MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
19 September 2016

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RATINGS

Olsztyn, City of

Domicile	Poland
Long Term Rating	Baa1
Type	LT Issuer Rating - Fgn Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Olsztyn, City of

Poland

Summary Rating Rationale

The City of Olsztyn's Baa1 issuer rating reflects its (1) adequate budgetary performance, as reflected by the satisfactory operating margins, (2) manageable debt levels, and (3) comfortable liquidity position.

At the same time the City of Olsztyn's rating is constrained by the city's investment requirements, which could exert a pressure on the budget and increase the city's debt levels. The limited tax revenue control under the current legislative framework also mitigates the credit positives.

On 16 May 2016, Moody's changed to negative from stable the outlook on the City of Olsztyn's Baa1 issuer rating and affirmed the rating following the outlook change on Poland's A2 government bond rating to negative from stable on 14 May 2016. The main driver of the rating actions is the strong correlation between Polish sovereign and sub-sovereign credit risk, reflected in their strong operational and financial linkages.

National Peer Comparison

Moody's currently rates three cities in Poland whose ratings span from Baa1 to A2. Olsztyn's Baa1 rating reflects the city's prudent budgetary management and manageable debt burden. The city exhibits gross operating balances and liquidity levels that are below the median of its peers (Warsaw A2/negative and Poznan A3/negative).

Credit Strengths

» Adequate operating performance

» Lowered investment programme relieves the pressure on city's finances

» Comfortable liquidity position

Credit Challenges

» Manageable debt burden although set to increase in 2017

» Limited revenue and expenditure flexibility

Rating Outlook

The rating outlook is negative and it mirrors the outlook on Poland's sovereign rating.

Factors that Could Lead to an Upgrade

» A stabilization of the outlook or an upgrade of Olsztyn's rating would require a similar action on Poland's sovereign rating, given their close financial and operational linkages.

» An evidence of Olsztyn's ability for continued improvement of its operating and financial performance

» A gradual reduction in the city's debt burden

Factors that Could Lead to a Downgrade

» A downgrade of Poland's sovereign rating will lead to a similar action on Olsztyn's rating

» A significant deterioration in financial performance and cash reserves

» An increase in debt levels above 60% of operating revenue

Key Indicators

Exhibit 1
Key Indicators
Olsztyn, City of

Key Indicators

Olsztyn, City of

	2011	2012	2013	2014	2015
Current Intergovernmental Transfers/Operating Revenue (%)	43.64	41.58	40.83	39.18	38.74
Cash Financing Surplus (Requirement)/Total Revenue (%)	-4.74	2.84	3.24	3.63	-11.58
Interest Expense/Operating Revenue (%)	1.77	2.15	1.55	1.07	0.79
Gross Operating Balance/Operating Revenue (%)	6.07	6.97	6.73	9.60	4.47
Self-financing Ratio	0.83	1.17	1.19	1.19	0.74
Net Direct and Indirect Debt/Operating Revenue (%)	44.56	37.86	34.28	28.50	41.83
Debt Service/Total Revenue (%)	6.79	11.16	6.36	7.05	4.00
CAPEX/Total Expenditure (%)	26.33	16.88	17.74	19.53	39.50

Source: City of Olsztyn

Detailed Rating Considerations

Olsztyn's Baa1 rating combines (1) the baseline credit assessment (BCA) of baa2; and (2) a moderate likelihood of extraordinary support coming from the national government in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

ADEQUATE OPERATING PERFORMANCE

Olsztyn's operating performance has been adequate over the last five years, although its gross operating balance (GOB) decreased to 4.5% of operating revenue in 2015 from 9.6% in 2015 as the operating expenditure growth of 9.1% outpaced the operating revenue growth of 3.2%.

We expect that Olsztyn's operating performance will improve in 2016 driven by the country's positive economic performance and expected growth of more than 3%. We also expect Olsztyn to benefit from its greater revenue-generating capacity and good financial performance relative to other Polish local governments. We believe that increased shared taxes and state transfers associated with good cost controls could lift the city's operating surpluses again to around 9%-10% of operating revenues in 2016.

Olsztyn's operating revenues consist of (1) central government transfers (39%); (2) shared taxes (27%); (3) local taxes (14%) and (4) other revenues (20%). These percentages have remained stable during the past five years and we don't expect this to be different in 2017.

In 2015 total operating expenses amounted PLN815 million, higher than in 2014 (PLN747 million). Personnel costs have consumed a high 39% of operating expenditures, followed by transportation, social and healthcare costs, all together representing almost 40% of operating expenditures.

LOWERED INVESTMENT PROGRAMME RELIEVES THE PRESSURE ON CITY'S FINANCES

The Olsztyn's capital expenditure programme is projected to significantly scale down at about 10% of total expenditure in 2016 from the historical high of 40% in 2015. As a result, the financial performance of the city is expected to improve remarkably reverting to financial surplus of around 3% of total revenue compared with a large deficit of 12% recorded last year.

In 2015, the City of Olsztyn implemented huge investment programme whose priorities focused mostly on the public transportation projects such as: creation of a tramway network, including purchase of 18 trams, implementation of the ITS system in the city, construction of new road junctions, construction of new streets and building city's ring road.

