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## Vastra Gotaland (Region of)

### ISSUER CREDIT RATING

#### Vastra Gotaland (Region of)

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Issuer Credit Rating	AA/Stable/A-1+
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#### Issuer credit rating history:

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Aug. 21, 2001	AA/A-1+
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### Major Rating Factors

**Strengths:**

- No direct debt
- Sound and improving financial performance
- Well-diversified local economy with low unemployment

**Weaknesses:**

- Relatively limited financial flexibility
- High unfunded pension liabilities

### Rationale

The Region of Västra Götaland—Sweden's second most populous local government area—comprises 49 municipalities surrounding the country's second-largest city, the City of Göteborg (Gothenburg; AA/Stable/A-1+). The region's main obligation is to provide health care, which accounts for about 90% of its total budget.

There is a higher concentration of manufacturing in the region than the national average, but the growing service sector is steadily diversifying the economic base and employment structure. Unemployment in Västra Götaland has closely followed the national average and remained low; at year-end 2005, it was 3.5%.

At year-end 2005, the region had no direct debt. It has high unfunded pension liabilities, however, at 60% of revenues. As a result, its net financial liabilities (tax-supported debt plus unfunded pension liabilities minus free cash and equivalents) were 55.2% of total revenues at year-end 2005.

The region closed 2005 with a strong 6.7% operating surplus to operating revenues, up from 1.9% in 2004. The improvement was partially due to a tax rate increase of Swedish krona (SEK) 0.20, but also to successful savings measures and improved revenues from a growing tax base and higher grants. Forecasts to 2009 indicate average surpluses at 3.7% of operating revenues, and accounts after investments are expected to be broadly balanced.

Västra Götaland's expenditure flexibility is low, with the majority of costs in compulsory labor-intensive services, which can be difficult to adjust. In addition, revenue flexibility is relatively low, with local income tax accounting for a high 68% of operating revenues, and a local tax rate (municipal plus county tax) slightly above the national average.

## Outlook

The stable outlook reflects the expectation of Standard & Poor's Ratings Services that Västra Götaland will be able to prudently match expenditures to revenues and keep its direct debt low.

A longer track record of robust budgetary balances without large-scale tax increases, along with a decline, or at least a stabilization of, net financial liability might trigger a positive rating action. Conversely, the rating could come under pressure if the region registered operating deficits or a very significant increase in debt ratios. Possible changes linked to the parliamentary Committee on Public Sector Responsibilities ("Ansvarsutredningen"), which might result in a redefinition of the region's geographic borders and/or a transfer of responsibilities, will also be taken into account when considering any rating action.

## Comparative Analysis

Overall, Västra Götaland's economy is well diversified, although it has somewhat high exposure to the manufacturing and automotive industries. Indicators such as population growth, age distribution, per-capita tax base, and unemployment are close to the national averages. Financial performance compares well with that of Swedish and international 'AA' rated peers. Direct debt compares very favorably with both Swedish and international peers, although net financial liabilities (including pension liabilities) are average compared with peers.

Table 1

Region of Vastra Gotaland 2005 (cont'd) Peer Comparison						
	Vastra Gotaland (Region of)	Champagne-Ardenne (Region of)	Goteborg (City of)	Saskatchewan (Province of)	Stockholm (County Council of)	Woking (Borough Council of)
Issuer credit rating*	AA/Stable/A-1+	AA/Negative/A-1+	AA/Stable/A-1+	AA/Stable/A-1+	AA/Stable/A-1+	AA/Stable/—
National scale rating*		K-1	NR	K-1	NR	K-1
Country	Sweden	France	Sweden	Canada	Sweden	United Kingdom
	<b>Vastra Gotaland</b>	<b>France</b>	<b>Goteborg</b> ¶	<b>Saskatchewan</b> §	<b>Stockholm</b>	<b>Woking</b> §
<i>Three-year averages, actual results</i>						
Operating balance (% of operating revenues)	4.4	30.5	4.2	9.8	3.6	4.3

