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Swedish Local Governments Face Greater Reliance On Tax Revenues As Extraordinary State Support Comes To A Halt

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The operating balances of rated Swedish local and regional governments (LRGs) are likely to decline over the next two years from the relatively strong levels of 2010 and 2011, Standard & Poor's Ratings Services believes. This is because the central government has now phased out extraordinary state support schemes introduced in 2009 to help the sector recover from the 2008-2009 financial crisis. In view of our base-case assumption that tax revenues will show only modest growth due to slowing growth in the Swedish economy in 2012, we think rated Swedish LRGs will face testing budgetary conditions over the next two years.

Faced with declining growth in operating revenues while continuing ambitious capital spending, rated LRGs will, in our view, increasingly finance their investments by issuing debt on the capital markets. Nevertheless, in our base-case scenario, we do not expect their budgetary performance to decline significantly because we believe the LRGs we rate have sufficient flexibility, primarily through possible spending cuts and increases in local income tax rates, to lessen the impact of budgetary shortfalls. Accordingly, we forecast that Sweden's rated LRGs will accumulate debt at a moderate pace over the next two years to finance their capital spending. We consider, however, that the Swedish LRGs we rate have sufficiently strong individual credit profiles to withstand a moderate medium-term decline in tax revenues without putting significant pressure on the current ratings. Consequently, all rated Swedish LRGs have stable or positive outlooks.

LRGs are increasingly tapping capital markets

To achieve cost efficient funding and improve funding flexibility, we expect LRGs to turn increasingly to the capital markets over the next few years. Moreover, we note that investors increasingly require LRG note programs to have ratings. Consequently, we expect that this will lead more LRGs to seek debt ratings in the next few years. We have already seen a clear increase in issuance of commercial paper and medium-term notes by larger LRGs over the past two years, and have assigned several new ratings in the sector. In 2010, we assigned new ratings to the municipalities of Orebro (AA+/Stable/A-1+), Helsingborg (AA+/Stable/A-1+), Huddinge (AA+/Stable/A-1+), Norrkoping (AA+/Stable/A-1+), and Lund (AAA/Stable/A-1+). In 2011, we rated the city of Malmo (AAA/Stable/A-1+) and the municipality of Sodertalje (AA+/Stable/A-1+). So far in 2012 we have assigned ratings to the City of Boras (AA+/Stable/A-1+). Several municipalities have also set up in-house banks to initiate or expand the financing of their respective municipal companies within their municipal treasuries.

We currently rate 14 municipalities and two county councils/regions out of a total of 290 municipalities and 20 county councils in Sweden (AAA/Stable/A-1+). Our ratings cover about 35% of the country's population. In terms of issuance volumes, we rate most domestic LRG entities with outstanding capital market debt.

