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Criteria | Governments | International Public Finance:

Methodology For Rating Non-U.S. Local And Regional Governments

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RELATED CRITERIA AND RESEARCH

Criteria | Governments | International Public Finance:

Methodology For Rating Non-U.S. Local And Regional Governments

1. Standard & Poor's Ratings Services is updating its non-U.S. local and regional governments (LRGs) rating methodology to clarify and enhance certain parts of the criteria. This article supersedes our previous methodology for rating non-U.S. LRGs, "Methodology For Rating International Local And Regional Governments," published Sept. 20, 2010. It also partially supersedes "Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs," published Oct. 15, 2009, and "Methodology And Assumptions: Analyzing The Impact Of Unfunded Pension Liabilities On The Credit Quality Of International Local And Regional Governments," published July 31, 2009. An overview of the changes compared with the previous methodology is in Appendix C.

2. "Principles Of Credit Ratings," published Feb. 16, 2011, form the basis of these criteria.

SCOPE OF THE CRITERIA

3. This methodology applies to issuer and long-term issue ratings on all non-U.S. LRGs. In this article, LRG refers to non-U.S. LRG, and rating refers to issuer credit rating (ICR), unless otherwise specified.

4. Although LRGs' scope of activities may vary, they bear, in our view, the same general responsibilities of delivering public services and funding infrastructure developments, which are supported directly or indirectly by taxes and fees levied on residents or transferred from other levels of government. In our view, LRGs' common task is financing the cost of these services and infrastructure developments with available revenues, as well as with recourse to debt when necessary. This methodology also applies to public-sector entities that are set up as local authorities and are responsible for providing similar services to those an LRG provides.

SUMMARY OF THE CRITERIA

5. This rating methodology addresses the factors that affect an LRG's willingness and ability to service its debt on time and in full.

6. The methodology sets out the framework for determining a local-currency ICR on an LRG. The foreign-currency ICR is the lower of the related sovereign's transfer and convertibility (T&C) assessment and the LRG's local-currency issuer credit rating (which incorporates, if relevant, the sovereign stress test per "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013). Also see, "Criteria For Determining Transfer And Convertibility Assessments," published May 18, 2009, for our T&C assessment criteria. Most often, local- and foreign-currency ICRs on an LRG are the same. (See section "D. Long-Term Issue Ratings.")

7. The framework for rating LRGs consists of quantitative and qualitative analyses of eight factors: institutional

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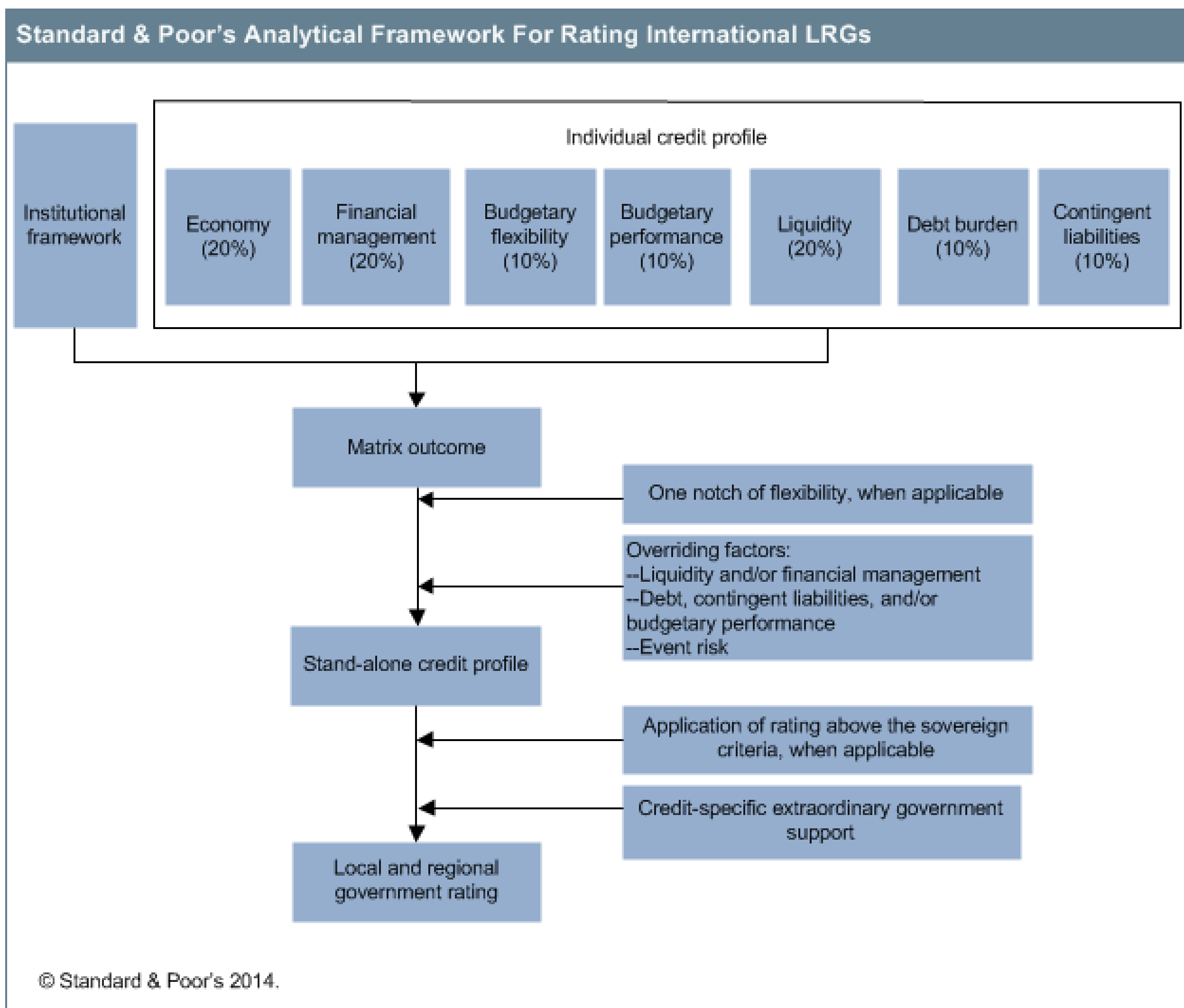
framework, economy, financial management, budgetary flexibility, budgetary performance, liquidity, debt burden, and contingent liabilities (see chart).

8. The first step is to assess the institutional framework and the other seven key factors. A weighted average of these other seven factors establishes the individual credit profile (see chart). The criteria then combine the institutional framework assessment and the individual credit profile per table 1. The resulting matrix outcome can be adjusted up or down by one notch (see paragraph 17). We would also apply the credit-specific overriding factors (see paragraphs 20-22), when relevant, to arrive at an LRG's stand-alone credit profile (SACP) (see Glossary). We then factor in the sovereign-related considerations (see paragraph 23) to derive the ICR on an LRG.



IMPACT ON OUTSTANDING RATINGS

9. Based on comprehensive testing, we currently expect a very limited rating impact. Specifically, we anticipate only one rating (less than 1% of the total portfolio of more than 300 credits) to change as a result of this criteria update.

EFFECTIVE DATE AND TRANSITION

10. These criteria are effective immediately. We will review the potentially affected rating over the next three months.

METHODOLOGY

A. LRG Issuer Credit Rating Framework

11. Standard & Poor's assigns ratings to LRGs based on its qualitative and quantitative analyses of eight main factors:

- Institutional framework,
- Economy,
- Financial management,
- Budgetary flexibility,
- Budgetary performance,
- Liquidity,
- Debt burden, and
- Contingent liabilities.

12. Standard & Poor's believes that an LRG's individual characteristics are best analyzed in the context of the institutional and legislative environments in which it operates. Consequently, our methodology distinguishes between our assessment of an LRG's institutional framework and the seven other rating factors. Those seven other factors, which are based on an LRG's individual characteristics, are combined to determine an individual credit profile.

1. Assessing the institutional framework

13. The institutional framework--which we analyze on a six-point scale, from '1' (the strongest assessment) to '6' (the weakest)--defines the environment in which an LRG operates. We view an LRG as part of the wider political, institutional, administrative, and budgetary systems of the country in which it is located. Standard & Poor's assessment of the institutional framework measures how the predictability, reliability, and supportiveness of public finance systems and legislative frameworks are likely to affect an LRG's ability to service debt in the long term. The institutional framework is the only LRG rating factor that we assess on a country basis for each level of government.

2. Determining an LRG's individual credit profile

14. The remaining seven key rating factors are based on an LRG's individual characteristics. To assess most factors, we first consider quantitative elements, and then qualitative factors. We assess each factor on a five-point scale, from '1' (the strongest) to '5' (the weakest) and then combine them to determine the individual credit profile. Specifically, the individual credit profile is a weighted average of the seven assessments: economy (weighted 20%), financial management (20%), budgetary flexibility (10%), budgetary performance (10%), liquidity (20%), debt burden (10%), and contingent liabilities (10%).

3. Combining the institutional framework assessment and the individual credit profile

15. The criteria then combine the institutional framework assessment and the individual credit profile per table 1.

16. If the individual credit profile is a whole number or ends with 0.5 (e.g., 1, 3, or 5.5), the matrix outcome is determined by table 1. If this is not the case (e.g., the individual credit profile is 2.2 or 4.9), the matrix outcome would fall within a range established in table 1. For instance, if an LRG is operating in an "evolving but balanced" institutional framework, with an individual credit profile of 2.3, the outcome would be in the 'aa-'/'a+' range. In these cases, we consider the position within that range (i.e., whether the individual credit profile is at the high or low end), our view of the future performance of the eight key credit factors, and a peer comparison to determine the matrix outcome.

17. Absent overriding factors, we expect that an LRG's SACP would, in most cases, fall within one notch of the matrix outcome. The main factors that can lead to an SACP that is one notch higher or lower than the matrix outcome are the following:

- At least one of the eight rating factors is improving/weakening, which supports/detracts from creditworthiness, and that is not already fully captured in the matrix outcome (in particular, as explained in paragraph 16), or
- The LRG is a sustained and projected overperformer in its peer group for most of the eight rating factors, and that is not already fully captured in the matrix outcome (in particular, as explained in paragraph 16), or
- The LRG is a sustained and projected underperformer in its peer group for at least one of the eight rating factors, and that is not already fully captured in the matrix outcome (in particular, as explained in paragraph 16).

Table 1

Combining The Institutional Framework Assessment And The Individual Credit Profile

--Institutional framework--		--Individual credit profile--								
Assessment	**Descriptor**	**1**	**1.5**	**2**	**2.5**	**3**	**3.5**	**4**	**4.5**	**5**
1	**Extremely predictable and supportive**	aaa	aaa	aa+	aa	aa-	a	bbb+	bb+	bb- and below*
2	**Very predictable and well balanced**	aaa	aa+	aa	aa-	a+	a-	bbb	bb	b+ and below*
3	**Evolving but balanced**	aa+	aa	aa-	a+	a-	bbb	bb+	bb-	b and below*
4	**Evolving and unbalanced**	N/A	a+	a	a-	bbb	bb+	bb-	b	b- and below*
5	**Volatile and unbalanced**	N/A	a-	bbb+	bbb	bb+	bb-	b	b-	b- and below*
6	**Very volatile and underfunded**	N/A	N/A	bbb-	bb+	bb-	b+	b-	b- and below*	b- and below*

*Selecting 'ccc+', 'ccc', 'ccc-', and 'cc' matrix outcomes is based on "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published on Oct. 1, 2012. N/A--Extremely unlikely combinations of ICP and IF assessments.

4. Credit-specific overriding factors and determining the SACP

18. The matrix outcome can be adjusted for one notch of flexibility (see paragraph 17) and for any overriding factors (see paragraphs 20-22), if applicable. This would then determine the SACP.

19. If an LRG has several overriding factors, we would adjust its matrix outcome by the cumulative effect of those overriding factors and would take into account the lowest cap indicated by those adjustments.

20. ***a) Liquidity and financial management override and caps.*** We give particular weight to liquidity and financial management assessments because the track record of LRG defaults suggests that weak liquidity and financial management are one of the main causes of defaults in the sector, in addition to systemic factors. If either the financial management or liquidity assessment is '5', the SACP is capped at 'bb+' and would be lower than the matrix outcome (by up to one full rating category). We lower the matrix outcome unless there are mitigating factors or the matrix outcome is already low (generally, in the 'b' category). Examples of such mitigating factors are strength of the institutional framework or liquidity support from the central government. The degree of the negative adjustment to the matrix outcome depends on the extent to which the risk stemming from one weak indicator (i.e., liquidity) is compounded by another weak indicator (i.e., financial management). When both the liquidity and financial management assessments are '5', the LRG's SACP is capped at 'b-'.

21. ***b) Debt, contingent liabilities, and budgetary performance overrides.*** We will lower the matrix outcome by one notch when tax-supported debt (see Glossary) is more than roughly 270% of consolidated operating revenues (i.e., 1.5x the weakest level of tax-supported debt in table 18), or when the deficit after capital accounts is more than roughly 23% of total adjusted revenues (i.e., 1.5x the highest level of deficit after capital accounts in table 15). If an LRG has both very high debt and deficit levels, then we generally lower the matrix outcome by two notches. In some cases, we will lower the matrix by just one notch if mitigating factors are present that indicate a stronger credit profile compared with peers that have similarly weak budgetary performance and debt ratios.

22. ***c) Event risk.*** In cases of imminent or rapidly rising political risk (such as war, escalating domestic conflict, or any acute and growing risk to institutional stability), an LRG's SACP could differ from the matrix outcome, depending on the conflict's expected magnitude and effect on the government's credit characteristics. This overriding factor aims to address risks beyond those already captured in the contingent liability assessment. Furthermore, the occurrence of a severe natural catastrophe could also lead to a material deviation from the matrix outcome depending on the extent of damage and the effect on the LRG's credit characteristics.

