STANDARD & POOR'S

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Kensington and Chelsea (Royal Borough of)

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Kensington and Chelsea (Royal Borough of)

Major Rating Factors

Issuer Credit Rating
AAA/Negative/A-1+

Strengths:

- Strong financial and regulatory support from the U.K. government
- Low net debt position by international standards
- Flexibility to draw on substantial reserves

Weaknesses:

- Dependence on the U.K. government (AAA/Negative/A-1+), which caps the rating
- Likely reduction in government grant beyond 2011
- Ongoing expenditure pressures, such as social care responsibilities

Rationale

The ratings on the Royal Borough of Kensington and Chelsea reflect its sound budgetary performance, substantial reserves, moderate debt, and the supportive U.K. local government regulatory system. Constraining factors include ongoing spending pressures such as social care responsibilities, and the dependence on transfers from the U.K government.

Due to the highly centralized U.K. local government system, Kensington and Chelsea is dependent on centrally-assessed revenues for about one-half of its income. Although there may be some reduction in these revenues due to the U.K. government's likely fiscal priorities, Standard & Poor's Ratings Services 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. This should therefore allow some political flexibility to raise tax rates in the future, although the council has generally gone only for modest increases in the past.

The borough's budgetary performance has been sound over the past few years, demonstrating good control over budgeted costs. Operating surpluses have been small (averaging 0.4% of cash flow operating revenues over the past three years), but surpluses of this level are not unusual for a U.K. local authority with such high visibility over revenues. Over the next few years, the borough expects to post deficits after capital expenditure due to its capital program. The planned program is diverse, allowing some flexibility to defer individual projects, but also includes two significant school projects, one of which is to be largely funded by planned land sales. Standard & Poor's believes 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 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, the borough may have to further increase its pension contributions to reduce its unfunded pension liability. This net pension liability, added to the borough's direct debt, with free cash and equivalents subtracted, led to moderate net financial liabilities of 32.0% of total revenues in 2008. That said, this represents a strong credit position, even compared with other 'AAA' local governments in Western Europe.

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Liquidity

The borough has a very strong liquidity position, demonstrated by its high level of cash and short-term investments comprising £223.5 million as of financial year-end 2008, which is in excess of its likely medium-term capital financing requirements. These investments are managed according to a highly risk-averse strategy.

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. 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 deficits after capital expenditures are being forecast over the medium term, which we expect to be funded by a combination of borrowing, the use of reserves, and eventually land sales. If, for some reason, land sales do not materialize and if we believe that the reserves used for the capital program may not be 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.

Comparative Analysis

Kensington and Chelsea's economy compares well with its other highly rated international peers in terms of average wealth levels and diversity, although its population is several times smaller than the 'AAA' median (see table 1). Due to the highly centralized U.K. local government system, however, Kensington and Chelsea is much less exposed to the performance of the local economy than most of its international peers. Instead, it has a far higher dependence on central government transfers than its peers such as the Cities of Saskatoon (AAA/Stable/--) in Canada, or Stockholm (AAA/Stable/A-1+; Nordic national scale K-1) in Sweden. This is likely to make its revenue base more predictable, which is positive from a credit perspective, but also constrains its prospects for future revenue growth, particularly given the U.K. government's current fiscal challenges.

In terms of budgetary performance, Kensington and Chelsea has performed comparably with its peers, posting healthy surpluses after capital expenditures over the past few years, although this is now set to be followed by several years of deficits. During this time, the borough will be able to draw on an unusually high level of cash and short-term investments that is roughly equivalent to 80% of its total debt. This makes a default in the short term highly unlikely. Taking into account its long-term pension liabilities, however, the borough's financial profile does not compare quite so favorably with the other 'AAA' peers listed in table 1, as indicated by its level of net financial liabilities, although it is still in a strong position relative to many other 'AAA' rated peers in Western Europe.

Table 1

Kensington And Chelsea (Royal Borough Of) 2008 Peer Comparison

	Kensington And Chelsea (Royal Borough Of)	AAA Median	Saskatoon (City Of)	Stockholm (City Of)	Taby (Municipality Of)
Issuer credit rating (LC)	AAA/Negative/A-1+		AAA/Stable/--	AAA/Stable/A-1+	AAA/Stable/--
Issuer credit rating (FC)	AAA/Negative/A-1+		AAA/Stable/--	AAA/Stable/A-1+	AAA/Stable/--

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Table 1

Kensington And Chelsea (Royal Borough Of) 2008 Peer Comparison (cont.)

