

**EMEA
Special Report****European Local and Regional
Governments Outlook 2010****Analysts****Head of IPF EMEA**

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The ongoing economic contraction has had a profound impact on many European local and regional governments (LRGs), primarily those with greater income reliance on economic activity in their territory. Although rating downgrades were not that extensive – only five LRGs were downgraded during January-November 2009 – there was a general shift toward Negative Outlooks. Fitch Ratings revised the Outlook on 20 entities either to Negative from Stable or to Stable from Positive. In contrast, five LRGs benefitted from positive rating actions (either through a rating upgrade, or an Outlook revision to Positive from Stable).

Fitch expects downward rating pressure to continue into 2010 – either through rating downgrades for those entities that the agency considers to have long-term structural problems, or through continued revisions of Outlooks to Negative. At present 32 Fitch-rated LRGs in EMEA have a Negative Outlook and of those 12% have a strong possibility of a rating downgrade in 2010 unless economic recovery is quicker and stronger than expected. These are mainly LRGs that have greater reliance on fiscal revenue related to economic activity on their territory (such as personal income tax, corporate income tax or VAT), or taxes related to property transactions (such as stamp duty). Furthermore, in some jurisdictions there is a time lag between a decline in economic performance and the impact on the LRGs' budgets. In some countries this can be one or two years depending on when tax returns are required to be filed.

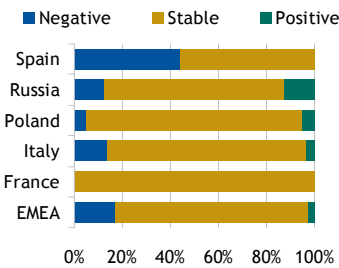
The main factors that will contribute to the negative credit trend in 2010 and 2011 include the following:

- The economic slowdown will result either at best in a very modest rise in tax revenue compared with 2008 or at worst a decline, as experienced by a number of LRGs in 2009, whose tax revenue declined by up to 20% compared with 2008. LRGs with a greater dependence on tax revenue from the sale of housing or building activities will be particularly negatively affected, as these sectors have experienced the greatest slowdown.
- Capital expenditure will remain high as LRGs adopt anti-cyclical measures to boost economic activities, in parallel with policies adopted by the various central governments.
- Fitch expects higher overall deficits to continue to be recorded into 2010 and in some cases this will be at the current balance level as some LRGs have found it difficult to rein in operating expenditure due to its rigidity. In addition, the sharp increase in the immigrant population, in Spain for example, will continue to put pressure on education and health care expenditure.
- Although access to the capital markets has eased and many LRGs have tapped this source of funding, there is still substantial debt that needs to be refinanced or raised in 2010 to cover budget deficits.

Major Considerations**Debt Issuance**

Capital market issuance for subnationals in Europe, which has generally been modest in volume compared with issuance by corporates and banks, was up significantly in 2009, with issuance to end-November 2009 totalling USD100bn compared with USD73.2bn for all of 2008. Due to the increased financing pressures

Ratings Outlook At End-November 2009



Source: Fitch

for LRGs, Fitch expects total issuance to remain high into 2010 as issuers are also using the capital markets as a source of deficit financing.

Fall in Revenue and Rigid Operating Expenditure

European LRGs will continue to face tough challenges and difficult policy decisions in 2010 as they adjust to reduced fiscal revenue. In some cases these reductions have been considerable, and combined with a very rigid operating expenditure structure and continued high demands for capital expenditure. Although Fitch acknowledges that some steps have been taken to cut back operating expenditure, for some LRGs most of this spending relates to staff costs or to expenditure in essential services such as health care and education. Consequently, they are more rigid and the cutbacks have not been sufficient. Even for those subnationals that have traditionally been more focused on investment, the reduction in capital expenditure has been modest as in some cases this spending has already been committed, is part of political promises or is at such an advanced stage that stopping it would have a very detrimental effect on the LRG.

Impact of Unemployment

The sharp rise in unemployment should not generally directly result in a substantial increase in expenditure for European LRGs, as most of these entities do not have responsibility for the payment of unemployment benefit. However, for those that have responsibility for the provision of social services, the negative impact may be severe. In general, the strongest impact of unemployment will be on revenue, with fiscal revenue such as personal income tax, corporate income tax and VAT under pressure due to muted profitability and a fall in consumer confidence and spending.

Liquidity

Liquidity is not a concern at present for most European subnationals, as the majority of LRGs have been able to obtain long-term finance and therefore had a conservative debt repayment profile – only about 12% of total rated debt matured in 2009 and around 10% will do so in 2010. A low-amortising schedule is typical of (western) European subnationals as most of the borrowing is long term and the average life of debt is extended. However, some entities have bonds with bullet maturities due in 2010, which they will need to refinance. Although the pricing of bond issues by LRGs has tended to increase, the decline in interest rates has meant that on the whole the overall cost of debt has been kept low. However, the proportion of fixed to variable rates has tended to decline as LRGs have tended to lock on to declining interest rates by taking a larger amount of their exposure at variable interest rates. If interest rates begin to increase, some entities will become vulnerable to significantly higher debt-servicing costs.

Deficits

As at the central government level, some LRGs will report deficits in 2009. A number of countries have relaxed their internal overall limits to allow for these deficits, as budgets for 2009 were prepared under the projections of a very different economic scenario. The direct impact of the deficits will be the need to take on higher debt to finance them in 2009 and 2010. Some LRGs built up cash reserves or reduced debt in the years of bonanza and will therefore be in a better position to better weather the economic cycle than those that did not.

Credit Quality and Rating Actions

Despite the worsened environment, as shown in the chart “Ratings Outlook at End-November 2009” the general creditworthiness of local governments in Europe remains strong. Of 203 Fitch-rated LRGs with international ratings in EMEA at end November, 76.35% had a Stable Outlook (2008: 86.4%) and 2.46% had a Positive Outlook (2008: 4.3%).

Overall, Fitch undertook 33 rating actions on European subnationals in 2009 as indicated in the table “Rating Actions for European Local and Regional Governments in 2009” below, of which eight related to either rating downgrades or upgrades and the remainder to changes in Outlook/Rating Watch. As expected, the number of negative rating actions significantly exceeded those of positive rating actions. The rating actions were primarily in Italy, Russia and Spain.

