

RESEARCH

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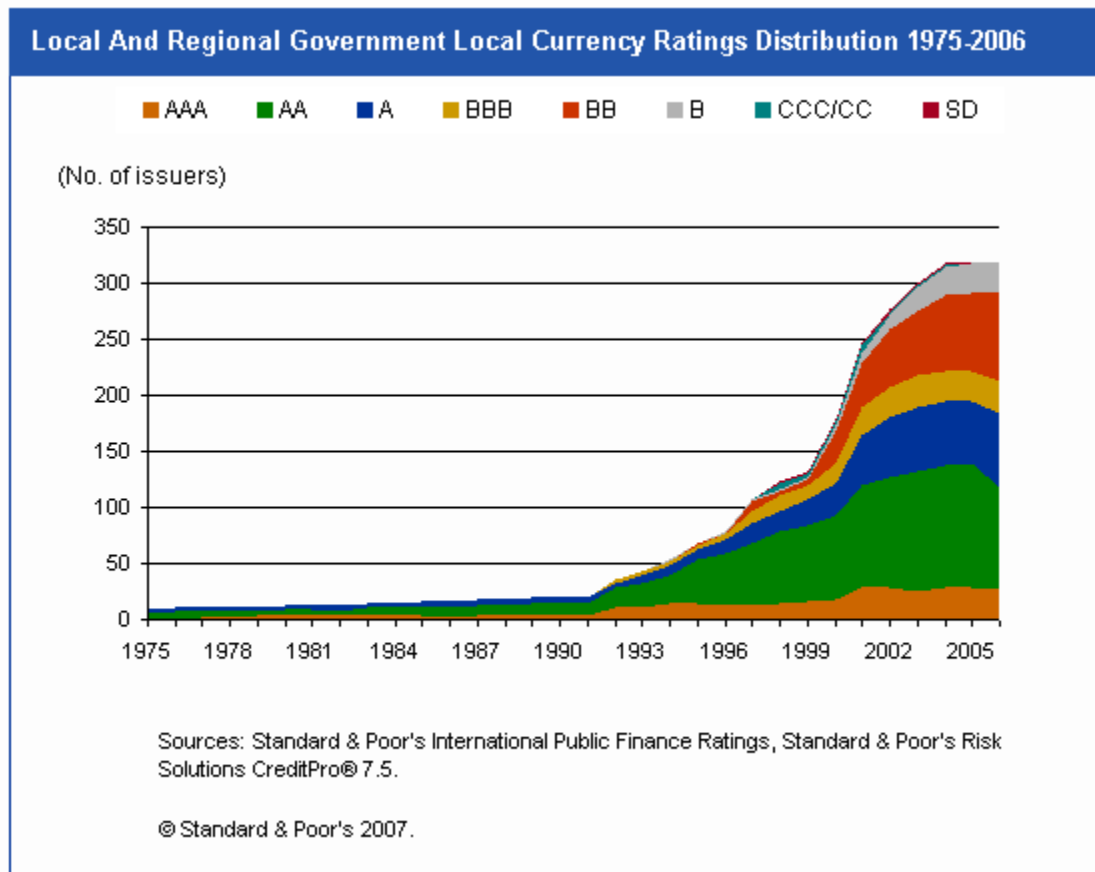
Rating International Local And Regional Governments: A Primer

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Introduction To Local And Regional Government Ratings

Standard & Poor's Ratings Services has been assigning credit ratings to local and regional governments (LRGs) around the world since 1975. At year-end 2006, Standard & Poor's had local currency ratings on 317 LRGs, including confidential ratings, in 31 countries outside of the U.S. In emerging countries the number of ratings has rapidly expanded since 2000, leading to the rating distribution illustrated in chart 1.

Chart 1



Although LRGs differ in the scope of their activities, our evaluations recognize that they bear the identical responsibilities of delivering public services and funding infrastructure developments, supported directly or

indirectly by taxes and fees levied on residents or transferred from other levels of government. LRGs' common task is to balance the level and cost of these services and to fund infrastructure developments with available revenues, with recourse to debt when necessary.

More information on LRG rating trends can be found in "2006 Default And Transition Study For International Local And Regional Governments," published on Feb. 02, 2007, on RatingsDirect.

Rating Methodology For LRGs

Standard & Poor's assigns credit ratings to LRGs based on in-depth qualitative and quantitative analysis of a wide range of financial, economic, and institutional factors. Public finance entities are part of the wider political, administrative, and budgetary systems of the country in which they are located. These systems need to be carefully evaluated in terms of their impact on LRG fiscal sustainability.

Our quantitative analysis of LRGs incorporates a number of measures of financial and economic performance. Our analysis is also qualitative, as we take into account political and policy developments, management sophistication and, in certain emerging countries, debt repayment culture. Qualitative analysis is particularly important for the assessment of medium-term trends, as our ratings indicate future debt service capacity. This is reflected in our overall analytical framework for LRGs, which includes the following sections:

- Economy
- System support and predictability
- Management capacity and institutional legitimacy
- Financial flexibility
- Budgetary performance
- Liquidity and debt management
- Debt burden
- Off-balance-sheet liabilities

As part of the committee process that we use to assign credit ratings, each LRG is ranked on a scale of one (the best) to five, for each of the eight analytical categories. There is no exact formula for combining the scores to determine ratings. The analytical variables are interrelated and the weights are not fixed, either across LRGs or over time.

Each of these sections is discussed in detail below.

Economy

The economic strength of a region or locality is among the most critical determinants of its creditworthiness. Fiscal solvency is intimately linked to economic prosperity in most cases. Our key analytical questions refer to the LRG's demographic situation, growth prospects, and economic diversification.

Population

Standard & Poor's aims to determine the extent to which the structure and growth of an LRG's population pose a risk or a benefit to LRG finances, in terms of the entity's role as both service provider and tax collector. Stable and moderate population growth generally positively affects the creditworthiness of the entity, while sudden changes in population due to strong migration shocks could indicate risk. This is particularly likely if those leaving the territory are largely of working age, and those entering are characterized by dependency. An important aspect of demographics is the size of the dependent population; that is, the portion of young and elderly people (under 15 or over 65 years of age). These groups place the greatest burden on locally delivered services, such as education and health care, and contribute the least to revenues.

Key ratios.

- Population (total and as a % of national population)
- Population growth rates

- Dependent population (% of young and elderly in the population)

Economic structure

The strength of the economic base depends on its diversity, in terms of both output and employment. A highly diversified economic base is generally less affected by external shocks and more resilient during sectoral downturns. In contrast, regions or localities highly dependent on one specific activity or company might have their creditworthiness put at risk if that activity or company suffers distress (low prices, new competition, modification of policies, or bad management, for example). In these cases, Standard & Poor's evaluates the health and prospects of these sectors or companies.

Comprehensive analysis of the labor force might be fundamental in regions or localities with high unemployment rates, a high and increasing level of labor precariousness, or a significant shadow economy. In those cases it is essential to determine whether, for example, high unemployment is a temporary problem driven by short-term economic cycles, or a long-term structural phenomenon. The latter may put significant pressure on LRG finances, as it translates into higher expenditure on social welfare policies and constraints on long-term revenue generation.

Key ratios.