5. Sovereign-related overriding factors and determining the ICR

23. We derive the ICR on an LRG by applying to the SACP, when relevant, sovereign-related overriding factors, which are:

- The application of "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," and
- Potential credit-specific extraordinary credit support from another government (another LRG or a sovereign) (see paragraphs 25-27).

24. We generally do not rate an LRG higher than its sovereign. In exceptional cases, when an LRG SACP is higher than the rating on its sovereign, the LRG should be able to meet the conditions and pass the stress tests described in "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013, and in "Rating A Regional Or Local Government Higher Than Its Sovereign," published Sept. 9, 2009, in order to be rated above the sovereign.

25. Separately, in certain exceptional circumstances, Standard & Poor's may conclude that an LRG having difficulty repaying its debt on time is likely to benefit from timely and extraordinary credit support from another government.

26. In cases where we view this extraordinary credit support as sufficiently predictable, the LRG rating will be one notch higher than its SACP. To qualify for this uplift, all of the following conditions must be met:

- We expect that the likely extraordinary support to the LRG will be temporary and targeted to include debt repayment, and that this extraordinary support comes on top of ongoing support (fiscal equalization, grants) and

systemic extraordinary support (in case of natural catastrophes, infrastructure projects of national importance, or severe and prolonged economic crisis) that we already integrate into our assessment of the LRG's institutional framework.

- We expect the extraordinary support to be provided to an individual LRG in case of stress, as opposed to support benefiting the entire LRG sector. The support may benefit only a select number of important LRGs in the country.
- The supporting government clearly expresses its willingness, or demonstrates incentives we believe to be strong, to provide timely credit support to the LRG, and the government's stance is backed by a supporting legislative or constitutional framework or by the existence of a consistent track record of such support for similar entities.
- The legislative or constitutional framework provides the supporting government with the ability and the necessary tools to give extraordinary support to an individual LRG on a timely basis in case of need, including on very short notice.
- The supporting government is rated higher than the LRG receiving the support before the application of this factor.
- We do not expect similarities or divergences in the political majorities to affect the provision of extraordinary support to an LRG at the time of stress.

27. In our experience, extraordinary support defined in these terms is rather exceptional in most countries. Given that LRGs are governments themselves, elected by local populations, we have observed that political considerations may affect the relationships between different levels of governments. One government's willingness to provide extraordinary support to another might be affected by its respective political majority at the time of financial stress, especially if an LRG's stress is perceived as stemming from poor or very aggressive management. Furthermore, in many countries, the financial relationships between the different levels of government are governed by a legislative framework that would require a lengthy approval process to provide this type of extraordinary support (such as parliamentary approval), which might make it difficult for a government to react in a timely manner.

28. We don't apply the GRE criteria ("Rating Government-Related Entities: Methodology And Assumptions," published Dec. 9, 2010) to LRGs because the relevant supporting governments tend to provide extraordinary support on a systemic basis. This systemic support is reflected in the LRGs' SACPs, particularly via our institutional framework assessments. Our GRE criteria, in contrast, are designed to address extraordinary support provided on a temporary and entity-specific basis. However, public-sector entities set up as local authorities that are government-owned or controlled enterprises can be considered in the scope of the GRE criteria (see Glossary), and their SACPs will be based on the application of the non-U.S. LRG criteria.

29. Finally, when pertinent, the LRG rating would be based on the application of "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC'," published Oct. 1, 2012, or "Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009.

B. Institutional Framework

30. We base our assessment of the institutional framework under which an LRG operates on legal and regulatory environments, local customs and political practices, and precedents. The assessment also considers some of the future changes that are likely to strengthen or undermine such a framework. This results in a forward-looking opinion, consistent with our overall approach to ratings.

31. The institutional framework is the only LRG rating factor that we assess on a country basis for each level of government. This means, for example, that our institutional framework assessment of all Mexican states could differ from that of Mexican municipalities. In some instances, when regional authorities have an influence on institutional frameworks under which municipal governments operate, the assessments for the municipalities may vary by a region (for example, varying assessments for municipalities based in different German federal states).

32. Key analytical factors in our assessment are:

- Predictability,
- Revenue and expenditure balance, and
- Transparency and accountability.

33. We assess each of these three factors on a five-point scale, from '1' (very strong) to '5' (very weak). We apply the following weights: revenue and expenditure balance (50%), transparency and accountability (25%), and predictability (25%). We then convert the resulting weighted-average assessment (on a one to five scale) to a one to six scale (per table 2) to determine the institutional framework assessment.

Table 2

Institutional Framework

Assessment	Description	Weighted average of three factors
1	Extremely predictable and supportive	1-1.5
2	Very predictable and well-balanced	1.75-2.25
3	Evolving but balanced	2.5-3
4	Evolving and unbalanced	3.25-3.75
5	Volatile and unbalanced	4-4.25
6	Very volatile and underfunded	4.5-5

1. Predictability

34. The predictability of the institutional framework assesses the frequency and extent of reforms affecting the division of responsibilities and revenues between the levels of governments in a jurisdiction. In addition, it incorporates an analysis of the laws that affect tax flexibility, the organization of the electoral system, and limitations on the use of debt, among others. We also consider the predictability of the outcome of reforms when they occur, based on their pace of implementation and on an LRG's ability to measure the short- and long-term impact that they will likely have on the LRG's finances. Finally, it includes our assessment of an LRG's ability to influence, and potentially veto, any decision taken at a higher level, particularly one that could adversely affect the LRG's financing system.

Table 3

Assessing The Predictability Of An LRG's Institutional Framework

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Frequency and extent of reforms affecting the intergovernmental system and predictability of their outcome:		
The system is mature and stable, with a limited number of reforms implemented gradually and with a predictable outcome. It provides very good visibility on the evolution of LRGs' revenue sources and responsibilities for at least the next five to seven years. The system is largely defined in the constitution and codified by law.	The system is evolving with ongoing but no radical reforms, which are likely to affect only moderately LRGs' main revenues and responsibilities. It provides good visibility on the evolution of LRGs' revenue sources and responsibilities for at least the next three years. The system is governed by law but with some overlap and lack of clarity.	The system is very volatile, with ongoing and ill-prepared large-scale transformations, which makes LRGs' main revenues and expenditures highly unpredictable. The visibility on the evolution of LRGs' revenue sources and responsibilities is inferior to one year. The system is not well defined, leading to disputes between governments and changing rules. The system might be subject to high political risks.
Ability of LRGs to influence or oppose reform affecting the intergovernmental system:		
LRGs have strong political power through a dedicated chamber in the national parliament, and they can veto unwanted changes.	LRGs have sufficient political power to soften, but not block, the negative consequences of reforms.	LRGs have weak institutional and political powers, with no power to block or influence unwanted changes.

2. Revenue and expenditure balance

35. The analysis of revenue and expenditure balance considers: the overall adequacy of the revenues that an LRG receives to cover its expenditure mandates, the existence of a fiscal policy framework imposing prudent limits on an LRG's debt and deficit levels, and the availability of extraordinary support in exceptional circumstances (see table 4).

36. For LRGs to maintain fiscal sustainability in the long run, their expenditure responsibilities should be balanced against their revenue generation capacity, in Standard & Poor's view. In highly centralized systems, a good revenue and expenditure match would mostly depend on an LRG having sufficient revenue sources (including taxes or subsidies and equalization transfers) to cover expenditure, as well as indexation mechanisms (e.g, indexing wages to inflation increases) evolving in parallel. In decentralized public finance systems, a good revenue and expenditure match would depend mostly on an LRG having sufficient tax-raising authority and financial autonomy to maintain adequate financing of its obligations. In determining the degree of imbalances between revenues and expenditures, we analyze the historical fiscal interaction between the governments and the likelihood of such interaction in the future. We aim to assess the long-term structural coverage level of both the population's essential service and infrastructure needs, although these could fluctuate somewhat through the economic cycle.

37. If an LRG does not generate enough revenue to cover its expenditure needs under a given institutional framework, it can balance its revenue and expenditures by adhering to prudent fiscal policies.

38. We define the fiscal policy framework as a set of rules or legislations that limits the public deficits and debt burden at the LRG level, including enforcing adherence to conservative debt and liquidity management rules. A strong fiscal policy framework is likely to result in an LRG being more aware of its debt affordability and sustainability, as well as promotes budgetary discipline. Measures associated with strong fiscal policy frameworks typically include:

- Requiring a balanced operating budget,
- Limiting long-term debt to capital investment purposes,
- Preventing the use of complex financial transactions or derivatives for speculation purposes,

- Limiting the growth of debt by setting a threshold and regulating recourse to foreign-currency debt, and
- Monitoring the financial position to control potential fiscal imbalances.

39. In exceptional circumstances, LRGs may balance their revenues and expenditures by accessing extraordinary support from the higher level of government. For Standard & Poor's to include this in its analysis of revenue and expenditure balance, such support must be systemwide (i.e., available to all LRGs in exceptional circumstances, such as natural catastrophes, major infrastructure projects, or particularly severe economic crisis). The support may be provided in the form of access to repayable and nonrepayable financial assistance from the budget or state financial institutions. The level of institutionalization and the track record of such assistance inform our views on the likelihood of such support.

40. Extraordinary support or negative intervention affecting all LRGs within a system is included in the institutional framework assessment. Conversely, if timely, extraordinary financial support is directed at a particular LRG, as explained in paragraph 26, we would factor this in at the entity level, by raising the ICR relative to the SACP.

Table 4

Assessing The Revenue And Expenditure Balance Of An LRG's Institutional Framework

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Overall adequacy of revenues to cover expenditures needs with state transfers and/or sufficient autonomy:		
The government provides LRGs with adequate resources to cover essential services and infrastructure needs. Transfers are predictable and allocated evenly throughout the financial year. OR LRGs have sufficient autonomy to manage their own revenues and responsibilities efficiently despite possible temporary imbalances during economic downturns.	Operating spending of most LRGs is covered by state transfers or own revenues, but meaningful differences can exist between the strongest and the weakest entities. Capital projects generally require moderate recourse to debt. Central government transfers are relatively predictable and timely.	Central government transfers and LRG's own revenues are not sufficient to cover essential services and infrastructure needs, resulting in large financing requirements or infrastructure gaps. Transfers are based on political relationships and in-year negotiations and come with delays.
Fiscal policy framework:		
A prudent fiscal policy is defined at the national level, aiming to reduce deficit and debt levels in the LRG sector over the medium to long term. Noncompliance with restrictions is penalized. Prudent restrictions on LRGs' debt and liquidity management limit their exposure to market risks.	A prudent fiscal policy framework is self-imposed at the LRG level. OR Prudent restrictions on LRGs' fiscal policy exist at the national level, but they were introduced recently, or do not prevent fast debt accumulation. Restrictions on LRGs debt and liquidity management are loose.	Restrictions on public deficits and debt are inexistent or inappropriate, leading to excessive debt accumulation, directly or through GREs or other off-budget financing. Monitoring of LRGs' financials is lax. Restrictions on debt and liquidity management are inexistent or inappropriate.
Extraordinary support:		
Strong track record of systemwide, consistent extraordinary support that enables LRGs to balance their revenues and expenditures in exceptional situations.	The system provides some extraordinary support to the LRG sector in exceptional situations, but there is no established framework and the track record is irregular. No risk of negative intervention.	The system provides limited extraordinary support, mostly politically driven, to the LRG sector for major infrastructure projects or natural catastrophes. OR The system is exposed to the risk of negative legal or financial intervention from the sovereign (or a higher level of the government).

3. Transparency and accountability

41. The strength of a public finance system also depends on national regulation of public-sector accounting systems, accountability of managers and politicians, and system transparency. We have observed that strong and predictable systems usually impose high standards for transparency and accountability (see table 5). These standards are established by law or are supported by the country's general management culture.

42. We believe that transparent and accountable systems promote the implementation of good practices, such as compulsory audits or external controls, full accrual accounting, consolidated reporting requirements, and long-term financial planning with proper assessment of external and internal risks. Such transparency and accountability reinforce the need for monitoring techniques for both the revenue and cost sides of operations. Comprehensive reporting implies the requirement to report financial performance, balance-sheet, cash reserves, cash flow statements, real and financial assets, debt, and detailed information on the GRE sector on a timely basis. It also implies the need to report estimates of contingent liabilities. We also assess the reliability of the information through the existence of controls on financial statements by public institutions or recognized private auditing firms. In our view, strong systems also ensure the general institutionalization of budgetary processes and the existence of a clear delineation of roles between the elected officials and the LRG's administration. Such best practices also increase awareness of the government's financial strengths and weaknesses, in our view.

43. On the other hand, we observe that in less transparent and less sophisticated public finance systems, LRGs tend to focus on short-term technical issues. They appear to operate with low-quality financial information and may have weak incentives for efficiency. Weak and unpredictable systems tend not to set requirements or promote the implementation of best practices aiming to improve transparency of LRGs' financial operations and long-term planning, audits of financial statements, or better accountability of financial managers.

Table 5

Assessing The Transparency And Accountability Of An LRG's Institutional Framework

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Transparency and institutionalization of budgetary processes:		
Roles and responsibilities, between elected officials setting priorities and managers implementing them, are clearly defined.	The delineation of roles and responsibilities is relatively clear, with elected officials setting priorities implemented by managers.	Delineation in the legislation of the relations between elected officials and managers is not clear, leading to potentially significant imbalances and frequent turnover of the administrative staff after each election.
Disclosure and accounting standards for public finance information:		
Nationally established transparent accounting standards exist, as well as a full accrual accounting system. Best practices and legal requirements are in place regarding public disclosure, comprehensive and timely information on LRGs' budget execution, historical data, and financial planning, including the GRE sector.	Accounting standards are generally transparent but not fully harmonized, leaving room for interpretation. Legal requirements or common practice on financial reports and budgets disclosure are solid but not very detailed, especially regarding the GRE sector.	Accounting standards are weak and inconsistent. Reporting requirements for financial statements and budgets are limited to basic information.
Control levels and reliability of information:		
The timely audit of financial statements, in compliance with national law, by an independent private company or public body is mandatory.	The external audit, in compliance with national law, by a public body is mandatory but is not always very detailed or timely.	The external audit is not mandatory and state agencies' overseeing of legal compliance is limited to basic information.

