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Criteria | Governments | International Public Finance:

# Methodology For Rating Local And Regional Governments Outside Of The U.S.

**July 15, 2019**

(***Editor's Note:*** *On June 4, 2020, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.)*


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## OVERVIEW AND SCOPE

1. S&P Global Ratings is publishing its methodology for assigning ratings to local and regional governments (LRGs) outside of the U.S. For the related guidance article, see "Guidance: Methodology For Rating Local And Regional Governments Outside Of The U.S.," published July 15, 2019.

2. The methodology applies to global scale, local currency, long-term issuer credit ratings (ICRs) on all LRGs. It also applies to some public-sector entities that are set up as local authorities and are responsible for providing similar services to those an LRG provides. The global scale, foreign currency, long-term ICR is the lower of the related sovereign's transfer and convertibility (T&C) assessment or the LRG local currency ICR. The foreign and local currency ratings incorporate, if relevant, the sovereign stress test, as per our rating above the sovereign methodology (see the Related Criteria section). Also see our T&C assessment methodology, listed in Related Criteria. The local and foreign currency ICRs on an LRG are often the same.

### Key Publication Information

- Original publication date: July 15, 2019
- Effective date: These criteria are effective July 15, 2019, except in jurisdictions that require local registration. In those jurisdictions, the criteria are effective only after the local registration process is completed (but in no case before July 15, 2019).
- This article is related to: "Guidance: Methodology For Rating Local And Regional Governments Outside Of The U.S."
- Impact on outstanding ratings: See the "Summary Of The Changes And Impact On Outstanding Ratings" section.
- These criteria address the fundamentals set out in "Principles Of Credit Ratings," published on Feb. 16, 2011.

3. Although LRGs' scope of activities may vary, they bear, in our view, the same general responsibilities of delivering public services and funding infrastructure developments. These are supported directly or indirectly by taxes and fees levied on residents or transferred from other levels of government. In our view, LRGs' common task is financing the cost of these services and infrastructure developments with available revenues, as well as with recourse to debt when necessary.

4. We generally do not apply our government-related entity (GRE) methodology (see Related Criteria) to LRGs. However, we can consider within the scope of the GRE methodology public-sector entities set up as local authorities that are government-owned or controlled enterprises. The stand-alone credit profiles (SACPs) of these entities will be based on the application of our methodology for LRGs outside of the U.S. (For further details, please see "Stand-Alone Credit Profiles: One Component Of A Rating," published Oct. 1, 2010.)

5. All references to LRG ratings in this article pertain to an LRG's willingness and ability to service all of its financial obligations on time and in full. However, we do not consider an LRG's nonpayment of intergovernmental debt as a default. We define intergovernmental debt as a type of debt that benefits from either formal or informal forms of ongoing or extraordinary support from another tier of government, most typically the central government (for further details, see Related Research).