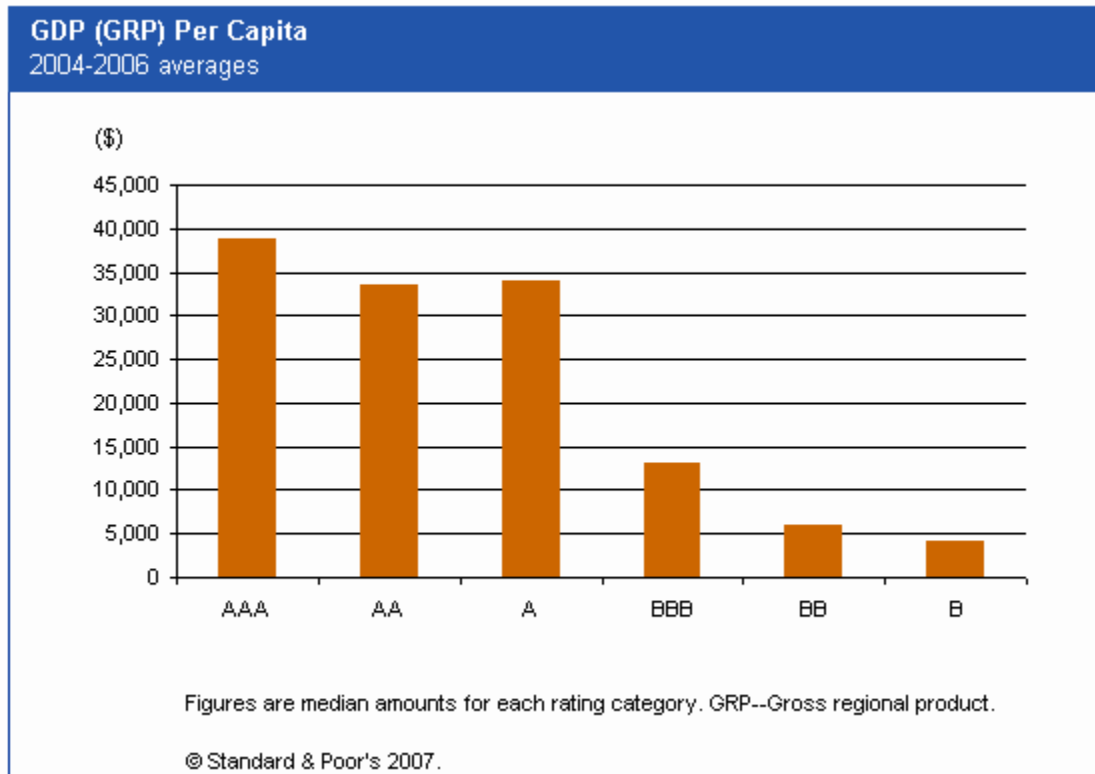
- Nominal and real GDP
- GDP (output) and employment distribution by sector
- Employment and unemployment levels
- Employment by largest employers

Wealth

Measurements of economic wealth underpin judgments about the flexibility a higher level of wealth brings to an LRG's capacity to raise taxes or restrict services, as well as serving as a proxy for greater or lesser economic, social and, therefore, political stability. Higher wealth levels also lead to lessened pressure on social policies for the support of low-income and poor segments of the population. Standard & Poor's incorporates into its analysis wealth indicators such as per capita GDP, but also poverty levels, educational attainment, and access to utilities. In addition, we review territorial disparities in terms of economic development, personal incomes, and infrastructure development. This latter group of indicators can be crucial, as economic and social disparities can create social tension and spending pressures, in particular during cyclical downturns or recessions, when decreasing tax revenues are already limiting fiscal flexibility.

There is a strong link between economic development, measured by GDP per capita, and credit ratings (see chart 2). The correlation is particularly marked for rating categories from 'B' to 'A'. LRGs with ratings in the 'A' category and higher are usually characterized by high levels of wealth, infrastructure, and public services, which are not significantly constrained. They tend to have well-developed economies and populations that have the ability to sustain adequate standards of living.

Chart 2



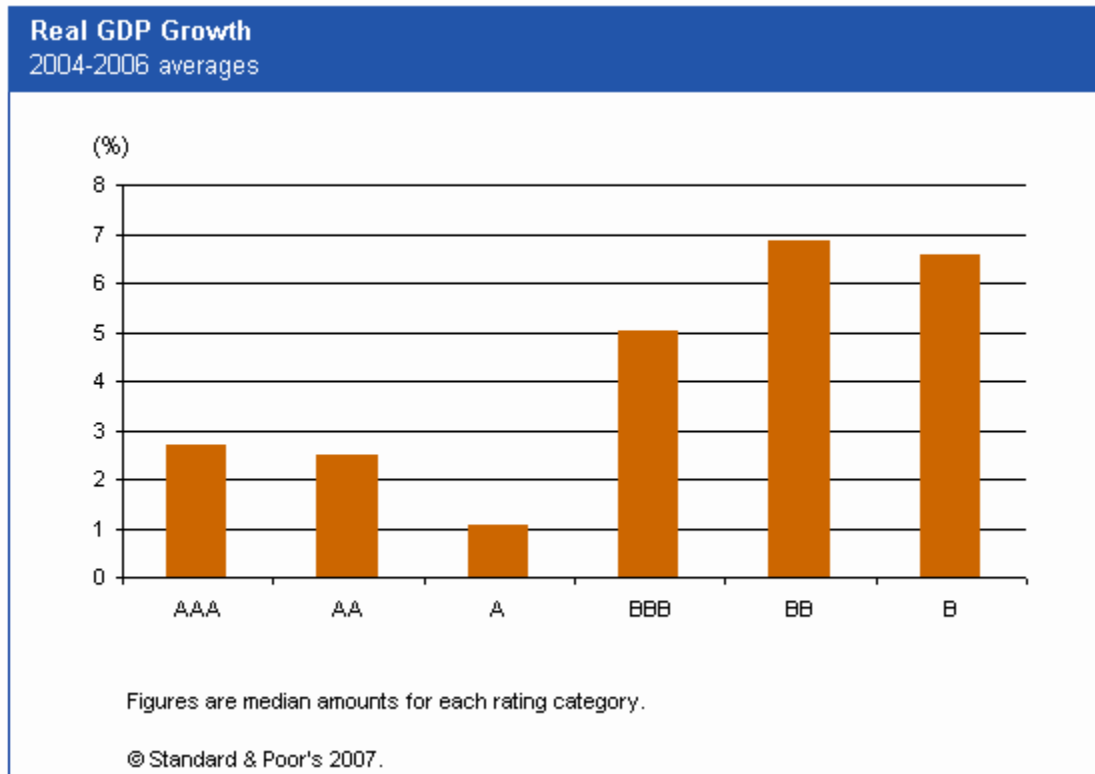
Key ratios.

- Per capita GDP

Growth prospects

Given that ratings are forward-looking assessments, a measure of the expected economic growth of a region or locality is one of the key determinants of its creditworthiness. Although difficult to determine, our estimations are based on recent trends in output, employment, and investments, adjusted for any structural or policy changes and controlled for business cycles. Sustainability is another very important concept in this regard. For that reason, our analytical focus is on the medium term. Optimal is real per capita GDP growth of 2%-3% per year for mature economies, or 5%-6% per year for less-developed countries, given the need to catch up on wealth levels. LRGs with speculative-grade ratings (below 'BBB-') demonstrate relatively higher GDP growth than their investment-grade peers (see chart 3). On the other hand, weaker scores are determined not only by very low or negative growth, but also by high volatility.

Chart 3



Growth trends must be understood in the context of national economic development and the competitive advantages or disadvantages of the region or locality. Those will certainly include location, natural and human resources, and export performance (as a means of increasing diversification and lessening dependence on local consumption). Expectation of future economic growth is also based on the state of infrastructure development. The availability and quality of airports, ports, railways, roads, and space for development are essential to accommodate and support the growth of economic activities. Other measures of a vibrant economy include recent and anticipated levels of private and public investment, including foreign direct investment trends (where available).

Key ratios.

- Real GDP growth
- Exports as a % of GDP, and export growth
- Investments, and investments as a % of GDP
- Foreign direct investments, and as a % of total investments

System Support And Predictability

The supportiveness and predictability of the public sector system offer a positive contribution to the rating if the institutional arrangements and environment give us additional confidence in the LRG's long-term capacity to maintain a strong financial profile. Key analytical topics include:

- The predictability of the administrative and political systems, intergovernmental relations, and public sector reforms.
- The match between revenues and expenditures, which is influenced by tax generation, the equalization system, financial assistance from the central government's budget, and the allocation of expenditure mandates.
- The legal framework and established (formal and informal) rules regarding transparency and accountability.
- The fiscal policy framework, including legal restrictions on debt and financial policy.