4. Linkages between the institutional framework assessments and sovereign ratings

44. The institutional framework assessments generally have a strong link with the credit quality of the related sovereign. While all the references in this section are to the sovereign credit quality, the reference point could be the credit quality of a higher level of government, which has a jurisdiction over the LRG, if more relevant. Typically, prudent

policymaking of high-rated sovereigns, coupled with predictable and stable institutions, translates into a well-balanced and supportive legal and regulatory framework that governs the relations between the sovereign and other levels of the governments. On the other end of the spectrum, low-rated sovereigns have generally less predictable division of revenues and expenditures between the levels of government, and their ability to provide extraordinary and ongoing support to lower levels of governments is weak. As a result, we expect LRGs operating in 'AAA' and 'AA' rated sovereigns would have associated institutional framework assessments of '1' or '2', in 'A' rated sovereigns with assessments of '3', in 'BBB' rated sovereigns with assessments of '4', in 'BB' rated sovereigns with assessments of '5', and in 'B' rated sovereigns with assessments of '6'. (All references are to sovereign foreign-currency rating categories.)

45. Exceptions to this do exist--although we view sovereign credit quality as a good proxy for the strength of the institutional framework. The institutional framework assessment, based on the methodology described in paragraphs 30-43, could be weaker (i.e., worse) than the linkages indicated in paragraph 44. Take, for instance, an LRG that has an assessment of '4' (per table 2), and the respective sovereign is rated in the 'AA' category (a category common for LRGs with institutional framework assessments of '1' or '2', as per paragraph 44). This combination, though rare, is possible if a system has any of the following:

- Weak transparency and accountability, which weigh on the institutional framework more than they do on the sovereign rating;
- Institutional framework characterized by low predictability regarding reforms affecting the main division of responsibilities and revenues between the different levels of governments; or
- Weak fiscal policy framework, including the risk of a negative intervention from a sovereign (or a higher level of the government).

46. Conversely, the institutional framework assessment based on the methodology described in paragraphs 30-43 could be stronger (by up to 1 point) than the linkages indicated in paragraph 44. This is possible if specific risks affecting a sovereign rating do not have direct implications for the institutional framework, or if a central government is protecting an LRG's institutional framework from economic stress, despite the deterioration of the central government's creditworthiness. For instance, an institutional framework assessment of '3' for an LRG located in a sovereign rated in the 'BBB' category (which typically would map to an institutional framework assessment of '4', per paragraph 44) is possible if all of the following conditions are met:

- Evidence of a sovereign (or a higher level of government) providing effective protection over an LRG's revenue and expenditure balance from a sovereign stress;
- A sovereign (or a higher level of government) undertakes enhanced monitoring over an LRG so as to ensure the sector's adherence to financial discipline and uphold the current level of the LRG's transparency and accountability; and
- A high visibility regarding the evolution and sustainability of an LRG's revenue sources and predictability of expenditure responsibilities.

47. Overall, the linkage to the sovereign ratings establishes the upper limit to the institutional framework assessment (per paragraphs 44 and 46). There is, however, no lower limit, as per paragraph 45, to the institutional framework assessment derived according to the methodology in paragraphs 30-43.

C. Individual Credit Profile

48. After analyzing institutional framework, we then assess the other seven key rating factors, which comprise an LRG's individual credit profile (see table 6).

Table 6

What Standard & Poor's Considers When Assessing An LRG's Individual Credit Profile
Economy
The economic assessment measures how economic factors are likely to affect an LRG's revenue generation capability and spending needs and ultimately its ability to service debt in the medium to long term.
Financial management
The financial management assessment measures how the quality of an LRG's financial management and its political context are likely to affect its willingness and ability to service debt over time.
Budgetary flexibility
The budgetary flexibility assessment measures how much an LRG could increase its revenues or reduce its expenditures in the case of need, to maintain its debt servicing ability.
Budgetary performance
The budgetary performance assessment measures the level and the volatility of an LRG's expected cash flows (from operations and investment activities) that are available to service debt. It also gauges the efficiency of the LRG's financial policy.
Liquidity
The liquidity assessment measures how an LRG's internal sources of liquidity, such as cash reserves and cash flow generation, and external sources, namely bank lines and market access, are likely to affect its debt servicing capability.
Debt burden
The debt burden assessment measures how our expectations for the level, structure, and sustainability of an LRG's debt is likely to affect its debt servicing capability.
Contingent liabilities
The contingent liabilities assessment measures to what extent the risk of occurrence of some off-balance-sheet risks and their relative size are likely to impair an LRG's capacity to repay its debt in the medium to long term.

1. Economy

49. To assess the economic strength of an LRG, Standard & Poor's reviews:

- Income levels,
- Diversification of the economy,
- Economic growth prospects, and
- Socioeconomic and demographic profiles.

50. Our analysis of income levels determines the anchor for our assessment of the economy. We then factor in the other three qualitative factors to determine the final economic assessment. Specifically, the anchor for an economic assessment is adjusted by up to two points up or down, based on the net effect of the qualitative factors (see table 7). If income levels fall at or near cutoff points, the assessment will improve by one point if economic trends are improving or worsen by one point if trends are weakening. The economic assessments are: '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

a) Income levels

51. Standard & Poor's generally recognizes income levels, as measured by GDP per capita, as a reliable indicator of the potential strength of an LRG's revenue or tax base and of the potential needs for social services, public assistance, and welfare, depending on the LRG's responsibilities.

52. To derive the anchor, we use either local or national GDP per capita data. The selection is made based on which set of data most adequately reflects the LRG's real revenue generation capacity. Specifically, this analytical decision is based on the composition and sources of an LRG's revenues, including the proportion of transfers from the central government and the existence and depth of a revenue equalization framework. (Revenue equalization is the transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity.) For instance, if an LRG is heavily dependent on a central government's transfers or a sizable share of its revenue stems from a far-reaching equalization system, rather than from its own revenue streams, national GDP per capita is a more appropriate starting point. The decision of which level of government data to use (i.e., national or local data) can vary depending on the tier of the government and reflects the institutional framework.

53. Standard & Poor's usually uses the GDP per capita data in U.S. dollars at market prices. Depending on the reporting norms in a given country, we might use other nationally recognized proxy for GDP per capita indicators (such as gross state product per capita). In other situations (for instance, when a significant portion of income accrues to nonresidents and is not taxable by the jurisdiction), we will focus on the gross national product per capita measure. If the municipal or provincial/state data are not available, we would generally use the data for a higher level of government with appropriate adjustments.

54. Standard & Poor's periodically raises the thresholds of the income levels in line with the world nominal annual GDP growth. GDP per capita has risen for many decades as the world has grown richer. The greater wealth has not led to a decline in LRGs default rates, so we adjust to preserve the relativities in our analysis. We expect to make such adjustments periodically, and we do not expect these changes to have a rating impact. The changes may not be the same across the scoring scale, either in absolute terms or on a percentage basis. The changes are incremental and are based on our judgment of how global economic growth and exchange rate movements may affect LRGs at different stages of development.

55. The anchor is based on a historical three-year average, using annual average exchange rates, to minimize the impact of currency fluctuations.

b) Diversification of the economy

56. The diversification of an LRG's economic structure is important to assess the potential volatility of the tax base and its resilience to stress. A deep, broad, and well-diversified economy with strength in several sectors is usually less exposed to a downturn in a specific industry and exhibits less volatile tax revenue than an economy with high exposure to a single industry or employer, especially one undergoing restructuring or experiencing negative trends. As such, we apply a positive adjustment to the anchor due to an exceptionally broad or diversified economy compared with peers in the anchor category. Alternatively, we adjust the anchor through a negative qualifier due to a concentrated or narrow economic base, which exposes LRGs to exogenous factors.

57. To assess the diversification of the economic structure, we analyze the share of each sector in terms of employment

and/or output (when relevant), while identifying potential significant employers that could affect the LRG's financial performance if they represent a large share of tax revenues or a sizable portion of local employment (directly and indirectly). When we see significant concentration--typically above 20% of the local employment base or tax revenues--we analyze the health and prospects of the relevant sectors or employers.

c) Economic growth prospects

58. Our economic analysis is based, among other things, on recent and projected trends in output, employment, productivity and investments, and takes into account a region's growth potential. We believe that the growth potential is best understood in the context of national economic development and the competitive advantages or disadvantages of the region or locality. These may include natural endowments, location, proximity to key markets, employment opportunities, educational offerings, or the tax structure. We believe that expectations for economic growth are also based on the state of infrastructure development. The availability and quality of airports, ports, railways, roads, and space for development are, in our view, essential to accommodate and support growing populations and economic activities. Other measures of an economy may include recent and anticipated levels of private and public investment, including foreign direct investment trends and export performance, as well as expected productivity gains, when they are available at the regional level.

59. Above-average growth prospects compared with those for peers in the same anchor category improve the anchor, while limited growth prospects due to structural economic or natural handicaps, or large infrastructure needs leading to growth prospects inferior to those of the peers, worsen the anchor.

d) Comparative socioeconomic and demographic profiles

60. In some cases, an anchor (whether based on national or local GDP per capita data) might not fully capture differences in socioeconomic conditions and demographic profiles between the LRGs. These differences may have an impact on LRGs' spending needs. To incorporate these locally driven differences, we could apply an adjustment to the anchor if socioeconomic conditions are above or below the average of the other LRGs from the same tier of government in that country. Specifically, we will apply a positive adjustment if an LRG has stronger socioeconomic indicators, implying lower spending pressure in the future compared with peers. Conversely, we will apply a negative adjustment (of up to two points) if an LRG faces weaker socioeconomic indicators, implying higher spending needs in the future, compared with the peers. Examples of such socioeconomic indicators requiring a negative adjustment could be high unemployment rates, a high proportion of income support and welfare recipients, and a demographic profile that might have a material negative impact on revenue growth and expenditure needs. Such demographic profile could be a population decrease or a high share of dependent population (generally greater than 55%).

Table 7
Standard & Poor's Assessment Of An LRG's Economy

GDP per capita* (nominal US$)	>38,000	27,001-38,000	16,001-27,000	5,500-16,000	<5,500
Anchor:	1	2	3	4	5

Qualitative factors positively affecting the anchor include:	Qualitative factors negatively affecting the anchor include:
Exceptionally broad or diversified economy compared with peers in the same anchor category, providing a strong resilience to economic cycles.	Very volatile and/or concentrated economy, carrying significant exposure to a single vulnerable or cyclical industry--generally greater than 20% of GDP (when relevant) or employment--and/or to a single taxpayer (generally greater than 20% of tax revenues), leading to potential revenue volatility.
Above-average growth prospects compared with those of peers in the same anchor category, supporting robust revenue growth.	Limited growth prospects due to structural economic or natural handicaps, or large infrastructure needs, leading to growth prospects inferior to those of the peers in the same anchor category.
More favorable socioeconomic and demographic profiles, implying lower spending needs relative to peers'.	Less favorable socioeconomic and demographic profiles, implying higher spending needs relative to peers'.

Income levels falling at or near cut-off points will receive the better anchor if trends are improving, and the worse anchor is trends are weakening, reflecting the expected future level. The adjustment impact of each qualitative factor may vary from one point, in most cases, to two points exceptionally (particularly for concentration risk and for socioeconomic indicators), depending on the magnitude of this risk relative to peers'. Overall, the economic assessment equals the anchor, adjusted by up to two points up or down, based on the net effect of the qualitative factors outlined above.

*Based on the average of the latest available three years of actuals or estimates using average annual exchange rates.

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61. Here are a few examples of how we would assess an LRG's economy.

- EXAMPLE 1: A region has a GDP per capita of US$45,000, implying an anchor of '1'. However, its economy is concentrated in the oil sector, which accounts for about 30% of the regional GDP and the same proportion of tax revenues. Assuming that the other factors are neutral, our economy assessment for the region would likely be '2', one point weaker than the anchor indicated by the GDP per capita, reflecting the exposure to the volatile oil industry. If the oil industry accounted for 70% of the LRG's GDP or tax base, the anchor would likely be adjusted by two points for a final assessment of '3', to reflect the magnitude of this risk.
- EXAMPLE 2: A city has a GDP per capita of US$20,000, implying an anchor of '3'. The city has a broad, well-diversified economy and is the capital city of a developing economy already well advanced in its transition. Assuming that the other factors are neutral, our economy assessment for the city would likely be '2', one point better than the anchor indicated by the GDP per capita, reflecting the city's exceptionally strong diversification profile.

2. Financial Management

62. Next, we assess how the quality of an LRG's financial management and the political framework in which it operates are likely to affect the LRG's willingness and ability to service debt over time. The financial management assessment encompasses five factors: political and managerial strength, long-term capital and financial planning, revenue and expenditure management, debt and liquidity management, and management of GREs.

63. We then combine the five factors through a weighted average to form an initial financial management assessment, which can range from '1' ("very strong") to '5' ("very weak") (see table 8). The weights are:

- Political and managerial strength (30%),
- Long-term capital and financial planning (20%),
- Revenue and expenditure management (20%),
- Debt and liquidity management (20%), and
- Management of GREs (10%).