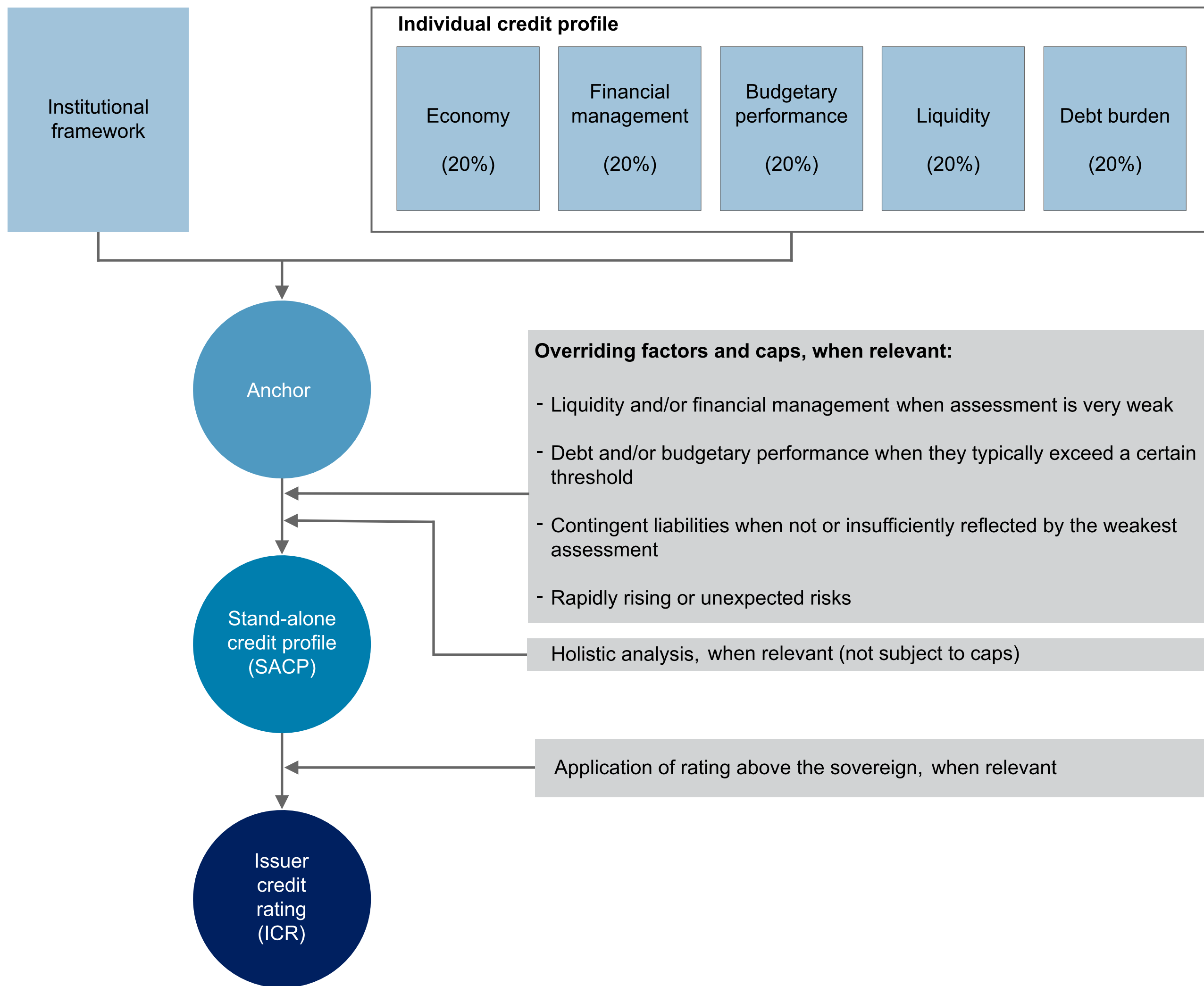
## METHODOLOGY

### Determining The ICR--Key Steps

6. We determine the rating on an LRG according to the steps depicted in the chart below:

- Assess the institutional framework;
- Establish the individual credit profile based on the equally weighted average of five other factors (economy, financial management, budgetary performance, liquidity, and debt burden);
- Combine the institutional framework and the individual credit profile to establish the anchor as per table 1;
- Adjust the anchor for credit-specific caps, overriding factors (see table 2), and our holistic view of the LRG, when relevant, to establish the SACP; and
- Apply our methodology for rating LRGs above the sovereign, when relevant.

7. The framework for rating LRGs combines quantitative and qualitative factors to establish the ICR. The initial assessments are adjusted by the net effect of qualitative factors, when they apply. Further, we assess factors on a forward-looking basis. In particular, quantitative indicators falling at or near the cut-off points presented in the applicable text and tables can receive a better assessment if trends are improving and a weaker assessment if trends are worsening.




Source: S&P Global Ratings.

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Table 1

## Combining The Institutional Framework Assessment And The Individual Credit Profile

| --Institutional framework-- | | --Individual credit profile-- | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Assessment | Descriptor | 1 | 1.5 | 2 | 2.5 | 3 | 3.5 | 4 | 4.5 | 5 |
| 1 | Extremely predictable and supportive | aaa | aaa | aa+ | aa | aa- | a | bbb+ | bb+ | bb- and below |
| 2 | Very predictable and well-balanced | aaa | aa+ | aa | aa- | a+ | a- | bbb | bb | b+ and below |