Rating Actions for European Local and Regional Governments in 2009^a

Rating downgrade	5
Rating upgrade	3
Outlook (or Rating Watch) revised to Negative from Stable or to Stable from Positive	20
Outlook (or Rating Watch) revised to Positive from Stable or to Stable from Negative	5

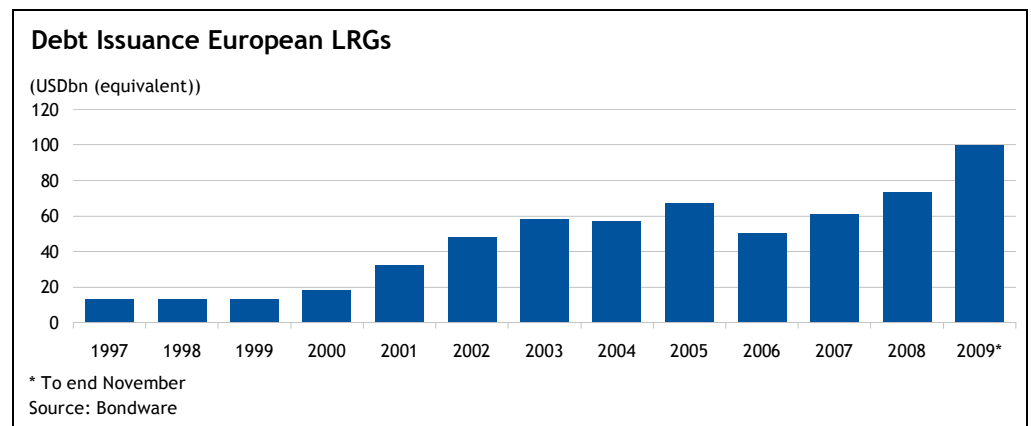
^a Only one rating action has been counted per issuer - if an entity had the outlook revised to negative and subsequently downgraded in the same year, it has only been counted as one rating action
Source: Fitch

Capital Market Activities Expected to Increase in 2010

Despite recent general market liquidity difficulties and the credit crunch, LRGs went into 2009 with high cash balances, which in some cases exceeded their debt level. Year-end liquidity was particularly strong for some Italian LRGs due to their regulatory requirement to draw on funding for budgetary capital investment even though the actual expenditure may not yet have been undertaken.

However, the rising deficits have needed to be financed in the first instance by the use of reserves (cash balances) and by debt issuance. As a result liquidity has declined and resort to the capital markets has increased. At the same time, financing from the traditional bank lenders has become more difficult in some instances and therefore the capital market has been an attractive source of long-term funding, particularly as investors still regard the public sector as generally low risk.

As indicated in the chart “Debt Issuance European LRGs” below, capital market issuance to end-November 2009 was the highest for 12 years. Fitch expects subnationals’ activities in the capital markets to remain strong in 2010, and that issuance will be undertaken primarily by a relatively small number of LRGs. Issuance will continue to be dominated by the German Laender (72% of total issuance to date) due to their need to refinance maturing liabilities and the increase in the proportion of bonds in total debt. For other European LRGs bank financing will be the preferred option, primarily due to their low funding needs in volume terms.



In countries where long-term bank funding is not so easily available LRGs will continue to either require funding from the central government or from multilateral lending agencies, such as the European Investment Bank, the World Bank and the

European Bank for Reconstruction and Development. Refinancing risk will be closely monitored by Fitch, particularly in those countries where LRGs' debt maturity profile is skewed towards the short term and/or where there are large bullet repayments of bonds in the short term.

Selected Country Outlooks

France

Overall Budgetary Performance in 2009

Fitch expects the overall budgetary performance of French LRGs (including municipal groupings) to weaken in 2009, in a context of French GDP decreasing by 2.25%, increased pressure from tax revenue and growing operating spending.

The economic crisis has had particularly important implications for French departments' finances (with the overall current margin dropping to 12.7% in 2009 from 14.2% in 2008, on the back, mainly of property transfer duty receipts decline). It has widened the scissors effect already observed in previous years, due to increased pressure on social spending. Cities' finances have been put under increased pressure also - albeit to a lesser extent than departments' - due to the slump in property transfer duties. Regions are less affected, even though they have maintained their spending to support the economy and have increased needs due to their recently transferred vocational training responsibilities.

Overall, LRGs' operating balance has decreased by 4.6%, in 2009 (by 3.8% in 2008), although LRGs were still able to post a sound overall operating margin equivalent to 20% of operating revenue (from 21.8% in 2008). This was due to LRGs' overall direct tax pressure increasing by 3.4%. The weakening of the overall operating performance was mainly due to a significant decrease in the property transfer tax proceeds (down 26%). This was particularly severe for departments. Operating performance also suffered from a very slow growth of operating state transfers (0.8%).

Although it grew more moderately in 2009 than in 2008 (at an estimated 4.7% compared with 5.2% in 2008), the structure of operating expenditure prevents sharp changes. Staff expenditure growth was fairly well controlled (at an estimated 5% compared with 7.7% in 2008) due to the levelling off of the transfer of public responsibilities from the state to the LRGs under the decentralisation laws. However, transfers paid surged by an estimated 5.2% in 2009 (compared with 3.3% in 2008), reflecting the increased demand for social services as a result of the overall economic downturn. The overall current margin was sound, at 17.4% of operating revenue, benefitting from the fall in short-term interest rates since October 2008.

Self-Financing Capacity

French LRGs' self-financing capacity, including capital revenue, has significantly benefited from exceptional state liquidity measures implemented within the 2009 economic stimulus programme. Specifically, the central government decided to reduce the VAT refund delay to only one year for local authorities that in 2009 maintain their capital expenditure above the 2004-2007 average. In 2009 this meant a total of more than EUR4bn expected VAT refund payments, ie 8% of the LRGs' capital expenditure in 2009. This measure is particularly welcome at a time when the cost of credit lines has tended to increase significantly.

Capital Expenditure and Funding

Capital expenditure usually slows down after local election years. Although elections were held in municipalities and municipal groupings in 2008, and in spite of the recessionary environment, LRGs have continued to be very active in capital spending in 2009, encouraged by the state not to reduce their investment effort compared to previous years. LRGs' overall capex therefore decreased by a lower-than-expected 2.7% in 2009. To meet the capex funding needs overall net

borrowing increased by EUR5.1bn in 2009, compared with EUR7.7bn in 2008. LRGs' total outstanding debt was an estimated EUR132.1bn at end-2009 (ie 6.9% of French GDP), a 4% increase on 2008. LRGs's debt burden remains moderate, however, as it represented only 4.2 years of overall LRGs' current balance.

Contingent Risks

Some contingent risks may loom large over the French LRGs' financial situation, especially for some municipalities and to a lesser extent the departments, due to their increased exposure to derivatives-related risks. Derivatives helped lower the cost of debt in past years but have translated into a significant rise in financial charges. Increasingly, they will become a challenge to the municipal current balance, a situation that Fitch will continue to monitor. Fitch estimates that about a quarter of the LRGs' total outstanding debt is based on structured products vulnerable to market mood swings. Although it was normal to have some exposure to such products for hedging purposes, in a handful of cases a lack of restrictions on risk-taking by local governments has probably led to unhealthy levels of such debt taken for speculative purposes. However, the depth of the problem is very hard to gauge given the differing situations of the LRGs involved.