Table 8

Financial Management Assessment

Descriptor	Weighted-average financial management assessment	Rounded financial management assessment
Very strong	1-1.4	1
Strong	1.5-2.4	2
Satisfactory	2.5-3.4	3
Weak	3.5-4.4	4
Very weak	4.5-5	5

64. The rounded assessment from table 8 can be raised or lowered by a maximum of one point in the following cases:

- Usually, if the financial management assessment is at the high or low end of any of the ranges in table 8, we could lower (or raise) the assessment to the next category if we expect any of the subfactors (that comprise financial management) to improve (or deteriorate). For instance, a weighted assessment of 2.3 can result in a final assessment of '3' if we expect a worsening in, for instance, revenue and expenditure management. Conversely, a weighted assessment of 2.5 can get a final assessment of '2' if we expect an improving trend in, for instance, debt and liquidity management.
- In rare cases, this one point of flexibility could be applied even if the initial assessment is not around one of the cutoff points. Take, for instance, a weighted-average assessment of 2.7, which corresponds to a rounded financial management assessment of '3' per table 8. If, in our view, any given financial management subfactor represents a disproportional credit weakness, we could change the assessment to '4'. Similarly, if any given subfactor represents a disproportional credit strength, we could change the assessment to '2'.

65. The rounded financial management assessment can be further adjusted if any overriding factors apply. There are two we consider: transparency and payment culture.

66. The transparency override sets the final financial management assessment at '5', when:

- Information is often quite basic and may be communicated with material delays, or
- Financial reporting is not detailed, and the accounting standards are consistently unclear. Key information is

missing on some government activities.

67. The payment culture override applies when an entity's willingness to make full and timely payments on its financial obligations is questioned. An LRG can, and sometimes does, default on its obligations even when it has the capacity to pay. If concerns about the payment culture exist (e.g., if we believe there is at least a moderate likelihood that an entity would not prioritize the timely payment of debt service in a stress scenario), the overall financial management assessment is '5' and the SACP is capped at 'bb+' (as per paragraph 20). If we believe there is a high likelihood than an entity would not prioritize the timely payment of debt service in a stress scenario, we cap the SACP at 'b-'. This analysis is usually evidence-based. Examples may include an LRG that is questioning the legitimacy of debt contracted by a previous administration, or the absence of material policy change since the last default. In extreme cases, the weak or uncertain willingness to pay will result in the application of "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings."

a) Political and managerial strength

68. Political and managerial strength gets the highest weighting in the total financial management assessment (30%). Policymakers' commitment to disciplined fiscal policies and their ability and willingness to make unpopular decisions to ensure financial and socioeconomic stability, as well as management's capacity to implement these decisions, are fundamental in promoting a sustainable fiscal framework within an LRG (see table 9).

69. When reviewing political strength, we focus on a government's strategies for and track record of passing budgets, meeting goals, and effectively implementing public policies. When analyzing management capabilities, we assess the expertise, continuity, and overall capacity of the administration's management. We assess the management's capability to implement the set policies, as well as its ability to maintain financially sustainable policies or adjust the policies as needed despite political pressures.

70. In addition, political and managerial strength is dependent on the structure of the financial management, independence of control functions, and quality of the administrative staff. We take into account management's performance in identifying, measuring, and planning responses to key external risks, such as an economic downturn, natural catastrophes, a major reduction in government grants, or a change in the institutional arrangements.

Table 9

How Standard & Poor's Assesses Typical Characteristics Of An LRG's Political And Managerial Strength

(An LRG would need to exhibit a majority of the characteristics listed in a given category to achieve that assessment.)

1	3	5
There is broad political consensus (supported by governing party majority) on fiscal policies, enabling the government to enact structural reforms, pass budgets, and make unpopular decisions, when necessary. The management team is experienced and qualified in implementing policy changes. There is an implicit agreement by which political and financial management teams respect their spheres of power to achieve fiscal sustainability. Management accountability is strong.	There is a generally strong consensus to implement structural reforms, albeit after some amendments or delay. Political disagreements may delay important fiscal decisions. Management team has adequate expertise in implementing policy changes. Distinctions between political and managerial responsibilities may, at times, be opaque. Adequate financial management accountability has been maintained throughout changes of administration.	The LRG is unable to implement unpopular reforms. Political stability is weak and untested through a political transition. The government repeatedly faces challenges in passing budgets on time. The management team is understaffed, lacks relevant skills, qualifications, or experience in implementing policy changes. Key man risk exists. Institutionalized public policies do not exist. There is no clear distinction between political and managerial responsibilities. The system of financial management to guarantee internal accountability is inadequate.

b) Long-term capital and financial planning

71. In this part of the assessment, we consider the quality of the long-term financial management, financial policies, and processes over a period longer than five years.

72. For long-term planning, we determine whether there is a credible and well-documented long-term financial plan that supports financial discipline and stability. We consider the operational aspects of the long-term planning (such as processes, formal documents explaining fiscal goals, and the financial resources needed to cover major infrastructure projects or long-term financial obligations such as pensions), the consistency around fiscal targets, and the plausibility of underlying assumptions concerning revenues and expenditures (see table 10).

Table 10

How Standard & Poor's Assesses Typical Characteristics Of An LRG's Long-Term Financial Planning

(An LRG would need to exhibit a majority of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Prudent and well-defined financial policies, reflected in a detailed and formal long-term financial planning with key fiscal targets that remain prudent and impartial to the political cycles. Well-documented and realistic revenue and expenditure assumptions. Long-term financial management (financial policies and processes) extends beyond five years.	Relatively prudent financial policies with a medium- to long-term plan that provides visibility but may not be very detailed. Realistic long-term goals, including disciplined fiscal targets only moderately affected by political cycles. Long-term financial management (financial policies and processes) covers the next two to three years.	Absence of medium- to long-term financial planning, reliance on short-term planning. There are no defined fiscal targets, or they are frequently changed and highly sensitive to political cycles. Aggressive financial strategy based on unrealistic assumptions and no clear financial benchmarks. Inferior cash flow forecasting, unreliable, short-term financial management, financial policies, or processes.

c) Revenue and expenditure management

73. When assessing revenue and expenditure management, we review the quality and comprehensiveness of an LRG's budgeting process. For revenues, our focus tends to be on the forecasting for the budget cycle, administration, and collection of the main taxes, considering the reasons behind any variations from forecast. On the operating expenditure side, we look at mechanisms in place to control and monitor costs. For capital expenditure, we consider the planning, funding, and prioritizing of the various projects, and the exposure to delays and cost overruns (see table 11).

Table 11

How Standard & Poor's Assesses Typical Characteristics Of An LRG's Revenue And Expenditure Management

(An LRG would need to exhibit a majority of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Budgeting is done on a fully consolidated basis, including government-related entities where relevant. Budgets reflect goals defined in the long-term financial plan and are based on realistic assumptions. Clearly formalized budgetary procedures ensure continuity and effectiveness in budgeting. Budget is approved before the start of the fiscal year, and limited budget revisions are made during the year.	Budgetary approach includes all budget-financed entities. Budgeted expenditures and revenues show realistic and well-documented assumptions, and actual variations from budget are only moderate. Clear budgetary procedures ensure an effective budgeting process. Small exceptional delays in budget approval. Moderate budget revisions during the year.	Budgeting excludes a large part of relevant activities and is short-term in nature. The approach is incremental, rather than based on result oriented budgets. Lack of clear processes lead to inconsistent procedures. Budgets often approved after the start of the fiscal year, with substantial revisions during the year.

Table 11

How Standard & Poor's Assesses Typical Characteristics Of An LRG's Revenue And Expenditure Management (cont.)		
Track record of accurate budget forecasting, with robust control over revenue and expenditures. Advanced control system in place. Culture of controlling costs and ensuring the effective use of funds by subsidized entities. Negligible overspending, compensated for by intra-annual corrective measures.	Adequate capacity to forecast operating revenues and to control operating expenditures largely within budget. Improving cost monitoring. Overspending is identified by the government during the year, and there is some capacity to take corrective measures.	Low predictability of revenues, significant variations from budget (including due to weak revenue collection capacity), and unreliable cost control measures. Most requests from subsidized entities are accepted or rejected without controls. Systematic and material overspending. Capital spending is not well monitored. Budgeting uncertainties due to protracted disputes (e.g., long-standing arrears to contractors).

d) Debt and liquidity management

74. Our assessment of debt and liquidity management considers an LRG's policies regarding the external sources of financing, as well as the available liquidity to repay debt (see table 12). We evaluate management's appetite for and understanding of debt-related risks, such as exposure to market risks, refinancing, and concentration of lenders.

75. Within the liquidity management evaluation specifically, we evaluate an LRG's investment and liquidity policies, as well as its ability to forecast cash flows accurately and identify pressure points during the year. Ongoing and cooperative relationships with banks and investors are also important in supporting strong debt and liquidity management. Relevant metrics include the level of overdue payables, accounts receivable, smooth maturity profile, and free cash or equivalents to cover short- and long-term financial obligations.

Table 12

How Standard & Poor's Assesses Typical Characteristics Of An LRG's Debt And Liquidity Management

(An LRG would need to exhibit a majority of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Very prudent debt management policy. Long-term debt used for capital expenditure (capex) and not operating costs. Sophisticated, active, risk-averse policy aimed primarily at minimizing risk, and secondarily cost. No unhedged foreign currency exposure, limited interest-rate risk, and low proportion of short-term debt. Clear liquidity policy with stipulated minimum and desired levels of cash and equivalents. Prudent combination of committed bank facilities (if needed) and own cash. Detailed annual planning with actual cash flows close to the plan, and detailed daily monitoring. Cash and debt management integrated, and managed by specialists. Centralized cash management for all government units.	Prudent debt management policy, including adherence to self-imposed limits. Long-term debt used for capex and refinancing of long-term borrowings. Derivatives only used for hedging purposes. Only small proportion of unhedged foreign currency debt, moderate interest-rate risk, and moderate level of short-term debt. Prudent liquidity policy, with a level of committed bank facilities that comfortably meets likely fluctuations. Comprehensive liquidity reports covering just the core government. Adequate cash flow planning, but not very precise and actuals noticeably differ from the plan. Planning only partly integrated with debt management. Fluctuating reserves not defined by specific policy.	Debt management lacks effective policies, and/or leaves the LRG vulnerable to market shocks. Long-term debt used to cover liquidity needs. Debt limits (self-imposed or national ones) are regularly breached. Aggressive debt management with use of derivatives for speculative purposes. High reliance on short-term debt, with high exposure to interest-rate and currency risks. No specific guidelines on liquidity and lack of cash flow planning. Material delays in payment to suppliers, and occasionally of wages. Poor liquidity reporting. Cash management is more an administrative payment function. Numerous and decentralized cash accounts, with little control or visibility over cash flows. Reliance on limited sources for funding.

e) Management of government-related entities

76. To assess the quality of the management of GREs, such as companies owned by an LRG, we review (with available data) the clarity regarding the GREs' mandates, the LRG's capacity and effectiveness in setting and monitoring the GREs' medium-term targets and financial performances, and the degree of transparency and frequency of financial reporting (see table 13).

77. Most rated LRGs manage GREs. However, there are some that directly manage services within the government. In these cases, the assessment will reflect our view of the quality of an LRG's management of these services (which is likely to coincide with our political and managerial strength assessment) and the rationale behind managing these activities directly rather than through GREs. The assessment will be worse if an LRG does not manage any GREs because it does not have the resources to run them, versus a better assessment if a model of operating without GREs is more effective.

Table 13

How Standard & Poor's Assesses Typical Characteristics Of An LRG's Management Of Government-Related Entities

(An LRG would need to exhibit a majority of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Sound rationale for the existence of all GREs, such as efficiency in provision of services or access to private finance. Transparent nomination process for board and CEO based on competence. Comprehensive plans linked to the LRG's financial strategy. Entities fully cover costs with own sources or fees/grants received from the LRG, in exchange for the contractually defined provision of a public service.	Most GREs provide essential services, although efficiency in the provision of services might not be their primary goal. They are controlled through government representation on board and annual reporting, and ultimately through the LRG internal control body. Planning is not comprehensive. Some GREs have moderate structural deficits, which are generally covered by the LRGs.	GREs lack a clear rationale, other than absorbing costs and debt on behalf of the LRG. Senior managers are political appointees, but a lack of information or planning means the LRG still has weak controls. Most companies are in structural deficit. Government funding for the provision of public service is insufficient, or GREs lack the capacity to perform within budget.

3. Budgetary Flexibility

78. Standard & Poor's believes that budgetary flexibility is particularly important to an LRG when government finances are facing external pressure. If an LRG has budgetary flexibility, it is more likely, in our view, to be able to adjust its revenues or expenditures in the face of external shocks, such as economic downturns or intergovernmental system changes, to maintain its debt servicing ability. We both qualitatively and quantitatively assess an LRG's willingness and ability to increase revenues and to cut expenditures.

79. An LRG's revenue flexibility depends, in our view, on three main factors:

- Its ability to raise taxes, fees, or tariffs;
- The political considerations and economic limits that could curb the use of this flexibility; and
- Potential revenues from asset sales.

80. And its willingness and ability to cut expenditures depends, in our view, on these main factors:

- Operating expenditures flexibility,
- Capital expenditures flexibility, and
- Potential limitations on expenditure flexibility.

81. Standard & Poor's derives its budgetary flexibility assessment (see table 14) by combining the two key ratios--modifiable revenues as a share of adjusted operating revenues and capital expenditures as a share of total expenditures--to determine the anchor. The anchor is based on the average of the two-year actual data, the current-year budget or estimate, and two years of Standard & Poor's forecasts. We then consider the other, qualitative

factors to determine the final budgetary flexibility assessment. The budgetary flexibility assessments are: '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

a) Revenue flexibility

82. ***i) Ability to raise taxes, fees, or tariffs.*** To measure an LRG's control over its revenue base, Standard & Poor's primary metric is the share of modifiable revenues as a percentage of adjusted operating revenues (see Glossary). Modifiable revenues are those that a local government may increase or decrease in case of need (including taxes, fees, and rents). In practice, revenue modification occurs mainly by changing a rate or the calculation of a base or by introducing a new tax or fee. Shared taxes distributed between LRGs based on centrally defined formulas are typically not part of modifiable revenues.