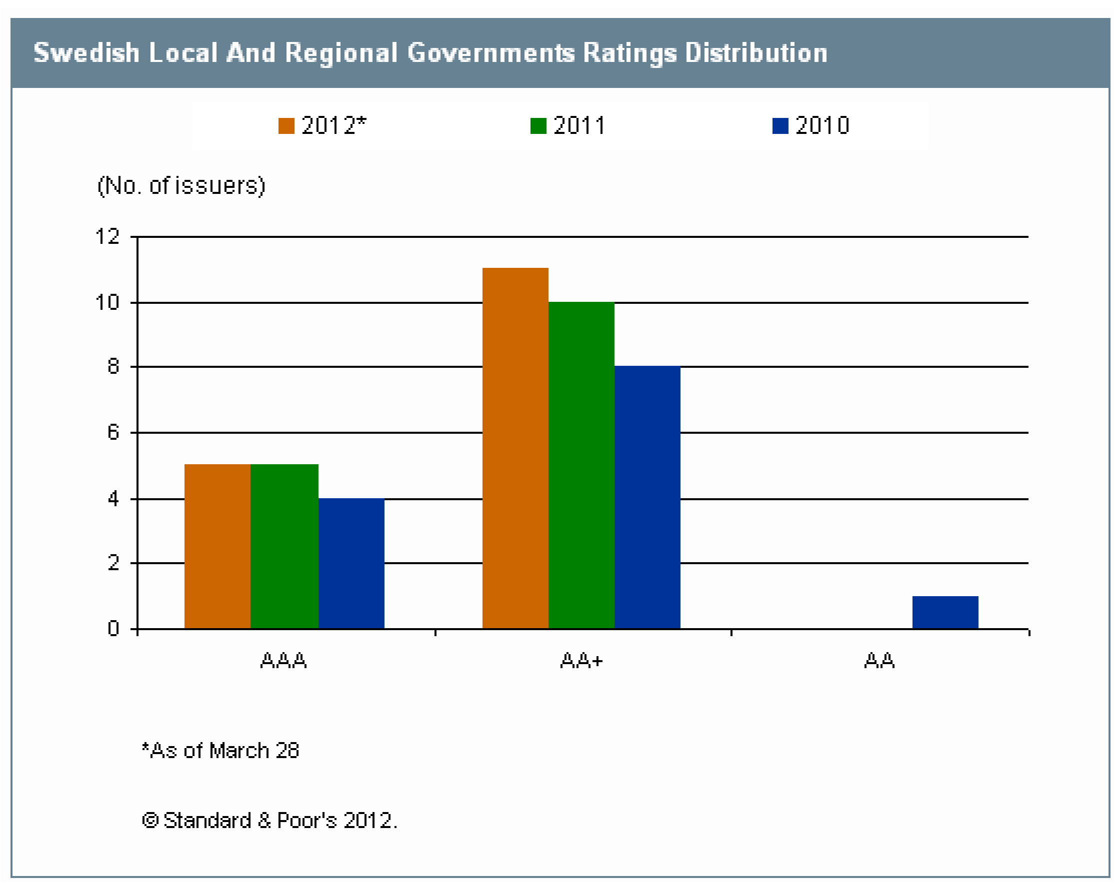
Rated Swedish Local And Regional Governments

	Issuer credit rating	Nordic national scale rating
City of Boras	AA+/Stable/A-1+	K-1
Goteborg (City of)	AA+/Stable/A-1+	K-1
Helsingborg (City of)	AA+/Positive/A-1+	K-1

Rated Swedish Local And Regional Governments (cont.)		
Huddinge (Municipality of)	AA+/Stable/A-1+	K-1
Lund (Municipality of)	AAA/Stable/A-1+	K-1
Malmo (City of)	AAA/Stable/A-1+	K-1
Norrkoping (Municipality of)	AA+/Stable/A-1+	K-1
Orebro (Municipality of)	AA+/Stable/A-1+	K-1
Stockholm County Council	AA+/Stable/A-1+	K-1
Stockholm (City of)	AAA/Stable/A-1+	K-1
Sundsvall (Municipality of)	AA+/Stable/--	K-1
Municipality of Sodertalje	AA+/Stable/A-1+	K-1
Taby (Municipality of)	AAA/Stable/--	K-1
Uppsala (City of)	AA+/Positive/A-1+	K-1
Vasteras (City of)	AA+/Stable/A-1+	K-1
Vastra Gotaland (Region of)	AAA/Stable/A-1+	K-1

Ratings as of April 3, 2012.

We now rate a total of 16 Swedish LRGs, all of them in the 'AA+' to 'AAA' range (see table). Our outlook on 14 is stable, while two have positive outlooks. In 2011, we took three rating actions on LRG entities with existing ratings. In March, we revised the outlook on Helsingborg to positive to reflect our expectations of strengthened liquidity. In April, we upgraded the municipality of Sundsvall to 'AA+' to reflect its strong economic position. In December, we revised the outlook on Uppsala to positive, again to reflect strengthened liquidity.



Growth in LRG personal income tax revenues may slow this year on weaker economic growth

The budgetary performance of Swedish LRGs is likely to weaken this year in line with slowing growth in the Swedish economy and a resulting decline in tax income, in our view. We expect the Swedish economy to lose growth momentum over the coming months after a strong rebound over the past two years, with real GDP growth of 5.7% in 2010 and another robust performance in 2011. This is because the recovery was fueled mainly by strong external demand from Sweden's main trading partners, the euro area, Norway, Denmark, the U.K., and the U.S. This year, we expect growth in these economies to slow. While the solid recovery demonstrated the resilience of the Swedish economy, the global recession has highlighted its susceptibility to slumps in external demand (for further details see "Sweden (Kingdom of)", published Dec. 15, 2011, on RatingsDirect on the Global Credit Portal.