Revenue Prospects

In 2010, even though GDP growth is likely to be slightly positive, LRGs' revenue is expected to remain sluggish, as most tax revenue is correlated to local wealth and, specifically, to the property market. State transfers will only grow at 50% of the inflation rate considered in France's Budget Law for 2010 (ie 0.6%), a lower growth than in the past. After the sharp drop in the number of real estate transactions initiated in 2009, property transfer taxes could fall again in 2010. Recovery is not expected to occur before 2011. Some other tax revenue may increase, however, with the regions able to develop additional modulation rates on the fuel consumption tax to fund alternative modes of transport to roads. This rate modulation could bring additional revenue of up to EUR450m, provided the regions undertake some capital investment compliant with environmental policies – but the scope of those specific investments has not yet been completely determined.

Operating Expenditure Prospects

Some specific items such as the management of the new social benefit scheme for poor workers ("Revenu de Solidarité Active") by departments will have their full-year impact in 2010 (with an expected net cost of about EUR600m). However, LRGs' operating expenses are expected to be better controlled in 2010 than in previous years. This expectation is based on the preliminary data available on LRGs' budgets now that almost all decentralised responsibilities have been completely transferred to LRGs. The main impact of the transfers was on staff costs.

Capital Expenditure Prospects

The overall amount of capital expenditure is also expected to be smooth compared with 2009, as LRGs benefitted in 2009 from extraordinary state incentives in order to accelerate capex execution. However, the pace of local and regional authorities' capex is to a certain extent linked to the state's current co-financing investment programmes, namely, for regions, the CPER programmes. The current CPER, begun in 2007, is to be completed in 2013, for a total amount of EUR29bn, spread between the state (EUR13bn), the regions (EUR15bn) and other local government tiers (EUR1bn).

Major Reforms and their Likely Impacts on Ratings

More significantly, LRGs will be severely challenged by a number of institutional and fiscal reforms that have been on the French Parliament's agenda since mid-2009. One of the key measures is the abolition of the business tax, which makes up the LRGs' main tax revenue (around 45% of their local direct tax proceeds and 17% of their operating revenue), with an expected negative overall impact on the LRGs' tax flexibility. The revenue that will be received as compensation for the reform is

expected to be less predictable and possibly less dynamic than the current tax revenue. Regions and departments will be the most affected owing to their already eroded tax flexibility.

The contemplated reform only foresees a limited improvement in the equalisation system for the municipalities: some of the historical discrepancies in the business tax base will be progressively compensated for over 20 years but no significant equalisation measure to compensate for wealth discrepancies related to other taxes or existing state transfers is planned. A second aspect of this large-scale reform is the possible merger of municipalities and inter-municipal groupings provided local executives take appropriate decisions to generate economies of scale and rationalise costs.

Fitch expects the overall impact of the business tax reform to be negative, mainly due to the reduction of fiscal flexibility. The agency will perform a comprehensive review of the French LRGs' ratings case by case once the final laws are passed by Parliament (expected in early 2010). Any rating actions will also take into account the decisions taken by each LRG to adapt to the new framework, including measures to control expenditure and ability to obtain sufficient affordable short-term funding from the banking sector, whose lending capacity has significantly shrunk due to the financial crisis. However, Fitch estimates that the territorial reform may have some positive effects, particularly where mergers of smaller LRGs take place as a consequence.

Another major reform on the agenda, possibly in 2010, is the revision of rental values. Rental values are the basis for the calculation of key local taxes – property taxes, housing taxes and business tax – but they have not been revised since the 1970s, and in some cases are far remote from realistic valuations, variously being overvaluations (social housing) or undervaluations (old properties), and creating discrepancies among the territories. This reform might take a long time to be implemented due to its technical nature, and especially due to the compensation that would need to be considered for the most heavily penalised municipalities.

Germany

Budgetary Performance

The economic and financial crisis has significantly affected the Laender and municipal budgets. After a good overall performance during 2006-2008 the two tiers have had to face shortfalls in tax revenue and a simultaneously increasing cost base in 2009 and 2010. According to the most recent data available for the Laender (Q309), total revenue decreased by 6.5% during September 2008-September 2009, while expenditure increased by 6.4% in the same period. This resulted in an overall deficit of EUR21.5bn for the 16 Laender by end-September 2009 after a surplus of EUR4.5bn at end-September 2008. This trend has already been reflected in the tax estimation of May 2009.

Fiscal Revenue

The tax revenue of the Laender and municipalities totalled EUR298.9bn at end-2008 and is expected to fall by 6.6% to EUR279.3bn in 2009 and further decline by 3.7% to EUR269.1bn in 2010, based on GDP growth rates of negative 5.3% in 2009 and 1.2% in 2010. However, there are signs of recovery in the German economy and the most recent tax estimate in November 2009 adjusted the economic assumptions to negative GDP growth of 3.9% for 2009 and positive growth rate of 1.6% for 2010. Despite the increased GDP growth, the tax estimate forecasts a further decline of tax revenue by 1.1% to EUR276.3bn in 2009 and by 3% to EUR268bn in 2010. Due to the quite rigid cost base of the Laender and municipalities, both will face deficits in 2009 and also in 2010, after balanced budgets before debt variation in 2008.

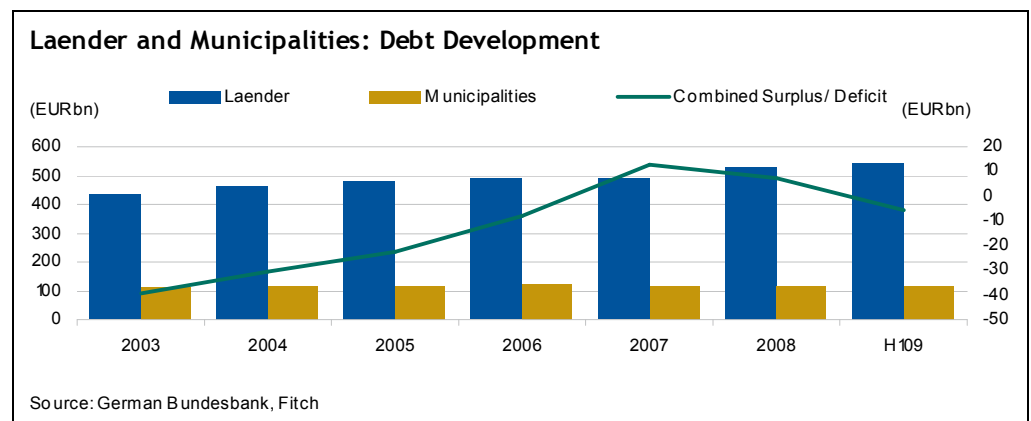
Laender and municipalities are more negatively affected by the changes in tax revenue since the tax estimate of May 2009 than the Bund. Although the Bund

expects some of its taxes to increase – for example energy tax revenue is expected to be up by EUR1.4bn on the May 2009 estimate – the main tax revenue of the Laender and municipalities is likely to decrease. For example, corporate income tax, a Laender tax, is set to further decline by EUR4.55bn in 2009 and EUR5.14bn in 2010. The business tax, the main revenue source for the municipalities, is likely to decline by EUR1.45bn in 2009 and EUR2bn in 2010.

