meet all of its obligations. This methodology applies to both international and domestic ratings, whether new or existing. It may also be applied in conjunction with other PCR methodologies, depending on analytical needs.

3. BASIC CONDITIONS

This methodology covers rating criteria for various types of bonds issued by regional and provincial governments and various public entities operating under such jurisdictions. Ratings will be assigned based on the issuer's creditworthiness and the characteristics of the bond or instrument (with the AAA category representing the lowest risk to the investor, and risk increasing through to the DD category, which represents the highest risk).

The risk categories are based, to varying degrees, on the following factors, considered as a whole:

- a) The probability of default, that is, the issuer's ability or willingness to pay the interest and principal owed, in accordance with the terms originally agreed upon in the issuance contract for the respective bond.
- b) Guarantees, sureties, or other types of features or special provisions included in the issuance, which may provide additional security beyond the issuer's creditworthiness.
- c) The protections for bondholders established in the issuance contract in the event of the issuer's insolvency, reorganization, or significant deterioration of its financial condition.

4. SPECIFIC CONDITIONS

4.1 Preliminary Analysis

The information regarding the bond will be evaluated. Information will be considered "insufficient" whenever there is a presumption of falsity in the information provided to the rating agency, or whenever the information requested by the rating agency from the issuer, relating to the rating items detailed in this manual, is not provided, or is deemed by the rating agency to be highly incomplete. In cases where the information is deemed "sufficient," the standard rating procedures detailed below will be followed.

In cases where the issuer has been recently incorporated and therefore lacks representative historical information, the rating agency will determine whether it has elements that could convincingly compensate for this deficiency. If the additional elements are deemed sufficient, this situation will be expressly noted with a special notation, and the normal rating procedures will continue to be applied.

4.2 Standard Rating Procedures

4.2.1 Assessment of the Issuer's Creditworthiness

This involves the joint analysis of the following four indicators:

- Demographics and economic geography.

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- Local economy
- Financial analysis
- Political and administrative risk

1) Demographics and economic geography

The resources of regional and provincial governments and public entities operating under such jurisdictions depend on local demographics and local economic geography. For example, if a migration process occurs that causes the population to decline, tax revenue and the bond issuer's solvency will be affected. The average years of education of the population are associated with the ability to generate income, etc. The key factors to consider here are as follows:

- a. **Population growth rate:** To evaluate this factor, the population growth rate of the unit under analysis (region or province) is compared with that of the country or region, as applicable in each case. This indicator will fall into one of three ranges or levels defined as 1, 2, and 3, with 1 representing the lowest risk (population growth above the reference average), 2 representing medium risk (population growth similar to the reference average), and 3 representing high risk in this regard (population growth well below the reference average). If a regional bond or a bond guaranteed by a regional government is being analyzed, the reference average will be that of the country; if a provincial bond or a bond guaranteed by a provincial municipality is being analyzed, the reference average will, in principle, be that of the region. The country's average may also be adopted if the regional average is not available, or if, in the rating agency's judgment, the country's average is more relevant.
- b. **Average years of education:** This is an indicator associated with the population's ability to generate income and pay taxes, which contributes to the assessment of the issuer's creditworthiness. To evaluate this indicator, the average years of education of the population in the unit under analysis (region or province) are compared with those of the country or the region, as applicable in each case. This indicator will fall into one of three ranges or levels defined as 1, 2, and 3, with 1 representing the lowest risk (average years of education above the reference average), 2 representing medium risk (average years of education similar to the reference average), and 3 representing high risk in this regard (average years of education well below the reference average). If a regional bond or a bond guaranteed by a regional government is analyzed, the reference average will be that of the country; if a provincial bond or a bond guaranteed by a provincial municipality is analyzed, the reference average will, in principle, be that of the region. The country's average may also be adopted if the regional average is not available, or if, in the rating agency's judgment, the country's average is more relevant.
- c. **Characteristics of the economic geography:** This is an indicator associated with the characteristics of the region or province in terms of the relative importance of residential, commercial, industrial, and rural areas; climate; the location of productive activities; and aspects of communications, transportation, and infrastructure in general. The rating agency evaluates the nature of the economic geography of the region or province in question and assigns this indicator to one of three defined ranges or levels: 1, 2, and 3. Level 1 represents the lowest risk, corresponding to comparatively high development; Level 2 represents medium risk, corresponding to comparatively average development; and Level 3 represents high risk, corresponding to comparatively low