Table 1

<b>Region of Vastra Gotaland 2005 (cont.'d) (cont.'d) Peer Comparison</b>							
	<b>Vastra Gotaland (Region of)</b>	<b>Champagne- Ardenne (Region of)</b>	<b>Goteborg (City of)</b>	<b>Saskatchewan (Province of)</b>	<b>Stockholm (County Council of)</b>	<b>Woking (Borough Council of)</b>	
Balance after capital expenditures (% of total revenues)	1.0	(21.0)	0.3	3.8	(2.2)	(17.6)	
Capital expenditures (% of total expenditures)	3.4	48.5	4.0	6.2	6.7	23.9	
Transfers received (% of total revenues)	20.1	57.0	13.5	17.5	(2.9)	13.7	
<i>2005</i>							
Total revenues (mil. €)	3,775.7	366.5	2,699.1	5,297.3	6,037.5	163.9	
Modifiable revenues (% of operating revenues)	79.7	38.9	70.3	163.2	95.7	77.9	
Direct debt (at year-end) (mil. €)	11.5	315.3	1,865.4	4,639.6	2,049.6	85.6	
Direct debt (% of operating revenues)	0.3	95.8	69.1	87.6	34.3	58.2	
Direct debt (% of GDP)	0.3**	0.4¶¶	N.A.	16.9	2.6¶	N.A.	
Tax-supported debt (% of total revenues)	0.6	87.5	68	91.5	37.5	52.2	
Interest (% of operating revenues)	1.1	2.5	5.7	6.6	1.6	1.7	
Debt service (% of total revenues)	1.9	7.2	5.7	18.4	4.3	12.0	
Free cash and equivalents (% of debt service)	596.6	0.0	N.A.	67.9	174.8	32.9	
Population	1,521,895¶	1,330,000¶	481,410	988,980	1,889,945	90,000	
Unemployment rate (%)	4.1¶	10.2¶	4.8	5.1	3.5	1.2	
GDP (nominal) per capita, unscaled (€)	28,878.2**	22,926.0¶¶	N.A.	27,695.5	42,791.7¶	24,958.6	
GDP per capita (% of national average)	100.0**	91.2¶¶	N.A.	101.2	140.9¶	N.A.	
Total revenues (% of GDP)	8.0**	1.0¶¶	N.A.	18.4	7.2¶	N.A.	

\*Ratings at Nov. 16, 2006; foreign and local currency ratings are the same for all peers. ¶ Figures for 2004. § Figures for 2006, apart from population, unemployment, and GDP figures for Saskatchewan. \*\* Figures for 2003. ¶¶ Figures for 2002. N.A.—Not available. NR—Not rated.

## System Support And Predictability

For further analysis of the Swedish local government sector, see the commentary “Report Card: Swedish Local And Regional Governments,” published on Jan. 25, 2006, on RatingsDirect.

## Economy

### *A dynamic local economy; slight concentration in automotive sector*

The region comprises 49 municipalities, including Sweden's second-largest city, Gothenburg. It is the country's second most populous county after the County of Stockholm (AA/Stable/A-1+), with more than 1.5 million inhabitants, or about 17% of the national population.

Manufacturing accounts for somewhat higher employment than the national average, at 22%, compared with about 18% nationally. Main industries include the automotive industry, shipping, petrochemicals, pharmaceuticals, and food. The region is particularly exposed to the automotive sector, through Ford Motor Co. (B/Negative/B-3), owner of Volvo Cars, which employs about 1.5% of the workforce, General Motors Corp. (B/Watch Neg/B-3), owner of Saab Automobile, which employs about 1.0%, and heavy truck manufacturer Volvo (publ), AB (—/—/A-2), which employs less than 1.0%. The automotive industry also provides work for many small subcontractors in the region.

Although the region still has above-average exposure to manufacturing, Västra Götaland's local economy is in transition. It is changing from being dominated by traditional engineering, represented by many small companies, to a region led by R&D in sectors such as IT, biotechnology, education, and research.

### *Unemployment in line with national average*

The region's unemployment has developed largely in line with national trends; at year-end 2005, it was 3.5%, in line with the national average.

Västra Götaland generates close to 17% of Sweden's GDP. The region's per-capita GDP was 97% of the national average in 2003, which, however, corresponds to about 119% of the EU average.

### *Positive population trend*

Västra Götaland has more than 1.5 million inhabitants. In the past five years, Västra Götaland's population has increased by 1.8%, slightly above the national increase of 1.5%. The positive growth trend is expected to continue; Västra Götaland's population increased by 0.5% in 2005, compared with 0.4% nationally.