Table 1

## Combining The Institutional Framework Assessment And The Individual Credit Profile (cont.)

| --Institutional framework-- | | --Individual credit profile-- | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Assessment** | **Descriptor** | **1** | **1.5** | **2** | **2.5** | **3** | **3.5** | **4** | **4.5** | **5** |
| 3 | Evolving but balanced | aa+ | aa | aa- | a+ | a- | bbb | bb+ | bb- | b and below |
| 4 | Evolving and unbalanced | aa- | a+ | a | a- | bbb | bb+ | bb- | b | b- |
| 5 | Volatile and unbalanced | a | a- | bbb+ | bbb | bb+ | bb- | b | b- | b- |
| 6 | Very volatile and underfunded | bbb+ | bbb | bbb- | bb+ | bb- | b+ | b- | b- | b- |

8. If the individual credit profile is not a whole number, the anchor would fall within the range outlined in table 1. For instance, if an LRG is operating in an "evolving but balanced" institutional framework, with an individual credit profile of 2.2, the outcome would be in the 'aa-'/'a+' range. In these cases, we determine the anchor by considering:

- The position within the range (that is, whether the individual credit profile is at the high or low end of the range);
- The expected future performance of one or several of the five key credit factors;
- Any credit characteristics that may be under-reflected earlier in the process; and
- A peer comparison.

Table 2

## Overriding Factors/Caps

| **Factors that generally cap the SACP** | |
|---|---|
| A financial management assessment of very weak | Cap at 'bb+' |
| A liquidity assessment of very weak | Cap at 'bb+' |
| Financial management and liquidity assessments of very weak | Cap at 'b-' |
| **Factors that generally lower the anchor*** | |
| An excessive debt burden not fully reflected in the debt score§ | -1 notch |
| Excessive deficits after capital accounts§ | -1 notch |
| Risk of materialization of large contingent liabilities not or insufficiently reflected in the debt score | -1 notch |
| Rapidly rising or unexpected risks | -1 notch or more |

*The overriding factors do not lower the SACP below 'b-'. §If an LRG has both very high debt and deficits levels, we would lower the anchor by only one notch if mitigating factors are present. SACP--Stand-alone credit profile.

9. When the application of several overriding factors or caps is warranted, we adjust the SACP by the cumulative effect of those overriding factors and take into account the lowest cap.

10. A holistic analysis is the final step in determining an LRG's SACP because it helps capture a broader view of stand-alone creditworthiness. The holistic analysis can have a one-notch impact up or down, not limited by any credit-specific caps or overrides. Such an adjustment may be based

on stand-alone factors, including our forward-looking view of an issuer's operating and financial performance. It may also reflect a comparable ratings analysis, or strengths or weaknesses that are not fully reflected through the application of the methodology because they pertain specifically to the issuer.

11. We derive the ICR on an LRG by applying to the SACP, when relevant, a sovereign-related overriding factor. We generally do not rate an LRG higher than its sovereign. In exceptional cases, when an LRG SACP is higher than the rating on its sovereign, the LRG should be able to meet the conditions and pass the stress tests described in our rating above the sovereign methodology in order to be rated above the sovereign.

12. Finally, when applicable, the LRG rating would be based on the "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings" or "Rating Implications Of Exchange Offers And Similar Restructurings, Update."

## A. Institutional Framework

13. The institutional framework is the set of formal rules and laws, as well as practices, customs, and precedents, that shape LRGs' institutional arrangements and influence their policies in public finance. Our assessment considers historical track record and some of the future changes that are likely to shape the framework. The institutional framework assessment is mostly qualitative.

14. We assess the institutional framework on a country basis and, when relevant, by level of government. Also, in some instances when regional authorities have an influence on the institutional frameworks that municipal governments operate under, the assessments for the municipalities may vary by region.

15. Factors in our assessment are:

- Predictability;
- Revenue and expenditure balance; and
- Transparency and accountability.

16. We assess each of these factors on a weighted basis: predictability (25%), revenue and expenditure balance (50%), and transparency and accountability (25%). And together these form our overall institutional framework assessment on a five-point scale. The resulting weighted-average assessment is then converted to a six-point scale to determine the institutional framework assessment: '1' (extremely predictable and supportive); '2' (very predictable and well-balanced); '3' (evolving but balanced); '4' (evolving and unbalanced); '5' (volatile and unbalanced); and '6' (very volatile and underfunded).

### 1. Predictability

17. Our assessment of the predictability of the institutional framework addresses factors such as:

- The frequency and extent of reforms affecting the division of responsibilities and revenues between the levels of governments in a jurisdiction;
- The predictability of the outcomes of reforms when they occur, based on their pace of implementation and impact on both short- and long-term finances; and
- The ability to influence and potentially veto decisions at a higher level, particularly those that may adversely affect an LRG's financing system.