83. Although modifiable revenues as a share of an LRG's adjusted operating revenues generally gives an approximation of its tax flexibility, we think this measure is appropriately complemented by a qualitative evaluation of the maximum additional revenues that the LRG could gain. This can vary significantly depending on the national legislation, as well as on the LRG's current taxation levels compared with the maximum level set by law. Furthermore, in cases where tax collection rates are very low, the effective impact of an increase in tax rates may remain marginal.

84. ***ii) Political considerations and economic limits.*** In our experience, practical limitations on budgetary flexibility may arise from political priorities or competition from neighboring jurisdictions. To evaluate these aspects, we may compare an LRG's key tax rates against the national average and those of the LRG's closest peers. We believe that significant unfavorable disparities may indicate a risk that the tax base could drift to other jurisdictions or create pressure to cut taxes. Such pressure can also, in our view, result from a political commitment to limit revenue increases. In certain jurisdictions, use of tax flexibility is also constrained by the need for approval from a higher level of government or voter ratification. Finally, economic limitations might stem from a low-income population or weak tax base.

85. ***iii) Potential additional revenues from asset sales.*** In certain countries, LRGs may have large portfolios of sellable assets, typically in the form of shareholdings in commercial companies or a large number of housing and commercial properties. Selling these assets could generate sizable one-time revenues for an LRG. But these divestments might be subject to legal hurdles, political opposition, lack of buyers, or long lead times. Hence, we typically would consider such revenues as benefiting budgetary flexibility if sellable assets can be realistically liquidated and will generate an equivalent of roughly 20% of the LRG's operating revenues. As such, we would also expect that the government would be willing to sell or would have a track record of selling such assets.

b) Willingness and ability to cut expenditures

86. LRGs' expenditures are generally broken down between operating expenditures and capital expenditures (capex) (see Glossary). Of the two, LRGs generally have broader flexibility to trim spending on the capex side. For instance, it is often easier to delay the construction--and costs--of a new school rather than cut the salaries of school teachers. Consequently, Standard & Poor's primary metric to measure an LRG's expenditure flexibility is capex as a percentage of total expenditures.

87. ***i) Operating expenditures flexibility.*** How flexible an LRG's operating costs are depends on the type of expenditure. Some operating costs can be totally inflexible, such as payments on financial obligations, or expenditures mandated by national legislation with prescribed service standards. Those that are generally inflexible but may offer some room for maneuver include personnel expenditures in certain jurisdictions (depending on employees' status), certain subsidies, or direct spending for core responsibilities, such as education and health care. Finally, other operating spending may be more easily cut to the extent that it is for nonessential services. However, governments generally find it politically

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difficult to take these types of actions, especially during an economic slowdown when taxpayers are already under stress.

88. ***ii) Capital expenditures flexibility.*** Although capex may, in principle, be easier to cut than operating expenses, capex can also be quite inflexible. This is particularly the case when a large project is under construction (i.e., it is difficult to stop the work on a subway line halfway through, especially under a long-term contract), when an LRG faces important infrastructure needs, when it has underspent for a long period (resulting in the possible need for catch-up spending), or when capital expenditures are co-financed by a third party (such as a higher level of a government or a multilateral institution). Furthermore, the effectiveness of large capital spending programs can be an important positive credit factor, especially for LRGs in emerging markets, where such programs support economic growth and the ability to generate taxes over the long term.

89. ***iii) Potential limitations on expenditure flexibility.*** Although expenditures can be difficult to cut, they can also be a source of pressure when they need to rise, such as when an LRG needs to increase services or upgrade infrastructure owing to a rapidly growing population, to meet the needs of a developing economy, or to improve standards in a developed market (for example, when tightening environmental norms).

90. We believe that an LRG's expenditure flexibility depends partly on its core responsibilities. For instance, there is generally less flexibility and more cost pressure associated with politically and socially important educational or health care spending than with vocational training or street lighting.

Table 14
Standard & Poor's Assessment Of An LRG's Budgetary Flexibility

Anchor derived from the combined ratios below:

	Modifiable revenues as % of adjusted operating revenues*				
Capex as % of total expenditures*	>70%	51%-70%	31%-50%	10%-30%	<10%
>=15%	1	2	3	4	4
<15%	2	3	3	4	5

Qualitative factors positively affecting the anchor include:	Qualitative factors negatively affecting the anchor include:
Demonstrated capability and willingness to cut operating spending--typically by more than 5% of operating spending--thanks to a flexible cost structure, flexible legislation, and widespread political support.	Highly limited leeway to adjust modifiable revenues--typically by less than 2% of operating revenues--either because tax rates are already high, tax collection levels are very low, or tax pressure is above peers', and/or because of a lack of political willingness to increase taxes.
Ability to increase operating revenues--typically by more than 5% of operating revenues--through the creation of new taxes or influence on shared taxes.	
Demonstrated ability to postpone capex due to excellent infrastructure, typically by more than 20% of capital spending.	Highly limited ability to cut expenditures because of significant infrastructure needs or large-scale projects, and/or owing to significant pressure on operating costs or political priorities.
Above-average capacity (as described in paragraph 85) to generate revenues from asset sales.	

Each qualitative factor generally accounts for a one-point adjustment. Anchor measures falling at or near cut-off points will receive the better assessment if trends are improving, the worse assessment if trends are weakening. Overall, the budgetary flexibility assessment equals the anchor, adjusted by up to two points up or down, based on the net effect of the qualitative factors listed above.

*Based on the average of the two-year actual data, the current-year budget or estimate, and two years of Standard & Poor's forecasts.

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91. Here are a few illustrations of our approach, including how our assessment takes into account qualitative considerations:

- EXAMPLE 1: 60% of an LRG's adjusted operating revenues are modifiable and capex is above 20% of total expenditures, which corresponds with an anchor of '2'. Tax rates are already close to the legal ceiling, or the LRG has a strong political commitment not to increase taxes. Assuming all the other factors are neutral, we would expect to assess the LRG's budgetary flexibility at '3', one point weaker than the anchor.
- EXAMPLE 2: 60% of an LRG's adjusted operating revenues are modifiable and capex is below 10% of total expenditures, which corresponds with an anchor of '3'. The LRG exhibits maneuverability on about 6% of its operating costs, including personnel expenses. Assuming all the other factors are neutral, we would expect to assess LRG's budgetary flexibility at '2', one point stronger than the anchor.

- EXAMPLE 3: 60% of an LRG's adjusted operating revenues are modifiable and capex is more than 25% of total expenditures, which corresponds with an anchor of '2'. Capex is not flexible because the LRG has large infrastructure needs and many of its investments are co-funded and carry earmarked transfers from an upper level of government and, therefore, cannot be cut contractually. Furthermore, the LRG has very low tax collection rates, which would significantly soften the effect of a hike in tax rates. Assuming all the other factors are neutral, we would expect to assign the LRG's budgetary flexibility an assessment of '4', two points weaker than the anchor.

4. Budgetary Performance

92. The budgetary performance assessment measures the level and the volatility of an LRG's expected cash flows (from operations and investment activities) that are available to service debt. It also gauges the efficiency of the LRG's financial policy. With this in mind, Standard & Poor's analysis of budgetary performance relies largely on two key ratios: operating balance and balance after capital accounts, which form the anchor.

93. The anchor is based on the average of the two-year actual data, the current-year budget or estimate, and two years of Standard & Poor's forecasts. The forecast figures in table 15 are based on our base-case projections, which, in turn, reflect our macroeconomic outlook and incorporate management's medium-term plan and any policy change and response, as well as expected pressures on and increases in revenues and expenditures.

94. We then consider other qualitative factors to determine the final budgetary performance assessment. The budgetary performance assessments are: '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

a) Operating balance

95. We believe the operating balance (see Glossary), when calculated on a cash or modified-cash basis, as a percent of adjusted operating revenues generally gives a good proxy for an LRG's cash flows from operations (see Glossary). The ratio reflects the extent to which an LRG can finance its operational costs and public services from recurring revenues--mostly taxes and operating subsidies. An operating balance of 5% of adjusted operating revenues or more typically indicates that an LRG generates self-financing capacity that it can use to partially or fully fund its capital investments and repay debt. An operating balance of less than 5% of adjusted operating revenues typically indicates less self-financing capacity and suggests the LRG would have greater vulnerability to a prolonged recession or to unexpected events. Persistent operating deficits indicate that an LRG would normally need to use debt to fund everyday operations. We note that such a situation is generally not sustainable in the long term and could indicate that the LRG's revenue base may not be sufficient to sustain its range of services, or could indicate management's lack of willingness to address structural imbalances.

96. In jurisdictions with full accrual accounting, we may use the modified (see paragraph 99) accrual operating balance.

b) Balance after capital accounts

97. The balance after capital accounts (see Glossary) represents a proxy of the overall funding needs or surplus that an LRG derives from its operating and capital activities and would generally correspond to changes in net debt in a pure cash-based accounting system. An LRG can finance the balance either by drawing on its cash reserves or by borrowing.

98. We have observed that analyses of budgetary performance often suffer from a lack of uniform definition of terms and from other inconsistencies in public-sector accounting standards across countries. The basis for public-sector accounting ranges from pure cash accounting to pure accrual accounting and includes a variety of modified-cash and modified-accrual accounting standards. The extent of consolidation of public-sector satellite companies in an LRG's accounts can also differ widely from one LRG to another.

99. Consequently, Standard & Poor's makes a series of adjustments to LRGs' reported financial indicators to minimize these inconsistencies. The adjustments aim to align financial information on LRGs, as much as possible, to form a modified-cash base (when relevant and appropriate in the context of the budgetary performance analysis), by eliminating the noncash items, such as depreciation and provisions, to obtain comparable financial data on LRGs across jurisdictions.

100. The anchor can be adjusted up or down by up to two points, based on our analysis of the net effect of the qualitative factors detailed in paragraphs 101-102 and in table 15. Each qualitative factor generally counts for one point of adjustment. Anchor assessments falling at or near cutoff points will receive the higher assessment if trends are worsening and the lower assessment if trends are improving.

101. Positive qualifiers to the anchor are:

- Expected structural improvement: if our base-case forecasts point to a material structural improvement versus the period average (i.e., that would lead to a better anchor score within our rating horizon), and
- High cash reserve levels: if deficits are temporary and can be largely covered by cash reserves.

102. Negative qualifiers to the anchor are:

- Expected structural deterioration: if our base-case forecasts point to a material structural deterioration from the period average (i.e., that would lead to a worse anchor score within our rating horizon);
- Pronounced volatility in performance as evidenced by a combination of one or more of the following factors: high inflation, very cyclical revenues, dependence on volatile state transfers, and exposure to event risk; and
- Underestimated spending as evidenced by a combination of one or more of the following factors: significant underspending, large unpaid debt to suppliers, and off-budget financing through public companies.

Table 15
Standard & Poor's Assessment Of An LRG's Budgetary Performance

Anchor derived from the combined ratios below:

	Balance after capital accounts as % of total adjusted revenues*				
Operating balance as % of adjusted operating revenues*	>0	0-(5%)	(5%)-(10%)	(10%)-(15%)	<(15%)
>5%	1	2	3	4	4
0%-5%	2	3	3	4	5
<0%	N/A	4	4	5	5

Qualitative factors positively affecting the anchor include:	Qualitative factors negatively affecting the anchor include:
Expected structural improvement: if our base-case forecasts point to a material structural improvement versus the period average (i.e., that would lead to a better anchor score within our rating horizon)	Expected structural deterioration: if our base-case forecasts point to a material structural deterioration from the period average (i.e., that would lead to a worse anchor score within our rating horizon)
High cash reserve levels: if deficits are temporary and can be largely covered by cash reserves	Pronounced volatility in performance as evidenced by a combination of one or more of the following factors: high inflation, very cyclical revenues, dependence on volatile state transfers, and exposure to event risk
	Underestimated spending as evidenced by a combination of one or more of the following factors: significant underspending, large unpaid debt to suppliers, and off-budget financing through public companies

Each qualitative factor generally counts for an adjustment of one point. Anchor assessment measures falling at or near cut-off points will receive the higher (worse) assessment if trends are worsening, and the lower assessment if trends are strengthening, reflecting the expected future level. Overall, the budgetary performance assessment equals the anchor, adjusted by up to two points up or down, based on the net effect of the qualitative factors listed above.

*Based on the average of the two-year actual data, the current-year budget or estimate, and two years of Standard & Poor's forecasts. N/A--Not applicable.

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103. Here are a few examples of our approach to assessing budgetary performance.

- EXAMPLE 1: Over the period considered (two years of actual performance, one current year, and two years of forecast), an LRG has an operating surplus of 6% of adjusted operating revenues but its deficit after capital accounts is 12% of total adjusted revenues because of the completion of its substantial capital investment in transit systems. Based on this, its anchor would be '4'. The LRG does not plan any further major investment, and our base-case forecast is for a small deficit after capital accounts of less than 5%. Assuming all other factors are neutral, we would expect to assign a budgetary performance assessment of '3', one point stronger than the anchor.
- EXAMPLE 2: An LRG has an operating surplus of 6% of operating revenues and its average deficit after capital accounts is less than 5% of total revenues. This implies an anchor of '2'. However, the LRG's performance is very volatile because a large share of revenues comes from state transfers that vary widely each year. In addition, the

LRG has a large stock of unpaid suppliers' bills, which means that operating expenditures on a cash flow basis are underestimated. Assuming all other factors are neutral, we would expect to assign a budgetary performance assessment of '4', two points weaker than anchor, taking into account the performance volatility and the sizable unpaid supplier debt.

5. Liquidity

104. The liquidity assessment measures how an LRG's internal sources of liquidity, such as cash reserves and cash flow generation (adjusted for debt service and borrowing), and external sources, namely bank lines and market access, are likely to affect its future debt-servicing capability.