Västra Götaland's demographic profile resembles that of Sweden as a whole—17% of the region's population are senior citizens (aged 65 or over), and 61% are of working age (18-64 years old).

## Management Capacity And Institutional Legitimacy

### *Health care is the main responsibility*

Västra Götaland has the same legal status and obligations as a county. It was formed in January 1999 through the merger of the three counties of Bohuslän, Älvsborg, and Skaraborg, and the transfer of some functions previously managed by Gothenburg, such as hospitals and cultural activities.

The regional government elections in September 2006 resulted in a continuation of the coalition of Social Democrats, Liberals, and the Center Party. Overall, there is healthy cooperation between politicians and management.

The region's main responsibility is health care, which accounts for about 90% of expenditures. It is also responsible for the planning of regional development issues. In addition, it provides services related to public transport, real-estate management, some cultural activities, tourism, and some upper secondary education. The region consolidates nine companies in its financial reporting. With the exception of the public transport company, the entities in the Västra Götaland group of companies are of minor financial significance.

#### *Structural reform expected*

The parliamentary Committee on Public Sector Responsibilities is expected to publish proposals on reform of the public sector in February 2007. This could, for example, include a redefinition of the geographic borders of county councils (i.e. regions) and/or a transfer of responsibilities. Standard & Poor's will continue to monitor developments closely for any potential impact on credit quality.

### **Financial Flexibility**

#### *Limited income and expenditure flexibility*

Local income tax made up 68% of Västra Götaland's operating revenues in 2005. The remainder is made up of state transfers (21%) and fees and charges (11%).

Although Swedish local governments have the authority to set their tax rate, Västra Götaland's revenue flexibility is still somewhat constrained, especially since, at SEK32.02, the total tax rate (the average municipal tax rate plus the county tax rate) is higher than the national average of SEK31.59. Västra Götaland's county tax rate of SEK10.45, however, is below the national average of SEK10.76.

User fees and charges for most services are capped by national legislation or by other means difficult to adjust, and offer only marginal additional revenues.

Västra Götaland's financial performance is strongly influenced by its expenditure structure, with about 90% attributable to health care. Expenditure flexibility is constrained because a large proportion of the operating cost is in compulsory labor-intensive services, which can be difficult to rationalize without impairing services or violating the central government's rules on how services should be provided.

The region's infrastructure is adequate, with good health care facilities; the rate of investment is therefore low compared with international peers, although some forecast investments could be postponed if needed.

### **Budgetary Performance**

#### *Strengthened budgetary performance, but problems with structural expenditure*

Overall, Västra Götaland's finances have strengthened since the region was formed in 1999, although this improvement largely results from a tax increase of 8% in 2001 and a 2% increase in 2005.

The region closed 2005 with a strong 6.7% operating surplus to operating revenues, up from 1.9% in 2004. Part of the improvement was due to the SEK0.20 tax rate increase, but it was also due to successful savings measures and improved revenues from a growing tax base taxes and higher grants. As the region is well invested and capital spending is consequently low, it managed to post a healthy 3.0% revenue surplus after capital expenditures.

Estimates for 2006 (based on an August 2006 interim report) indicate a surplus of 5.1% of operating revenues. The forecast to 2009 indicates average annual surpluses at 3.7% of operating revenues, and accounts after investments are expected to be broadly balanced.

Nevertheless, even though financial performance is healthy, the region still has a structural expenditure problem, which has required tax increases to correct imbalances between expenditure and revenue growth. To avoid future deterioration in performance and a consequent build-up of debt, the region will either have to pursue prudent fiscal management with a focus on strict cost control, or increase its local tax rate further.

## Liquidity And Debt Management

### *Strong liquidity and predictable cash flow*

Västra Götaland's borrowing is centralized and is managed through the county treasurer. The region's policy is that the maximum amount of total debt maturing in one year is 35%; it also requires that the average interest maturity is 18-36 months. The average interest maturity was 1.2 years at year-end 2005, down from 2.6 years in 2004.

The region has no foreign currency exposure. The use of derivative instruments is regulated by the county's prudent financial policy, and these are allowed for hedging purposes only.