### 2. Revenue and expenditure balance

18. We assess LRGs' ability to maintain fiscal sustainability in the medium and long terms systemwide. Our assessment of revenue and expenditure balance addresses factors such as:

- The overall adequacy of the revenues that an LRG receives or collects to cover its expenditure mandates;
- The strength of a fiscal policy framework imposing prudent limits on an LRG's debt and deficit levels; and
- The availability of exceptional support from a higher government tier.

### 3. Transparency and accountability

19. Our assessment of transparency and accountability addresses factors such as:

- The national regulation of public-sector accounting systems and standards of financial reporting and planning; and
- The accountability of managers and politicians.

## B. Individual Credit Profile

20. After analyzing the institutional framework, we then assess the other five key rating factors that make up an LRG's individual credit profile (see chart).

## 1. Economy

21. Our economic assessment is driven by wealth and income levels, adjusted when relevant for economic growth prospects, economic concentration and/or volatility, and socioeconomic profile.

22. Our economic analysis starts with determining an initial economic assessment, which is based on national GDP per capita thresholds (see "Guidance: Sovereign Rating Methodology," published Jan. 22, 2019). We then factor in qualitative factors to determine the final economic assessment at the local or regional level.

23. The adjustment for each qualitative factor is generally one assessment category and no more than two assessment categories.

24. The economic assessments are '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

### Initial economic assessment

25. We recognize income levels, as measured generally by GDP per capita, are a useful indicator of a country's potential to generate revenues.

26. The initial economic assessment is based on table 1 of "Guidance: Sovereign Rating Methodology," with one change. The LRG methodology has a scale from '1' to '5' for economic assessment, and the sovereign methodology has a scale from '1' to '6'. So, we merge the two lowest categories in table 1 of the sovereign guidance (corresponding to the scores of '5' and '6' in

the sovereign methodology) to form an assessment of '5' under our LRG methodology.

### Qualitative adjustments

27. While national GDP per capita is a starting point, we may apply further adjustments to capture additional local nuances. These may include economic growth prospects, economic concentration and/or volatility, and socioeconomic profiles at the LRG level.

28. **Economic growth prospects.** In deciding if this adjustment is applicable, we consider national growth prospects--that is, if they are in line with or well below or above those of sovereigns in the same GDP per capita category (see both the sovereign methodology and guidance). We also consider the LRG's performance (for example, as measured by real local GDP growth) vis-à-vis the national average.

29. **Economic concentration and/or volatility.** We consider an LRG to be exposed to significant economic concentration and/or volatility if:

- It has exposure to a single cyclical industry, or
- Its economic activity is vulnerable because of growing risks due to a potential asset bubble or a constant risk of natural disasters.

30. **Socioeconomic profiles.** This adjustment applies when the socioeconomic profile of an LRG departs from the national average. In evaluating this divergence, we consider the impact of the LRG's available local socioeconomic indicators on its financial standing, taking into account the revenue-sharing arrangements and set of responsibilities defined by the institutional framework under which the LRG operates.

## 2. Financial Management

31. We assess how the quality of an LRG's financial management and the political framework in which it operates are likely to affect the LRG's willingness and ability to service debt over time. When it is relevant, we may also extend this analysis to environmental, social, and governance-related risks. The assessment is mostly qualitative.

32. The financial management assessments are '1' (very strong), '2' (strong), '3' (satisfactory), '4' (weak), and '5' (very weak). We cap the financial management assessment at '5' under certain circumstances, as explained below.

### Financial management assessment

33. Our assessment of an LRG's financial management relies on the following three key analytical areas:

- Political and managerial strength. We evaluate policymakers' commitment to disciplined fiscal policies and their ability and willingness to make decisions that will ensure LRGs' fiscal sustainability, as well as management's capacity to implement these decisions over several administrations.
- Financial planning and implementation. We consider the quality of the financial planning and the processes to implement it over time. We determine whether there is a credible and well-documented medium- to long-term financial plan that supports financial discipline and

stability; quality and comprehensiveness of the budgeting process (including the consolidation of the relevant related entities); and the approval process in place to monitor revenues and control expenditures, including pension responsibilities and the implementation of large-scale infrastructure projects.