105. Standard & Poor's liquidity analysis takes into account an LRG's levels of cash and readily marketable securities, committed bank lines, access to capital markets, and projected cash inflows and outflows within one year, including their seasonality and sensitivity to economic performance. In analyzing liquidity, Standard & Poor's focuses on the:

- Internal cash flow generation capability; and
- External liquidity deriving from access to banks and capital markets, and financing from other levels of governments and government agencies.

106. For an in-depth explanation of these factors, see "Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs," published Oct. 15, 2009. Our analysis of an LRG's debt and liquidity management policies and its risk management is a component of the financial management assessment. The adjusted cash reserves and internal cash flow generation capability set the anchor for the liquidity assessment. Various qualitative factors, including the access to external liquidity, are applied to the anchor to determine the final liquidity assessment. The range of assessments is: '1' (exceptional), '2 (strong), '3' (adequate), '4' (less than adequate), and '5' (weak).

a) Internal liquidity

107. Standard & Poor's cash flow analysis (and initial liquidity anchor assessment in table 17) consists of a forward-looking assessment of an LRG's adjusted cash reserves and internal cash flow generation capability, relative to annual debt service.

108. To evaluate the internal liquidity available to repay debt, we seek to determine free cash and liquid assets (see Glossary), a measure we define as liquid assets that are unrestricted, not needed to meet daily operating needs or planned capital costs in a forward-looking perspective, available to cover debt service over the next 12 months, and adjusted for market risk on noncash investments. Specifically, we count only highly liquid and immediately sellable assets and generally apply a discount to the market value of fixed-income securities and equities to reflect potential volatility due to various market risks (see liquidity criteria article for more details).

109. To determine the liquidity anchor, we assess the average cash position expected over the coming 12 months (excluding debt service and borrowing) divided by debt service coming due over the next 12 months.

110. If an LRG does not provide a reliable, forward-looking liquidity plan, we project an LRG's internal liquidity based on a combination of historical trends (i.e., free average cash over the past 12 months) and our cash forecast for the next 12

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months. We evaluate the latter using our forecasted yearly balance after capital expenditures (adjusted for interest payment) divided by 2, as a proxy. Such forecasted cash position is then divided by the debt service coming due in the next 12 months.

b) Committed bank lines

111. Although we generally regard cash and liquid assets as the strongest form of liquidity, many issuers rely on bank facilities for their financing and liquidity management. In our view, though committed bank facilities may provide a sense of security, back-up facilities do not guarantee that liquidity will always be available. Also, in some countries, bank facilities are not committed over several years, but rather are up for renewal every year. For this reason, we focus on various factors, which, in our opinion, affect the degree of the bank's commitment to advance cash under all circumstances. More information on Standard & Poor's criteria to assess committed bank facilities can be found in "Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs." When we analyze the committed bank facilities as available liquidity support under these criteria, we take the undrawn amounts into account when calculating the liquidity anchor assessment. We view entities whose internal cash generation capacity is sufficient to cover debt service coming due over the next 12 months more positively (i.e., by assigning them better anchor assessments) than those that rely on existing committed liquidity and revolving lines (see table 17).

112. The liquidity anchor reflects an average cash position (daily or monthly) compared with annual debt service. Therefore, a ratio of less than 100% is not necessarily a source of concern because annual debt service is usually spread out throughout the year (i.e., there is no expectation that a cash balance in a particular day should cover 100% of the annual debt service), and an LRG may have access to external liquidity (borrowing from the capital markets, central government, or additional credit lines) to cover debt service.

113. The average cash balances over the debt service (the anchor in table 17) are used to rank LRGs based on their ability to pay debt from the adjusted cash reserves and internally generated cash flows and undrawn but committed bank lines, if available. However, the average balance will not signal liquidity troughs, especially if the cash flows are volatile. Hence, we closely review how cash projections match the debt service schedule throughout the year.

114. The SACP will be 'b-' or lower for entities that meet all three conditions: (1) have "limited" or "uncertain" access to liquidity (see table 16), regardless of the initial anchor score; (2) are unable to improve their liquidity positions (through cutting or postponing spending or raising revenues); and (3) for whom the cash flow analysis around debt repayment periods indicates that adjusted cash reserves and internally generated cash flow will be insufficient (including prefinancing) to cover balance after capital expenditures (including debt service). (See example 1 in paragraph 125.)

115. Finally, for an LRG with a final liquidity assessment of '5', its SACP would be the lower of the 'bb+' cap or the matrix outcome, which, in turn, will be worsened by as much as one rating category, unless there are mitigating factors (see paragraph 20).

c) Access to external liquidity

116. Standard & Poor's observes that market funding--bank loans, bonds, and commercial paper--can be an important source of LRG financing, particularly in countries with liquid and mature banking systems or capital markets. In some countries, such as Germany and Canada, LRGs rely largely on a well-developed capital market for their funding, while

in many other countries, public finance entities rely mostly on bank loans. As observed during periods of severe market dislocation, such as in 2008, the LRGs did not lose access to the market to the same extent as did other asset classes.

117. We also observe that the legislative framework under which an LRG operates can affect its access to liquidity. This is particularly the case when the LRGs benefit from special and timely access to liquidity from the central government or from other levels of government, or, on the contrary, when the use of debt instruments for liquidity purposes is intermittently restricted or legally banned.

118. Consequently, we analyze an LRG's liquidity position in the context of both country- and entity-specific characteristics that affect its access to external liquidity and, therefore, its refinancing capacity and risk. Our analysis includes:

- The legal framework defining an LRG's access to liquidity, including to central government. We analyze the track record, predictability, and sustainability (amid potential pressures on the sovereign creditworthiness) of such legal framework;
- The general strength and diversity of domestic banks, focusing particularly on active lenders to the municipal/public sector;
- The development of the domestic bond market in general and for LRGs in particular; and
- An individual LRG's track record of market access or links with a diversified pool of banks and our opinion as to whether this track record will continue.

119. Based on the above considerations, we classify LRG access to external liquidity in five categories, outlined in table 16. We then use these classifications as qualitative adjustments to our overall liquidity assessment, as described in table 17.

Table 16
Standard & Poor's Assessment Of An LRG's Access To External Liquidity

Access to external liquidity	Typical characteristics
Exceptional*	--Both characteristics listed for the "strong" category, and legally defined exceptional access to sources of liquidity from other levels of government or a central government-owned bank or agency.
Strong§	--Proven track record of sufficient access to a deep and liquid capital market at all times (including during periods of severe market dislocation such as 2008 and 2009), or to a strong and diversified pool of domestic and international banks, in banking systems with a BICRA of '1' to '3'†, or --Access to well-established and effectively operating sources of liquidity from other levels of government or a central government-owned bank or agency.
Satisfactory	--Continued access to a strong and diversified pool of domestic banks, in banking systems with a BICRA of '1' to '4'† .
Limited	--Possible or intermittent legal restrictions on the use of debt instruments for liquidity management, or --Limited development of domestic capital market for LRGs, or --Generally good access to the domestic banking system, but a limited number of players in the LRG field or moderate strength of the domestic banking system, carrying a BICRA of '4' to '8'† .
Uncertain	--Legal restrictions banning the use of debt instruments for liquidity management, or --Undeveloped domestic capital market for LRGs, or --Weak domestic banking system, carrying a BICRA of '7' to '10'†, with a limited number of lenders to LRGs.

*These characteristics can only be found in very highly rated sovereigns (rated 'AA' and higher). §These characteristics can only be found in sovereigns rated 'BBB-' and higher. †If BICRA assessment is available.

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120. We use the assessment from table 16 to derive the final liquidity assessment in table 17 as such:

- "Exceptional" access to external funding improves the liquidity anchor assessment (in table 17) by two points.
- "Strong" access to external funding improves the anchor assessment by one point if only one condition listed is met. In exceptional cases, if both conditions listed are met, the anchor assessment improves by two points.
- "Limited" access to external funding worsens the anchor assessment by one point. However, if the liquidity anchor assessment is '1' ("exceptional"), based on structurally very strong capacity to generate internal cash, no negative adjustment is made.
- "Uncertain" access to external funding worsens the anchor assessment by two points. However, if the liquidity anchor assessment is '1' ("exceptional"), based on structurally very strong capacity to generate internal cash, the assessment will worsen by just one point.

121. Separately, if an entity's liquidity access is potentially limited by covenant or other restrictive terms, our assessment per table 16 is reduced to no better than the "limited" category.

122. Overall, the liquidity assessment equals the anchor assessment, adjusted up or down by as many as three points, based on our analysis of the net effect of the qualitative factors detailed in paragraphs 123-124 and in tables 16 and 17. The impact of each qualitative factor generally counts for one point, except when we consider an LRG's access to external liquidity to be "exceptional," "strong," or "uncertain." Anchor assessment measures falling at or near cutoff points will receive the higher assessment if trends are worsening and the lower assessment if trends are strengthening, reflecting the expected future level.

123. Positive qualifiers that can be applied to the anchor are:

- "Exceptional" or "strong" access to external liquidity, as defined in table 16;
- Policy response by an LRG: For entities with a very low debt service coverage ratio (anchor assessments of '5') as defined in table 17, we use this positive qualifier if there is a track record of appropriate and timely policy response from the respective LRG to liquidity pressures in the form of delayed or cancelled expenditures to meet debt service in all circumstances, and if we believe the same policy will be carried out by this LRG and will allow to target cash inflows to timely match debt service disbursements; and
- Very robust internal cash flow generation capability compared with peers in the same category (translating into an annual operating balance before interest/debt service of roughly 200% or greater). Cash flows are evenly distributed during the year and very predictable.

124. Negative qualifiers that can be applied to the anchor are:

- "Limited" or "uncertain" access to external liquidity, as defined in table 16;
- Very large expected funding needs beyond the coming year (up to 36 months). These needs can stem from working capital, multiyear investment programs (either not covered by prearranged financing, or covered by loans already drawn down), or potential large amounts of unpaid supplier debt at the LRG level or at its satellite companies (typically equating to more than four months of operating spending); and
- Expected volatility in the liquidity ratio during or beyond the 12 coming months (up to 36 months) due to, for instance, a lumpy debt amortization profile, or large bullet maturities.

Table 17
Standard & Poor's Assessment Of An LRG's Liquidity

	Free cash and liquid assets as a % of next 12 months' debt service	Free cash, liquid assets, and committed and undrawn bank lines as a % of next 12 months' debt service			
	>100%	>120%	81%-120%	40%-80%	<40%
Anchor	1	2	3	4	5

Qualitative factors positively affecting the anchor include:	Qualitative factors negatively affecting the anchor include:
Access to external liquidity is "exceptional" or "strong," as defined in table 16.	Access to external liquidity is "limited" or "uncertain," as defined in table 16.
Proactive policy response, as defined in paragraph 123.	Very large expected funding needs.
Internal cash flow generation capability is very robust compared with peers in this category.	Expected volatility in the liquidity ratio over the next 12 months or beyond.

The adjustment impact of each qualitative factor may vary from one point (in most cases) to two (in cases where we consider an LRG's access to external liquidity to be exceptional, strong, or uncertain). Overall, the liquidity assessment is based on the anchor, adjusted up to three categories up or down, based on the net effect of the qualitative factors listed above.

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125. Here are a few illustrations of our approach.

- EXAMPLE 1: An LRG in a developing country has almost no debt, so its debt service coverage of free cash and liquid assets is more than 100%, implying an anchor of '1'. However, the LRG is located in a country where we view access to external liquidity as "uncertain," meaning that the LRG might not be able to borrow if necessary. Because of the "uncertain" external liquidity access, we review the LRG's cash flow, especially around debt repayment periods, to ensure that, despite a strong cash position on average (as explained in paragraph 114), the adjusted cash reserves and internal cash generation cover the balance after capital expenditure and debt service. If no liquidity gaps are identified, we likely will assess the LRG's liquidity at '2', one point below the anchor (as per paragraph 120). However, if we identify a liquidity gap around the debt service payment, and no adjustment is envisaged, the SACP will be capped at 'b-', per paragraph 114.

- EXAMPLE 2: An LRG in a developed country has debt service coverage of free cash and liquid assets plus undrawn committed facilities of about 50%, which would indicate an anchor of '4'. However, the LRG is located in a country where we consider access to external liquidity to be "exceptional." Assuming all other factors are neutral, we would likely assess the LRG's liquidity at '2', or two points better than the anchor.

6. Debt Burden

126. An LRG's debt burden, while important, is not viewed as an absolute measure of an LRG's creditworthiness. We have observed that LRGs rated 'BBB-' and above have, on average, much higher debt levels than those rated 'BB+' and lower. This is because the higher-rated LRGs generally benefit from better access to liquidity, a more predictable revenue and expenditure structure, and broader budgetary flexibility enabling them to sustain higher debt burdens. When examining extreme cases, such as defaults, the track record of defaulting LRGs suggests that most of these defaulted with relatively low debt levels.

127. With this in mind, our debt burden analysis focuses on the following factors:

- A forward-looking assessment of debt stocks and interest burden;
- Potential volatility in the cost of debt from exposure to market risks; and
- An assessment of other long-term liabilities, mostly unfunded pension liabilities and other postemployment benefits (OPEBs).

128. We derive our debt burden anchor from the combination of a forward-looking assessment of an LRG's debt and interest burden, relative to its available resources. We can adjust the anchor up or down by up to two points, to reflect our assessment of the qualitative considerations detailed in paragraphs 140-141 and in table 18. The adjustment impact of each qualitative factor generally counts for one point. Debt indicators falling at or near cutoff points will receive the higher assessment if trends are worsening and the lower assessment if trends are strengthening. The range of final debt burden assessments is: '1' (very low), '2' (low), '3' (moderate), '4' (high), and '5' (very high).

a) Forward-looking debt and interest burden assessments

129. We do not analyze an LRG's debt burden in isolation, and we do not confine our analysis to core government debt. Accordingly, we also take into account the GREs which, in our view, are likely to rely on financial assistance from the LRG, if their own resources are not sufficient to meet their obligations. Factors affecting our analysis of an LRG's debt obligations and those of GREs include examining existing explicit obligations--mostly in the form of guarantees--or implicit moral obligations that the LRG may have, stemming for instance from the size of an LRG's ownership stake in a given GRE and the role it performs. We also take into account the financial standing of GREs.