Total tax revenue for the Laender is expected to decline by 6.7% to EUR207bn (down EUR14.9bn) in 2009 and by 2.7% to EUR201.5bn (down EUR5.5bn) in 2010. Municipalities' tax revenue is expected to decline by a severe 10% to EUR69.3bn (down EUR8.3bn) in 2009 and 4% to EUR66.5bn (down EUR2.8bn) in 2010 compared with actual results for 2008. Another challenge will be changes in tax law for 2010. The reduction of the corporate income tax rate to 15% from 25%, the re-introduction of the commuter allowance ("Pendlerpauschale"), the economic growth package and other measures will put pressure on budgets and result in permanent tax losses. Therefore, the budgetary performance of the LRGs will in the short term mainly depend on rapid economic recovery, as cost-cutting measures are more effective in the medium term.

Debt

The individual performances of each of the 16 Laender are also affected by the rescue packages for their Landesbanks in 2008 and 2009. The states of Bavaria, Baden-Wuerttemberg, Hamburg and Schleswig-Holstein put about EUR18bn in equity capital and silent participations into their Landesbanks, significantly affecting their budgets. Bavaria had to pay more than EUR7bn to Bayerische Landesbank in 2009, resulting in the largest deficit among the states, of EUR7.3bn, by end-September 2009. Nevertheless, some of the Laender still reported surpluses in Q309. Although the same also applies to municipalities, the total debt of both tiers will significantly increase in 2009 and 2010. The chart "Laender and Municipalities: Debt Development" below indicates this trend.



The Laender were able to slow the significant increase of debt in 2007 but due to the financial crisis, Laender debt increased in 2008, caused by the first rescue packages for the Landesbanks. At the same time, municipalities reduced their debt. In 2009, budgetary pressure further increased, caused by the economic crisis. H109 results show a debt increase for both tiers. Although the overall deficits are expected to be lower in 2010, Laender and municipalities face significant funding needs, which in Fitch's view remain manageable, as both have a good access to the capital markets and sufficient credit lines.

Prospects

Fitch expects the 'AAA' ratings of the 16 Laender to remain stable in 2010, as they are linked to the 'AAA' rating of Germany. Challenges are more likely in the municipal sector, which usually contracts loans with the local savings banks or make use of its credit lines ("Kassenkredite"). It will probably now need to expand the

range of its counterparties as the increasing funding needs may exceed certain limits and banks have simultaneously reduced their credit lines. The main concern is therefore the already high level of debt rather than liquidity or access to funding. An ongoing debt increase will further limit the Laender and municipalities' budgetary flexibility due to higher interest costs and erosion of debt coverage ratios.

Italy

Performance

Italian local governments have not fared particularly badly in 2009, with the majority of the 50 ratings affirmed. The low sensitivity of direct taxes and fees to GDP performance has allowed them to weather the impact of the economic downturn, which in 2009 will cause GDP to decline by about 5% nationally, followed by a mild recovery of about 1% from 2010. Local governments' almost balanced budgets even in a year of deep economic recession reflect: a still rather centralised system, under which the national government bears the brunt of the recession and its growing borrowing helps make resources available to regions and local governments via operating subsidies; and borrowing constraints that spread the burden of euro membership.

Debt

The gross long-term debt of local governments has been about EUR110bn since 2006 and is not expected by Fitch to grow significantly over the medium term. As a reflection of the internal stability pact rules, LRGs are expected to match their recovery will primarily hinge on the EUR12bn of debt incurred by cities and regions make more timely repayment of their outstanding bills of up to EUR35bn owed to commercial suppliers. To do this, the regions would require a better match of revenue and spending in the health care sector.

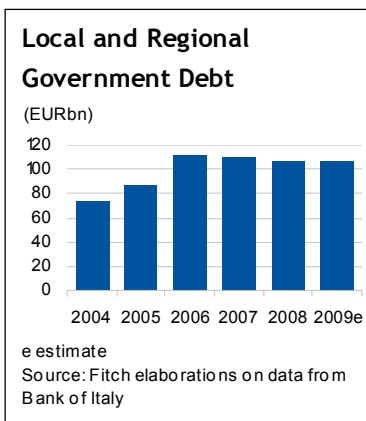
Potential Impact of Fiscal Federalism

However, there may be too high expectations among regions, particularly those in northern Italy, that the upcoming devolution of fiscal power would eventually increase their level of revenue. By summer 2010 the national government should outline how transfers to regions and local authorities will be replaced by shares of national taxes, probably VAT and personal income tax, in order to phase in the "fiscal federalism". However, with national deficits forecast to persist at EUR70bn-80bn, 5% of GDP, over 2009-2011 and expectations that the government will also outline an "exit strategy" from heavy deficits from mid 2010, the risk of disappointment is high. Fitch does not expect substantial growth in regions' ordinary revenue.

In southern Italy the impact of fiscal federalism may be negative due to a lower fiscal capacity and EUR2bn-3bn off-balance-sheet liabilities in the health care sector. The revision of the Region of Calabria's Outlook to Negative reflects Fitch's expectations of lower resources for responsibilities other than health care, and efforts to overcome the structural health care deficit, which might wipe out the operating surplus during 2009-2011. The same issues affect Sicily ('A'/Stable) and Lazio ('A'/Stable), whose lower ratings already capture those long-standing challenges.

Municipalities

Municipalities could increase their budget flexibility with a different asset-liability policy. Major cities such as Rome ('AA-'/Negative) and Milan ('AA-'/Stable) could shrink annual interest and principal repayments by reducing their debt loads if they divested stakes or real estate properties. Although real estate divestment programmes are being pursued by large (Turin, rated 'A+'/Stable) and smaller cities (Verona, rated 'AA-'/Stable; Viterbo, rated 'AA-'/Stable; and Busto Arsizio, rated 'A'/Stable), a law (DL 135/2009) passed in late 2009 may provide incentives to divest shares in utility companies as well. Cities wishing to maintain "in-house" services in sectors such as water provision, waste collection/recycling and bus



transport could be required to shrink their stakes in utility companies listed on the stock exchange to 30%, or to 60% if companies are not listed. However, municipal companies may, in some cases, such as Naples ('A-/Negative) or Palermo (not rated), be a source of concern, rather than a source of potential capital gains, due to their liabilities, which ultimately weigh on the municipalities' budgets. Meanwhile, rigid budget items are being tackled by curtailing services, or raising revenue through minor fee increases.

Derivatives and Capital Market Activities

Frozen for about one year, use of financial derivatives may be resumed in 2010 to hedge against rate rises or lower debt costs if fixed rates are swapped into floating ones. However, the increased disclosure requirements and recent disillusionment with derivative transactions indicate that there may be much less enthusiasm than in the mid 2000s, when about EUR25bn of underlying debt was swapped by about 500 local authorities. The prospects for other capital market activities, such as bond financing, also appear drastically reduced. They will largely be replaced with more traditional loans, primarily extended by the State lending arm, Cassa Depositi e Prestiti ('AA-/Stable). The low risk of debt refinancing remains a positive credit factor because the annual interest and principal components both have to be expensed on the operating side of the budget and the burden of bullet bonds has to be smoothed away through sinking funds or amortising swaps.