Next year, we expect the city to align its capex funding scheme with the approach used in the previous EU financial framework, avoiding where possible a recourse to debt. Current projections for 2017 indicate increased capex levels at PLN291 million, representing 27% of total expenditure, of which around 15% to be funded by issuing new debt and the rest co-financed from the EU and own funding sources. Although the city's capex is projected to grow, it is not expected to trigger a financing deficit given the ability of the city to adjust investment plans to revenue developments. In addition, we expect Olsztyn to take advantage of new infrastructure funding opportunities during the 2014-20 round of allocations from the European Union's Funds. The requirement to co-fund these investment is unlikely to exert excessive pressure on Olsztyn's budget, given its overall solid operating performances. Olsztyn's main investments in 2016-17 will be the construction of a waste incineration plant and the continuation of the construction and renovation of its transport infrastructure.

In addition, over the next two years, the city will likely use its municipal companies to ensure the execution of some of its capital investments. We will monitor these developments to determine if such off-balance sheet operations could be considered debt-like obligations for the city.

COMFORTABLE LIQUIDITY POSITION

Although Olsztyn's cash, including budgetary reserves and short-term bank deposits, slightly deteriorated in 2015 to partially support the city's capex, we regard it as adequate. It averaged PLN52 million throughout 2015 compared with PLN58 million in 2014, representing 1.1x of the city's annual debt service. In addition, the city has an access to a PLN30 million uncommitted credit line, although the city has never used it until now.

Olsztyn's liquidity position should have remain stable in 2016-17 as the city is going to finance its investment programme mostly by the available European Union funds or public-private partnership.

MANAGEABLE DEBT BURDEN ALTHOUGH SET TO INCREASE IN 2017

With the acceleration of its capital spending, the city issued new debt to support the investment programme in 2015. Olsztyn's direct debt grew to PLN357 million representing 42% of operating revenue up from 29% in 2014. Adjusted budget of 2016 envisages decrease in outstanding debt to PLN305 million, which is equivalent to 33% of operating revenue projected for this year. However, with the planned increase of investment activities in 2017 the appetite for new debt will increase, which will result in debt growth to around 40% of operating revenue.

At the end of 2015 about 44% of Olsztyn's debt was in form of bonds, bank loans made up 53%, with an additional 3% comprised of state supported environmental loans. While the city's debt has no foreign-currency exposure, the majority of it is floating, which exposes the city to interest-rate volatility.

Although the Olsztyn's indebtedness increased in 2015, the city benefits from long term maturities averaging 9 years, which makes the debt and related debt service manageable. The debt service decreased to 4% of total revenue in 2015 from 7% in 2014, but is set to increase to 8% in 2016-17, which is driven by higher funding requirements. The city remains well within the national borrowing limit effective from 2014, according to which its debt service should not exceed three-year average of operating surplus to total revenue.

LIMITED REVENUE AND EXPENDITURE FLEXIBILITY

Olsztyn has limited control over its revenue and operating expenditure bases under the current institutional framework. Local taxes, which allow for some discretion over rates, are of limited importance (14% of operating revenues in 2015), while state transfers and shared taxes (personal income tax and corporate income tax) still represent the greater part of Olsztyn's revenues (65% in 2015).

We do not expect that the composition of Olsztyn's operating revenue will significantly differ in 2016, given that local finances in Poland depend on the decisions of the central government, which leaves the local governments with only marginal leeway with regard to taxes and fees.

In terms of expenditure, Olsztyn has to manage a large and evolving scope of competencies including social expenditure, healthcare, housing and public transport, over which the city has limited flexibility given the strategic and sensitive nature of these responsibilities.

Extraordinary Support Considerations

The moderate likelihood of extraordinary support from the national government reflects Moody's assessment of the central government's promotion of greater accountability for Polish RLGs and its relatively strong oversight of local government finances.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Olsztyn, the BCA matrix generates an estimated BCA of baa3, close to the BCA of baa2 assigned by the rating committee.

The matrix-generated BCA of baa3 reflects (1) an idiosyncratic risk score of 5 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of A2, as reflected in the sovereign rating (A2 negative).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of standalone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Methodology and Scorecard Factors

Exhibit 2
Rating Factors
Olsztyn, City of

Rating Factors						
Olsztyn, City of						
Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	82.71	70%	5.2	20%	1.04
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	6	20%	1.20
Financial flexibility	7		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	6.26	12.5%	3.25	30%	0.98
Interest payments / operating revenues (%)	1	0.98	12.5%			
Liquidity	5		25%			
Net direct and indirect debt / operating revenues (%)	3	41.83	25%			
Short-term direct debt / total direct debt (%)	3	11.62	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						4.72(5)
Systemic Risk Assessment						A2
Suggested BCA						baa3

Source: City of Olsztyn

Ratings

Exhibit 3

Category	Moody's Rating
OLSZTYN, CITY OF	
Outlook	Negative
Issuer Rating	Baa1

Source: Moody's Investors Service

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