- Extraordinary support from other levels of government.

Predictability

A mature public sector and intergovernmental system, which offer a predictable institutional framework; a limited number of reforms affecting the division of revenues and responsibilities between levels of government; or a track record of changes being implemented gradually, we view as positive for the credit rating on an LRG. The strength of the system can also be shown by cooperative intergovernmental relations with a strong political power and/or LRGs having a decisive voice in the process affecting their legislative framework. A situation that is higher risk is one in which intergovernmental relations are evolving, with a wide range of ongoing reforms affecting the division of revenues and competencies, which could put pressure on LRGs' fiscal sustainability and create a highly volatile legislative and financial framework. In addition, if LRGs have no influence on the central government's decisions regarding the allocation of revenues and expenditures, they may suffer from inadequate compensation for newly devolved expenditure responsibilities or reforms reducing their revenues.

Revenue/expenditure match

For LRGs to maintain fiscal sustainability in the long run, it is essential that their expenditure responsibilities are well matched with their revenue generation capacity. In an ideal situation, if the government system is centralized, the central government would provide LRGs with stable and adequate revenue sources, including taxes and/or subsidies and equalization transfers. If the system is decentralized, subsovereigns would also enjoy sufficient tax-raising authority and financial flexibility to maintain the adequate financing of their competencies. It is essential that a country's equalization system operates effectively, so LRGs receive financial grants in a timely, objective, and predictable way, and that any new LRG expenditures imposed by the central government are adequately compensated. An LRG's fiscal sustainability can be at risk if there is a systemic unbalance between its poor revenue generation capacity and significantly higher expenditure requirements driven by scope of competencies, poorly-funded central government mandates, or residents' expectations. The risk often stems from potential unfunded expenditure responsibilities foisted on the LRG (downloaded) by other levels of government without matching revenues. We analyze the history and future expectations of such behavior to estimate the future degree of risk for the mismatch between revenues and expenditures.

The supportiveness of the system can also be reflected in an adequate vertical and horizontal equalization system, which extends proportionately greater revenue transfers to areas with less taxing power and higher poverty. In addition to fair equalization mechanisms, in supportive systems the central government may have policies that guarantee minimum revenue growth (national GDP or personal income tax--PIT--average increases, for example), and one-time sums granted to share the cost of unpredictable events, such as natural or chemical disasters.

Transparency and accountability

From a credit rating perspective, the supportiveness of the system is also dependent on national regulation and managerial traditions for the long-term strategic focus of policies, public sector accounting systems, accountability of managers and politics, and transparency. In mature and strong systems there are usually high standards for strategic management, transparency, and accountability practices, established legally or, more importantly, demanded by the country's management culture and by the general public. In weak institutional environments, fiscal frameworks tend to be focused on short-term technical issues, and to operate based on low-quality financial information and weak incentives for efficiency.

Thus, the extent to which national accounting rules conform to international standards of best practice is factored into our analysis. Compulsory audit and accrual accounting and consolidated reporting requirements reinforce the need to implement monitoring tools for both the revenue and cost sides of operations. Comprehensive reporting implies disclosure of financial surpluses, cash reserves, and cash flow statements; the reporting of real and financial assets, debt, and infrastructure endowments; and the estimation of contingent liabilities and future borrowing needs. They also ultimately increase awareness of financial strengths and weaknesses. Compulsory multi-annual budgets aiming to force regional and local governments to predict operating and investment spending, and work out in advance the optimal policy mix to maintain fiscal balance, are positives for our credit ratings.

Fiscal policy framework

In conjunction with debt-limitation ratios, a multi-annual financial plan can result in an awareness of debt affordability and lead an LRG to refrain from additional, ultimately unaffordable, debt spending. In order to promote budgetary discipline a higher level of government may:

- Require an operating budget balance.
- Limit debt to investment (one-time items) purposes and the speculative use of financial derivatives.
- Limit the growth of financial debt by setting a threshold (ratios of debt to revenues, debt to GDP, or debt to assets, for example) and regulating recourse to foreign currency debt.
- Monitor the evolution of the LRG's financial position by implementing early warning indicators (thresholds and ratios, for example) to anticipate fiscal imbalance and, subsequently, mandate the restoration of fiscal balance and/or the provision of resources.

Extraordinary support

Finally, system support and predictability takes into account the likelihood of external extraordinary support if the LRG were to experience financial difficulties. Standard & Poor's gives credit if the central government has an established practice of monitoring its subsovereigns' financial performance and debt and has a legal framework for bailing out the LRG and the financial capacity to do so. The central government should also have a track record of bailing out LRGs when necessary, with the intention of continuing such a policy in the future. For the risk of default, we also take into consideration expectations on the timeliness of such aid.

Management Capacity And Institutional Legitimacy

Whereas our considerations in the "Economy" and "System Support And Predictability" sections deal with external constraints and strengths, which influence LRGs' fiscal sustainability, this section focuses on the sophistication of internal government structures and practices, as well as on institutional legitimacy. It factors in the LRGs' medium-term financial objectives and capacity to implement them through management and monitoring tools.

Management capacity

Our analysis of management capacity is divided into seven categories:

- Transparency and disclosure
- Budgeting
- Long-term capital and financial planning
- Revenue and expenditure management
- Debt management
- Reserve and liquidity management
- Management of government-related entities

When looking at the above seven categories we assess the LRG's sophistication compared with global best practices. Governments in emerging markets sometimes do not have even basic fiscal management processes, which results in poor public sector performance and weak capacity to deal with social and infrastructure issues. For example, underdeveloped budgeting and debt management constrain the government's ability to carry out large-scale infrastructure projects and ensure their successful long-term operation. They also undermine the effectiveness of public spending and limit LRGs' access to more favorable funding sources.

The performance dimension of fiscal management practices is a supplementary, but important, tool for revealing risks related to difficulties in the application of public finance practices, or the inability of current fiscal management arrangements to respond to changing local realities. While evaluating the performance of practices, Standard & Poor's checks if there are any serious failures in business processes within all seven elements of fiscal management. For annual budgeting, for example, such indicators include the weak reliability of initial budget estimates, ad hoc budget revisions, and delayed budget approval. For accounting and reporting, performance problems could be shown by qualified auditor opinions or frequent changes of auditor.

Some of the key characteristics of high financial management capacity--financial management

strengths--follow.

Transparency and disclosure

- Management is willing and able to communicate required information.
- Accounting and reporting policies are advanced, such as accrual-based accounting, full consolidation, comprehensive reporting (balance sheet, P&L, cash flow statements).
- There is an internal and external audit, which ensures the accuracy of accounting and financial statements. Audit reports are unqualified.
- Annual and interim financial reporting is comprehensive, accurate, timely, and disclosed through public annual reports and a website.
- Accounting staff have sound qualifications. Advanced accounting software is employed.

Budgeting

- Budgeting is accrual and program based.
- There is a consolidated approach to budget planning: The budget encompasses all of the LRG's fiscal operations and financial liabilities, such as, for example, the consolidation of government-related entities in the budget.
- The budget is approved in a timely fashion--before the start of the fiscal year.
- Financial assumptions and projections are unbiased, realistic, and well grounded, and account for both long-term and near-term perspectives. The communication of such policies is well documented.
- Goals are explicitly stated and translated into budgetary appropriations.
- Information systems support budgetary planning and execution.
- Actual numbers do not deviate significantly from initially budgeted figures.

