

Poland Credit Analysis

City of Gdansk

Ratings

Security Class	Current Ratings
Foreign Currency	
Long-Term	BBB+
Local Currency	
Long-Term	BBB+
outlook	

Outlook

Foreign Long-Term	Stable
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Financial Data

City of Gdansk	31 Dec 06	31 Dec 05
Operating revenue (PLNm)	1,308.6	1,159.7
Debt (PLNm)	271.8	348.9
Operating balance/operating revenue (%)	11.8	8.3
Debt service/current revenue (%)	6.8	8
Debt/Cur Balance(Yrs)	1.8	4
Operating balance/interest paid (x)	11.9	4.7
Capital Expenditure/Total Expenditure (%)	16.8	10.5
Surplus (Deficit) Before Debt Variation/Total Rev. (exc. New Debt) (%)	2.1	2.6
Current Balance/Capital Expenditure (%)	59.1	64.2

Analysts

Elzbieta Kaminska
+48 22 338 62 84
elzbieta.kaminska@fitchratings.com

Renata Dobrzynska
+48 22 338 62 82
renata.dobrzynska@fitchratings.com

Related Research

- *International Rating Methodology for Local and Regional Governments*

Rating Rationale

- The ratings upgrades to 'BBB+' from 'BBB' reflect Gdansk's improved operating performance, high liquidity and low debt. They also reflect budgetary surpluses reported in 2003-2006 and conservative financial management. However, they take into account some rigidity of operating expenditure and a projected increase of debt.
- Gdansk's operating performance improved significantly in 2006. The operating margin reached an eight-year peak of about 12% and comfortably covered debt servicing. The 2007 operating balance may reach PLN171m, 11% higher than in 2006. In 2002-2006 Gdansk's liquidity was very high, averaging PLN153m. Interest from deposits covered about 50% of interest paid. Since 2003 Gdansk has posted budgetary surpluses (PLN30m in 2006). Fitch Ratings expects that in 2008-2012 the city will maintain a similar operating performance as in 2006-2007.
- Gdansk's financial management is conservative. Historically, actual operating revenue exceeded projections and debt was lower than projected. In the medium term the operating balance should be sufficient for debt servicing, consuming about 66% of the operating balance on average.
- A 50% decrease of debt in 2003-2006 and improved operating performance have increased the city's financial flexibility. The debt/current balance ratio decreased to 1.8 years in 2006 from 4 years in 2005. A further improvement is expected in 2007 as Gdansk might not incur new debt of PLN110m. An ambitious investment plan for 2008-2012 will be partly debt financed. Fitch believes that debt ratios will not worsen dramatically, that a sound operating performance will mitigate Gdansk's recourse to debt and that less important investment projects will be postponed if necessary.
- Gdansk boasts a favourable socio-economic profile. It is one of wealthiest and fastest-growing cities in Poland. Its well-diversified economy is competitive and attractive to investors, as proved by growing tax revenue. Ongoing investment in local infrastructure development will support these positive trends.
- The city's flexibility on operating expenditure is limited, as 43% of it is staff costs. Gdansk may face some pressure on increasing staff expenditure in 2008 due to a national salary rise of over 10%. However, continuing restructuring of education should offset some spending rigidity.

Key Rating Drivers

- **Positive Impact:** Further improvement of operating performance, accompanied by still moderate debt coverage ratios.
- **Negative Impact:** Deterioration of operating performance, weak debt coverage ratios, adverse changes in institutional framework.

Profile

The City of Gdansk is located on the Gulf of Gdansk and is home to approximately 456,000 inhabitants. Gdansk, together with the neighbouring cities of Gdynia and Sopot, forms a large conurbation, creating a favourable environment for local economic development. Its main responsibilities are education, social care, public transport, road construction and maintenance, culture and libraries.

Institutional Framework

Responsibilities

The City of Gdansk is an urban powiat (or “miasto na prawach powiatu”) and, as such, shares the same scope of responsibilities as both the gminas and ordinary powiats.

As a powiat, the city is responsible for secondary schools and special schools, the construction and maintenance of powiat roads, programmes aimed at fighting unemployment and care of the disabled. As a gmina, the city is wholly responsible for water supplies and sewage treatment, waste collection and disposal, energy and heating systems, pre-school and primary education, municipal road construction and maintenance, and municipal cemeteries and libraries. It also has varying degrees of responsibility in areas such as healthcare and social welfare services, public transport, sports facilities, land use and urban planning, environmental protection, fire prevention and public order.

Central Government Delegated Tasks

Cities also perform functions classified as “central-government-delegated tasks”, which are fully financed from state grants. The list of delegated tasks is established at the national level and is modified almost every year. Some significant changes took place in 2004 and 2005 (see table below) and were continuing in next years.

Changes in Delegated Responsibilities

Responsibilities	Until 2003	Since 2004 or 2005
Social benefits for retired teachers	Grants	Educational subsidy
Forestry inspection	Grants	Income taxes
Foster families	Grants	Income taxes
Street lighting	Grants	Income taxes
Housing allowances	Grants	Income taxes
New responsibilities:		
Family allowances	-	Grants
Child maintenance	-	Grants

Source: Local Governments' Revenue Act 1998, Local Governments' Revenue Act 2003

Funding

Cities (miasta na prawach powiatu) are entitled to receive revenue as both a gmina and a powiat. Their revenue can be divided into two categories: own revenue (including a share of personal income tax (PIT) and corporate income tax (CIT), local taxes, charges and fees, and income from the city's consolidated entities and assets), and subsidies and targeted grants from the central government budget.