Three-year averages, using actual results only					
Operating balance (% of operating revenues)	0.4	14.4	13.8*	(1.9)*	6.2
Balance after capital expenditures (% of total revenues)	1.6	2.2	(6.3)*		
Capital expenditures (% of total expenditures)	6.8	13	35.0*	6.8*	7.9
Transfers received (% of total revenues)	49.7	26.7	8.5*	3.7*	(12.0)
2008 (£ 000s)					
Total revenues	694,588.0	6,753,404,341	214,559.2*	3,385,758.8*	230,826.4
Direct debt (at year-end)	224,703.0	949,640,288	21,761.1*	1,529,560.3*	3,674.4
Direct debt (% of operating revenues)	34.6	27.4	14.1*	46.5*	1.6
Net financial liabilities (% of conso oper rev)	32.0	N.A.	(52.2)*	21.4*	33.6
Interest (% of operating revenues)	2.6	1.3	2.0*	3.9*	2.1
Population	201,000	696,519.0§	208,300.0*	795,200.0*	62,123.0

*Figures for 2007. ¶Figures for 2006. §Figures for 2005. N.A.--Not available.

Economy

Wealthy, well-diversified economy

Kensington and Chelsea is a wealthy, densely populated area, with a residential population of 201,000 (according to the Office for National Statistics projection for 2009-2010). Its local economy is well diversified in terms of companies (about 10,500) and sectors, with 94.3% of employees being employed in services. Major local employers include Harrods, Associated Newspapers Ltd., the Virgin Group, and the borough itself.

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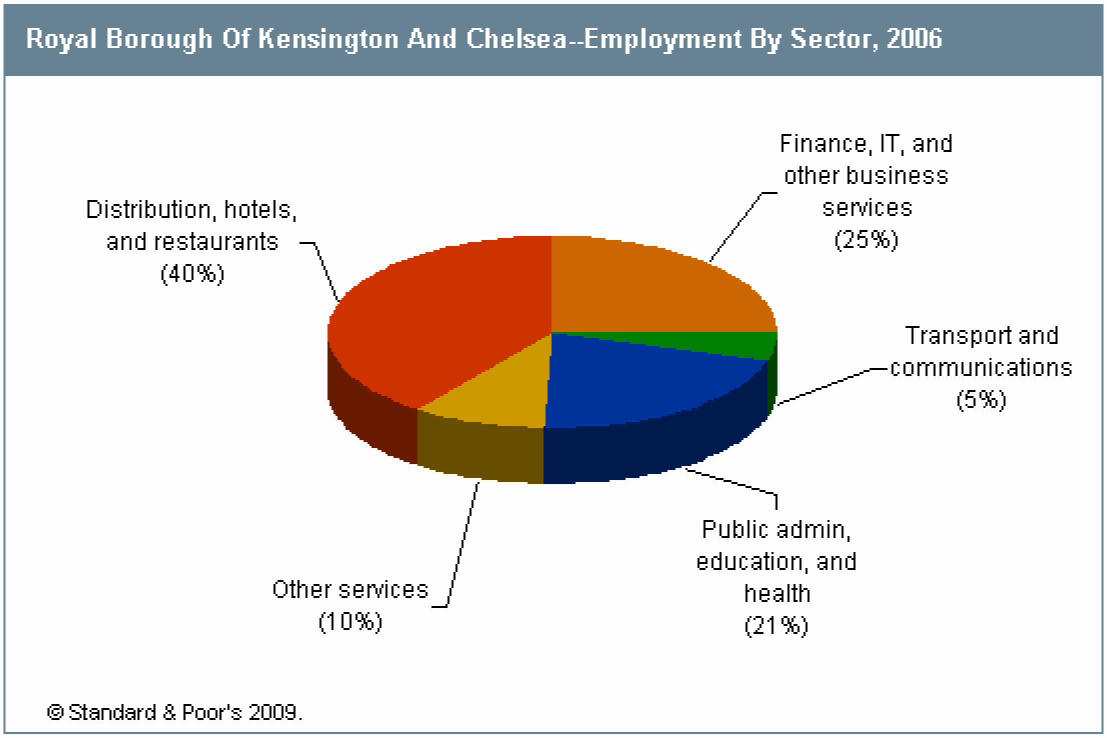

Kensington and Chelsea's overall economic structure is well developed and wealth levels are high, which should provide some resilience in the current U.K. recessionary environment. Over the medium term, growth in the borough may be hampered by the lack of available and affordable real estate, given that Kensington and Chelsea has the highest house prices in the country. At the same time, there are areas of relatively high socioeconomic deprivation within the borough, notably in the north around Ladbroke Grove. This area tends to be the focus for regeneration and renewal initiatives, and is also a focus of service spending pressures.