130. Among the debt measures we analyze to capture differing levels of consolidation from one LRG to another, we believe that the ratio of tax-supported debt to consolidated operating revenues (see Glossary) is the most appropriate measure for international comparisons. This measure helps to smooth out some of the differences stemming from accounting systems and political frameworks around the world. It is also a good measure, in our view, of all debt that ultimately relies on an LRG's total revenues (tax and other revenues) because it incorporates the debt of satellite companies that rely at least partially on the LRG for their financial standing.

131. In rare cases, when an GRE's revenues are disproportionally large compared with those of the LRG and, hence, could distort the debt burden measure on the consolidated level, we will use the government direct debt (see Glossary) as a share of its direct revenues as an anchor. This conservative approach more properly accounts for revenues available for payment of government debt and avoids the risk of rapid deterioration in the debt assessment should the GRE with high revenues and low debt become self-supporting. (In that case, the GRE's financials would be excluded from the debt measure calculation and included instead in the analysis of contingent liabilities.)

132. The second ratio we analyze is interest payment (see Glossary) to adjusted operating revenues, meaning gross interest on direct debt at the LRG level. This ratio gives us an indication of the sustainability of an LRG's debt by measuring the share of income it uses to cover cost of debt. We may also consider the ratio of debt service to operating revenues, but we give it less weight in our debt burden assessment because it includes some considerations of an LRG's refinancing capacity, which can differ widely across countries, and which our liquidity assessment already captures.

b) Qualitative factors: exposure to market risks and unfunded pension and OPEB liabilities

133. We monitor an LRG's exposure to market risks, aiming to factor in effects that could lead to volatility in the interest and debt service burden. In turn, these effects could influence the size of and volatility in the LRG's debt burden. We focus specifically on the following areas.

134. ***i) Interest rate risk.*** Some LRGs structure their debt portfolios to take advantage of expected movements in interest rates and are therefore exposed to losses if interest rates do not move as they had anticipated. When analyzing an LRG's exposure to interest rates, we generally focus on the share of its debt that is sensitive to interest rate fluctuations, the degree of exposure to main market rates, or other variables from which pricing is derived (for instance LIBOR or Euribor), and the mechanisms the LRG uses to monitor and respond to adverse interest rate movements, such as the use of hedging strategies.

135. ***ii) Currency risk.*** If an LRG has foreign currency-denominated debt, we generally analyze the consequences of adverse exchange rate movements and how it could mitigate these through hedging strategies. When an LRG bears foreign exchange risk either by choice or because it lacks hedging tools, we analyze the mechanisms it employs for monitoring and managing exposure to determine the degree of risk it faces and the existence of any mitigants to this risk. As part of our analysis of currency risks, we seek to ascertain how volatile the exchange rates are between relevant foreign currencies and the LRG's domestic currency.

136. ***iii) Use of derivative or nonstandard financial instruments.*** We also usually analyze the use--or nonuse--of derivative or nonstandard financial instruments to manage exposures to market risks. Taken by themselves, derivatives are not necessarily detrimental to an LRG's credit profile if they are primarily used for hedging purposes. We analyze the LRG's objectives in entering into derivative contracts and other financial instruments, including hedging, trading, and cost reduction; the type of risk they are designed to mitigate; the extent of their use; management's risk tolerance; management's competence in executing hedging and its understanding of the risks involved; and the controls in place to monitor derivatives and their potential impact on the LRG's liquidity risk.

137. ***iv) Debt maturity profile.*** We factor the debt maturity profile mainly into our liquidity assessment, but we also take it into account when we evaluate an LRG's interest burden and volatility. In our observation, an LRG with a very short-term amortization profile--typically average debt maturity of less than two years--is much more sensitive to interest rate fluctuations, because a greater proportion of its debt might require refinancing.

138. ***v) Other long-term liabilities.*** In certain countries, LRGs are responsible for all, or part of, the pensions of their employees. In these countries, pension liabilities may affect the credit quality of LRGs to varying degrees, depending on the nature of the local pension plans, the demographic profile of the LRG's employees, and the financial coverage of future obligations.

139. The impact of pension and OPEB obligations depends on:

- The magnitude of unfunded pension and OPEB liabilities assessed in the context of the budgetary impact. We typically make a negative adjustment to a debt assessment if the unfunded liabilities are greater than 50% of operating revenues and are unaddressed, hence necessitating larger budgetary outlays in the future. We aim to incorporate the unfunded liability as calculated using the accumulated benefit obligation (ABO) method (see Glossary). In countries where ABO-based data are not available, we will use projected benefit obligation (PBO) data (see Glossary).
- The degree to which pension costs will likely escalate and whether the government has plans to address them. Relative to debt, governments have a higher level of flexibility to address these costs, both in terms of timing and level of payment. Many governments have the flexibility to alter benefit levels, and some governments already have availed themselves of this ability. Most governments also can pay less than the annual required contribution without leaving the fund unable to meet actual payments in the current and following year. On the other hand, such delays accelerate the growth rate of future payments. When the potential for such accelerations exists and the increased payments increase budget stress, the final debt assessment worsens by one point when a specific and credible plan to address this burden is in place (unless this is already explicitly reflected in our forward-looking budgetary performance assessment). Otherwise, the anchor worsens by two points.

140. Overall, positive qualifiers that can be applied to the anchor are:

- Exceptionally high operating balance (i.e., cases when direct debt typically represents less than three years of operating margin), and
- Large debt on-lent to self-supporting entities (see Glossary). Some LRGs raise debt to on-lend it to subsidiaries or GREs. If these subsidiaries are self-supporting and if the share of such on-lent debt is a substantial portion of the total debt of the LRG (so that, if we exclude this on-lent debt, the debt anchor assessment would improve by one point or more), we will improve our anchor debt assessment by one point to recognize a lower credit risk associated with the LRG's debt profile.

141. Negative qualifiers that can be applied to the anchor are:

- Potential significant volatility in the debt burden owing to high exposure to market risks (e.g., interest, currency risk, a short-term maturity profile, and aggressive use of derivative or nonstandard instruments), which could lead to an increase in the cost and level of debt such, that it would weaken the anchor by one point, and
- Unaddressed large unfunded pension and OPEB liabilities and/or large and rising pension costs.

Table 18
Standard & Poor's Assessment Of An LRG's Debt Burden

Anchor Is derived from the combined ratios below:

Interest payment as % of adjusted operating revenues†	Tax-supported debt as % of consolidated operating revenues§				
	<30%	30%-60%	61%-120%	121%-180%	>180%
<5%	1	2	3	4	5
5%-9%	2	3	4	4	5
> 9%	3	4	5	5	5

Qualitative factors positively affecting the anchor include:	Qualitative factors negatively affecting the anchor include:
Exceptionally high operating balance (typically, direct debt represents less than three years of operating margin)	Potential significant volatility in the debt burden owing to high exposure to market risks
Debt burden mitigated by self-supporting on-lent debt	Unaddressed exposure to large unfunded pension and OPEB liabilities and/or large and rising pension costs (see paragraph 139)

The adjustment impact of each qualitative factor generally counts for one point. Debt indicators falling at or near cut-off points will receive the higher assessment if trends are worsening, and the lower assessment if trends are strengthening, reflecting the expected future level. Overall, the debt burden assessment equals the anchor, adjusted by up to two categories up or down, based on the net effect of the qualitative factors listed above.

§Based on the debt level forecasted in two years time (i.e., debt in a year t+2). †Based on the average of last actual data, current-year budget or estimate, and following year forecast.

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142. Here are a few examples of how we would assess an LRG's debt burden:

- EXAMPLE 1: An LRG in a developing country has forecast tax-supported debt of 28% of consolidated operating revenues and an interest burden of 4% of operating revenues, which would indicate an anchor of '1'. However, it has high exposure to market risk because of its very short-term debt profile--most debt is maturing within two years. Assuming all other factors are neutral, we would likely assign the LRG a debt burden assessment of '2', one level worse than the anchor assessment.
- EXAMPLE 2: An LRG has forecast tax-supported debt of 50% of consolidated operating revenues and an interest burden of 3% of operating revenues, implying an anchor of '2'. The LRG has unfunded pension liabilities accounting for 60% of operating revenues and no plans in place to address this gap. Assuming all other factors are neutral, we would expect to assess this LRG's debt burden at '3', one level worse than the anchor.

7. Contingent Liabilities

143. Contingent liabilities correspond to explicit (such as guarantees to self-supporting GREs) or implicit obligations (such as litigation costs or potential financial support to unguaranteed self-supporting GREs) that an LRG may incur under certain circumstances. If these liabilities materialize, they could affect an LRG's financial position, usually by increasing debt, potentially weighing down budgetary performance, or drawing down on liquidity. As the contingent liabilities materialize, the improvement in the contingent liability assessment usually is offset by deterioration in our other assessments of the LRG. The contingent liability assessment might also improve if the risks are minimized (for instance, if the local government support is no longer needed due to an entity's privatization) or become more remote. We take into consideration a government's planning and preparedness for the potential realization of contingent liabilities. This could take the form of budgetary allocations for these risks (contingency reserves, a provision or other non-financial measures, such as emergency management preparedness). A high level of preparedness can be an important mitigating factor in our assessment of contingent liabilities, even if the contingent liabilities' risks are significant.

144. Contingent liabilities are difficult to assess because they may vary substantially from one country to another, and the likelihood of occurrence of related risks may be tough to predict. Furthermore, contingent liabilities might arise from hundreds of small risks, not all of which may be material for our LRG rating analysis.

145. For these reasons, Standard & Poor's assessment of an LRG's contingent liabilities is mostly qualitative, focusing on the nature of the contingent liability and its materiality (see table 19). When possible (see paragraphs 147-148), we quantify the LRG's expected support under a significant stress scenario. In other cases (see paragraphs 150-153), we use a qualitative assessment of such risks. We also take into consideration the amount of contingency reserves, allocations, or provisions that the LRG sets aside to cover for these risks when they exist. The range of contingent liabilities assessments is: '1' (very low), '2' (low), '3' (moderate), '4' (high), and '5' (very high).

146. The most frequent types of contingent liabilities that we have observed for LRGs across different countries include (1) liabilities related to self-supporting nonfinancial and financial GREs, (2) nondebt obligations (such as payables to suppliers) of non-self-supporting GREs (debt of and guarantees to non-self-supporting GREs are part of our debt burden assessment), (3) support to lower levels of the government (for instance, regional government supporting municipal government), (4) other contingent liabilities, such as public-private partnerships (PPPs), securitizations, litigations, insurance plans, natural disasters, and other event risk. The size and materiality of these contingent liabilities can differ substantially from one LRG to another.

a) Contingent liabilities from rated GREs

147. An LRG may incur a contingent risk from companies in which it owns stakes or from other public or private GREs. For rated GREs, we analyze their size, risk profile, likelihood of support by a respective government, and, when possible, the cost of such support under stress.

148. In instances when LRGs own, control, or guarantee a financial institution, we seek to assess the maximum risk that the institution could represent for the LRG, based on the depositary financial institution's size, its credit profile, the LRG's ownership profile, the amount of debt guaranteed, and the support that could come from other governments or

institutions in the event of financial stress. When possible, we quantify this risk using our risk-adjusted capital framework model (see "Bank Capital Methodology And Assumptions," published Dec. 6, 2010). Specifically, we estimate stress-case losses over a three-year period under a substantial, 'A' stress scenario and calculate ensuing hypothetical recapitalization cost. The 'A' stress scenario, defined in "Understanding Standard & Poor's Rating Definitions," published on June 3, 2009, corresponds to a GDP decline by as much as 6%, an unemployment rise up to 15%, and a stock market drop by up to 60%. When such analysis is not possible, we will estimate the potential financial assistance from the local government in case of stress based on the GRE's financial and business profile.

b) Contingent liabilities from unrated GREs

149. When an LRG owns or controls unrated GREs, including a multitude of small companies (for which it can be difficult to obtain detailed information), we aim to obtain relevant financial information, when possible, to understand potential government's exposure. This may include information on the consolidated debt figure for the relevant companies, the LRG's stakes in these companies, the sector in which they operate, and some key indicators of their financial situations (such as profits and losses, revenues, the ratio of debt to equity, and debt, including that to suppliers). When possible, we analyze the risk profile and nature of operations/associated costs of the sector, in which a GRE operates. For instance, resolution of technical problems in the electricity generation sector might be a higher liability to the government, compared with potential financial assistance to a water company.

c) Public-private partnerships

150. We evaluate PPP projects in our analysis, either under our debt burden assessment or as a contingent liability, depending on the degree of risk transfer to the private sector (see "Methodology And Assumptions: The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment," published Dec. 15, 2008). Even though a PPP's legal documentation may state that associated private debt is nonrecourse to the LRG, we have observed that the LRG may nevertheless on certain occasions aid a given PPP project for political or economic reasons; hence we view these arrangements as presenting contingent liability risks. In addition, the risk stemming from PPP arrangements might affect our view of the LRG's budgetary performance, debt, and liquidity.

d) Securitizations

151. The approach we use for PPPs also applies to an LRG's securitization of existing credits or future revenues (taxes or fees or transfers). If an LRG executes a securitization simply to raise debt off balance sheet, we would consolidate it in the LRG's debt. Other securitization deals are treated as contingent liabilities. This is because similar to PPPs, even if there is a true sale of existing or future revenues, with investors having no recourse to the LRG, we have observed that the LRG may nevertheless have a moral obligation to aid a given securitization deal if it were failing. In addition, the risk stemming from the securitization transaction might affect our view of the LRG's budgetary flexibility, debt burden, and liquidity.

e) Litigations

152. LRGs might face a variety of litigation (linked, for instance, to expropriations or environmental considerations). When these risks are not covered in the LRG's budget, through a provision or budget allocation, we may view them as a contingent liability. This risk is difficult to evaluate because the liabilities depend on court decisions. As a result, we generally assess litigation risk through discussions with the LRG's senior management and by reviewing the LRG's track record of annual payments relative to total outstanding claims and the LRG's budget size.

f) Other common types of contingent liabilities

153. Other types of contingent liabilities are workers' compensation, insurance plans, extraordinary support to lower levels of the government (for instance, to support payables' repayment or infrastructure projects), natural catastrophes, and geopolitical risks.