Under the local government system implemented in 2004, cities started to receive an increased share of PIT and CIT revenue.

EU Financing

All EU financing must be included in the city's budget. The amounts received for social projects (from the European Social Fund) are recorded as operating revenue and the corresponding expenditure is classified as operating expenditure. The amounts received for infrastructure projects are capital revenue, while the corresponding expenditure is capital expenditure.

Share in PIT and CIT

(%)	Previous act 1999-2003	New act				
		2004	2005	2006	2007	2008
Gmina						
CIT	5.0	6.71	6.71	6.71	6.71	6.71
PIT	27.6	35.72	35.61	35.95	36.22	36.49
Powiat						
CIT	None	1.40	1.40	1.40	1.40	1.40
PIT	1.0	8.42	10.25	10.25	10.25	10.25

Note: In 2001-2002 coal-mining gminas were entitled to additional revenue from PIT. Their share was 5pp higher than for other gminas

Source: Local Governments' Revenue Act 1998, Local Governments' Revenue Act 2003

Debt Limits

According to the Public Finance Act, local governments must comply with debt and debt-servicing ratios. Debt cannot be higher than 60% of total revenue and debt-servicing expenditure cannot exceed 15% of total revenue. These debt limits have been broadly criticised as they constrain the ability of economically sound cities to incur debt, and new debt regulations are under discussion.

Budgeting and Reporting

Urban powiats prepare a single budget, but their budgetary resolutions break revenue down into amounts corresponding to either the gmina or the powiat, as well as defining which items of expenditure correspond to the respective responsibilities of the gmina and the powiat.

From 2008 local and regional governments' budgets will have to split revenue and expenditure into operating and capital headings, which will increase their transparency and should help to improve budgetary management at the operating and capital level.

The scope of budgetary reporting and external control is clearly set out in legislation. Local governments are obliged to report to the regional accounting chambers (regionalna izba obrachunkowa, RIOs). Reports are made on a quarterly, interim and annual basis.

Supervision and Control

Local governments are controlled by the RIOs, which represent the Ministry of Finance at the regional level, and the Supreme Chamber of Control (NIK).

The RIOs supervises local government activity in budgetary matters and carry out training activities. Local governments must provide RIOs with budget resolutions, semi-annual and annual budget completion reports and revisions of budgets for a year so that the RIO can assess their compliance with the relevant statutes. If a city's council does not approve its annual budget by 31 March, the RIO can impose a provisional budget plan. It also reviews the city's borrowing decisions and checks whether the local government complies with the debt and debt-servicing limits. Once every four years the RIO is obliged to carry out a complete review of local government finances, covering accounting standards and reporting procedures.

The NIK's role is to control public finances at all levels. It is especially interested in local governments' use of grants and subsidies from the state budget.

Internal Audits Required by the Public Finance Law Since 2004

All tiers of local government must employ an internal auditor responsible for analysing and defining risks in every area of local government activity. Auditors report directly to the president.

Administration

Political Stability

Following the last local elections in November 2006 only two parties are represented in the city council. Twenty-one seats out of 34 went to the Civic Platform Party (Platforma Obywatelska, PO) and 13 to the Law and Justice Party (Prawo i Sprawiedliwosc, PiS), both broadly centre-right parties. The president, being a member of PO, has an absolute majority in the city council, which guarantees political stability and continuity. None of populist parties are represented on the city council.

The city's president, Pawel Adamowicz, was elected for a third term in November 2006, winning over 60% of votes. A member of the PO party, he is also the party chairman in the Pomorskie Region or voivodship.

The local government consists of the city's president, vice presidents appointed by the president, and the city council, the legislative body.

The administration's main priorities are established in the city's development strategy and multiyear investment plan. The policy focuses on the economic and social development of the city through:

- improving infrastructure, such as roads, water and waste water systems and public transport, and services, including education and culture;
- attracting investors, which will help strengthen the local tax base and boost tax revenue;
- continuing heavy investment, some in tandem with neighbouring cities, and increasing the economic, cultural and educational integration of these cities;
- active international promotion of the city directed at investors and tourists;
- supporting the development of tourism; and
- improving housing and generally supporting the city's small and medium-sized enterprises (SMEs).

The current administration has clear plans for the further development of the city and a clear view of its most important advantages and needs.

The city wants to facilitate the development of new technology and innovation and, in general, support SMEs, the maritime sector and the logistics industry. The city is also focusing on investments that will improve the quality of life for Gdansk's residents and eliminate barriers to local development, such as the lack of roads and housing.

A high share of planned investments will benefit from capital transfers from the EU. The city is also aware that it has to maintain its high self-financing capacity to be able to carry out its investment plan. Thus the multiyear investment plan is accompanied by multiyear financial projections.