Long-term capital and financial planning

- There is a clearly stipulated financial policy, which incorporates a long-term perspective and explains the LRG's vision of its future financial position.
- Sectoral policies and expenditure allocation are guided by strategic and fiscal planning.
- There is multi-year financial planning with multi-year appropriations.
- Fiscal targets are realistic, approved in a timely fashion, and consistently implemented.
- The LRG's financial policy is designed to support financial stability and disciplined financial management.
- The LRG has a proactive approach to the identification, evaluation, and treatment of potential risks. There is a comprehensive and institutionalized risk management process.

Revenue and expenditure management

- Revenue policies regarding taxes and user charges are stable and predictable.
- Medium-term and in-year revenue forecasting is reliable.
- The collection of revenues is timely, and supported by advanced and reliable billing systems.
- Expenditure control mechanisms are effective. There is a long-term policy for the transfer of expenditures (such as financial grants to lower levels of government).
- Budgets are split into operating and capital expenditures. There are clear indications of the medium-term implications of capital investment projects on operating expenditures.
- There is an explicit investment policy, with the focus of LRG investments on public sector development, based on an effective priority-setting mechanism and principles of competitiveness and transparency.
- Expenditure plans are put into place efficiently, without systematic overspending or material expenditure hikes in the last month of the fiscal year.

Debt management policies

- The LRG's debt policy is:
 - Conscious of market, credit, liquidity, funding, operational, and concentration risks.
 - Explicitly formulated and consistently implemented.
 - Stable and predictable without unplanned debt issuance or sudden turns in debt policy.
 - Communicated to the legislative authority and the wider community.
- Long-term debt is used only to finance capital expenditures and short-term debt to manage liquidity.
- Debt limits imposed by national and/or supranational legislation are respected.
- The LRG's debt management policies are demonstrably conservative and efficient—with limited exposure to interest and currency risk, an even debt repayment profile, and competitive cost of borrowing—without jeopardizing financial stability.

Reserve and liquidity management

- The liquidity policy is conservative, with minimum and desired levels of cash and equivalents clearly stated.
- Cash and debt management are integrated.
- In-year cash flow planning is sound.
- Banking and treasury arrangements are secure, with fast and convenient cash disbursements for spending units.
- The LRG has electronic transaction processing systems.
- Funds are available to spending units on a timely basis. The government historically operates without cash shortages and unmet liabilities (of any kind).

Management of government-related entities

- There is a sound rationale for the existence of each public company.
- The principles of good corporate governance are adhered to, with proper representation of the LRG's interests.
- LRG-owned companies employ comprehensive corporate business planning and performance reporting.
- The performance of LRG companies and their top managers is systematically monitored.
- Large LRG-owned companies are independently externally audited.

Institutional legitimacy

Although it is difficult to measure, the legitimacy of an LRG can be critical to the willingness of residents to endure spending cuts or tax and fee increases. The levels of voter participation and the size and cohesion of the governing majority can be important measures here.

The capacity to implement legislation and enact budgets in a timely manner; the ability of the executive to gain approval for structural reforms; and the level of dialogue between the administration and the legislature and the government and its residents, can all indicate the credibility and depth of political institutions.

The frequent turnover of administrations and personnel can influence perceived legitimacy and management effectiveness. In general, post-election changes, when a new administration has been elected, occur at the top of ministries and departments, while the rest of the administrative staff remains in place, enabling the continuity of managerial and budgetary procedures.

Financial Flexibility

Financial flexibility is another factor in Standard & Poor's analysis of LRGs' credit quality, which is particularly important during periods of external pressure on government finances. If the LRG has high financial flexibility, it is likely to be able to effectively adjust its revenues or expenditures in the face of external shocks, to maintain an adequate financial performance.

Financial flexibility is a very qualitative aspect of credit analysis. It is defined according to comparisons between specific intergovernmental systems, and to how each LRG compares with its peers in the same system. Financial flexibility can be generally categorized by, although is not limited to, the following:

- Legal limits on fiscal flexibility
- Political and competitive limits on flexibility
- Limits on flexibility due to future spending requirements
- Potential sources of pressure

Standard & Poor's also uses several quantitative measures, which assist financial flexibility analysis by showing the rigidity or flexibility of revenue and expenditure structure and growth. Capital expenditures and uncommitted operating expenditures, as well as LRG-controlled revenues, can be modified by the LRG in the short term. The higher the share of these revenues and expenditure, the higher the LRG's estimated financial flexibility. Comparing trends in operating revenue and expenditure growth can also bring to light a shift in financial flexibility. For more details, see the subsection "Key ratios," below.

Legal limits

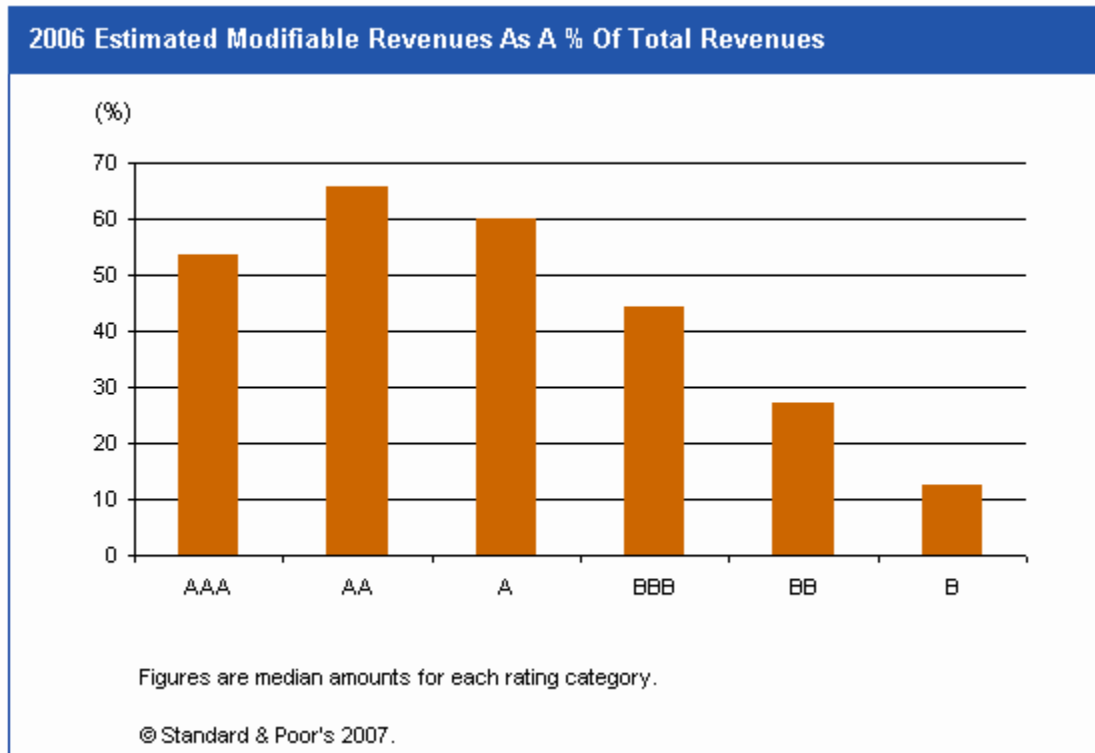
Legal limits on flexibility--such as the degree of control the LRG has over its revenue base, expenditure responsibilities, and the potential for unfunded mandates--are very important in an initial rating, but in our experience do not change much on a year-to-year basis. To measure an LRG's control over its revenue base Standard & Poor's implements the concept of modifiable revenues.

Modifiable revenues

Any tax, nontax (such as fees or tariffs), and other operating revenues, which are levied on the local economy and that the LRG can modify by adjusting the rate and/or the base, including through tax exemptions or collection procedures. According to this definition, shared taxes on which the local government has no direct influence, and cannot adjust the rate even marginally, are not modifiable revenues.

Investment-grade LRGs tend to have modifiable revenues of above 40%, indicating a high degree of discretion in adjusting revenue streams, which could be used to meet financial liabilities (see chart 4).

