

Public Finance Ratings



Research: Gdansk (City of)

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ISSUER CREDIT RATING

Gdansk (City of)
Issuer Credit Rating BBB/Stable/--

Issuer credit rating history:

Sept. 7, 2000 BBB

■ Rationale

The rating on the City of Gdansk, the sixth most-populous city in the Republic of Poland (local currency A+/Stable/A-1; foreign currency BBB+/Stable/A-2), reflects:

- The city's strategic location and its strong local economy, with unemployment substantially below the national rate;
- Its position as northern Poland's main educational center; and
- Prudent fiscal and planning procedures and, by international standards, a modest debt burden.

The ratings are constrained by:

- Economic concentration in the cyclical shipping and shipbuilding sectors;
- Very limited revenue flexibility;
- Heavy capital expenditure requirements; and
- A slight underfunding of new fiscal responsibilities.

In 2001, Gdansk, like Poland, suffered from a substantial economic slowdown (real GDP growth in Poland was only 1%). The slowdown, coupled with ongoing economic restructuring, pushed Gdansk's unemployment rate up to 10%, from slightly less than 6% in 2000. Unemployment is, however, still significantly lower than the rapidly rising national average, which was almost 17% in 2001.

Gdansk's economic prospects are good, however, due to the city's position as one of Poland's main educational centers, with a well-educated population, and a favorable location on the Baltic coast. There are several ongoing and planned investment projects in the port area and the city's road infrastructure, despite the general slowdown in the national economy.

Standard & Poor's will continue to monitor Gdansk's competitive position in the cyclical maritime sector, which still represents a significant proportion (10%) of the city's employment base.

The results for 2001 were better than initial budget projections, and the moderate operating surplus of 5% was the result of prudent management of operating expenditures, despite operating revenue growth falling to 5% year-on-year from 10% in 1999-2000. This smaller operating surplus and the continuation of the ambitious investment program led to a deficit before debt repayment of about 12% of total revenues. This is expected to deteriorate further in 2002, owing to the expected slowdown in the national economy. Conservative estimates of the budget deficit (after capital spending, but before debt repayment) indicate that it should peak at less than 14% of total revenues (although budgets are usually outperformed).

Gdansk has very limited revenue flexibility, as the largest revenue sources are controlled by central government. There is also a slight underfunding of new fiscal responsibilities, which were transferred from the central government as part of the Polish administrative reform. In addition, the city's capital-spending program encompasses several large projects, the most important being the upgrade of road and transportation infrastructure. Consequently, as financing requirements grow, debt (39% of total revenues at year-end 2001) will also rise, to about 55% of total revenues in 2002.

■ Outlook

Standard & Poor's expects that Gdansk's municipal government will continue to exercise prudence, through close monitoring and control of the forecast minor deterioration in budgetary performance and the increase in debt levels.

■ National Peer Comparison

Compared with the six other large and medium-sized Polish cities rated by Standard & Poor's (see Table 1), Gdansk's wealth is above average and its unemployment rate is similar to that of Szczecin and Wroclaw. With regard to economic structure, Gdansk is, after Lodz, one of the most industrialized of its peers, with 44% employment in manufacturing (Lodz has 50%). Gdansk, together with Szczecin, have a high concentration of jobs in one industry (the maritime industry; at about 10%), however, this does not compare with Lodz, where 35% are employed in the textile industry. Employment in Gdansk is less concentrated in individual companies than in peer cities.

Gdansk has traditionally enjoyed a similar financial situation to its 'BBB' rated Polish peers, but, until 2000, the city reported slightly better operating balances. Gdansk is not insulated from the weakened environment and, like the rest of Poland's cities, its financial profile has recently deteriorated. Overall, Gdansk's 2001 deficit was higher than Szczecin's, but remained lower than those of Krakow, Wroclaw, and Bydgoszcz. Gdansk's debt burden at year-end 2001 remained the highest of its peers after Krakow. Financial flexibility is low in all Polish cities, owing to low tax-raising powers and a rigid expenditure structure characterized by significant infrastructure needs.