Västra Götaland's liquidity is strong. Cash flows are relatively predictable; there are regular dates for large ingoing and outgoing payments, which are evenly spread over the month and year. Furthermore, according to the financial policy, liquidity reserves (cash and committed credit lines) available within three days should amount to at least three months' expenditure for salaries and wages. At year-end 2005, the region had liquidity reserves totaling SEK3.0 billion available within three days.

## Debt Burden

### *Net creditor position, although pension liabilities create net financial liability*

At year-end 2005, the region had no direct debt. According to forecasts to 2009, investments will be largely financed by internal funding, and therefore direct debt is expected to be close to 0%.

Standard & Poor's assesses unfunded pension obligations as debt like. As the region had unfunded pension obligations corresponding to about 55.2% of total revenues at year-end 2005, its net financial liabilities (tax-supported debt plus unfunded pension liabilities minus free cash and equivalents) were 60% of total revenues at year-end 2005. Furthermore, due to imminent changes in the calculation of the present value of these pension obligations, where the discount rate is likely to be lowered by between one-half to one percentage point and the life expectancy is likely to increase by about three years, these unfunded pension obligations would increase by up to between 10-20 percentage points.

Annual pension payments, at about 3% of operating expenditures, are stable, but a small increase is expected in the medium term.

## Contingent Liabilities

Excluding the pension liabilities, Västra Götaland has contingent liabilities in the form of guarantees corresponding to less than 0.3% of operating revenues. These liabilities consist of guarantees granted to consolidated companies and different organizations in the region. The inherent risk is considered low.

**Public transport company carries limited risk**

The largest entity among Västra Götaland's consolidated companies is the public transport company, Västtrafik. Västra Götaland owns 50% of Västtrafik, with the remainder held by the region's 49 municipalities. Västtrafik is, however, a controlled entity within the Västra Götaland company group, because the region appoints most board members. The company requires the support of its owners in the form of a regular shareholder contribution, and Västra Götaland's contribution accounts for about 2% of the region's operating expenditures.

Table 2

<b>Region of Vastra Gotaland Financial Statistics</b>						
	<b>—Year ended Dec. 31—</b>					
<b>(Mil. SEK)</b>	<b>2006e</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
<i>Budget indicators</i>						
Operating revenues	38,449	34,853	32,388	32,163	30,528	29,005
Operating expenditures	36,467	32,526	31,776	30,714	29,011	27,502
Operating balance	1,982	2,327	612	1,449	1,517	1,503
Operating balance (% of operating revenues)	5.2	6.7	1.9	4.5	5.0	5.2
Capital expenditures (capex)	1,568	1,265	1,016	1,035	1,016	964
Balance after capex	414	1,062	(404)	414	501	539
Balance after capex (% of total revenues)	1.1	3.1	(1.3)	1.3	1.6	1.9
Capex (% of total expenditures)	4.1	3.7	3.1	3.3	3.4	3.4
Operating-revenue growth (%)	10.3	7.6	0.7	5.4	5.3	11.4
Operating-expenditure growth (%)	12.1	2.4	3.5	5.9	5.5	6.1
<i>Debt and liquidity</i>						
Direct debt (debt outstanding at year-end)	N.A.	106	400	1,212	2,125	2,393
Direct debt (% of operating revenues)	N.A.	0.3	1.2	3.8	7.0	8.3
Cash plus committed facilities (% of operating expenditures)	N.A.	14.6	11.2	9.9	12.4	11.9
SEK—Swedish krona. e—Estimated. N.A.—Not available.						

Table 3

<b>Region of Vastra Gotaland Economic Statistics</b>						
	<b>—Year ended Dec. 31—</b>					
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Population	1,528,455	1,521,895	1,514,332	1,508,230	1,500,807	1,494,000
Population growth (%)	0.4	0.5	0.4	0.5	0.5	0.3
Unemployment rate (%)	3.5	4.1	4.5	3.6	3.7	3.6
GDP (nominal) per capita (SEK)	N.A.	N.A.	265,000	257,000	254,000	244,000
GDP per capita (% of national average)	N.A.	N.A.	100.0	97.1	103.7	97.5
SEK—Swedish krona. N.A.—Not available.						

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