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development. If a regional bond or a bond guaranteed by a regional government is being analyzed, the benchmark for the assessment will be the country; if a provincial bond or a bond guaranteed by a provincial municipality is being analyzed, the benchmark for the assessment will, in principle, be the region. The country may also be adopted as the benchmark if the provincial benchmark is not available, or if, in the rating agency's judgment, the use of the country benchmark is more appropriate.

The economic geography and demographics rating will be based on the rating assigned to each of the previously defined indicators. The rating criteria for economic geography and demographics will be as follows:

- If one or more of the indicators are rated at Level 3, the demographic and economic geography rating will be Level 3 (high risk).
- If two or more of the indicators are rated Level 2, the demographic and economic geography rating will be Level 2 (medium risk).
- If none of the above cases apply, the demographic and economic geography rating will be Level 1 (low risk).

2) Local Economy

The ability of a region, province, or public entities operating within such jurisdictions to generate revenue depends primarily on the local economy. This factor can be significantly altered by transfers of funds from the national or regional government that help supplement the resources the issuer can raise based on the local economy. In this regard, both the nature of the local economy and the nature of such transfers are analyzed. Problems in the local economy can adversely affect the finances of the region, province, or public entities operating under such jurisdictions, through a decline in revenue or an increase in expenditures. For example, increased local rainfall that floods farmland will reduce production and revenue and likely increase expenditures on drainage works.

Revenues and expenditures are influenced by local economic conditions. The analysis also includes an assessment of the level of economic diversification in the region or province, as economic diversification provides protection against economic fluctuations and enhances the ability to service issued bonds. The analysis also examines the stability of the local economy, local GDP and its growth rate, income levels and their growth rates, unemployment and employment levels and their trends. It further examines the main sources of income and employment, and analyzes the primary, secondary, and tertiary sectors. Regional or provincial investment plans are also evaluated, as they directly affect the performance of the local economy.

Regions and provinces with relatively high income levels and a diversified local economy provide protection against economic fluctuations and demonstrate a greater capacity to pay bondholders. This must be analyzed over a time horizon that coincides with the bond's repayment horizon, as a high current payment capacity does not guarantee a high payment capacity at the time of bond redemption. If the issuer is an entity other than the regional or provincial government, an analysis will also be conducted on how local economic conditions affect the entity in question. In particular, how demand for its services or products and its overall operations are affected by the local economy.

Likewise, a sensitivity analysis of the local economy will be conducted in light of significant changes in the area. In an optimistic scenario, the receipt of increased resources from the central government or natural resource extraction companies will be considered, while a pessimistic scenario will account

for a change in resource distribution policies by both the government and companies, as well as the occurrence of significant climatic factors.

The rating agency will compare these indicators globally relative to those of the country, region, or entities, as applicable, and will assess the nature of the local economy and its effects, based on their risk to the bonds' payment capacity, across one of three defined ranges or levels: 1, 2, and 3, where 1 represents the lowest risk, 2 represents medium risk, and 3 represents the highest risk.

3) Financial Analysis

The finances of the regions, provincial municipalities, or public entities operating under such jurisdictions are analyzed. Preference is given to a situation of financial soundness characterized by transparency in public accounts, growing revenues, controlled expenditures, normal financing needs, and adequate debt service coverage. The financial analysis follows, to the extent possible, the evaluation guidelines established for debt issuance risk ratings in the Rating Manual. However, in this case, emphasis is placed on the basic aspects presented below.

