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Summary:
Kensington and Chelsea (Royal Borough of)

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Summary:

Kensington and Chelsea (Royal Borough of)

Credit Rating: AAA/Negative/A-1+

Rationale

The ratings on the Royal Borough of Kensington and Chelsea reflect its track record of a cautious fiscal stance, which has allowed the borough to build up substantial reserves and post moderate debt levels. The ratings further reflect the supportive U.K. local government regulatory system. Constraining factors include the expected reduction in government grants from 2010 onwards, which might not be offset by additional sources of revenue and might lead to changes in the current capital program or to curtail services. In addition, the borough's limited revenue flexibility further constrains the rating.

Due to the highly centralized U.K. local government system, Kensington and Chelsea depends on the U.K. central government for over two-thirds of its income. Although there may be some reduction in these revenues due to the U.K. government's likely fiscal priorities, we believe they will generally remain stable and predictable. Another key source of income, the council tax, is still relatively low when compared with similar taxes charged by other councils. Although this could allow some political flexibility to raise tax rates in the future, we believe the borough would be keen to maintain its fiscal advantage. In any case, we understand that the new U.K. government foresees a further freeze of the council tax rate at least for fiscal year 2011/2012.

The borough's budgetary performance has been sound over the past few years, with good control over budgeted costs. Operating balances-to-operating revenues have been 2.3% on average over the past three years. Over the next few years, the borough expects to post deficits after capital expenditure due to its capital program, in particular in 2011, when we forecast a deficit of 11% of total revenues. The planned program is diverse, allowing some flexibility to defer individual projects. We believe that Kensington and Chelsea is well placed to fund its capital program at the current rating level, given its moderate debt levels, significant reserves, and the prospect of further capital receipts from land sales.

Like other U.K. local authorities, Kensington and Chelsea is facing increased spending pressures relating to waste management, social care, and staff costs--in particular pensions. To mitigate this risk, the borough has already implemented savings in management personnel and procurement costs and we understand that there is a commitment to further decrease management costs in the future. However, the borough may have to further increase its pension contributions to reduce its underfunded pension liability. This net pension liability, added to the borough's direct debt, with our estimate of free cash and equivalents subtracted, led to moderate net financial liabilities of 32% of total operating revenues in 2009. That said, this represents a strong credit position, even compared with other 'AAA' rated local governments in Western Europe.

Very strong liquidity

The borough has a very strong liquidity position, demonstrated by its high level of cash and short-term investments at £260 million at the end of February 2010, which is well in excess of its medium-term capital self-financing requirements of £69 million. These investments are managed according to a highly risk-averse strategy.

A further source of liquidity is the Public Works Loan Board (PWLB), the government-funded main lender to the sector. The PWLB provides loan finance for capital investments on request, provided the borough is within its Prudential Code borrowing limits and is acting legally. The borough's debt levels are expected to remain well within the specified limits during the forecast period.

Outlook

The negative outlook reflects that on the U.K., as the rating on Kensington and Chelsea is constrained by that on the U.K. The outlook on the U.K. was revised to negative on May 21, 2009, as a result of a structural deterioration in the public finances, and the lack of a well-specified fiscal consolidation plan, against a backdrop of the rapid increase in the government debt burden. Standard & Poor's Ratings Services maintained its negative outlook on the U.K. government on July 12, 2010, on the basis of uncertainty about the implementation of the fiscal consolidation plan presented by the government. A positive rating action on the U.K. would most likely be followed by a similar action on Kensington and Chelsea, in light of the borough's robust financial and economic indicators. Conversely, if the ratings on the U.K. come under downward pressure, so would those on Kensington and Chelsea.

The outlook also reflects our expectation that the borough's creditworthiness will not be significantly affected by the planned step-up in capital expenditures. Moderate-to-high deficits after capital expenditures are forecast over the medium term, which we expect to be funded by the use of reserves and land sales. If, for some reason, reserves used for the capital program are not replenished in due course, then Kensington and Chelsea's net financial liabilities position might reach the higher end for a 'AAA' rated Western European local government, and further borrowing at the borough-level could put pressure on that position.

Related Criteria And Research

- Rating A Regional Or Local Government Higher Than Its Sovereign, Sept. 9, 2009
- Analyzing The Impact Of Unfunded Pension Liabilities On The Credit Quality Of International Local And Regional Governments, July 31, 2009
- Assessing The Institutional Framework For International Local And Regional Governments, July 30, 2009
- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- Rating International Local And Regional Governments, Jan. 5, 2009
- Assessing Financial Management in non-U.S. Local and Regional Governments, March 2, 2010

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