Rated Swedish LRGs had healthy budgetary performances in 2011, though more modest than in 2010. We estimate that rated LRGs posted average operating balances of about 4% of operating revenues in 2011, down from 5% in 2010. It is uncertain how rated LRGs will perform in 2012 now that all the extraordinary grants extended in 2009 have been removed. In our base-case scenario, we forecast the average operating balance of Swedish LRGs will decline, but remain positive at 2%-3% of operating revenues. However, we consider the LRGs that we rate to be well positioned to deal with further deterioration in their budgetary performance if tax revenues prove lower than we currently assume. If the sector's tax revenue significantly deteriorates, we believe Swedish LRGs would use their budgetary flexibility to compensate for any shortfalls, primarily through spending cuts and increases in local income tax rates.

LRG borrowing needs are driven by capital spending

In response to limited revenue growth over the next few years, we anticipate that rated Swedish LRGs will continue to control spending. Consequently, we do not expect any borrowing needs as a result of operational deficits. Because debt maturities in Sweden have historically been short term, LRGs have used gross borrowing mainly to refinance maturing debt. In the years ahead, our base case assumes that any borrowing needs will result from financing capital spending, refinancing existing loans, and funding investment in municipal companies.

We, however, anticipate that rated LRGs will maintain reasonably high capital spending in 2012, in line with the wider domestic LRG sector. This higher capital spending is likely to result in a net borrowing need.

In our base-case scenario, we estimate the average investments of rated LRGs in 2012 will amount to 7% of total spending, a level similar to that of 2011. These investments refer to capital spending by core municipal entities, but exclude investments by municipal companies. To the extent that these companies use the in-house bank, we capture the associated debt financing of their investments in our tax-supported debt ratio, which we estimate at a modest average 40% of consolidated revenues for rated Swedish LRGs. By year-end 2012, we forecast the average tax-supported debt of rated Swedish LRGs will have increased to about 45% as a consequence of debt-financed investment. Although we expect rated LRGs to keep investments high by Swedish standards, we believe they are sufficiently flexible to postpone investments, if necessary, in the event of poor budgetary performance.

Pension liabilities are increasing, especially for LRGs that provide health care

Shifting interest rate assumptions have driven LRG pension liabilities higher in recent years. We estimate that the total pension liabilities of municipalities stood at Swedish krona (SEK) 215 billion at year-end 2010, with the corresponding figure for county councils at SEK180 billion. We estimate the unfunded pension liabilities of rated LRGs at about 40% of total revenues as at year-end 2011, which is largely in line with the sector average. County councils, which provide health care, have higher pension liabilities than municipalities, which do not. Accordingly, Stockholm County Council and the Region of Västra Götaland have unfunded pension liabilities corresponding to 60% of total revenues, whereas the 14 rated municipalities have pension liabilities of only 35%.

In terms of accounting treatment, LRG pension liabilities are typically split, with liabilities accrued before 1998 reported as off-balance-sheet liabilities, whereas those accrued after 1998 are reported on the balance sheet. In 2011, the Swedish Association of Local Authorities and Regions introduced new guidelines for the calculation of LRG pension liabilities. Persistently low interest rates prompted the association to lower its assumption and guidelines for the discount rate used in computing the present value of the sector's pension liabilities. This had an aggregate effect of SEK2 billion on the income statements of for municipalities and SEK6 billion on those of county councils in 2011. The change had no implications for cash flow.

Some rated LRGs, such as Lund and Helsingborg have decided to place their entire future pension liabilities on balance sheet, which will see their income statements more adversely affected in the profit and loss statement than those of their domestic peers. We assess the pension liabilities of rated LRGs as debt-like. Accordingly all pension liabilities, whether on or off balance sheet, are factored into our debt analysis.

A Constantly Fine-Tuned LRG System Underpins The Ratings

The Swedish LRG system is a key supporting factor in our ratings on the country's LRGs. A key aspect of the system is the principle of equalization, whereby adverse income levels and cost structures are compensated by state grants and transfers of revenues from wealthy LRGs to those with less affluence. While major reforms to the system are rare, it is constantly refined and subject to fine tuning. In 2011, two central government inquiries into the sector's institutional framework presented their findings.