- Nature of accounting practices and their impact on accounting and financial documents.
 - Revenue analysis
 - Expenditure Analysis
 - Financing needs
 - Debt service coverage
- a. **Nature of accounting practices and their impact on accounting and financial documents:** Although the rating agency will not perform audit tasks, in order to fully understand the implications of the accounting and financial documents, it will pay attention to the nature of the accounting practices used in the preparation of such documents. Any peculiarities that may have a differential effect on the presentation of the data will be taken into account in the analysis. The rating agency will compare these peculiarities overall relative to the most common accounting practices and evaluate them within one of three defined ranges or levels: 1, 2, and 3, where 1 represents the lowest risk, 2 represents medium risk, and 3 represents the highest risk.
- b. **Revenue Analysis:** The trend and growth of revenues are analyzed, along with their sources, diversification, stability, and composition of ordinary and extraordinary revenues. Additionally, the frequency and amount of resource transfers occurring between other political entities or entities under the jurisdiction of a political entity are analyzed. The rating agency will compare these indicators on a global basis relative to those of the country, region, province, or entities, as applicable. In this way, the risk regarding the ability to pay the bonds will be determined within one of the three ranges or levels defined as 1, 2, and 3, with 1 representing the lowest risk, 2 representing medium risk, and 3 representing the highest risk.
- c. **Expenditure Analysis:** The trend and growth of expenditures, their sources, diversification, stability, and composition into ordinary and extraordinary items are analyzed. Investment expenditures are also analyzed. The rating agency will compare these indicators overall with those of the country, region, or entities, as applicable. It will assess the nature of the expenditures based on their risk to the ability to pay the

bonds within one of three ranges or levels defined as 1, 2, and 3, where 1 represents the lowest risk, 2 represents medium risk, and 3 represents the highest risk.

d. Financing needs: The trend and growth of uncollected debts—whether tax-related or for services—are analyzed, along with current and future financing needs, with these needs broken down into operating and non-operating financing. Additionally, budget execution and borrowing capacity are analyzed. The rating agency will compare these indicators globally relative to those of the country, region, or entities, as applicable. It will assess the nature of the financing need based on its risk to the ability to repay the bonds within one of the three ranges or levels defined as 1, 2, and 3, where 1 represents the lowest risk, 2 represents medium risk, and 3 represents the highest risk.

e. Debt Service Coverage: The indicator is defined as

$$\text{Cobertura del servicio de la deuda} = \frac{\text{Total de ingresos} - \text{Gastos operativos (sin amortizaciones ni intereses)}}{\text{Servicio anual de la deuda}}$$

This indicator is rated within one of the three ranges or levels defined as 1, 2, and 3, where 1 represents the lowest risk (when the indicator is greater than 2), 2 represents medium risk (when the indicator is greater than 1 but less than or equal to 2), and 3 represents the highest risk (when the indicator is less than or equal to 1).

The financial analysis rating will be based on the rating assigned to each of the previously defined indicators; the financial analysis rating criteria are as follows:

- If one or more of the indicators are rated Level 3, the financial analysis rating will be Level 3 (high risk).
- If two or more of the indicators are rated Level 2, the financial analysis rating will be Level 2 (medium risk).
- If none of the above cases apply, the financial analysis rating will be Level 1 (low risk).

4) Political and Administrative Risk

The finances of regions, provincial municipalities, or public entities operating under such jurisdictions are analyzed. Preference is given to a situation of financial soundness characterized by transparency in public accounts, growing revenues, controlled expenditures, normal financing needs, and adequate debt service coverage. The financial analysis follows, to the extent possible, the evaluation guidelines established for debt issuance risk ratings in the Rating Manual. However, in this case, the basic aspects presented below are emphasized.

4.2.2 Issuer Solvency Rating

The issuer’s solvency rating will be determined based on the rating assigned to each of the previously defined indicators: demographics and economic geography, local economy, financial analysis, and political and administrative risk. Scores will be assigned to each of these indicators’ ratings according to the following criteria:

	Level	Score
Demographics and Economic Geography	1/2/3	1/2/4
Local Economy	1/2/3	1/2/4
Financial Analysis	1/2/3	1/2/4
Political and administrative risk	1/2/3	1/2/4

Likewise, the issuer’s credit rating category shall generally be determined in accordance with the following procedure:

Rating Category	Sum Score
AAA	4
AA	5
A	6
BBB	7
BB	8–9
B	10–11
CCC	12–16

It should be noted that the total score cannot equal 15. The minimum possible score is 4, and the maximum possible score is 16. If, in the opinion of the evaluator, an exception to the scoring criteria described above is warranted, this shall be expressly noted, along with the rationale, in the corresponding reports.