Economy

The City of Gdansk is the capital of Pomorskie Region, located on the southern coast of the Baltic Sea. Gdansk, Gdynia and Sopot form a large conurbation with more than 740,000 residents and over 98,000 companies. This conurbation of three independent municipalities is one of the wealthiest areas in Poland. Its gross product amounted to over PLN26bn in 2004, which was equivalent to 50.6% of the Region of Pomorskie's gross regional product (GRP) and 2.8% of the national GDP. Local GRP per capita was 144% of the national average, ranking the conurbation fourth out of 45 Polish subregions.

Population

At end-2006 the city's population was 456,700. The number of inhabitants in Gdansk has continued to fall during the last years, in line with the national trend, caused by a combination of negative birth and migration rates.

Gross Value Added Composition in the Major Polish Cities (end-2004)

(%)	Warsaw	Wroclaw	Gdansk-Gdynia-Sopot	Lodz	Poland
Agriculture and forestry	0.0	0.1	0.2	0.1	5.0
Industry and construction	15.9	22.8	25.7	27.0	30.2
Services	84.1	77.1	74.1	72.9	64.8
Total	100.0	100.0	100.0	100.0	100.0

Source: Central statistical office

Services Dominated Local Economy

The local economy is increasingly becoming a hub for new technology, as evidenced by the arrival of companies such as Intel Technology Poland, AT&T Polska, Ericsson, Lufthansa Systems Poland and Young Digital Planet. At end-2006 over 58,800 companies operated in the city. Services dominated the local economy. They accounted for around 74% of gross value added in 2004, against a national average of about 65%, employing over 61% of the local workforce. The focus is on financial services (many banks have branches in Gdansk), business services (such as Ernst & Young), IT, real estate, tourism, educational facilities and healthcare institutions (including nine hospitals). The importance of services to the local economy is growing. A benign climate, its proximity to the coast and its many historic and architectural monuments make the city a popular tourist destination, and it receives more than 1 million tourists every year. Several investment projects involving new hotels and tourist centres are underway in the city.

Gdansk's location gives it a strategic advantage. The city will be a central interchange on Trans-European Transport Corridor No. VI, which will connect it with northern and southern Europe. Construction projects will include the A1 motorway from Gdansk to Vienna, linking northern and southern Europe. The city also lies on the route between Kaliningrad Oblast (Russia) and Western Europe. Both these road developments and a high-speed train project will link Gdansk with the rest of Poland and Europe, which should foster the city's development. The modernisation of the high-speed train track, which started in 2007, will shorten the Gdansk-Warsaw journey to 2.5 hours from 4.5 hours. Gdansk is easily accessible from Warsaw and other European cities thanks to Lech Walesa Airport, in which the city has a 29% stake. The third-largest international airport in Poland, it handled about 2 million passengers in 2007. Its further extension is projected for 2007-2010. Unlike other local airports in Poland, it has been profitable, reporting growing net profits in the last five years.

Gdansk's seaport is the most important in Poland and the maritime sector consequently continues to play an important role in the local economy in the areas of international trade, maritime transport, fishing, shipbuilding and ship maintenance, repairs and re-fits. The sector leaders are Gdanska Stocznia Remontowa S.A. (the Gdansk refitting shipyard), Stocznia Polnocna S.A. (the northern shipyard) Stocznia Gdanska S.A. (the Gdansk shipyard) and Zarzad Morskiego Portu Gdansk S.A. (the port authority).

The largest and most significant of the investment activities underway at the seaport is the construction of the 40-hectare deepwater container terminal, DCT Gdansk SA, at a cost of EUR190m. The project was split into two phases, the first of which, involving the construction of two berths with overall annual throughput of 500,000 TEU (20-foot equivalent units), came into operation in 2007. The second phase covers the construction of additional berths. The targeted total annual capacity of the container terminal will be 1 million TEU. In 2007 the city and the

port authority agreed on the construction of a 210-hectare logistics centre near the Port of Gdansk. The total cost will be EUR250m, which, together with the berths that are currently under construction, should lead to the creation of 5,000 new jobs. The construction of the logistics centre will be a joint project involving the City of Gdansk, the Special Economic Zone (SSE) and the port authority.

In 2005 the SSE was extended after Gdansk made an in-kind contribution of a plot of land that will be the site of the Gdansk Technology Park. The Gdansk SSE will primarily be a hi-tech business park spanning some 15 hectares. Individuals or entities that invest in it are entitled to income tax and property tax exemptions. Many foreign companies from the IT, metallurgy and automotive sectors are developing their operations in the SSE.

- GE Money Bank is a bank owned by General Electric, headquartered in Gdansk, with around 2,000 employees. It will strengthen its position after its acquisition of part of Bank BPH comes into effect in December 2007.
- Lotos Group SA is the second-largest refinery in Poland, previously state-owned, which has since June 2005 been listed on the Warsaw Stock Exchange. The company has reported consistent growth in sales and net profit since end-2001 and remains one of the biggest taxpayers in the city. It has invested some PLN1bn in its production plant and the construction of the new premises, which will increase the city's tax revenue as well as creating additional employment.
- The Gdansk and Gdynia shipyards – Stocznia Gdansk and Stocznia Gdynia – merged in 1998, but become separate entities once again in 2006. The state is the majority shareholder. According to the city, Stocznia Gdansk will be sold to a strategic investor in 2007. Its non-productive assets (mainly plots of land) will be sold to investors.