	Gdansk 2001a	Szczecin 2001a	Wroclaw 2001f	Krakow 2001a	Lodz 2001f	Bydgoszcz 2001b
Long-term rating	BBB	BBB	BBB	BBB+	BBB-	BBB-
Population (million)	0.46	0.42	0.63	0.74	0.79	0.39
% employed in manufacturing	44	22	38	39	50	55
Total revenues (Mil. PLZ)	957	848	1,484	1,430	1,632	672
Financial flexibility	Very low	Very low	Very low	Very low	Very low	Very low
Operating balance (% operating revenues)	5	11	(2)	10	(2)	3
Balance before debt repayment (% total revenues)	(12)	(10)	(15)	(20)	(12)	(15)
Debt (% of operating revenues)	41	26	35	49	22	39
Debt service (% total revenues)	11	4	9	6	5	6

a-Actual. b-Budgeted. f-Forecast. PLZ-Polish zloty.

■ Economy

Gdansk has a young and educated, but declining, population. With 456,000 inhabitants, Gdansk is Poland's sixth most populous city, accounting for 1.2% of the country's total population in 2001. Owing mainly to a negative birth rate, but also to negative migration, Gdansk's population decreased by 0.3% per year on average between 1995 and 2001 (the national average is 0%). Forecasts are for continuing population decline, albeit at a slower pace, which is set to average 0.2% per year 2001-2005 (the national average is forecast to remain static). Gdansk's population is young compared internationally, with 20% under the age of 17 in 2000. The share of minors and seniors, at 36% of the total, is lower than the national average (39%) and is also low by international standards.

With almost 20% of the working-age population consisting of students (the national average is 7%), Gdansk is the most important educational center in northern Poland, and is home to six state universities and four colleges. Gdansk's population is well educated, with 13% of working-age inhabitants having completed higher education (the national average is 7%), which leads to higher incomes and, therefore, a higher tax base for the city.

Strategic location.

Gdansk benefits from its strategic location at the water and rail crossroads of Europe, and the city's maritime tradition dates back more than 1,000 years. It is a regional transportation hub with an ice-free deep harbor, and rail and road connections to the central parts of Central and Eastern Europe (CEE). Moreover, the newly renovated Gdansk Airport is one of Poland's three international airports. Road infrastructure, however, both in the city and connecting national highways, contains bottlenecks. Highways are facing financing obstacles--mainly the lack of government guarantees--with the result that there is no single completed highway in Poland. Gdansk is, however, actively working on improving the local road infrastructure.

City of Gdansk, Poland

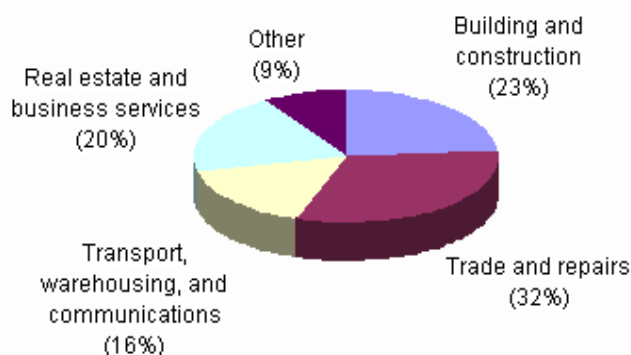


A mainly maritime industrial city.

Gdansk is an industrial city, and manufacturing represents a substantial share of the economy, accounting for 44% of the city's total employment (down from 49% in 1996). Supported by the population's above-average education, Gdansk's economy is characterized by high productivity.

Chart 1

Employment Distribution in Gdansk in 2001



Source: The City of Gdansk.

The maritime sector—including port operations, shipping, and shipbuilding—is the flagship industrial sector in Gdansk. In 1999, about 10% of the total workforce worked in the sector or related activities. However, concentration on shipbuilding and related activities has declined significantly since the 1970s.

In 2000, the city's three shipyards (the Gdansk Shipyard, the Gdansk Repair Shipyard, and the Northern Shipyard) employed about 5% of the working population. Concentration in individual companies is less significant, with the largest company, Gdansk Shipyard, accounting for 2.5% of employment, and the city's five largest companies accounting for 8.0% of total employment. As a reflection of the transition from a planned to a market economy and the privatization of state-owned companies, public-sector employment has decreased considerably, to 19% in mid-2001 from 32% in 1996.