Chart 4



The next step in our assessment of revenue flexibility focuses on the LRG's power to raise new revenues through the introduction of new taxes, the regulation of tax bases, or by increasing tax rates. Very often limitations on revenue increases are imposed by a higher level of government, or through a requirement to seek voter approval. When measuring financial flexibility, we attempt to identify the amount of additional operating revenues that would be gained if the LRG used its flexibility to the maximum possible.

Legal control over expenditure responsibilities depends on the degree of prescription of the government's spending responsibilities by national and subnational legislation. The most inflexible LRG expenditures are those mandated by national legislation, with prescribed service standards. Such expenditures are very difficult to cut during a downturn in revenues or if there is pressure on other expenditures. On the other hand, the LRG's expenditures related to its general competencies without any long-term commitment, as well as capital expenditures, are usually the most flexible part of the entity's expenditures.

Political and competitive limits

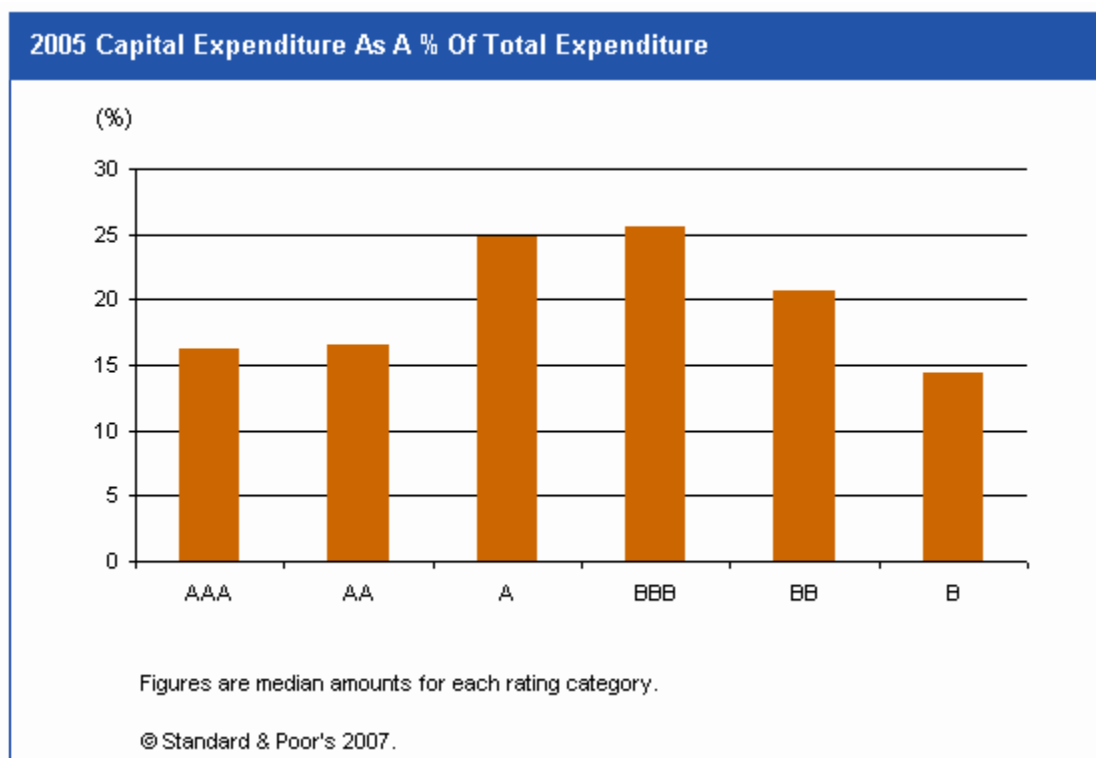
Practical limitations on financial flexibility arising from political priorities or competition from neighboring jurisdictions are likely to change slightly more often than legal limits, but still remain fairly stable. To evaluate these aspects of LRGs' financial flexibility, we compare key tax rates, revenue per capita, and the level of public services, against the national average and those of the LRG's closest peers. Significant unfavorable disparities may indicate a risk of tax base drift to other jurisdictions and create pressure to cut taxes and provide higher levels of services. Such pressure can also be driven by a political commitment to limit revenue increases or improve and expand services.

Limits on flexibility due to future spending requirements

Future spending requirements invoked by infrastructure and the social and operational situation of the LRG are likely to be the next most changeable aspects. The adequacy of spending on social and economic services and infrastructure is estimated by comparing the population's expectations against benchmarks and peer spending levels. Medium-term spending requirements can be found if previous governments were under-spending in certain sectors leading to a deterioration of assets; if this is the case, some catch-up spending is needed.

The qualitative assessment of infrastructure quality is the most challenging analytical endeavor when assessing financial flexibility. A review of historical trends and a peer comparison of capital expenditure per capita or as a proportion of total expenditure assist a judgment on future capital expenditure requirements. Highly rated LRGs usually demonstrate medium levels of capital expenditures--in relative terms about 13%-15% of total expenditures--which indicates mature and adequate infrastructure (see chart 5). However, due to higher per capita budget revenues and expenditures, this level of investments can still be high in absolute terms if compared with lower rated subsovereign governments. Relatively high capital expenditures of about 25% are shown by LRGs with ratings in the 'A' and 'BBB' categories, which usually results from a combination of solid financial capacity and demands to expand and improve existing infrastructure.

Chart 5



Other potential sources of pressure, and one-off revenues

Potential sources of pressure on financial flexibility include external factors, which can change frequently, especially in unstable environments. For example, LRG financial flexibility depends on the degree to which revenues and expenditures can be influenced by economic cycles and shocks. We therefore assess the degree to which the LRG's budget is exposed to economic or other conditions. For example, corporate taxes and welfare responsibilities are likely to be more exposed to economic conditions than property taxes and education spending. Other exposures include likely future staffing numbers and wage increases.

Pressure can also stem from LRGs' pension obligations, which may increase due to government policies or changes in the local employment situation. Although LRGs are not responsible for the pensions of their population, they can be accountable for the pensions of their employees. This is not the case in all countries, however, and in some cases LRGs are not responsible for the entirety of pension obligations but only for a complement to the main benefit provided by the central government. From a fiscal flexibility perspective, Standard & Poor's studies the weight of annual pension expenditures in total operating expenditures and above all the anticipated medium-term evolution of this ratio. For more details please see "International Local And Regional Governments Are Grappling With Rising Pension Liabilities," published on March 7, 2007, on RatingsDirect.

Flexibility can, however, be supported by the one-off revenue generation capacity of the LRG's assets,

such as real estate and public companies. At the LRG level a large portion of government assets does not generate large cash returns and they, by their very nature, are unlikely to be sold. Nevertheless, there are some assets that could be privatized or disposed of if necessary--an electricity company, for example, or real estate assets. When assessing the possible beneficial impact of these assets on the LRG's fiscal flexibility, and hence credit quality, we consider:

- The likelihood that the assets would ever be sold. There may be legal or political limitations to an LRG selling an asset.
- The time taken to sell. Some trade sales may require legislative approval, which could mean the process takes years.
- The extra risks to which owning the assets exposes the government. For example, if the government is guaranteeing the debt of a trading entity, it is exposed to the business risks associated with that entity.

Key ratios.

- Modifiable revenues as a % of total revenues (see definition above in this section)
- Capital and operating expenditures as a % of total expenditures
- Personnel and interest expenditures as a % of operating expenditures
- Operating expenditure growth
- Operating revenue growth

Budgetary Performance

Budgetary performance is a central part of the financial analysis of LRGs, in which forecasting of future trends plays a central role. To a large extent this is a number-crunching exercise focusing on some specific standardized ratios. Discussion about budgetary performance often suffers from a lack of uniform definitions of terms, and the diversity of public sector accounting standards across countries. Currently, Standard & Poor's analysis of budgetary performance mainly rests on cash-based ratios, but it also takes into account accrual information when available. Our terminology with respect to specific concepts for the characterization of budgetary performance can be seen in the table. The operating balance is operating revenues minus operating expenditures. Capital revenues, including assets sales and dividends, are added, and capital expenditures and investments to acquire assets are subtracted out, to arrive at the balance after capital expenditures. Finally, we reconcile the LRG's pre-financing balance to external financing, lending activity, and changes in the entity's own cash balance. In the example shown, XYZ government has a \$0.9 million cash shortfall in year two, which had to be met with a combination of additional borrowing and drawdown of its own cash.