Gdansk is a major national educational, cultural and scientific centre, with 14 universities and high schools. These include six public universities, the Technical University, Gdansk University and the Medical Academy. The total number of academic teachers totalled about 4,600 and students 72,270 (or 87,800 including Gdynia and Sopot). The presence of universities provides a highly qualified labour force, which, together with favourable location of the city and the availability of attractive plots of land, makes the city one of the prime locations for investment in Poland. The city's authorities are actively supporting the ongoing development of the city by further improving the local infrastructure (e.g. constructing and modernising roads), participating in the construction of a logistics centre at the seaport, and modernising the city's water and sewerage systems.

Very Low Unemployment

Unemployment is continuing to decrease, following the national trend. At end-2006 it fell to 6.2% from 9.6% in 2005.

Falling Population

The city's population has been falling in the last 10 years due to negative natural growth and net migration, declining to 456,050 in 2006 from 462,300 in 1996. The city's authorities want to counteract the trend of negative migration by making it easier for private investors to construct new apartments by, for example, selling off publicly owned land to encourage real estate development.

Budgetary Framework

The city has relatively few municipal companies. Gdansk is the outright owner of six public-sector companies, including one that was created in 2006; it has majority shares of about 50% and 60% in two, and minority shares ranging from less than 1% to 49% in 12.

The majority of municipal companies' debt (89%) belonged to two wholly owned housing associations, GTBS and MTBS, whose debt totalled almost PLN90m at end-

2006. Both companies build apartments for families with below-average incomes. These debts reflect the nature of their activities: in order to construct the apartments, they incur preferential-rate loans with the state-owned Bank Gospodarstwa Krajowego (BGK), which are repaid from rental income from the properties. The rent collection rate is high, averaging 97% in 2004-2006. The city increased the companies' equity via capital injections or in-kind contributions (in the form of land on which apartments can be constructed) totalling PLN12.6m in 2006.

The city holds minority stakes in 12 other companies. Some of the minority stakes in seven companies, ranging between 0.002% and 5.7%, were received as compensation for overdue property tax, and as such the city wants to sell the shares. In the remaining six companies the city's holdings range from 16.34% to 49%, as detailed below.

- Saur Neptun Gdansk Plc supplies water and collects waste water. The city has a 49% stake and the International Saur Company holds the remainder. The company reported net profits in 2003-2006 (PLN4.6m in 2006).
- Zuraw Sp. z o.o. (33.30% stake) is a very small company with equity of PLN51,000, responsible for the refurbishment of the Rynek Weglowy square in the city centre. This company reported small net losses in 2004-2006, including a loss of PLN2,339 in 2006.
- Port Lotniczy Gdansk Sp.z o.ol (Gdansk airport), in which the city's stake is 29.45%, has been profitable since 2004 and reported net profits rising to PLN6.5m for 2006 from about PLN2.8m in 2005. The company is developing quickly, investing in new passenger and cargo terminals. The city will make in-kind contributions (mainly plots of land) to the company and may increase its stake as a result.
- Miedzynarodowe Targi Gdanskie, in which the city has a 26.87% stake, organises trade fairs and exhibitions. It generated net profits of about PLN2.4m in 2006.
- The heating utility GPEC Sp. z o.o., in which the city has a 16,34% stake, has been improving its financial results, reporting a net profit of PLN2.1m in 2006. The company had long-term debt of PLN41m at end-2006, up from PLN2,2m at end-2005, related to its investments.

Healthcare Sector Fully Privatised

The city's only healthcare responsibility is to finance educational and preventative diagnostic healthcare programmes for different diseases, such as breast cancer, stomach cancer and heart disease. In 2006 healthcare expenditure totalled PLN13.5m, about 2% of operating expenditure. The city is not exposed to

Key Financial Figures on Corporate Exposure

Company	City's stake (%) 2006	Equity 2006	Total assets 2006	Net income		Long-term debt	
				2005	2006	2005	2006
Gdansk Infrastruktura Wodociagowo-Kanalizacyjna (water and sewerage utility)	100.0	682.2	709.1	0.3	0.2	0.0	0.0
Zaklad Komunikacji Miejskiej w Gdansku (public transport)	100.0	68.8	130.2	2.4	1.5	0.0	11.6
Gdanskie Towarzystwo Budownictwa Spolecznego (housing association)	100.0	47.8	143.6	0.1	0.4	66.3	66.4
Towarzystwo Budownictwa Spolecznego - Motlawa (Motlawa housing association)	100.0	27.3	71.8	0.3	0.4	12.4	23.7
Zaklad Utylizacyjny (solid waste treatment)	100.0	7.4	34.1	-7.3	-8.0	0.0	0.0
Gdanskie Melioracje (sewerage)	60.0	0.2	4.5	0.2	0.0	0.0	0.0
Wielofunkcyjna Hala Sportowo-Widowiskowa Gdansk-Sopot (sports facility)	50.0	0.4	0.2	-0.2	-0.01	0.0	0.0
Gdansk Infrastruktura Spoleczna - (municipal housing)	100.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total						78.8	101.6

Source: City of Gdansk

healthcare sector risk as it does not own any of the hospitals in its jurisdiction and all outpatient clinics have been privatised. Medical services are provided by hospitals and polyclinics owned by the Pomorskie voivodship and the Medical Academy, among others.