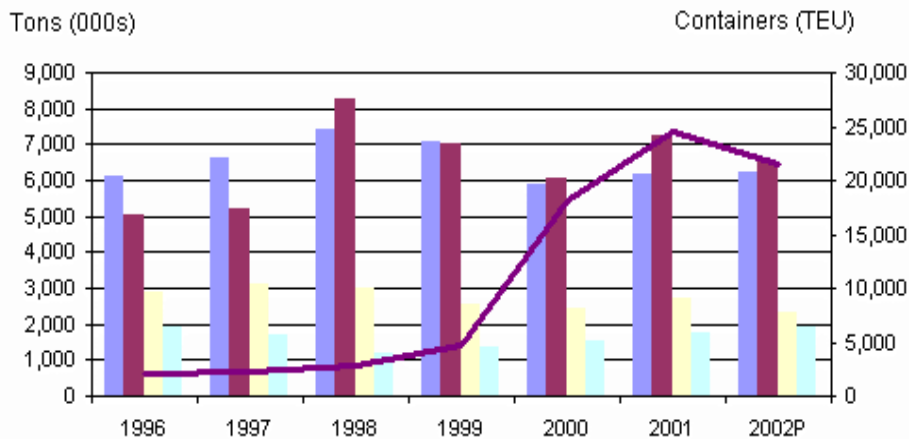
One of Poland's main ports.

Gdansk is one of the main Polish ports, together with Szczecin, Swinoujscie, and Gdynia, and benefits from its favorable location on Scandinavian and Western, Eastern, and Central European routes. In 2000 (most recent data), about 35% of all cargo-loading in Poland took place in the port of Gdansk, 23% in Szczecin, and 19% in Swinoujscie. In 2000, almost 35% of total cargo loading in Gdansk consisted of oil transports.

The Port of Gdansk Authority Co. is owned jointly by the State Treasury (51%) and the City of Gdansk (49%), with private companies providing cargo-handling services. Despite being fairly small compared internationally, the port is well diversified, with well-developed infrastructure, and can service the largest vessels entering the Baltic Sea. Gdansk port is not yet a transshipment hub for container traffic, but the increasing flows are a sign of the port's potential and reflect economic growth in the area.

Chart 2

Port of Gdansk Cargo Handling



P-Prognosis. Source: Port of Gdansk. TEU-Ton equivalent unit.

Dynamic economic prospects supported by the city's attraction for foreign investors.

Data on total foreign direct investments is not available. Nevertheless, several well-known companies have invested in Gdansk and neighboring areas. Investments are spread over various sectors, including:

- Supermarkets--IKEA, OBI, Carrefour S.A. (A+/Stable/A-1);
- Fast-food restaurants--McDonald's Corp. (A+/Stable/A-1);
- Petrol stations--Shell Petroleum Co. Ltd. (AAA/Stable/A-1+) and BP Amoco PLC;
- Telecommunications equipment--Lucent Technologies Inc. (B+/Stable/C);
- Banking--Deutsche Bank AG (AA-/Stable/A-1+) and GE Capital Bank (not rated); and
- Manufacturing--Eaton Corp. (A-/Negative/A-2).

There are plans to privatize one of the city's largest taxpayers, Gdansk Refinery S.A., by selling a 75% stake to the British-Russian consortium Rotch Energy-Lukoil. If central government decides to conclude this deal, it could generate an estimated \$400 million to finance the upgrading and expansion of the refinery's tangible fixed assets.

As a result of national economic growth slowing to about 1% in 2001, down from an initial official forecast of 4.5%, Gdansk's unemployment rate increased to 10% in December 2001 from 6% in 2000. This is still low compared with CEE peers, and is substantially below the national average of 17% and the regional average of 20%. Based on 1999 (latest available data) GDP per capita, the tri-city area of Gdansk, Sopot, and Gdynia was 60% above the national average, mirroring the economic activities in the region.

In addition to development of the national economy and Poland's pending EU membership, expected in 2004, much of the city's future growth will depend on its ability to attract both foreign and domestic investment, and to diversify its economic base away from the manufacturing sector (especially from the cyclical shipbuilding industry). Implementation of planned road infrastructure investments in the area, especially the construction of the A1 highway, will be key for further development of the city.

■ Government Structure

Gdansk is the capital of the Pomeranian 'voivodship' (region) and, following Poland's 1999 administrative reform, Gdansk now has urban 'powiat' (county) status, in addition to being a 'gmina' (municipality). This new status has triggered changes in Gdansk's budget structure and finances, chiefly as some new spending responsibilities have not matched additional resources.