- Liquidity, debt, and contingent liabilities management. We evaluate management appetite for debt-related risks, such as exposure to market risks, refinancing, and concentration of lenders. We also evaluate the ability to maintain prudent liquidity management practices and manage contingent liabilities, including off-balance-sheet financing of infrastructure projects and liabilities of GREs.

### Caps

34. Two factors can lead to capping the assessment at '5': transparency and payment culture.

35. The transparency cap applies when key information on some government activities is missing and/or is communicated with material delays.

36. The payment culture cap applies when an entity's willingness to make full and timely payments on its financial obligations is questioned--for example, if we believe there is at least a moderate likelihood that an entity would not prioritize the timely payment of debt service in a stress scenario.

## 3. Budgetary Performance

37. The budgetary performance assessment measures the level and the volatility of an LRG's expected cash flows (from operations and investment activities) that are available to service debt. The initial assessment may be complemented by adjustments such as budgetary trends, volatility, budgetary flexibility, and various forms of underspending (for example, pension, off-budget financing, and payables) to form the final budgetary performance assessment.

38. The adjustment impact of each qualitative factor is generally one assessment category and no more than two assessment categories.

39. The budgetary performance assessments are '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

### Initial budgetary performance assessment

40. Our initial assessment of an LRG's budgetary performance relies on two key ratios: (1) operating balance as a percentage of adjusted operating revenues, and (2) balance after capital accounts as a percentage of total adjusted revenues.

41. We often deal with different public-sector accounting standards across countries. The basis for public-sector accounting varies from pure cash accounting to pure accrual accounting and includes a variety of modified cash and modified accrual accounting standards. The extent of the consolidation of public-sector entities in an LRG's accounts can also differ widely from one LRG to another.

42. We make adjustments to LRGs' reported financial indicators to minimize these inconsistencies. The adjustments aim to align the financial information on the LRGs as much as possible to form a modified cash base (when relevant and appropriate in the context of the budgetary performance analysis). We do this by eliminating the noncash items, such as depreciation and provisions, to

obtain comparable financial data on LRGs across jurisdictions.

43. We believe that the operating balance (see Glossary), when calculated on a cash or modified cash basis as a percentage of adjusted operating revenues, gives a good proxy for an LRG's cash flows from operations. The ratio reflects the extent to which an LRG can finance its operational costs and public services from recurring revenues--mostly taxes and operating subsidies.

44. The balance after capital accounts (see Glossary) represents a proxy of the overall funding needs or surplus that an LRG derives from its operating and capital activities and would generally correspond to changes in net debt (debt net of cash and liquid assets) in a pure cash-based accounting system. An LRG can finance the balance either by drawing on its cash reserves or by borrowing.

### Qualitative adjustments

45. Positive adjustments to the initial assessment may include:

- Expected structural improvement: if our base-case forecasts point to a material structural improvement versus the period average;
- High cash reserves: in particular, when deficits are temporary and can be largely covered by cash reserves; and
- Strong flexibility: if, on top of our base-case assumptions reflected in the initial assessment, we consider that a policy adjustment could lead to material additional revenues or cost savings.

46. Negative adjustments to the initial assessment may include:

- Expected structural deterioration: if our base-case forecasts point to a material structural deterioration from the period average;
- Pronounced volatility in performance: as evidenced by factors such as high inflation, very cyclical revenues, or dependence on volatile state transfers;
- Underestimated spending: as evidenced by factors such as significant underspending on public services or infrastructure, large unpaid debt to suppliers, or off-budget financing through public companies;
- Underspending on pensions; and
- Limited flexibility: if, on top of our base-case assumptions reflected in the initial assessment, we consider that a policy adjustment could lead to very limited additional revenues or to a very limited expenditure cut.

## 4. Liquidity

47. The liquidity assessment measures the adequacy of internal and external sources of liquidity in the context of debt service needs. The analysis consists of three steps:

- First, determining an initial liquidity assessment based on a debt service coverage ratio (DSCR), adjusted when warranted for qualitative aspects;
- Second, assessing an LRG's access to external funding; and
- Third, combining the first two steps to derive the final liquidity assessment.

48. The overall liquidity assessments are '1' (exceptional), '2' (strong), '3' (adequate), '4' (less than

adequate), and '5' (weak).