Proposals suggest amendments to the equalization system in 2013

In 2008, the central government commissioned a survey to investigate the sector's equalization system with a view to better understanding how it relates to and affects local economic growth possibilities. The survey concluded that the equalization system in its current form does not impede LRG growth, but proposes some amendments to improve transparency.

Specifically, the survey suggested that equalization of LRG income be harmonized for both municipalities and county councils at 115% of the national average tax base. The proposal passed into law on Jan. 1, 2012. Previously, the levels stood at 115% for municipalities and 110% for county councils. The rebalancing is expected to facilitate reallocation of revenue to municipalities from county councils and vice versa. Such reallocations can occur whenever the provision of a public service changes hands from one tier of government to the other.

The survey suggests other amendments to the cost equalization mechanism as of Jan. 1, 2013. For example, it suggests simplification of the model for identifying adverse cost structures in areas such as pre-schooling, child care,

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and education to put more emphasis on the age structure of the local population. A few municipalities stand to be hit hard by the proposed changes. For example the Municipality of Lund will have to contribute an additional SEK130 million in total to the amended equalization system. Similarly, the Region of Västra Götaland and the City of Stockholm are likely to be significantly adversely affected.

The survey further suggests implementing the proposed changes to the equalization system over a five-year period. The proposals are open to debate by sector participants until the central government takes a final decision on final implementation. It is not yet clear if any of the proposed revisions will be included in the central government budget bill in April 2012.

In our view, the proposals as they stand will have little impact on the supportive principles of the equalization system. We currently assess the Swedish institutional framework as predicable and supportive as our criteria define those terms and assign the highest score of 1 (on a scale of 1-6) under our LRG rating methodology. We do not expect the proposals to alter this.

SEK50 billion stabilization fund proposed

The 2008-2009 global financial crisis sent the Swedish economy into deep recession and significantly reduced LRG revenue generation. To deal with the loss of revenues while remaining compliant with a legally binding "balanced budget requirement", Swedish LRGs reduced operating spending, which quickly reduced the sector's overall consumption.

In September 2011, a central government study investigating the LRG sector's response to the 2009 economic downturn presented its findings and two key conclusions.

First, it proposes that LRGs should be allowed, to a greater extent than at present, to build up funds during upswings in the economic cycle to be used to even out revenue declines in economic downturns, thereby avoiding significant cuts in consumption. The study claims that this would enforce a longer-term view of the balanced budget requirement and help individual LRGs to save. In addition, it would promote "good economic housekeeping" at a local level and increase local responsibility for long-term economic sustainability.

Second, the study proposes a centrally administered stabilization fund to be funded by yearly stabilization fees from LRGs amounting to 0.15% of the local tax base (about SEK2.5 billion yearly for the entire sector). The fund would accumulate to a target SEK25 billion and be supplemented by a state credit line of an equal amount. Under the proposal, the fund would serve as an automatic stabilizer of revenues when the nominal annual growth of the sector's tax revenues is below 2.2%, thereby increasing revenue predictability.

The proposals, if enacted, could be introduced as early as 2013. We note, however, that the proposed stabilization fund has drawn criticism and we do not expect it to materialize in its currently proposed form. We do not expect the adoption of either proposal to alter our view of the fundamental supportiveness of the LRG sector's institutional framework.

Decision on proposed administrative reform put on hold

A parliamentary committee on public sector responsibilities (Ansvarsutredningen) has proposed the merger of Sweden's 20 counties into 6-8 larger administrative units and the central government has encouraged counties to seek such mergers on a voluntary basis through the Swedish Association of Local Authorities and Regions. The deadline for applications for voluntary mergers was January 2012.

We understand that informal talks have been conducted across the sector but so far we are unaware of any concrete decisions. In fact, it appears that efforts to reach voluntary mergers have mostly ground to a halt with only a limited number of counties actively proceeding. It is likely that any significant re-organization along the lines proposed by the committee will be put on hold until after the next general elections in 2014.

We are unaware that either of the two county councils we rate, namely Stockholm County Council and the Region of Västra Götaland, are considering mergers with neighboring county councils. We consider them to be of an adequate size to avoid having to seek merger partners. Previous LRG mergers suggest that well-established procedures are already in place. For this reason we expect any mergers to have no obvious rating implications for rated LRGs.

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