Gdansk now has the revenue and expenditure responsibilities of both a municipality and county. As a result, the local government has had to add extra social welfare, education, culture, and public security services, while maintaining its existing responsibilities (except for the majority of healthcare spending, which has undergone nationwide reform). The city's revenue sources have remained basically the same, except for some changes in the distribution of shared taxes.

Stable political environment.

Following political changes at the national level in 2001, when AWS (Solidarity Election Action) broke into three different political parties, there were some changes in Gdansk's governing coalition. The new coalition retains enough clout, however, to pass budgets and vote on tough issues. Gdansk's political environment should therefore remain stable until the next elections in the autumn of 2002, thereby aiding economic and financial development.

The municipal government's main priorities are to maintain and improve educational standards, and develop housing and road infrastructure and public safety.

■ Finances

Low revenue flexibility, with most taxes controlled by central government.

In line with the current administrative structure, Gdansk's major revenue sources include:

- Subsidies from central government. Following the administrative reform and the city's newly acquired responsibilities, subsidies now account for the largest share of revenues--almost 50% in 2001. About one-half of the transfers are earmarked for education.
- A portion of national taxes. The city receives a share of national personal income tax (28.6% of the amount collected in the city) and corporate tax (5%). In total, these accounted for 20% of the city's revenues in 2001 and, with personal income tax accounting for the vast majority, it remains Gdansk's main tax revenue.
- Local taxes and fees. Together, these accounted for about 20% of the municipality's 2001 revenues. The most important of these is the real estate tax, which accounted for 17% of operating revenues in 2001.
- Revenues from the city's assets and municipal companies accounted for about 5% of Gdansk's revenues in 2001.

Revenue flexibility is very limited, since the city's largest revenue sources are controlled by central government, which also sets rates and ceilings on local taxes. Gdansk's rates on real estate tax (the only meaningful revenue source controlled by the local government) are, like those of its Polish rated peers, almost at the legal maximum. Short-term flexibility exists in the rent and sale of municipal assets (such as land), which are large enough to ensure additional revenue. Proceeds from asset sales accounted for 6% of total revenues in 2001.

Tax proceeds are not concentrated on a few large taxpayers, but are fairly well distributed. This significantly reduces exposure to any downsizing or a crisis in any economic sector.

Expenditure flexibility limited by pressing infrastructure needs.

Expenditure flexibility is limited as about 80% of total expenditure is made up of operating costs, including hard-to-cut items such as education and social welfare. Education is a priority for the local government and accounts for about 45% of operating expenditure, of which about 80% consists of wages. Social welfare spending, however, accounts for 11% and is, after Wroclaw, the lowest of the rated Polish cities, and reflects the lower scale of need.

Teachers' wages in Poland are centrally regulated. Gdansk has no influence over them, and functions mainly as an intermediary (funds from government flow via the city to teachers). Gdansk tops up the wages, however, adding a 5% motivation supplement to the funds from the central government. Personnel other than teachers work under a collective employment agreement, and the city has more control over their wages. Although there has been some pressure on teachers' salaries in recent years, this is mitigated by certain factors. The number of pupils is expected to decline gradually because of the low birth rate in Gdansk, the progressively aging profile of the population, and because private education--which is significantly underdeveloped in Gdansk (as in the rest of Poland)--is expected to develop rapidly, easing some of the burden.

Most healthcare expenditure--previously a major budgetary item--has been removed from the city's accounts following the national health care reform. In 2001, health care expenditure accounted for 2% of operating spending, down from 14% in 1998.

Gdansk's capital expenditures, however, are not as flexible as those of most Western European cities. Its investment program cannot be delayed or cut as easily because infrastructure upgrade projects, especially for the city's road infrastructure and transportation, are essential for the city's future development.

Investment in road infrastructure is one of the main priorities for the city government, along with environment-related issues such as waste disposal and treatment. Gdansk was, however, one of the first Polish cities to hand over water and sewage systems management to an external company, retaining 49% of ownership, while 51% was transferred to Société d'Aménagement Urbain et Rural International (SAUR).