Finances and Performance

Revenue

The city's operating revenue has increased continuously, rising by about 13% in 2006 and 7% in 2005. The 2006 actual operating revenue was PLN152m higher than budgeted. Taxes accounted for 53% of operating revenue. Tax rates of modifiable (local) taxes are increased every year following rates established by the Ministry of Finance. In its tax policy the city is maintaining tax rates close to maximum levels. In particular, property tax rates for houses and commercial premises have been set at the highest allowed level. Not-for-profit organisations or healthcare entities pay preferential rates. Some tax relief on local levies is offered to potential investors creating new jobs, especially new investors in the SSE.

Property tax is the most important local tax, representing 75% of local taxes. Its growth has been dynamic, averaging about 10% per year in 2003-2006, which reflects the city's strong and developing tax base. The 10 largest payers of the property tax accounted for about PLN86.2m or 34.4% of attributed property tax. Overdue accumulated property tax was PLN42.3m at end-2006, of which PLN14m related to companies going bankrupt and is unlikely to be recovered.

The city has not lost significant revenue as a result of local tax rates being set below the maximum limits and overdue taxes being written off by the city. It amounted to about PLN7m in 2006, about 3% of local tax revenue or 4.5% of the operating balance.

The importance of income tax revenue has been growing since 2004 in line with the developing economy and strengthening tax base. At end-2006 income taxes represented 32% of operating revenue and actual tax revenue was higher than projected (13%), which was not the case until 2003. In the 2007 budget income tax revenue was projected at PLN497.1m, 17% higher than the 2006 actual. Its collection is also good and will exceed projections. Based on preliminary data, income tax revenue may total PLN527m.

Current Transfers

In 2006 current transfers rose 4% yoy to account for 29% of operating revenue. Nominally, they reached PLN376m. Their main element is the general subsidy (66% of transfers), 96% of which is directed to education, nominally PLN251.9m. The city received PLN92m in grants for delegated tasks in 2006 (24% of current transfers) due to new responsibilities it performs on behalf of the state government (central-government-delegated tasks), such as the payment of family allowance and child maintenance payments to some lone parents the city. In addition, grants were boosted by EU financing for projects in the social sphere. In 2006 the city received PLN30m from the EU for its social programmes.

Breakdown of Taxes

(PLNm)	2003	2004	2005	2006
PIT	172.4	269.3	319.0	366.0
CIT	20.2	44.0	38.4	58.0
Property tax	171.4	183.8	187.1	202.5
Other local taxes	43.5	43.5	49.8	68.8
Total tax revenue	407.5	540.6	594.3	695.3

Source: City of Gdansk's budgets

Prospects

The city's pre-close data estimates that in 2007 collections of operating revenue will exceed projections. This positive trend is supported by the developing economy and expanding tax base, which will continue in 2008. Due to some income tax relief to families with children from 2008, the city may lose PLN60m. However, Fitch expects that this loss may be mitigated by the growing economy, increasing salaries and enlarging tax base. In its 2008 draft budget the city projects PIT and CIT revenue at PLN530m. Moreover, Polish local governments are negotiating with the state to compensate them the loss in income tax revenue due to tax relief for families.

Expenditure

Operating expenditure is mainly for staff (42.6%) and goods and services (33.6%). The city controls staff costs, limiting its increase to about 5% in 2006. However, Fitch expects more pressure on salaries in 2008 due to two factors: the 10% rise in teachers' salaries announced by the Ministry of Education and an average wage rise of over 10% in the national economy in 2007. However, Fitch expects that the raise of teachers' salaries will be covered from the higher educational subsidy.

The city's long-term financial projections include a 0.5% annual increase of staff costs above inflation and other operating costs increasing in line with inflation rates, averaging 2.5% annually.

Traditionally, the city's largest area of expenditure is education, which in 2006 represented 40% of operating expenditure. The city restructured the school network in 2002-2005 and the local administration is continuing the process by implementing some cost-cutting measures, which standardise, among other things, teacher/pupil ratios, class sizes and the ratio of administrative to teaching staff. The programme should optimise and contain costs in education. The restructuring programme also includes the privatisation of kindergartens, which would limit the city's participation in financing kindergartens to 70% from 100%.

According to the city, the programme will cut the number of teachers by about 150 per year in the next three to four years, which should help slow rising expenditure in education, as 74% of it is staff costs. In the 2008 draft budget Gdansk's participation in financing education is projected to decrease to PLN240m from PLN242m in 2007.

On the other hand, the local authorities are aware that they must be prepared to meet increasing demand for highly qualified employees, and they want to provide high-quality educational services for inhabitants of the city and surrounding gminas. Gdansk provides additional classes for school pupils, such as teaching a second and third foreign language or sports classes. These lessons will be financed from costs savings and EU funds.