4.2.3 Characteristics of the instrument

The characteristics of the instrument will be classified into two levels: Level 1 and Level 2. This classification is based on the greater or lesser protection afforded to the investor by the nature of the instrument’s set of guarantees, safeguards, and attributes regarding its payment.

It will be classified as Level 1 when the guarantees, safeguards, or special attributes possessed by the instrument provide additional protection to the investor regardless of the issuer’s creditworthiness. It will be classified as Level 2 when the instrument does not possess safeguards or special attributes, or, if these exist, they do not provide the investor with protection beyond the issuer’s creditworthiness.

4.2.4 Characteristics of the Instrument

The issuer’s credit rating, which determines the different categories, is combined with the rating of the instrument’s characteristics to obtain the final rating. This is assigned based on whether point a) or point b) below is met:

- a) If the instrument’s characteristics were rated at Level 2, the final rating will be the issuer’s credit rating. In this case, the final rating is equal to the issuer’s credit rating since the instrument has no guarantees, safeguards, or special attributes, or, if these exist, they do not provide the investor with additional protection beyond the issuer’s creditworthiness. The final rating corresponds to that determined in the last table.
- b) If the instrument’s characteristics were rated at Level 1, the final rating may be the issuer’s credit rating determined in the last table, increased by up to two categories, depending on the nature and extent of the guarantees, safeguards, or special attributes possessed by the instrument.

Alternatively, the rating agency may, at its discretion, and if the scope and nature of the guarantees, safeguards, or special attributes so warrant, conduct a creditworthiness analysis of the guarantor in accordance with the procedure applied to the guarantor, to determine, in this case, the credit rating of the bond’s guarantor. If this analysis is performed, and the guarantor’s credit rating is higher than the issuer’s credit rating, the final rating of the bond will be equal to the guarantor’s credit rating.

If the guarantor’s creditworthiness analysis is conducted, and the guarantor’s credit rating is lower than or equal to the issuer’s credit rating, then the final rating will be equal to the issuer’s credit rating.

If the guarantor’s credit rating analysis is performed and there is more than one guarantor, the highest credit rating obtained among the guarantors will be considered for the analysis, to the extent that the nature of this guarantee warrants it. If it does not warrant it, the next highest credit rating obtained among the guarantors will be used, and so on.

4.3 Rating Categories

Provincial, municipal, and public entity bonds operating under such jurisdictions will be rated according to the following categories:

1) Medium- and Long-Term Issues and Preferred Shares (LP)

Level		Details
Outstanding	AAA	Issues with the highest credit quality. Risk factors are virtually nonexistent.
High	AA	Issues with high credit quality. Protective factors are strong. Risk is modest and may vary occasionally due to economic conditions.
Good	A	Issues with good credit quality. Protective factors are adequate; however, during periods of economic downturn, risks are higher and more variable.
Satisfactory	BBB	Risk protection factors are reasonable and sufficient for an acceptable investment. There is considerable variability in risk across economic cycles, which could lead to fluctuations in the rating.
Not investment grade	BB	Issues rated below investment grade. It is estimated that their financial flexibility could limit their ability to meet obligations at maturity. The quality of these issues can fluctuate frequently, so they are considered speculative.
	B	Issues rated below investment grade. There is a higher risk of default. Financial buffers fluctuate significantly depending on economic cycles, industry conditions, and the company’s management’s ability to navigate these challenges.
	CCC	Issues rated well below investment grade. They are characterized by a high risk of timely payment. Protective factors are scarce, and risk can be substantial in adverse industry and company conditions.
Default	DD	Issues where interest and/or principal payments have been missed, or where the issuer has incurred other causes of default.
	DP	Preferred shares with overdue preferred dividends.
No information	E	Refers to those shares for which there is insufficient information or the information is not representative, making it impossible to issue an opinion on their risk.

These categories may be supplemented, if applicable, with the symbols (+/-) to improve or downgrade, respectively, the rating achieved within the categories AA through B, inclusive. Additionally, local scales will be identified by adding a prefix according to the identification assigned to each market¹.

¹ The nomenclature used corresponds to the international coding system based on ISO 3166-1 alpha-2, a two-letter code system.