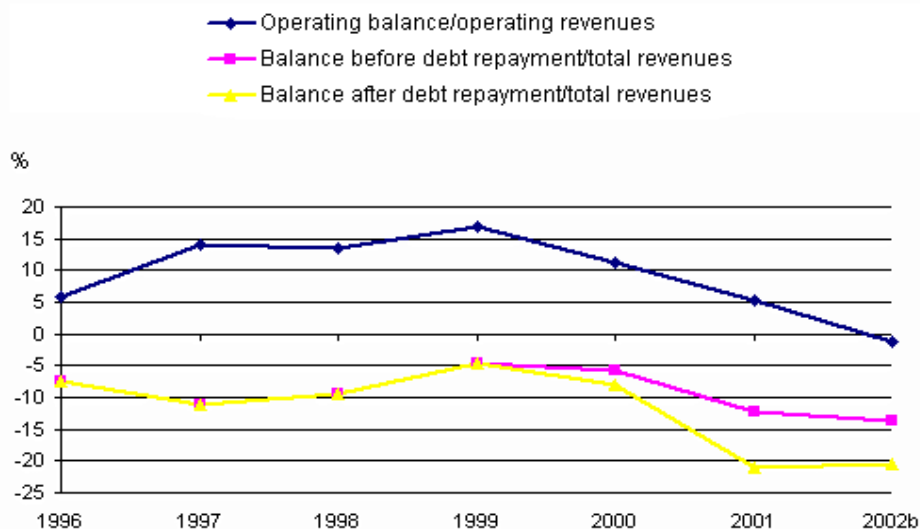
Capital expenditure have risen sharply over the past five years, and this trend is expected to continue. In 2001, capital spending amounted to Polish zloty (PLZ) 226 million (\$57 million; compared with only PLZ92 million in 1996) and accounted for 21% of total expenditures.

The city has put forward its long-term investment strategy for 2002 and beyond in its investment program. The main projects are road and transportation infrastructure (accounting for 24% of total planned investments), followed by sewage treatment (23%) and investment in flood protection (21%). Capital expenditures as a share of total expenditure should remain between 20% and 25% during 2002-2004.

Robust, but weakening, financial performance and very conservative budgeting.

Despite the transitional nature of the economy, Gdansk's financial performance has been robust. The five-year (1997-2001) average for the operating balance of operating revenues was 12%. Following the implementation of several investment projects, the deficit after capital investments (but before debt repayment) averaged about 9% of total revenues. However, since the administrative reform in 1999 and the slow-down in the Polish national economy, operating surpluses have fallen (as shown in Chart 4). Gdansk has managed to finance its investment needs with asset sales and debt financing. This is the case for all rated cities in Poland.

Chart 3
City of Gdansk Budgetary Balances Analysis



b—Budget. Sources: City of Gdansk and Standard & Poor's.

Nevertheless, the city's budgeting is very conservative and the budgets are usually outperformed. The 2001 results were better than initial projections, and the moderate operating surplus of 5% was due to prudent operating expenditure management, despite operating revenue growth having halved to 5% year-on-year from 10% in 1999-2000. This smaller surplus and the continuation of the ambitious investment program led to a deficit before debt repayment of about 12% of total revenues.

Although this represents a continued deterioration relative to 2000, the deficit remains manageable by international standards, and well below the initial 2001 conservative budget projections of 16%. Operating revenue growth of 5% in 2001 (10.4% in 2000) can be attributed to proceeds from the share of taxes, which rose by 23% in 2001. This rise was due mainly to increased income tax revenues (up by 12% year-on-year) and real estate tax revenues (up by 44% year-on-year), despite the slowdown in the national economy. The stable performance of personal income and real estate taxes and robust growth in state operating transfers partly offsets the lower-than-expected proceeds from corporate tax and other revenues. Although income tax proceeds in 2001 were slightly higher than in 2000, they were well below expectations. Nevertheless, despite operating revenue growth falling short of operating expenditure growth, Gdansk's operating balance for 2001 was a moderate 5%, which still enabled the city to finance some of its investment program internally.

Operating expenditure growth in 2001 exceeded both inflation and operating revenue growth. All main operating expenditure items registered above-inflation growth, including education, which currently accounts for the bulk of the city's budget. Other large expenditure items, such as social welfare and public safety, also increased sharply, although these two items are mostly funded through earmarked state subsidies and therefore do not represent a significant burden for the city's own budget. Future expenditure pressure will be centered on education, as state decisions can negatively affect municipal expenditures (as they did in 2000 with the implementation of new regulations for teachers' salaries). The local administration believes that education expenditure is not adequately financed by subsidies from central government.

As the city's budget has recently become more dependent on subsidies from central government, the growth of these funds will be essential for the maintenance of the city's healthy finances, as will the local government's ability to cut nonobligatory spending, should the need arise.