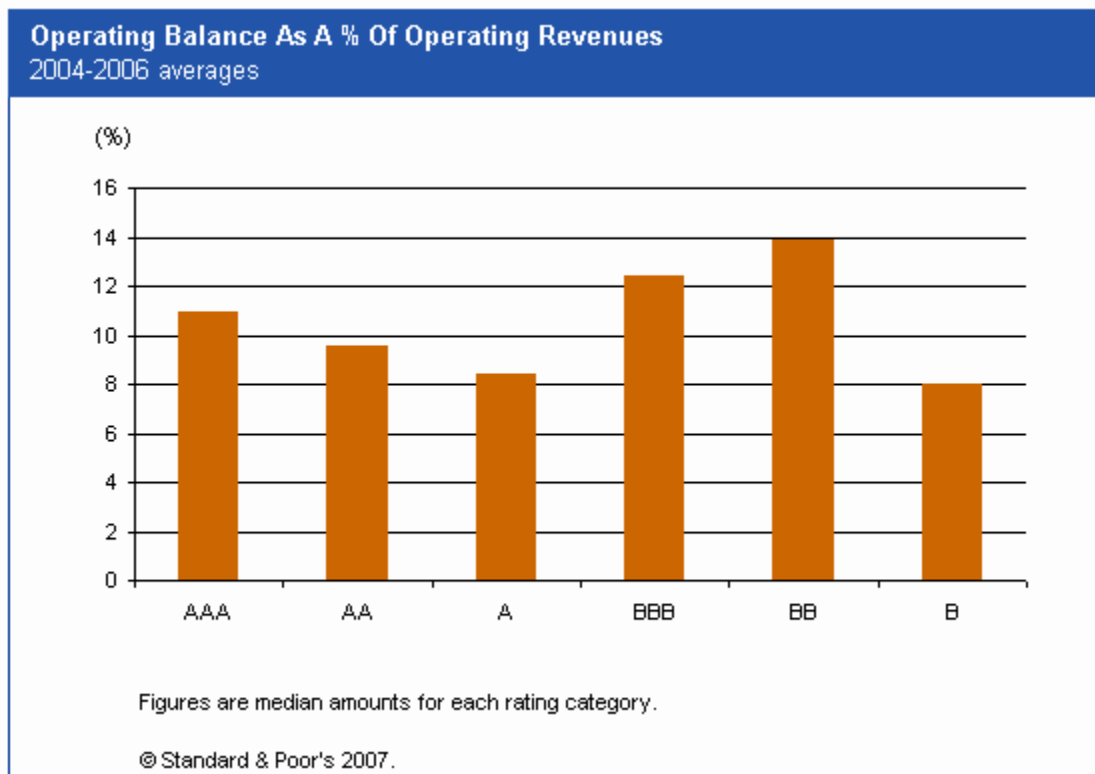
Measuring Budgetary Performance: XYZ Subsovereign Government		
(Mil. \$)	Year one	Year two
Operating revenues	15.8	17.5
Operating expenditures	13.2	16.1
Operating balance	2.5	1.4
Capital revenues	1.3	1.2
Capital expenditures	3.2	3.5
Balance after capital expenditure	0.6	(0.9)
Debt repaid	2.6	2.5
Net budget loans	0.3	0.2
Gross borrowing	2.5	3.6
Balance after borrowings	0.2	(0.1)
Reserve movement (change in cash balance)	0.2	(0.1)

Key ratios.

- Operating balance as a % of operating revenues
- Balance after capital expenditures as a % of total revenues
- Balance after borrowings as a % of total revenues

When evaluating budgetary performance, a good starting point is an assessment of trends in the entity's operating balance, which measures the LRG's capacity to manage its recurrent activities and helps to identify any structural mismatch between ongoing income and expenses. Medium- to long-term positive operating balances are vital for all rating categories from 'B' to 'AAA'. Median operating balances across all rating categories tend to be positive at about 8%-12% (see chart 6). Persistent operating deficits indicate that the LRG's revenue base is not adequate to sustain the entity's range of services, or, conversely, points to management's lack of acceptance of the burden of raising sufficient funds. Prudent management of capital needs is best measured by LRGs' ability to finance capital maintenance requirements over the medium term from sources such as operating surpluses and capital grants, as well as its ability to finance some capital additions.

Chart 6



When making assumptions on future budgetary performance, our analysis incorporates management's medium-term plan and any policy changes, as well as expected pressures on and support of revenues and expenditure. If we find any deviation from a solid budgetary performance we consider whether it is truly a one-off or whether it is a sign of a structural shift in budgetary performance. For example, a government with a good history of strong budgetary performance can probably afford one or two years of operating deficit, provided there is some reassurance that measures have been taken to ensure that things will improve and the rationale for the deficits is sound. However, even a government with a history of strong budgetary performances cannot sustain continued excessive borrowing, even to fund large capital expenditure programs, without a deterioration in credit quality.

Liquidity And Debt Management

Standard & Poor's analysis of LRG credit quality places a large emphasis on liquidity and debt management issues. This includes an assessment of the appropriateness of debt and liquidity management policies and the level of internal liquidity and committed bank and other credit lines, as well

as the analysis of projected cash inflows and outflows during the year, their seasonality, and the LRG's average and minimum reserves and cash balances. The types of risk that we assess are grouped into the following categories:

- Liquidity risk
- Currency risk
- Interest rate risk
- Refinancing risk
- Derivative usage
- Counterparty credit risk
- Operational risk

Liquidity risk

The adequacy of liquid assets and cash flows is a key short-term determinant of timely debt service. The evaluation of what constitutes prudent liquidity depends on several factors: the seasonality of revenues and expenditures, the debt structure, the nature of short-term investments, and the entity's access to external financing. Liquidity back-up reserves may consist of unrestricted cash reserves, liquid investments, and committed bank lines.

Our analysis focuses on the LRG's average and minimum reserves and cash balances relative to annual debt service requirements. As well as checking on the adequacy of liquidity back-ups, we review the LRG's internal liquidity monitoring and management policy and practices. This is particularly important where seasonal concentration of revenue inflows or expenditure outflows leads to sharp swings in reserves or cash balances. Ideally, an LRG should have a cash flow monitoring system that matches available liquidity with cash demand from ongoing operations and the need to refinance maturing short- and long-term debt.

LRGs sometimes hold large balances of cash and other investments on their balance sheets. We analyze whether these should be defined as free cash and equivalents and therefore credited in the calculation of net debt.

Increased availability of information on balance sheets also allows us to consider working capital issues. An increase in receivables outstanding can be an important early warning signal of an LRG's liquidity problem. Receivables may be increasing because of collection inefficiency, or because people are having trouble paying their taxes, fees, and fines due to weakening economic conditions. It could be also a sign of significant delays in the payment of transfers from higher levels of government. An increase in the LRG's payables may also be an early warning of problems or of management inefficiency or liquidity pressure resulting in delayed payments to suppliers.

The key quantitative indicators that assist our analysis of liquidity risk are:

- Cash as a % of operating expenditure
- Cash and committed facilities as a % of operating expenditure
- Cash as a % of debt service
- Cash and committed facilities as a % of debt service
- Payables as a % of total expenditures
- Receivables as a % of total revenues

Currency risk

If an LRG has foreign-currency-denominated debt we analyze the consequences of adverse exchange rate movements. A conservative strategy would mean the LRG offsets any potential foreign exchange exposure through the use of hedging strategies. Where foreign exchange risk is accepted, either through choice or because through a lack of hedge instruments the LRG has no alternative, we analyze the mechanisms for monitoring and managing exposure to determine the degree of risk. There is one key ratio for estimating an LRG's exposure to currency risk.