Rating Prospects

The risk of downgrades in 2010 could recede for provinces if GDP starts growing again, pulling car sales along with it. Taxes related to such sales represent the overwhelming majority of provincial revenue. Meanwhile, mismanagement of working capital may weigh on municipalities' cash inflow/outflow match as low proceeds from accrued local taxes and fees fuel the accumulation of troubled receivables. Fitch estimates such receivables at about EUR4bn now that about EUR2bn of difficult-to-collect car fines, rents and other fees have been stripped out of Rome's budget.

Although Rome may eventually escape a downgrade if the extra help granted by the national government in 2008 and 2009 becomes structural from 2010, the prospects for other cities seem bleaker. Prioritising debt-funded capital spending (as at Carrara, rated 'A+/Negative), or postponing the adoption of measures to restore the fiscal balance, amid persisting fund-balance deficits (as at Foggia, rated 'BBB+/Negative, and Naples) may result in rating downgrades. Downward pressure may also arise from the devolution of personal income tax and other shares of national taxes if that results in a partial curtailment of subsidies and/or municipalities hesitate to face the responsibilities brought by the devolution of fiscal powers by showing reluctance either to increase taxes or to cut their own spending.

Poland

Budgetary Performance

The downturn of the national economy negatively affected Polish LRGs' budgetary performance in 2009. The whole LRG sector experienced decreasing operating revenue, mainly from income taxes but also from some local ones. For 2009 the LRG sector projected income tax revenue to grow in line with state government projections of 3.5% growth of GDP. However, during 2009 the state government's projections appeared far too optimistic, resulting in the revision of expected GDP growth to only 1%.

This meant that Polish LRGs also had to reconsider their budgetary assumptions. The LRGs have consequently amended their budgets several times during the year and cut operating revenue to more realistic levels. Cuts were 5%-10% depending on the LRG. However, the same reductions could not be applied to budgeted operating expenditure due to its rigidity. Fitch noted that cuts in operating expenditure were

insignificant. This negatively affected Polish LRGs operating performance in 2009.

Fitch expects the LRGs' budgetary performance to have weakened in 2009. It faces pressure not only from falling tax revenue but also from growing operating spending. In 2009 Polish LRGs have faced greater pressure on operating expenditure, especially from such sectors as education, social care, public transport and healthcare. LRGs' operating performance was affected by steadily growing spending on goods, services and salaries. The aggregate personnel cost in 2008 was PLN42bn (up from PLN39bn in 2005) and is projected to increase to almost PLN46bn in 2009, partly due to increases in teachers' salaries, which were automatically raised by 5% in January and by another 5% in September 2009. A further increase of about 7% is projected for 2010. LRGs are therefore not able to curb operating spending to protect their operating performance.

The 2009 budgetary projections indicate that operating spending will have increased by more than 14% and that operating revenue will have grown by only 5%. This disparity may result in a sharp decline in operating balance of about 20%-30% compared with 2008, to PLN15bn-17bn from PLN22bn.

Tax Revenue

Polish LRGs' H109 budgetary results (the most recent available data) show that tax revenue has been collected more slowly than in 2008. At end-H109 the sector's income tax revenue was PLN15.4bn, about 42% of the amount projected for 2009. In 2008 this figure was 48%. LRGs' revenue was adversely affected by the slowdown of the national economy and by the cuts in personal income tax rates to 18% and 32% from 19%, 30% and 40% from 2009. Increased unemployment and tax relief for families with children also curtailed PIT growth. Furthermore, the slowdown of the economy has undermined corporate profits and weakened the financial position of companies, affecting LRGs' revenue from corporate income tax.

This is of particular importance for Polish regions (voivodships) as they do not have any tax leeway and are not able to compensate for this fall with any other revenue. Polish regions' only tax revenue is from corporate and personal income tax, collected by the state and redistributed to local governments. By law, regions' share in income taxes is 14% of corporate income tax and 1.6% of personal income tax collected within their boundaries. These taxes represent more than 40% of regions' operating revenue in 2008, making them highly exposed to economic cycles.

In H109 corporate income tax collected by regions was only 46% of the amount projected for 2009, compared with 52% in H108. It was also 12% lower in nominal terms. In H109 Polish regions collected PLN2.2bn of corporate income tax, while in H108 this was PLN2.5bn. This loss in corporate income tax will not be compensated for by the state government.

Transfers

Overall operating revenue may to some extent be protected by an increase in current transfers from the state government and the EU, the second-largest element of operating revenue. Fitch does not expect transfers to be negatively affected by the economic circumstances. However, as transfers are earmarked revenue, they will not protect the sector's operating performance. They may even put some additional pressure on operating spending if LRGs have to co-finance some EU projects.

Capital Expenditure

Weakening operating performance has been accompanied by growing capital expenditure. In 2009 capital spending may have increased by 40%-48% compared with 2008, to PLN59bn from PLN31.9bn. Although a significant proportion of capex will be financed from EU funds it will need LRGs' co-financing, which will cause debt growth. The sector's 2009 projected deficit before debt variation may total about PLN26bn (2008: PLN2.6bn). Although it proved to be lower than projected it

will be largely covered from debt. Fitch also expects cash holdings to decline. Due to declining liquidity, many LRGs have used their liquidity facilities in 2009. Fitch expects LRGs' liquidity to weaken further in 2010-2011.

LRGs have some flexibility to limit capex in unfavourable financial positions or when they have limited access to external financing, but the pressure on investment will be high as many infrastructure projects have received (or will receive) financing from the EU and therefore have to be completed by 2013. Some large cities (Warsaw, Poznan, Gdansk and Wroclaw), which will host European Football Championships in 2012 are under extraordinary pressure to implement investment projects related to this event. Their budgetary deficits and demand for debt financing have therefore risen sharply.

Use of Public-Sector Entities

To limit LRGs' direct debt increase, several investments have been undertaken by public-sector entities (PSEs). Many LRGs have decided to implement large infrastructure projects (water and waste water collection, solid waste management, public transport) through their companies or special-purpose vehicles (SPVs). This enables LRGs to limit their direct debt increase; the PSEs' debt growth is not restricted by public law nor included in public debt. However, this method of fundraising will result in a considerable increase of indirect risk in the sector.

It is difficult to estimate the level of indirect risk as LRGs are not legally obliged to report any indirect debt at their PSEs. The indirect risk of LRGs rated by Fitch is increasing steadily. In many cases it more than doubled in 2008-2009. Usually, SPVs are financially weak and will need financial support from their owners in the form of capital injections, or need guarantees from LRGs to incur debt, again increasing indirect risk. At end-H109 guarantees issued by LRGs increased by almost 14%; they totalled about PLN5bn, up from PLN4.3bn in Q208. Fitch expects this trend to continue in 2010-2013.