Gdansk's 2002 budget is very conservative, and operating revenues are forecast to decrease by about 2% below the 2001 level. This reflects the forecast continued slowdown in the national economy, which is expected to affect the city's share in personal income and corporate taxes. The city has, at the same time, budgeted for 5% growth in operating expenditures, which would result in an operating deficit of about 1%. Overall for 2002, the city has budgeted a deficit before debt repayment of 14% of total revenues. Results in mid-2002 are encouraging, and it is expected that the 2002 performance target will be fully met.

A moderate debt burden and enhanced liquidity.

According to current municipal projections to 2010, direct debt will peak in 2002 at about 55% of total revenues, up from 40% in 2001; this just below the legal limit of 60%. The increase is related to, among other loans, the money still to be drawn in 2002 from the loan arranged in 2000 with the European Bank for Reconstruction and Development (EBRD). The bulk of these loans will be drawn in 2002 for the implementation of the road and transportation projects.

The debt-service burden, budgeted at 12% of total revenues in 2002, is also manageable and below the maximum limit of 15% of total revenues. The city is not hedged against foreign currency risk (euro-denominated debt amounts to about 32% of total debt) as the hedging instruments available are very costly.

However, the city has the option to convert the loans to Polish zloty should the exchange rate start to deteriorate.

The speed of debt accumulation will depend on the evolution of the local government's financing system (the willingness of central government to compensate for new or changed mandates) and also on Gdansk's ability to attract EU pre-accession funds for some of its infrastructure programs. To date, Gdansk has received a total of about €6 million (\$5.9 million), and \$1 million from the Global Environmental Facility for the Gdansk Bicycle Project.

The city's liquidity position is average, with cash equal to 3% of operating expenditures at year-end 2001. The municipality has no committed bank lines, apart from an overdraft facility of PLZ30 million, although funds are easily accessed if needed. Cash inflows and outflows are predictable and tend to be evenly distributed over the year.

■ Contingent Liabilities

Limited off-balance-sheet risk.

The most significant municipal company still incorporated in the city budget is ZKM, which is responsible for providing bus and tram services for the city and some parts of neighboring cities. Subsidies to ZKM represented 5% of Gdansk's operating expenditures in 2001, and are expected to remain at about this level for the foreseeable future. The city is, in co-operation with EBRD, preparing the privatization of ZKM and expects to finish the process by 2003.

Gdansk has shareholdings in 10, mainly small, limited liability companies, including the tri-city airport, the port, and the district heating and water and sewage company. The city is not liable for these companies' debt, and the debt at these companies is not expected to increase. The city is also actively working to privatize the district heating company.

Table 2 City of Gdansk Financial Statistics*					
	--Year ended Dec. 31--				
(%)	2002b	2001	2000	1999	1998
Budgetary balance					
Operating balance/operating revenues (%)	(1.2)	5	11	17	13
Balance before debt repayment¶/total revenues (%)	(13.7)	(12)	(6)	(5)	(10)
Balance after debt repayment/total revenues (%)	(21)	(21)	(8)	(5)	(10)
Nondebt financing ratio§ (%)	31	48	75	83	71
Inflation rate in Poland (%)	4	5	10	7	12
Revenues					
Total revenues (mil. PLZ)	945	957	921	829	731
Total revenue growth (%)	(1)	4	11	13	27
Own-source revenues**/total revenues	32	28	27	28	31
Expenditures					
Total expenditures (mil. PLZ)	1,075	1,076	974	866	800
Total expenditures (% growth)	0	10	12	8	25
Education	N.A.	N.A.	20	23	25
Healthcare	N.A.	N.A.	21	(81)	20
Municipal services	N.A.	N.A.	3	(14)	18
Social welfare	N.A.	N.A.	37	48	27
Capital expenditures/nondebt expenditures (%)	17	21	22	25	30
Debt					
Short- and long-term direct debt (Mil. PLZ)	520	370	252	213	202
Direct debt/total revenues (%)	55	39	27	26	28
Debt service/total revenues (%)	12	8	5	2	2
*Owing to changes in the financing system for Polish cities from 1999, 1998 and 1999 are not fully comparable. ¶Operating balance plus capital revenues. §Operating balance plus capital revenues/capital expenditures. **Revenues controlled by the municipal government (operating and capital). b—Budget. PLZ—Polish zloty. N.A.—Not available.					

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