Key ratio.

- Foreign currency denominated debt as a % of total direct debt

Interest rate risk

The degree of exposure of the debt portfolio to interest rate movements is the key component of interest rate risk. Sophisticated LRGs are usually assertive in structuring their debt portfolio to take advantage of expected movements in interest rates, and are therefore exposed to losses if interest rates do not move in the expected direction. A conservative approach would be one in which the LRG has low-to-moderate exposure to interest rate movements and has timely systems in place to monitor and manage its degree of exposure, as well as mechanisms to respond to adverse interest rate movements.

Refinancing risk

This refers to the risk associated with the rollover of existing debt maturities. We focus our analysis on LRGs' refinancing policy, debt maturity profile, and ability to access particular markets to refinance maturing debt. A heavy reliance on short-term debt or debt with an irregular maturity profile can pose a significant risk in the absence of credible refunding options. It can be acceptable in very liquid and mature markets, but becomes particularly risky in emerging countries. Where there are bullet maturities we pay special attention to the liquidity management associated with these maturities and their refinancing.

Another important question is whether an LRG's usual funding sources will still be available to it in times of financial stress. If it is possible that some markets will be closed off to the LRG in a stress scenario, we determine the possibility of alternative sources of funds, such as from a higher level of government or related financial institutions.

Key ratio.

- Short-term debt/total debt

Use of derivatives

Where an LRG uses derivatives, we examine closely the mechanisms for controlling and managing their use. Although there is a place for derivatives, even in a conservatively managed LRG, their use needs to be within the context of a broader debt management plan and adequate controls must be in place to oversee their use. From a credit rating perspective it is important that derivatives are not used for speculative purposes.

Counterparty credit risk

In their debt management activities, LRGs may enter into many transactions with other parties, exposing themselves to the risk that the counterparty will not be able to complete its part of the transaction. LRGs that are managed conservatively will have a policy that sets out the level of creditworthiness of counterparties with which they are willing to enter into transactions--the credit rating of the counter party, for example--and specifies limits for varying degrees of creditworthiness. In markets where convenient information on counterparty creditworthiness is not available (credit ratings are not available), Standard & Poor's makes an effort to identify significant counterparties and assesses the level of credit risk associated with them.

Counterparty credit risk is also important in respect of an LRG's financial investments. Ideally, guidelines should exist on the creditworthiness of entities in which the LRG may invest. A conservative policy would limit investments to highly credit worthy entities, particularly for invested liquidity reserves.

Operational risk

This focuses on the controls and procedures in place to ensure that transactions entered into in relation to debt management activities have been authorized and are consistent with established policies. Risk can arise from the unclear delegation of responsibilities and concentration of debt and liquidity management with a very small number of professionals. We make an assessment according to whether these controls and procedures are adequate to prevent either mistakes occurring or rogue trading.

For more details on liquidity and debt management, see "Balance Sheets, and Local and Regional Government Credit Analysis," published on Feb. 1, 2004, on RatingsDirect.

Debt Burden

We measure LRGs' debt burdens by comparing annual charges and year-end stocks with available resources. An LRG's debt burden cannot be looked at in isolation nor confined to core government debt.

We also take into account the obligations of trusts or government-related entities, which includes companies in which the local government has a majority share or for which it is formally or "morally" responsible. Factors affecting our consideration of these obligations include whether the government formally guarantees them, whether the entity is self supporting, and the size of these obligations relative to the size of the LRG's core debt.

Our analysis focuses on both debt-related financial flows and debt stock (balance sheet) items, including past and current levels, but also very importantly forecasts or estimates for the coming two to three years.

Our analysis of LRGs' annual debt charge focuses on two key ratios:

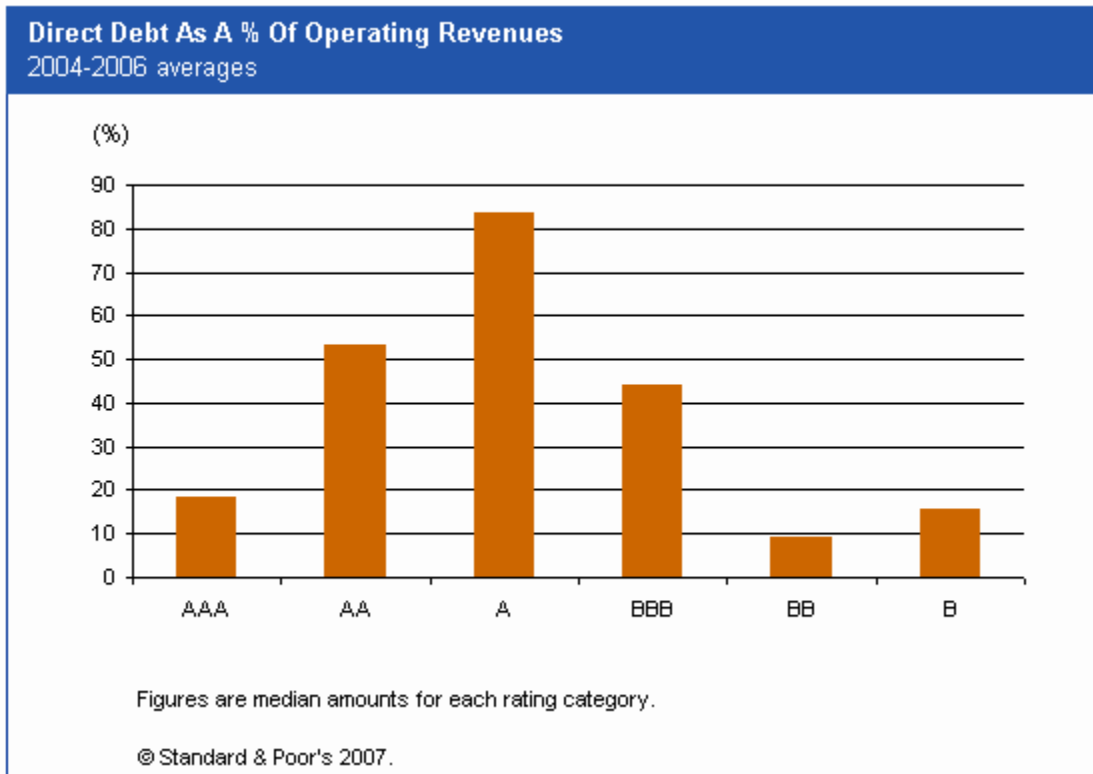
- Net interest payments as a % of operating revenues
- Debt service as a % of total revenues

The evaluation of debt stocks involves the comparison of varying degrees of public sector debt consolidation with public sector revenues and some measure of the size of the regional economy, such as GDP. The key ratios we analyze are:

- Direct debt as a % of operating revenues
- Net direct debt as a % of operating revenues
- Net tax-supported debt as a % of total revenues

Importantly, we view the debt burden in the context of an LRG's ability to maintain certain amounts of debt obligations. In the most developed markets, LRGs rated as investment grade usually have stable access to long-term debt. Coupled with high financial flexibility, this helps them to build smooth long-term debt maturity profiles and relatively low short- to medium-term debt burdens, compared with speculative-grade LRGs. The highest direct debt as a percentage of operating revenues is held by LRGs rated in the 'A' category, and is mainly due to LRGs in Italy and Canada (see chart 7). LRGs in the 'AAA' and 'AA' categories do not often fully use their borrowing capacity, as they tend to have more conservative debt policies and fewer external financing requirements. Relatively little borrowing by LRGs in the 'BB' and 'B' categories can be explained by the volatile and short-term nature of the debt markets available to them, a lack of sophistication in debt management, low financial flexibility, legal constraints, and volatile budgetary performances.