Projections

Poland's economy should start improving in 2010, with projected GDP growth of 1.5%. This would positively affect shared taxes (personal and corporate income tax), which should at least reach the 2008 level or even slightly increase (by 2%-3%). However, pressure on operating spending may strengthen in 2010-2011. Social aid, personnel costs and other rigid items will grow. Expected local elections in 2010 will not be supportive for curbing operating expenditure. In addition, due to a tight national budget in 2010 the state government may transfer some rigid operating responsibilities (eg education) and not provide the LRGs with sufficient financial resources to pay for them. The latter's financial position may therefore weaken further in 2010.

All Polish LRGs may face difficulties in 2010-2013 as they will need to sharply accelerate the implementation of their investment projects if they want to benefit from the EU financing available in the present programming period, in which about EUR67.3bn of EU funds are available. LRGs' co-financing of EU projects will mainly come from debt, which has become more costly, less available and of shorter maturity (five to seven years) than it was until 2009. Demand for debt could be slightly lower if the sector generates reasonable liquidity or/and reports sound operating performance. However, both these elements may be difficult to achieve in 2010 and probably in 2011.

Another challenging factor that may affect the LRG sector from 2010 is a new Public Finance Law. This will introduce several institutional changes, which may be unfavourable to local budgets.

Their proximity to legal debt limits (60% debt to total revenue) may limit many LRGs' access to debt financing. The sector's weakening liquidity, growing costs of debt financing and shorter debt maturity than before the financial crisis (down to

five years from above 10) make LRGs' access to debt more difficult. Fitch expects this trend to continue in 2010.

Furthermore, the LRGs' access to debt may be constrained by growing state government borrowing, which, according to some projections, may rise to above 56% of GDP, breaching the 55% level that triggers debt limits on the 2012 state budget and public debt, including LRGs' debt.

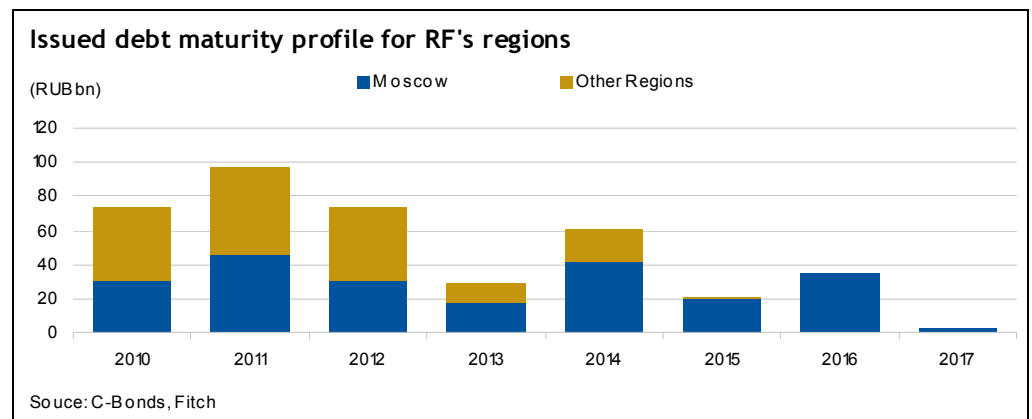
Russia

General Review of 2009

The general economic downturn that has negatively affected issuers in many sectors has also affected the credit quality of Russian LRGs in 2009, although to a more moderate extent. Major economic indicators declined in most Russian regions: overall industrial production for January-October 2009 fell by 13.3% yoy. Furthermore, 11 Russian regions (out of 83) experienced a sharp 25% decline in industrial output. Unemployment peaked at 9.5% in May 2009 from a low 5.4% in mid-2008.

The financial results of the corporate sector have experienced a dramatic deterioration. The net financial result before tax turned negative in Q109, and despite gradually recovering it still recorded a 50% decline in 9M09 yoy. LRGs with a greater dependence on tax revenue, especially corporate income tax, were therefore particularly vulnerable. Due to the uneven distribution of the corporate income tax base across the country, the impact was different for each region. The most affected were those with high revenue concentration on the metallurgy, mining, machinery and petrochemical industries.

Corporate income tax fell by more than 50% in 17 Russian regions in 9M09 yoy. On average corporate income tax decreased by 44% and the reduction for full-year could be 35%. The corporate income tax contribution to LRGs' consolidated budget declined to 18% of total revenue in Q309 from 28% in 2008. The other major tax revenue sources – personal income tax (27% of total revenue in 2008) and property taxes (8%) – were less vulnerable and partially compensated for the decline in corporate income tax. LRGs' aggregate tax revenue fell by 17% during 9M09 yoy.



In the current circumstances, less developed regions, which are highly reliant on federal transfers, appeared to be more resilient to a sharp deterioration in revenue. In 2009 about 40 Russian regions with weak fiscal capacity have received more than 40% of revenue in the form of various transfers from the federal budget. However, due to the deterioration of tax revenue, federal transfers became an important source of revenue stabilisation even for economically strong regions that were affected by the crisis. The federal Ministry of Finance therefore decided to increase the amount of financial aid to the regions by RUB170bn in addition to the RUB374bn initially budgeted for 2009. Another measure of support for regional budgets was the provision of three-year maturity low-cost loans from the federal budget. The

interest rate on those budget loans was set at a quarter of the Bank of Russia refinancing rate (9% at 1 December). This is significantly below market rates, which reached 20% in H109.

Transfers from the federal budget grew by 50% during 9M09 yoy and totalled RUB1.2bn. Their contribution to the total LRG budget increased to 28% of total revenue from 18% during 9M08 and mostly compensated for the tax revenue shock. In 2009, therefore, the budget revenue of most Russian LRGs is likely in general to remain close to actual 2008 results in absolute terms. Several historically strong LRGs – about six of the 83 Russian regions – will record weaker-than-average results, with operating revenue declining by up to 25%. Per capita revenue will also become more evenly spread among LRGs, as the decline in revenue will affect wealthier regions the most.

Debt, Liquidity and Potential Funding Requirements

The debt burden of Russian subnationals was moderate at the beginning of 2009, as most LRGs practiced very conservative debt policies in the past. Direct debt, totalling RUB476bn at 1 January 2009, represented less than 10% of current revenue in 2008. However, the significant proportion of short-term bank loans and the relatively short maturity of issued debt has created refinancing problems, especially in light of the limited access to capital markets in the unstable financial environment of H109.

At 1 January 2009 LRGs had accumulated RUB134bn of short-term bank loans and an additional RUB55bn of issued bonds were planned to mature in 2009, bringing short-term refinancing needs to RUB189bn, or about 40% of LRGs' direct debt. Refinancing needs for short-term loans and maturing bonds were partially compensated for by cash and liquid deposits, which were accumulated by several wealthy regions during favourable years. LRGs' total accumulated cash totalled RUB529bn at 1 January 2009, but a significant about 70% of this money was committed for postponed expenditure.