Expenditure in the social sphere represented 14% of operating expenditure. The vast majority of it relates to spending on central-administration-delegated tasks, which are fully financed through state grants and which the city has no means of limiting. Its "own tasks" are financed from the city's revenue and partly from state grants. Owing to improvements in the local economy, the city has noted decreasing demand for some categories of social care services such as, for example, housing allowances. The city projects that in 2007 spending on social care may increase by about 3.4%. The city delegates the performance of its own tasks in social care to non-profit organisations, which are more effective and cheaper for the city.

Capital Revenue and Expenditure

The city's capital expenditure averaged PLN163m per year in 2002-2006, representing 14% of total spending, mainly financed from sale of assets and through debt. In the last five years capital revenue financed about 70% of capex. Capital

grants, mainly from the EU, increased to PLN30m in 2006 and PLN70m in 2007. A further increase of grants is expected in the new programming period 2007-2013. The Multi-year Investment Plan (WPI) for 2007-2011 projects revenue from grants and subsidies of PLN2.6bn, 59% of capital expenditure.

The total capital expenditure in 2007-2011 amounts to PLN4.4bn, averaging about PLN890m per annum. The city's main areas of investment are roads and the public transport system, which will absorb over 40% of capital expenditure, and sports facilities at above 20%.

Off-Budget Capital Expenditure

Off-budget investments are projected to reach PLN800m in 2007-2011. One of the major projects is the new water and sewerage system, for which the city has set up an infrastructure company, GIW-K. The city has made a PLN675m in-kind contribution of the water and sewerage network to GIW-K, which reduced pressure to increase the city's direct debt and the costs of the projects, as the company is entitled to reclaim the VAT, currently at a rate of 22%. The total cost of the project is PLN513m, 29% of which will be financed from the company's own sources (including a PLN47m loan from the European Bank for Reconstruction and Development (EBRD), and the remaining 71% from the EU's Cohesion Fund.

Gdansk and the City of Sopot have signed an agreement, , to build Wielofunkcyjna Hala Widowiskowo-Sportowa, a sports and entertainment facility, and reconstruct the surrounding road network at total cost of PLN250m. This will be financed from EU sources (PLN32m), grants from the state budget (PLN50m) and Gdansk's and Sopot's own resources. Once the sports facility has been built, it will be transferred as an in-kind contribution to Wielofunkcyjna Hala Widowiskowo-Sportowa, which will manage Hala Olivia.

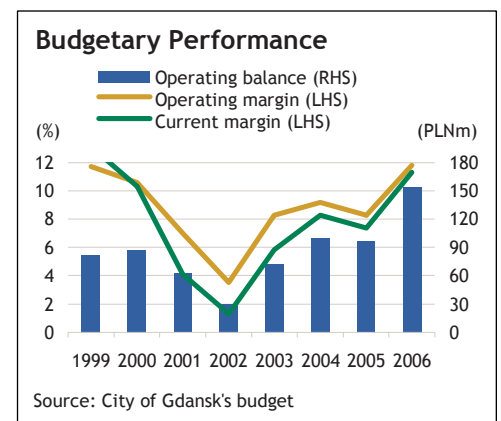
A project including the purchase of 28 new buses and three new trams will be carried out by the public transport company ZKM Sp. z o.o. The project will be co-financed from EU sources. ZKM's expenditure will amount to PLN33m.

Budgetary Performance

Gdansk's operating performance improved significantly in 2006. The city reported an operating margin of about 12% at end-2006. Operating revenue grew about 13%, faster than operating expenditure (8.5%). Since 2004 the operating balance has been sufficient to meet debt servicing requirements.

The city estimates that the 2007 operating balance will reach PLN171m, up 11% yoy. This would give an operating margin of 11.8%. According to Gdansk's conservative financial projections, the operating margin will average about 9.4% in 2008-2012; its most pessimistic scenario has it remaining at or above 7.8% in 2008-2026. Moreover, since 2003 Gdansk has posted a surplus before debt variation, which in 2005-2006 averaged PLN31m. The city is aware that implementing its investment plan will require tight control on operating expenditure and maintaining satisfactory operating balances. Fitch sees Gdansk's projections as realistic.

Conservative debt policy and improved operating performance have allowed the city to strengthen its debt ratios. At end-2006 debt and debt servicing ratios were 20.7% and 6.8% of current revenue, respectively, and the debt repayment ratio (debt to current balance) improved to 1.8 years from 4 years in



2005. A further improvement is expected in 2007. It is likely that in 2007 Gdansk will not incur new debt of PLN110m (projected in the 2007 budget after amendments).

The city complies with the internal measures in its integrated financial management system, implemented in 2003, which stipulate that the ratios of free financial resources¹ to debt servicing and of operating balance to total revenue should not be lower than 1.1 and 7%, respectively. The city has always met these requirements. In 2006 reported ratios were 2.6 and about 12%, respectively.

Debt and Liquidity

Gdansk's direct debt amounted to about PLN272m at end-2006, equivalent to 20.7% of current revenue, down from PLN515m and 29.8% in 2003. In 2004-2007 the city focused on limiting its direct debt and improving its financial flexibility, which is important for implementing Gdansk's investment plan.