Chart 7



As a result, and in light of the increasing weight of pension obligations for LRGs, we now consider the actuarial pension deficit, or the net present value of the unfunded portion of future pensions, as a debt-like obligation. LRGs' stock of unfunded pension obligations is, therefore, now consolidated with their financial debt, into a new ratio:

Net financial liabilities as a % of total revenues

Net financial liabilities is a sum of net tax-supported debt and the actuarial valuation of unfunded pension obligations at year end. For more details on this new ratio, see "New Debt Measure For International Local And Regional Governments" published on March 7, 2007, on RatingsDirect.

Other useful indicators, depending on the entity analyzed and the information available, are:

- Direct debt as a % of local GDP
- Total public sector debt (at the local level) as a % of combined public sector revenues
- Direct debt plus guaranteed debt, as a % of total revenues

Definitions

Net interest payments. The total amount of interest payments in the budget period, including the interest part of financial leases, net of interest revenues from cash and marketable securities.

Debt service. Net interest payments plus the amount of principal repaid during the year, including the capital part of financial leases and including one-off short-term debt fully repaid during the period. Debt service on a revolving (rollover) credit line would be exaggerated, if the full amount of turnover on the revolving line is recorded as repayment. Therefore, repayment under the revolving line should include only the maximum amount drawn under the line during the year, minus debt outstanding under the revolving line at year end.

Direct debt. The amount of long- and short-term financial debt assumed directly by the borrower (loans, bonds, credits, and capitalized lease obligations) that an LRG is obliged to pay to another entity in accordance with an expressed agreement or for any other legally binding reason. This excludes guaranteed debt and the debt of government-related entities, unless it is serviced by the LRG on an ongoing basis. It includes debt serviced via subsidies from other levels of government unless the legal obligation to service this debt is transferred to the other government.

Net direct debt. This is direct debt net of free cash and equivalents.

Free cash and equivalents. All cash and marketable securities that meet the following criteria:

- "Motivation criteria": investment of the funds must be a conscious and rational decision
- "Commitment criteria": there must not be any imposed restrictions on how the funds can be spent
- "Stability criteria": the level of funds must be neither transitory nor seasonal
- "Liquidity criteria": a deep secondary market must exist for the assets in which the funds are invested
- "Value risk criteria": cash must be deposited with financial institutions that have a short-term rating not significantly inferior to that of the LRG; the same rating restriction applies to any fixed income investment.

Analysis should focus on the average and minimum reserve levels, rather than year-end balances.

Guaranteed debt. The amount of financial debt on which the principal and interest payments are the responsibility of the LRG (guarantor) if the issuer primarily liable fails to perform. If an LRG has to service the debt that it has guaranteed, then the guaranteed amount should be included in its direct debt.

Public sector debt. Debt of the local government and its government-related entities, as well as the debt of any overlapping jurisdictions.

Tax-supported debt. Includes the direct, guaranteed, and nonguaranteed debt of government-related entities, but excludes the debt of self-supporting entities and onlending to self-supporting entities. The use of the word "tax" here is in the broader sense of any operating revenue (defined below).

Self-supporting debt. The debt of arm's-length government-related entities that do not need financial support from the local government in a forward-looking prospective. Financial support includes any direct or indirect contribution aiming at balancing operating accounts, financing investments, or repaying debt, but not the transfer of a dedicated fee, nor the reception of a revenue from the local government in exchange for a defined service.

For the largest entities, which are significant in relation to the financial balance of the core LRG, we make an assessment of the stand-alone creditworthiness of the company.

Operating revenues. These are recurrent revenues received by an LRG. They are comprised of taxes and nontax revenues such as grants, operating subsidies, fines, and fees for services, tariffs, rents, and other sources levied by the LRG. They exclude capital revenues such as capital subsidies and sales of assets, and any revenues from borrowed funds.

Total revenues. Total revenues reported by an LRG excluding all operating and capital adjustments (double counting, offsets, off-budget funds, previous year results, borrowings, movements of reserves.)

Off-Balance-Sheet Liabilities

The size and quality of nondebt contingent liabilities can have a material impact on the creditworthiness of an LRG. For many LRGs the risk to their financial standing from these liabilities may be greater than that from their on-budget activities.

Key considerations include the financial situation of public enterprises and a range of quasi-government programs (workers compensation, accident compensation, home loan assistance, special insurance, for example) for which there may be a moral obligation on the LRG to keep solvent. We also assess possible risks to LRGs from public private partnership projects.

Financial health of public enterprises

An understanding of the intrinsic financial health of major public enterprises such as a government-owned financial institutions or electric or water utilities is important for our credit analysis of LRGs. This analysis is based on their stand-alone profitability adjusted for any subsidies, and the historical need for capital injections. A stand-alone credit assessment can determine the likelihood that the LRG will need to provide emergency financial assistance to ensure timely debt service, or to give support to the company for its investments and financial balance.

For more on our assessments of the credit quality of government-related entities, see " Rating Government-Related Entities: A Primer," published on June 14, 2006, on RatingsDirect.

Quasi-government programs

LRGs may be associated with a range of programs related to compulsory workers compensation, accident compensation, home purchase assistance, and other insurance. The LRG is not always a guarantor and the liabilities of these programs are not necessarily legal liabilities of the LRG, but the LRG's association may be through providing a legislative base for the program, sponsoring or promoting it, or mandating the use of it in certain circumstances. Because of the LRG's association, there may be a moral obligation incumbent upon the LRG to ensure that these programs remain solvent. We, therefore, see it as necessary to check on these programs' financial standing.

Public private partnerships

The growth of public private partnerships is reflected in our credit analysis. Where private sector debt is being serviced by a government payment stream (a privately financed public hospital for which the LRG pays a rental fee, for example), that government payment stream may be capitalized, if we consider that the risk transfer to the private sector is minimal. Privately financed infrastructure projects, which are financed by user charges (a toll road, for example), may also pose a risk for the LRG. Even though the legal documentation may make it clear that the private debt is nonrecourse to the LRG, we take the political, moral, and financial incentives facing the LRG if the project gets into financial difficulty into consideration. In some circumstances, LRGs may still aid the project, even though it has no legal obligation to do so.

Bailout of private companies

LRGs also have been known to bail out private companies, especially large employers or tax payers, even though they have no legal obligation to do so. Although these occurrences are difficult to predict, it may be possible to identify certain companies whose financial failure could pose special problems for the local economy, prompting a bailout from the LRG. LRGs can also demonstrate higher or lower tendencies toward intervention in the private sector through other means, such as subsidies or participation in commercial entities, which might signal their willingness to bail out private companies.

Annex: Influence Of Sovereign Ratings On LRG Ratings

Before Standard & Poor's rates any issue or issuer, it determines the creditworthiness of the sovereign government. In order to determine an LRG's foreign currency rating, we first determine its local currency rating, which reflects our opinion of that entity's willingness and ability to service its financial obligations in both local and foreign currency and in the absence of restrictions on the entity's access to foreign exchange needed to service debt. We then factor in the relevant transfer and convertibility risks, to arrive at the foreign currency rating. The risk of restrictions on access to foreign exchange needed for debt service is reflected in transfer and convertibility (T&C) assessments, which are available for each of the 113 countries for which we have a sovereign rating. A T&C assessment is the rating associated with the probability of a sovereign restricting nonsovereign access to foreign exchange needed for debt service.

However, other forms of sovereign risk may constrain a rating on an LRG (both local and foreign currency). For example, the sovereign can impinge on the autonomy of these entities by setting the terms of intergovernmental transfers of both revenue and expenditure responsibilities, allocating tax authority, mandating spending, and controlling debt authorization. Furthermore, LRGs are influenced by the national macroeconomic environment, such as the prevailing inflation rate and other features of monetary and fiscal policies that are incorporated into sovereign ratings. As a result, it is rare to see an LRG with a higher rating than its sovereign.

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