Another refinancing source was the federal government, which has budgeted RUB170bn to lend to regions in 2009 (see above). By 1 October 2009, LRGs had accumulated RUB105bn of budget loans, up from RUB41bn at 1 January 2009. Those loans are relatively cheap and have up to three years' maturity.

From H209 market sources of deficit financing have also become more available. Most regions successfully rolled over matured bank loans, albeit at higher interest rates, and borrowed another RUB14bn by October 2009. Bond issuing remained less popular among the regions, but those with good credit history have issued new bonds. The net increase of issued debt was RUB85bn by October 2009 and mostly related to the City of Moscow, whose outstanding bond stock increased by RUB76bn.

Overall, due to the expected RUB400bn deficit before debt variation in 2009, LRGs' direct risk will increase by a significant 1.6x and reach RUB760bn (EUR17bn) at end-2009. Refinancing remains a concern for Russian LRGs as the potential funding requirement (short-term bank loans and matured bonds) is about RUB245bn (EUR5.5bn) in 2010.

2010 Prospects

The negative effects of the financial and economic crisis are expected to gradually diminish in 2010. Following the stabilisation of the economic environment the operating revenue of LRGs will recover slowly. However, due to the crisis they will have higher, albeit still moderate, debt and much weaker liquidity positions.

The problem of refinancing remains and increasing debt servicing will increase expenditure pressure as most new debt has much higher interest rates than in the past. Ad hoc financial aid from the federal budget will be less expected, so regions will rely more on their own resources. Prudent public financing policies remain

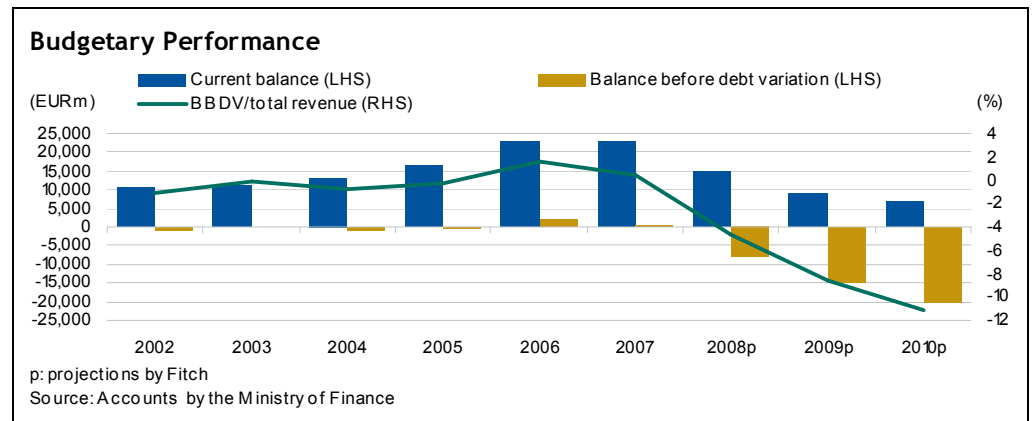
crucial for the regions. Fitch expects credit quality to be sustained by those regions that maintain a positive balance between the budget's current revenue and expenses, and avoid deterioration of operating performance.

Spain

During 2009, Spanish LRGs published their 2008 budget out-turns. The impact of economic downturn was already being felt, although at different levels of severity depending on the tier of government. Nevertheless, Fitch feels that the impact of the economic stress on LRG finances is likely to be much stronger in 2009 and 2010.

Autonomous Communities

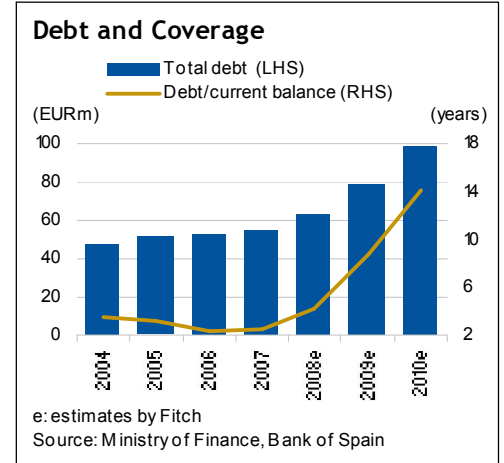
Most of the Fitch-rated autonomous communities experienced a decline in their operating performance in 2008. This was forecast by Fitch in its Outlook report for 2009. Fitch was already projecting a sharp deterioration with an estimated aggregate deficit for 2009 of about EUR10bn, the equivalent of about 1% of the national GDP, and a similar deficit for 2010.



Nevertheless, the full impact of the Spanish economic downturn on regional finances will be worse than originally expected. Although for 2009 the overall deficit may only be slightly wider than 1% of national GDP, it is reasonable to expect a much wider deficit for 2010 than the 1% projected in December 2008. One of the key signals of such a brutal change of scenario was the decision by the Council of Financial and Fiscal Policy, which represents autonomous communities, and the Ministry of Finance, to soften stability goals for 2010-2012 in June 2009. The aggregate deficit for 2010-2012 could therefore total EUR67.2bn (around 5.5% of GDP), assuming that all the autonomous communities enter into an economic and financial plan so as to benefit from the permitted increase in their deficits. Nevertheless, it is possible that not all the autonomous communities will reach the limits authorised.

Should the overall deficit widen to the maximum limits allowed, it is quite likely that the current balance would absorb the bulk of the negative adjustment, with a more moderate impact on the capital balance. The average current margin of autonomous communities, above 15% in 2006 and 2007, is now likely to decline sharply and could be 0%-5% for 2010, with several autonomous communities even reporting in 2009, and budgeting for 2010, a negative current balance. In light of this gloomier scenario, during its annual review process in 2009 Fitch decided to place several autonomous communities on Negative Outlook.

Although the autonomous communities will benefit from a new funding system, announced in July 2009, that is likely to lead to an increase in revenue, its implementation will be gradual. It has so far been quite difficult to assess accurately the overall net impact on revenue as greater fiscal revenues may be offset by reduced government transfers. Fitch considers that gains made under the new funding system would be offset by negative tax collection trends, at least in 2010 and 2011.



Due to the lack of visibility on when the economic recovery will result in increased revenue, Fitch is likely to maintain, and potentially increase, the number of regions it has on Negative Outlook in 2010. Nevertheless, the agency does not currently expect there to be major downgrades in that year.

The expected level of current balance from 2012 will be a key factor determining whether a region will be downgraded or placed on Stable Outlook. In this context of expected large increases in debt, another factor that is also taking on importance is the structure of debt and liquidity conditions. Fitch would be concerned about a further steep increase in short-term debt, whose proportion in the total rose to 12.4% in Q209 compared with 7.4% at end-2007.