## Initial liquidity assessment

49. The first step of our initial liquidity assessment is determining the DSCR, which compares the total free cash position in the numerator with debt service in the denominator over the next 12 months.

50. The total free cash position typically sums up:

- Adjusted cash (cash adjusted for any amount that is not fully available for debt service within the next 12 months and for any amount that we expect to fund spending or debt repayment beyond the next 12 months);
- Liquid assets;
- Balance after capital accounts (to which we add back interest);
- Onlending (when relevant); and
- Already contracted short- and long-term funding available to cover spending over the coming 12 months.

51. We assign the strongest DSCR-based assessment of '1' when total free cash minus contracted funding (the strongest form of liquidity) covers more than 100% of the forthcoming debt service. For other scores ('2' to '5'), our initial liquidity assessment also considers forms of short- and long-term funding, but only when they are firmly contracted and, for long-term funding, when they are available to cover all or a portion of expenses--generally the capital expenditure--throughout the period.

52. If applicable, we can further adjust the DSCR-based assessment for various positive and negative qualifiers, each of which generally counts for one category and no more than two categories.

53. Positive adjustments to the initial assessment may include an expected structural improvement in the DSCR over the next two to three years.

54. Negative adjustments to the initial assessment may include:

- An expected structural deterioration in the DSCR over the next two to three years;
- Underfunding--large amounts of unpaid supplier debt at the LRG level or related public-sector entities; and
- Expected volatility in the liquidity ratio during or beyond the coming 12 months (up to 36 months) due to, for instance, an uneven intra-annual cash position, a lumpy debt amortization profile, or large bullet maturities.

## Access to external liquidity

55. As the second pillar of our analysis of an LRG's liquidity position, access to external funding considers:

- An individual LRG's track record (and our opinion on whether this track record will continue) of access to well-established and effectively operating sources of liquidity provided by a central government, upper levels of government, or a central government-related entity;
- The development of the domestic bond market and the diversity of banks willing to lend to the LRG sector; and

- An individual LRG's track record (and our opinion as to whether this track record will continue) of market access or links with a diversified pool of banks.

56. Our assessment of an LRG's external access to liquidity includes its capacity to refinance debt and to cover its new borrowing requirements. The assessment is qualitative and mostly considers entity-specific characteristics, although we recognize that the legislative framework under which an LRG operates may affect its access to external liquidity.

## 5. Debt Burden

57. The debt burden assessment reflects our forward-looking view of an LRG's debt and interest burden relative to its available resources. It includes an initial assessment based on two key measures--tax-supported debt and cost of direct debt--which we can further adjust, when appropriate, based on our analysis of debt structure (including onlent debt) and contingent liabilities, among others. The impact of the various adjustments on the initial debt burden assessment differs.

58. The debt burden assessments are '1' (very low), '2' (low), '3' (moderate), '4' (high), and '5' (very high).

### Initial debt assessment

59. We believe that the ratio of tax-supported debt to consolidated operating revenues (see Glossary) is the most appropriate measure for international comparisons. This measure helps to smooth out some of the differences stemming from accounting systems and political frameworks around the world. It is also a good measure, in our view, of all debt that ultimately relies on an LRG's total revenues (tax and other revenues). This is because it notably incorporates the debt of companies that perform a public policy that otherwise would have been directly assumed by the LRG and that rely significantly on the LRG either for operating or for honoring their own financial obligations.

60. The second ratio we analyze is interest payment (see Glossary) to adjusted operating revenues, meaning gross interest on direct debt at the LRG level. This ratio gives us an indication of the sustainability of an LRG's debt by measuring the share of income it uses to cover the cost of debt.

### Qualitative adjustments

61. Positive adjustments to the initial assessment may include:

- Exceptionally high operating balance (that is, when direct debt typically represents less than five years of operating margin) typically improves the initial assessment by one category; and

- Debt burden mitigated by large onlent debt. Some LRGs raise debt to onlend it to subsidiaries, GREs, or lower tiers of governments. If we expect these entities to have the capacity and willingness to repay onlent debt and if the share of such onlent debt and interest is a substantial portion of the LRG's total debt and interest, the initial debt burden assessment would improve by up to two categories, depending on the size of the debt and the risk associated with onlent entities.