All debt carried floating rates linked to various indices (three- and six-month WIBOR or three- and six-month EURIBOR). Of the total debt, 10.5% were subsidised loans from the National and Regional Environment Protection and Water Management Funds (NFOSiGW and WFOSiGW) and some other financial institutions, which carry very low interest rates and entail grace periods of one to six years. The interest rates for NFOSiGW and WFOSiGW loans are 0.3x or 0.1x the promissory notes rediscount rate but should not be lower than 3% or 4%. In December 2006 the promissory notes rediscount rate was 4.25%.

In 2006 debt servicing totalled PLN89m (EUR24m) or 6.8% of current revenue. Debt servicing consumed only 58% of operating balance, while in 2001-2003 the operating balance was insufficient for debt servicing. In 2003 debt service was 36% higher than the operating balance. Fitch sees significant improvement of Gdansk's operating management and its financial position. The debt repayment ratio (debt/current balance) decreased from 10 years in 2003 to 1.8 years in 2006.

Breakdown of Debt

	(PLNm)		(%)	
	2006	9M07	2006	9M07
Bank credits	238.8	206.9	87.9	89.5
Preferential loans	33.0	24.2	12.1	10.5
Total debt	271.8	231.1	100.0	100.0
Floating interest rate (%)			94.4	93.5
Foreign-currency debt (%)			33.3	33.4

Source: City of Gdansk

Debt Prospects

In 2007 Gdansk's debt will be lower than budgeted. The city has sufficient own sources for financing capex. At the end of September 2007 it amounted to about PLN231m, 51% lower than projected. In the medium term (2008-2010) Fitch expects direct debt to increase to about PLN750m in 2011, which may represent about 46% of projected current revenue. At the same time debt servicing should not exceed 7% of current revenue on average. The projected operating balance should exceed debt servicing requirements. On average debt servicing will consume about 66% of operating balance.

As shown in previous years, debt may increase at a lower pace than projected due to city's high own sources for financing investment. In addition, revenue projections are conservative. The 2007 budget indicated that projected debt would amount to PLN475m, but according to the latest data it should be lower than in

¹ Free financial sources are: total revenue - capital grants - current expenditure + proceeds from municipal asset sales

2006 (as discussed above). The city has signed a contract with the European Investment Bank (EIB) for a credit of PLN140m, which has to be withdrawn by end-2009 and will be repaid by 2026. The highest annual servicing of the credit from EIB is about PLN16m. The interest is below WIBOR.

Pre-Financing Loans

Under the Public Finance Act, loans received from central government to pre-finance EU-funded projects are not included in the debt ratio (debt to total revenue) and the debt-servicing ratio (debt-servicing requirements to total revenue), for which the ceilings are 60% and 15%, respectively. These loans will be repaid using the EU funds once each phase of the related project is completed, provided that the projects are carried out in accordance with the contract documentation.

Projected pre-financing needed for the EU projects scheduled to be completed by end-2008 totals PLN161m. By end-2007 it will amount to PLN37m. Pre-financing loans carry very low interest rates and are provided by BGK Bank. They can be used only for bridge-financing of projects co-financed from the EU funds. The city does not have any access to this money.

Contingent Liabilities

At end-2006 outstanding indirect debt amounted to about PLN102m, compared with PLN78.8m at end-2005, and most of it (89%) related to two housing associations, GTBS and MTBS. Gdansk's contingent liabilities are equivalent to less than 8% of operating revenue. According to the multi-year investment programme, several projects will be carried out by municipal companies or special-purpose vehicles established solely for investment purposes. Contingent liabilities may well increase (see *Expenditure* above).

The city does not report any indirect risks relating to the healthcare sector, as Gdansk is not a funding body for any healthcare entities.

Very Low Level of Guarantees

Guarantees extended by the city are very small, amounting to PLN3m at end-2006. In 2003 the city issued a guarantee of PLN3.7m against a 10-year loan taken by MTBS; the loan will be repaid from rental income (see *Budgetary Framework* above). The city did not issue any other guarantees in 2006 and 2007 and does not intend to do so in 2008.

Liquidity

Gdansk reports high liquidity. In 2005-2007 monthly cash and liquid deposits averaged PLN117m. The city makes several deposits a year, which give it significant financial revenue. In 2004-2006 interest revenue covered almost 50% of interest paid. Gdansk also has a stand-by liquidity credit line of PLN50m, which has not been used in 2006-2007.

Gdansk has reported high year-end cash reserves, averaging PLN152m in 2002-2006 and covering about 40% of debt.