There are some factors that could worsen the situation. These include the impact of the spectacular rise in population that took place before 2007, which might result in further spending on social service provisions. This will undoubtedly also translate into more pressure on operating expenditure in the following years. Healthcare expenditure is estimated to account for a third of the overall budget and apparently the measures adopted individually by autonomous communities to rationalise healthcare cost did little to slow its robust growth since 2002 (9.3%). Several autonomous communities might have been very optimistic in budgeting moderate growth for 2009 given the continued strong expenditure pressures in this area. According to individual 2009 budgets, total healthcare expenditure will reach EUR58.2bn, rapid growth given that in 2004 it was EUR38.8bn. The introduction of a user fee would be positive, not so much because of the revenue generated, but as a means of containing demand, which would slow expenditure growth.

Rated Provinces

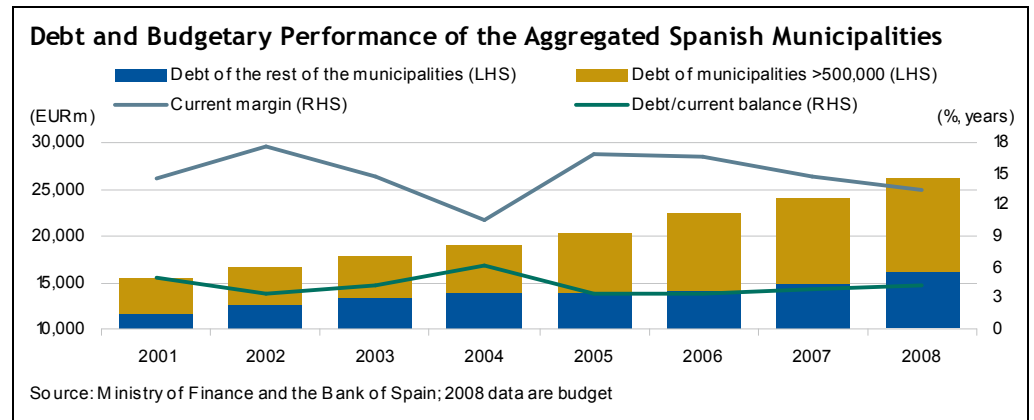
The rapid change in Spain's economic environment affected the tax performance of the three Basque provinces during 2008, as it was not entirely expected. Fitch believes that the 2009 accounts will show an acceleration of the decline in VAT and corporate income tax revenue. In the case of Bizkaia ('AA+'/'F1+') the agency revised the rating Outlook from Positive to Stable as clear signs of a potential recovery in the local economy have yet to emerge. Concerns about the decline of fiscal revenue were the main factors behind the revision of the Outlooks on Gipuzkoa ('AAA'/'F1+') and Alava ('AAA'/'F1+') from Stable to Negative.

Spanish Municipalities

The downturn of the Spanish economy did not translate into a substantial deterioration of the finances of the municipalities rated by Fitch in 2008, as unlike the autonomous communities their current revenue is much less exposed to the economic cycle. Nevertheless, Fitch expects a greater impact in 2009 and in 2010, particularly due to a decline of transfers from the central government. However, some coastal municipalities that have in the past balanced their budgets either

through capital revenue from the sale of land or from more volatile fiscal revenue, such as fees for the granting of building permits, have experienced a sharp deterioration of their finances.

An important proportion of municipality funding comes from tax sharing transfers from the central government, which for 2010 are budgeted to decline by about 8.4% according to central government budget projections. This shortfall is expected to be partially compensated for by an increase in debt. The sector's aggregate financial debt is not yet a large concern, as in Q209 financial debt totalled EUR26.5bn or a 6.5% rise yoy (previous year: 6.7%). Another positive element for the sector is the sound budgetary performance indicated by an operating margin above 10% since 2004.



Rating Actions European Local and Regional Governments - to End November 2009^a

				From	To
France	29 June 2009	City of Aubagne	Outlook revision	RWN	Stable
France	20 October 2009	Department of Essonne	Rating action	AA+	A
Italy	3 November 2009	Region of Calabria	Outlook revision	Stable	Negative
Italy	7 April 2009	City of Caponori	Outlook revision	Stable	Positive
Italy	11 September 2009	City of Carrara	Outlook revision	Stable	Negative
Italy	30 November 2009	City of Naples	Outlook revision	RWN	Negative
Italy	24 March 2009	Province of Pescara	Outlook revision	Stable	Negative
Italy	20 January 2009	Province of Treviso	Outlook revision	Stable	Negative
Italy	6 October 2009	Province of Varese	Outlook revision	Stable	Negative
Poland	24 November 2009	Municipality of Myslenice	Outlook revision	Positive	Stable
Poland	17 July 2009	City of Wroclaw	Outlook revision	Stable	Negative
Poland	17 September 2009	City of Bielsko-Biala	Rating action	BBB	BBB+
Portugal	4 September 2009	City of Cascais	Outlook revision	Stable	Negative
Portugal	4 September 2009	City of Porto	Outlook revision	Stable	Negative
Russia	18 November 2009	Krasnodar Region	Outlook revision	Stable	Positive
Russia	15 July 2009	Novosibirsk Region	Outlook revision	Stable	Negative
Russia	2 September 2009	Altai Region	Rating action	BB-	BB
Russia	10 February 2009	Krasnoyarsk Region	Rating action	BB	BB+
Russia	4 February 2009	City of Moscow	Rating action	BBB+	BBB
Spain	5 October 2009	Autonomous Community of Andalusia	Outlook revision	Stable	Negative
Spain	16 November 2009	Historical Territory of Alava	Outlook revision	Stable	Negative
Spain	25 November 2009	Autonomous Community of Basque Country	Outlook revision	Stable	Negative
Spain	25 November 2009	Transport Consortium of Bizkaia	Outlook revision	Stable	Negative
Spain	24 July 2009	Autonomous Community of Canary Islands	Outlook revision	Stable	Negative
Spain	22 July 2009	Autonomous Community of Gipuzkoa	Outlook revision	Stable	Negative
Spain	18 February 2009	Autonomous Community of Madrid	Outlook revision	Stable	Negative
Spain	15 July 2009	Autonomous Community of Murcia	Outlook revision	Stable	Negative
Spain	24 July 2009	VISOCAN	Outlook revision	Stable	Negative
Turkey	27 October 2009	Metropolitan Municipality of Istanbul	Outlook revision	Stable	RWP
Turkey	27 October 2009	TOKI	Outlook revision	Stable	RWP
Ukraine	12 November 2009	City of Kharkov	Rating action	B	B-
Ukraine	12 November 2009	City of Kyiv	Rating action	B	B-
Ukraine	12 November 2009	City of Odessa	Rating action	B	B-

^a Only one rating action has been counted per issuer - if an entry had the outlook revised to negative and subsequently downgraded in the same year, it has only been counted as one rating action

RWN - Rating Watch Negative; RWP - Rating Watch Positive

Source: Fitch

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