62. Negative qualifiers to the initial assessment may include:

- Potential significant volatility in the debt burden owing to high exposure to market risks--for example, interest risk, currency risk, a short-term maturity profile, and aggressive use of derivative or nonstandard instruments. Such risks could lead to an increase in the cost and

level of debt such that they would weaken the initial assessment by one category; and

- Risk of materialization of contingent liabilities that could affect an LRG's financial standing such that it would weaken the initial assessment by up to two categories.

63. **Contingent liabilities.** Contingent liabilities correspond to explicit obligations (such as guarantees not already captured in tax-supported debt) or implicit obligations (such as litigation costs or potential financial support to unguaranteed GREs) that have the potential to affect an LRG's financial profile.

64. Contingent liabilities can generally be grouped into three broad categories:

- Contingent liabilities related to nonfinancial GREs that are not already reflected in tax-supported debt (including the GREs' guaranteed debt) and whose likelihood of support by the LRG is typically not in the lowest categories;
- Contingent liabilities related to financial GREs; and
- Other contingent liabilities--for example, public-private partnerships (PPPs), securitizations, litigation, GREs' payables, guarantees on non-GREs, unless already serviced by an LRG on an ongoing basis, and when relevant contingent liabilities related to environmental, social, and governance risks.

65. Because contingent liabilities and tax-supported debt are closely linked, with potential conversion or shifts from one to the other type of risk, our assessment of contingent liabilities acts as a qualitative adjustment to our debt analysis of an LRG, focusing on the following steps:

- First, we assess an LRG's exposure to the contingent liabilities, mainly through the debt of nonfinancial GREs as well as the estimated recapitalization cost and other potential liquidity support to financial GREs, when relevant. An LRG may incur a contingent risk from companies in which it owns stakes or from other GREs. Due to significant differences in the reporting and consolidation of individual GREs, we focus on the larger GREs.
- We then assess the risk of the materialization of the contingent liabilities.
- The combination of these reflects our view of the magnitude of the effect of the contingent liabilities on an LRG's financial standing.

## Issue And Short-Term Ratings

66. The issue rating on an LRG's unguaranteed foreign or local currency long-term debt instrument is usually the same as the respective long-term ICR because subordination is uncommon in this sector. We do not assign recovery ratings to LRGs' obligations. To assign short-term ratings to LRGs, we use our methodology for linking long- and short-term ratings (see Related Criteria).

67. This methodology does not apply to securitized issues, such as tax participation transactions or transactions backed by local taxes (see Related Criteria).

## Glossary

### Budgetary performance

68. **Operating revenues.** Recurring revenues that an LRG receives. Operating revenues comprise taxes and nontax revenues, such as grants, operating subsidies, fines, fees for services, tariffs, rents, and other sources from which the LRG derives revenues. They exclude capital revenues, such as capital subsidies and proceeds from asset sales, and any revenues from borrowed funds.

69. **Adjusted operating revenues.** Operating revenues adjusted for material noncash and pass-through items when we deem it relevant.

70. **Consolidated operating revenues.** An LRG's operating revenues and the commercial revenues (comprising fees and sales, among others), when available, generated by nonfinancial GREs (whose debt we include in either the LRG's tax-supported debt or its contingent liabilities). We deduct from the GREs' revenues material sums that come from the LRG itself, such as a subsidy or service contract.

71. **Operating expenditures.** Correspond to the costs of an LRG's operations, its administration, and its provision of services to the population, directly or through other public bodies, as well as interest expenses.

72. **Adjusted operating expenditures.** Operating expenditures adjusted for material noncash (provisions, depreciation) or pass-through items.

73. **Operating balance.** Equals adjusted operating revenues minus adjusted operating expenditures.

74. **Capital expenditures.** Typically cover the repair and replacement of existing infrastructure and the development of new infrastructure.

75. **Capital revenues.** Chiefly comprise proceeds from asset sales and capital grants.

76. **Balance after capital accounts.** Results from the addition of capital revenues to and the subtraction of capital expenditures from the operating balance.

77. **Total adjusted revenues.** The sum of adjusted operating revenues and capital revenues for a given budgetary period.

### Liquidity

78. **Total free cash.** The total free cash position sums up adjusted cash, liquid assets, balance after capital accounts, interest spending, onlending (when relevant), and already contracted short- and long-term funding available to cover spending over the coming 12 months.