Table 19
Standard & Poor's Assessment Of An LRG's Contingent Liabilities

Assessment	Typical characteristics
1	-- LRG's overall exposure* to GREs is estimated at less than 20% of LRG's operating revenues. Self-supporting GREs are unlikely to require LRG's support in the event of stress§ or support will be very limited (i.e., estimated at below 2% of the LRG's consolidated operating revenues)†, AND --Other contingent liabilities are limited (e.g., no large GREs and no significant litigations, PPPs, or securitizations) OR very high level of provision/preparedness for potential CL risks.
2	-- LRG's overall exposure* to GREs is more than 20% of operating revenues. Self-supporting GREs are unlikely to require LRG's support in the event of financial stress§ or support will be limited (i.e., estimated at below 10% of the LRG's consolidated operating revenues†), AND --Other contingent liabilities are limited OR high level of provision/preparedness for potential CL risks.
3	-- Self-supporting GREs may require and are likely to receive government support in the event of financial stress†. The potential recap cost for rated (and unrated, if estimate is available) GREs is estimated at below 15% of the LRG's consolidated operating revenues (see paragraph 148), OR --Other contingent liabilities are moderate. LRG is exposed to some contingent liabilities listed in paragraphs 149-153, the risks are higher than in a better category OR CL are high but provisions/other measures could partially compensate for losses.
4	-- Self-supporting GREs may require and are likely to receive government support in the event of financial stress†. The potential recap cost for rated (and unrated, if estimate is available) GREs is estimated between 15%-30% of the LRG's consolidated operating revenues (see paragraph 148), OR -- Other contingent liabilities are significant, and the risk of them materializing (and negatively affecting LRG's performance) is substantial.
5	--Self-supporting GREs may require and are likely to receive government support in the event of financial stress†. The potential recap cost for rated (and unrated, if estimate is available) GREs is estimated above 30% of the LRG's consolidated operating revenues (see paragraph 148), OR --Other contingent liabilities are very significant. In some cases, the probability of material risks being realized is significant (with no adequate provision against it), with potentially substantial impact on other areas of the LRGs credit standing.

*Defined as debt and guarantees of self-supporting entities and non-debt obligations of non-self-supporting entities. §"Low" or "moderate" likelihood of support, if assessed under GRE criteria. †"Moderately high"/"high"/ "very high"/"extremely high"/"almost certain" likelihood of support, if assessed under GRE criteria, due to large government stake if unrated, or due to non-self-supporting status.

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D. Long-Term Issue Ratings

154. The rating on an unguaranteed foreign-currency issue of an LRG is the same as the LRG foreign-currency issuer credit rating because subordination is uncommon in this sector. We do not assign recovery ratings to LRGs' obligations. The

rating on an unguaranteed LRG's local-currency issue is generally the same as the local-currency issuer credit rating on the LRG. We rate fully guaranteed debt that meets our guarantee criteria at the same level as the guarantor.

155. These criteria do not apply to securitized issues, such as tax participation transactions (see "Methodology And Assumptions For Rating Mexican Tax Participation Transactions," published Feb. 19, 2014) or transactions backed by local taxes (see "In Mexico, Local Governments Turn To Future Tax Revenue Securitization To Free Up Funds," published Oct. 26, 2007).

APPENDIX

A. LRG Rating Calibrations

156. The overall calibration of the LRG ratings criteria is based on our analysis of the history of LRG defaults, the effect of past financial and economic crises on LRGs' creditworthiness, and our view of the credit characteristics of LRG governments compared with those of other issuers.

157. Our annual default and transition study (see "International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike," published March 28, 2013) tracks LRGs' default and transition performance since 1975. Through year-end 2012, we have recorded 19 defaults among rated non-U.S. LRGs. None of the LRGs that defaulted were initially rated investment grade. According to the 2012 default and transition study, the cumulative default rate for speculative-grade LRGs was 7.3% over a 60-month horizon and 18.6% over a 120-month horizon. This compares with 16.4% and 24.4% corporate default rates, respectively, as per "2012 Annual Global Corporate Default Study And Rating Transitions," published March 19, 2013. We observed that historical defaults were associated with sovereign stress (such as in Argentina and Russia), as well as credit-specific characteristics, including poor liquidity and weak financial management (e.g., defaults of Mexican LRGs in 2012). Liquidity and financial management, in addition to systemic factors (reflected in the institutional framework and economic assessments), are common leading indicators of LRG defaults, and so these criteria further refine our assessments of these factors. In addition to receiving a higher weight in the framework, liquidity and financial management are included as overriding factors to the matrix outcome. The ongoing emphasis on the sovereign-related risk is highlighted in the linkages between the IF assessment and the sovereign ratings.

158. The analysis of the institutional framework is a critical part of the LRG criteria. Governments with sufficient autonomy may raise taxes or cut services to strengthen their fiscal profiles. For governments without such autonomy, relationships with higher-level governments are key. As such, a local government's legal and political relationships with higher levels of government can be more important to its ability to meet debt service (see Glossary) than its immediate financial position.

159. Standard & Poor's calibrates its LRG rating criteria based on the above observations and on its general framework outlined in:

- "Understanding Standard & Poor's Rating Definitions," published June 3, 2009;
- "Credit Stability Criteria," published May 3, 2010; and

- "The Time Dimension Of Standard & Poor's Credit Ratings," published Sept. 22, 2010.

B. Glossary

Local and regional government (LRG)

160. ***Government-related entity (GRE).*** Enterprises potentially affected by extraordinary government intervention during periods of stress, as defined in "Rating Government-Related Entities: Methodology And Assumptions," published on Dec. 9, 2010. GREs are often partially or totally controlled by a government (or governments), and they contribute to implementing policies or delivering key services to the population. However, we have observed that some entities with little or no government ownership might also benefit from extraordinary government support because of their systemic importance or their critical role as providers of crucial goods and services. In this article, GREs generally refers to companies either owned or controlled by LRGs.

161. ***Stand-alone credit profile (SACP).*** Reflects Standard & Poor's opinion of the entity's creditworthiness, before taking into account the potential for direct entity-specific extraordinary intervention from the entity's parent company or, in the case of a GRE, the government that controls or owns it.

Budgetary flexibility and budgetary performance

162. ***Operating revenues.*** Recurring revenues that an LRG receives. Operating revenues comprise taxes and nontax revenues, such as grants, operating subsidies, fines, fees for services, tariffs, rents, and other sources from which the LRG derives revenues. They exclude capital revenues, such as capital subsidies and proceeds from asset sales, and any revenues from borrowed funds.

163. ***Adjusted operating revenues.*** Operating revenues adjusted for material noncash or pass-through items.

164. ***Consolidated operating revenues.*** An LRG's operating revenues and the commercial revenues (comprising fees and sales, among others) generated by GREs that the LRG owns or controls, for which we include debt in the LRG's tax-supported debt ratio. We generally deduct from the GREs' revenues material sums that come from the LRG itself, such as a subsidy or service contract.

165. ***Operating expenditures.*** Correspond to the costs of an LRG's operations, its administration, and its provision of services to the population, directly or through other public bodies.

166. ***Adjusted operating expenditures.*** Operating expenditures adjusted for material noncash (provisions, depreciation) or pass-through items.

167. ***Operating balance.*** Equals adjusted operating revenues minus adjusted operating expenditures (including interest expense).

168. ***Capital expenditures.*** Typically cover the repair and replacement of existing infrastructure and the development of new infrastructure.

169. ***Capital revenues.*** Chiefly comprise proceeds from asset sales and capital grants.

170. ***Balance after capital accounts.*** Results from the adding of capital revenues to and the subtracting of capital expenditures from the operating balance.

Liquidity

171. ***Free cash and liquid assets.*** Liquid assets that are unrestricted, not needed to meet daily operating needs or planned capital costs in a forward-looking perspective, available to cover debt service over the next 12 months, and adjusted for market risk on noncash investments.

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Debt burden and contingent liabilities

172. ***Interest payments.*** Correspond to the amount of interest paid within a given budgetary period, including the interest component of financial leases.

173. ***Debt service.*** Equals interest payments plus the amount of principal repaid during a given budgetary timeframe, including the capital component of financial leases and short-term debt repaid during the period. We believe that debt service on a revolving credit line tends to be exaggerated if the full amount of turnover on the revolving line is recorded as repayment. Therefore, in our calculations, repayment under the revolving line would include only the maximum amount drawn under the line during the year, minus debt outstanding under the revolving line at year-end.

174. ***Direct debt.*** Comprises 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 express agreement or for other legally binding reasons. It excludes guaranteed debt and the debt of GREs, unless 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.

175. ***Guaranteed debt.*** Financial debt on which the principal and interest payments are the responsibility of the LRG (as the guarantor), if the borrower that is primarily liable fails to repay the debt. If an LRG has to service the debt it has guaranteed, then we would include the guaranteed amount in the LRG's direct debt.

176. ***Tax-supported debt.*** The sum of the following items:

- Direct debt of the LRG;
- Guaranteed debt of GREs or other entities that are not self-supporting;
- Nonguaranteed debt of GREs that are not self-supporting;
- Debt of nonbank GREs, when the long-term rating on the GRE is the same as the long-term rating on the LRG, based on our opinion of an "almost certain" likelihood that the LRG will provide support for the GRE (generally excluding those GREs that are self-supporting) if needed, or when the GRE's debt is issued by the LRG's central treasury (as is the case in Australia); and
- Debt of PPPs and securitizations, when the risk transfer to the private sector is not material enough to treat the public sector entity's financial commitment as a contingent liability.

177. In instances where we believe that a GRE is not self-supporting, we consolidate in the tax-supported debt ratio all the GRE's debt and own commercial revenues, regardless of the LRG's percentage of ownership of the GRE.

178. ***Self-supporting entities.*** The debt of a GRE that does not need financial support from its LRG and is unlikely to require support in the future is self-supporting debt. Financial support includes any direct or indirect contribution aiming at balancing operating accounts, financing investments, or repaying debt. When a GRE receives sizable revenues from its LRG for a service, we evaluate the exchange as if it were a remuneration at market rates for a service that could be provided in comparable terms by a private contractor. Self-supporting entities generally have investment-grade stand-alone credit profile (or estimated creditworthiness, if SACP is not formally established). For speculative-grade LRGs, GREs whose SACPs (or estimated creditworthiness) are at the same level or higher than that of the LRG's (hence unlikely to require government support) can also be classified as self-supporting.

179. ***Projected benefit obligation.*** An estimate of the present value of an employee's pension that assumes that the employee will continue to work and that his or her pension contributions would increase as their salary increases.

180. ***Accumulated benefit obligation.*** A method that assumes that the employee ceases to work for the company at the time the actuarial estimate is made.

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181. ***Total adjusted revenues.*** The sum of adjusted operating revenues and capital revenues for a given budgetary period.

C. Changes From Previous Methodology

182. These criteria fully supersede "Methodology For Rating International Local And Regional Governments," published Sept. 20, 2010. The main changes aim to streamline, specify, and enhance certain parts of the criteria. In particular:

- In the institutional framework assessment, we combined the analysis of revenue and expenditure balance with that of the systemic government support. This approach better captures the interconnectedness of these two assessments, recognizing that LRGs may balance their revenues and expenditures by accessing ongoing and extraordinary systemic support from the higher level of government.
- We more closely linked the impact of the sovereign macro fundamentals on the credit standing of an LRG, by establishing a mapping between the institutional framework assessment and the foreign-currency rating on the related sovereign.
- We provided flexibility in assigning the economic anchor assessments based on the national income data (as an alternative to using local GDP per capita) to better reflect institutional characteristics of various LRG systems. We introduced a qualifier for comparative socioeconomic indicators, which includes previously used adjustments for high unemployment and weak demographic profile, but also addresses a broader set of factors which could pressure an LRG's spending.
- In the financial management assessment, we put greater emphasis on the factors that, in our opinion, are important drivers of an LRG's creditworthiness, such as political and managerial strength, transparency, and credit culture. We also formalized the scoring framework for the financial management assessment.
- We emphasized the forward-looking aspect in our assessment of the LRG's liquidity and refined certain adjustment factors to improve the application consistency.
- Other changes were mainly to address frequent criteria application questions, refine the criteria to better capture regional differences in LRGs' frameworks and operations, align this methodology with other criteria, and ensure global consistency and transparency of the criteria application.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Credit Stability Criteria, May 3, 2010
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- Methodology: Rating A Regional Or Local Government Higher Than Its Sovereign, Sept. 9, 2009
- Methodology And Assumptions: Analyzing The Impact Of Unfunded Pension Liabilities On The Credit Quality Of International Local And Regional Governments, July 31, 2009

- Understanding Standard & Poor's Rating Definitions, June 3, 2009
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- The Impact Of PPP Projects On International Local And Regional Governments: Refined, Dec. 15, 2008

Related Research

- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013
- The Time Dimension Of Standard & Poor's Credit Ratings, Sept. 22, 2010

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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