Appendix A

City of Gdansk

(PLNm)	Actual				
	2002	2003	2004	2005	2006
Taxes	372.5	407.5	540.6	594.3	691.4
Transfers received	388.1	355.1	333.7	360.9	376.0
Charges, fines and other operating revenue	98.8	106.7	210.9	204.5	241.2
Operating revenue	859.3	869.2	1,085.2	1,159.7	1,308.6
Operating expenditure	-829.3	-797.0	-985.2	-1,063.3	-1,154.2
Operating balance	30.0	72.2	100.0	96.4	154.4
Financial revenue	7.9	6.4	12.4	11.2	7.3
Interest paid	-26.7	-27.7	-21.2	-20.5	-13.0
Current balance	11.3	50.9	91.2	87.1	148.7
Capital revenue	45.2	101.0	198.1	81.2	133.3
Capital expenditure	-152.8	-134.0	-141.5	-135.7	-251.8
Capital balance	-107.7	-33.0	56.6	-54.5	-118.5
Surplus (deficit) before debt variation	-96.4	17.9	147.8	32.6	30.2
Debt repayments	-34.6	-70.5	-59.0	-73.4	-76.4
New borrowing	139.5	65.3	5.6	1.5	1.6
Net debt movement	104.9	-5.1	-53.4	-71.9	-74.8
Overall results	8.5	12.8	94.4	-39.3	-44.6
Debt stock					
Short-term	0.0	0.0	0.0	0.0	0.0
Long-term	491.6	515.1	430.1	348.9	271.8
Direct debt	491.6	515.1	430.1	348.9	271.8
+ Other Fitch classified debt	0.0	0.0	0.0	0.0	25.3
Direct risk	491.6	515.1	430.1	348.9	297.1
- Cash, liquid deposits, sinking fund or pre-financing	99.4	123.2	225.9	185.3	129.6
Net direct risk	392.2	391.8	204.2	163.6	167.5
Guarantees and other contingent liabilities	10.4	12.2	3.8	3.5	3.0
Net indirect risk (public-sector entities exc. gteed amount)	75.5	78.4	73.7	78.8	101.6
Net overall risk	478.1	482.4	281.7	245.9	272.1
Memo (%)					
Debt in foreign currency	32.1	41.4	38.9	36.0	33.3
Issued debt	7.6	0.0	0.0	0.0	0.0
Fixed-interest-rate debt	5.3	3.0	3.6	4.5	5.6

Source: City of Gdansk

Appendix B

City of Gdansk

	Actual				
	2002	2003	2004	2005	2006
Fiscal performance ratios (%)					
Operating balance/operating revenue	3.50	8.30	9.21	8.31	11.80
Current balance/current revenue ^a	1.30	5.81	8.31	7.44	11.30
Surplus (deficit) before debt variation/total revenue ^b	-10.56	1.83	11.40	2.60	2.08
Overall results/total revenue	0.93	1.31	7.28	-3.14	-3.08
Operating revenue growth (annual change)	-2.29	1.15	24.85	6.87	12.84
Operating expenditure growth (annual change)	1.42	-3.89	23.61	7.93	8.55
Current balance growth (annual change)	-69.07	351.62	79.15	-4.45	70.72
Debt ratios					
Direct debt growth (annual % change)	32.74	4.78	-16.49	-18.88	-22.10
Interest paid/operating revenue (%)	3.11	3.19	1.96	1.77	0.99
Operating balance/interest paid (x)	112.53	260.48	471.06	470.24	1,187.69
Direct debt servicing/current revenue (%)	7.07	11.21	7.31	8.02	6.79
Direct debt servicing/operating balance (%)	204.15	136.02	80.20	97.41	57.90
Direct debt/current revenue (%)	56.68	58.82	39.19	29.80	20.66
Direct risk/current revenue (%)	56.68	58.82	39.19	29.80	22.58
Net overall risk/current revenue (%)	55.13	55.09	25.66	21.00	20.68
Direct debt/current balance (yrs)	43.63	10.12	4.72	4.01	1.83
Direct risk/current balance (yrs)	43.63	10.12	4.72	4.01	2.00
Direct debt/GDP (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Direct debt per capita (PLN)	1065	1117	937	760	592
Revenue ratios					
Operating revenue/budget operating revenue (%)	n.m.	n.m.	n.m.	n.m.	103.77
Tax revenue/operating revenue (%)	43.34	46.88	49.82	51.25	52.84
Modifiable tax revenue/total tax revenue (%)	43.40	43.80	35.29	32.73	30.66
Current transfers received/operating revenue (%)	45.16	40.85	30.75	31.12	28.73
Operating revenue/total revenue ^a (%)	94.18	89.00	83.75	92.62	90.30
Total revenue ^a per capita (PLN)	1976	2119	2822	2727	3157
Expenditure ratios					
Operating expenditure/budget operating expenditure (%)	n.m.	n.m.	n.m.	n.m.	96.65
Staff expenditure/operating expenditure (%)	51.80	52.10	44.84	44.06	42.60
Current transfer made/operating expenditure (%)	9.63	14.09	7.84	6.72	7.66
Capital expenditure/budget capital expenditure (%)	n.m.	n.m.	n.m.	n.m.	77.43
Capital expenditure/total expenditure (%)	14.65	13.02	11.72	10.50	16.84
Capital expenditure/local GDP (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Total expenditure per capita (PLN)	2,260	2,233	2,629	2,816	3,257
Capital expenditure financing (%)					
Current balance/capital expenditure	7.37	37.97	64.42	64.19	59.05
Capital revenue/capital expenditure	29.56	75.37	140.00	59.84	52.94
Net debt movement/capital expenditure	68.63	-3.82	-37.72	-52.98	-29.71

^a Includes financial revenue

^b Excluding new borrowing

n.a.: not available

n.m.: not meaningful

Source: City of Gdansk

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