79. Adjusted cash includes reported cash at the beginning of the fiscal year, adjusted for any amount that is not fully available for debt service within the next 12 months and for any amount that we expect to fund spending or debt repayment beyond the next 12 months.

80. Liquid assets include unrestricted assets that are available to cover debt service over the next 12 months--that is, they exclude sellable assets that have already been taken into account as capital revenues in our forward-looking balance after capital accounts.

### Debt burden and contingent liabilities

81. **Tax-supported debt.** The sum of the following items:

- Direct debt of the LRG;
- Debt of nonfinancial GREs (whether it is guaranteed or not), when: 1) We view the likelihood that the LRG will provide support for the GRE in case of stress as being very high and above; and 2) The GRE needs, or we expect it to need in the foreseeable future, payments or ongoing support either to operate or to honor its financial obligations; and
- Guaranteed debt.

82. **Interest payments.** Correspond to the amount of interest paid within a given budgetary period on direct debt, including the interest component of leases, PPP, and securitizations, when relevant.

83. **Debt service.** Equals interest payments plus the amount of principal repaid during a given budgetary timeframe, including the capital component of leases, PPP, and securitizations, when relevant, as well as short-term debt repaid during the period.

84. **Direct debt.** Comprises long- and short-term financial debt assumed directly by the borrower--loans, bonds, credits, and, when material, capitalized lease obligations. It also comprises debt of PPPs and securitizations when we assess that the primary motivation for the LRG is to achieve off-balance-sheet treatment and when no significant risk transfer to the private sector is apparent, making the PPP payment more akin to debt payment.

85. It excludes guaranteed debt and the debt of GREs. It includes debt serviced via subsidies from other levels of government, unless the legal obligation to service this debt is transferred to the other levels of government.

86. **Guaranteed debt.** Financial debt on which the principal and interest payments are the responsibility of the LRG (as the guarantor), if the borrower that is primarily liable fails to repay the debt. When an LRG is servicing, or we expect it to service, the debt it has guaranteed, then we include the guaranteed amount in the LRG's tax-supported debt, whether it is related to GREs or non-GREs. When not included in tax-supported debt, guaranteed debt is included in contingent liabilities.

## SUMMARY OF THE CHANGES AND IMPACT ON OUTSTANDING RATINGS

87. The main changes we have made to our methodology intend to better capture country- and entity-specific situations and ultimately enable greater rating consistency. The goal of this update is also to simplify and provide greater clarity to our LRG analytical framework.

88. We believe that there will only be a limited impact on the ratings within the scope of this methodology. Assuming entities in scope maintain their current characteristics, our testing suggests that less than 10% of our portfolio of public ratings will see a potential impact. Most of those LRGs would be either upgraded or downgraded by one notch. These numbers do not include the potential impact on LRG confidential ratings, on national scale ratings, or on the ratings on LRG-related entities.

## REVISIONS AND UPDATES

Changes introduced after original publication:

- On June 4, 2020, we republished this criteria article to add "Guidance: Rating Implications Of Exchange Offers And Similar Restructurings, Update" to the "Related Publications" section.

## RELATED PUBLICATIONS

### Fully Superseded Criteria

- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment, Dec. 15, 2008

### Related Criteria

- Public-Sector Funding Agencies: Methodologies And Assumptions, May 22, 2018
- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Methodology And Assumptions For Rating Mexican Tax Participation And Local Revenue Future Flow Transactions, Nov. 6, 2015
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Credit Stability Criteria, May 3, 2010
- Understanding S&P Global Ratings' Rating Definitions, June 3, 2009
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009

## Related Guidance

- Guidance: Rating Implications Of Exchange Offers And Similar Restructurings, Update, June 4, 2020
- Guidance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- Guidance: Sovereign Rating Methodology, Jan. 22, 2019

## Related Research

- How Environmental, Social, And Governance Factors Help Shape The Ratings On Governments, Insurers, And Financial Institutions, Oct. 23, 2018
- 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018
- What Does S&P Global Ratings Consider A Default For Sovereign And Non-U.S. Local And Regional Governments?, April 13, 2017
- The Time Dimension Of Standard & Poor's Credit Ratings, Sept. 22, 2010

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as S&P Global Ratings assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

This report does not constitute a rating action.

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