Management Capacity And Institutional Legitimacy

The borough has benefited from political stability since its formation in 1965. It has been under the continuous majority leadership of the Conservative Party, which now holds 45 seats to the nine held by the Labour Party. The councilors, a number of whom bring an expertise in finance, exercise their influence either as members of Cabinet or through a number of Overview and Scrutiny Committees. The high level of political continuity has been matched by a strong level of continuity among senior management, although the former Executive Director for Finance, Information Systems and Property, Sue Beauchamp, resigned in 2008 and has been replaced by Nicholas Holgate. Mr. Holgate was previously Chief Operating Officer at the Department for Culture, Media, and Sport. The appointment does not appear to have resulted in any major policy change in the provision of services or financial management, although Mr. Holgate has instituted a more cautious approach to treasury management.

The U.K. local government system encourages a highly transparent system of governance, requiring regular external inspections to be carried out by the independent Audit Commission, which then publishes its reports. The Audit Commission's latest Comprehensive Performance Assessment report on Kensington and Chelsea awarded it the top four-star rating, and deemed it to be improving strongly. In Standard & Poor's view, the borough also demonstrates

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a very strong risk management capacity. Together with its extensive reserves, this should enable it to maintain its financial obligations even under severe financial stress.

Financial Flexibility

The borough has a high level of financial flexibility for a U.K. local authority, although only a moderate level compared with European peers, given its high dependence on government grant. Government grant is set to decline in real terms over the next few years, but we consider that the borough can readily absorb this real-term decline, particularly given its flexibility to draw on reserves, raise council tax, and reduce expenditures.

(To calculate total operating revenues, Standard & Poor's takes operating cash flows and deducts the level of non-domestic rate receipts that are collected and passed on to the national pool. This deduction is intended to increase transparency about the borough's own revenues.)

Revenues dominated by central government grant settlements

Kensington and Chelsea's revenue profile is dominated by the allocation of central government transfers, which comprise about one-half of the borough's operating revenues. The current three-year settlement will mean small nominal increases until 2011, but the U.K. government's fiscal challenges could well mean a grant reduction beyond then, even in nominal terms. The grant is calculated according to a funding formula, with reductions limited to a minimum floor. Despite the possibility of reductions in government grant, we still view the borough's dependence on it as largely positive from a credit perspective, given its relative stability and predictability as a revenue source.

Council tax remains low

Council tax, another highly predictable revenue source, generally comprises about 15% of the borough's cash flow operating revenues. Council tax charged by Kensington and Chelsea is relatively low when compared with to the tax charged by most other councils. This allows the borough some political flexibility to raise rates in the future, while keeping to its policy of maintaining council tax in the bottom quartile for London. In the unlikely event that the borough's policy should change, then its maximum possible increase is subject to capping parameters outlined by the central government, which can limit increases to 5% per annum. Such an increase could add about £4 million to Kensington and Chelsea's revenues.

Other income sources

Car-parking income is one of the most important of the borough's other revenue sources, generating net income of about 3% of total operating revenues. Following the extension of the congestion charge zone, revenues from this source have declined by about £3 million (only about 0.5% of operating revenues), but this may return following the Mayor of London's decision to cancel the extension from April 2010.

Various expenditure pressures

Like many U.K. local authorities, Kensington and Chelsea is facing growing spending pressures, particularly in waste management, staff costs, and social care.

For local authorities in general, the rising costs of social care are a major expenditure issue. Demographic trends indicate an increasingly elderly population which will raise the demand for social care, and some of this additional cost may have to be met from within the general budgets of local government. Kensington and Chelsea has more flexibility than most in this area, as it currently provides social care in excess of the statutory minimum requirement. Nevertheless, the funding of social care is likely to be a long-term issue affecting the borough's ability to control

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expenditure.

Capital program will involve significant expenditures

Kensington and Chelsea is currently in the midst of a £248.6 million capital program, running from 2008 to beyond 2012. Of the total program, approximately 60% is set to be funded from grants and land sales, while the remainder will come from the borough's own reserves. The program is spread among a large number of diverse projects, allowing a degree of flexibility to defer expenditures. The main projects include rebuilding Holland Park School, the costs for which should be largely offset by related land sales; the provision of a site for a new academy school in Chelsea, principally funded from the capital expenditures reserve; and investment in council housing stock designed to ensure that 100% of the stock meets the central government's Decent Homes Standard ahead of the current deadline of 2010.

Schools

The borough has some exposure to cost overruns related to Holland Park School, although the nature of schools exposes them to a simpler level of construction risk than, say, hospitals. For the new academy skill, the Department for Education and Skills has agreed to share exposure equally with the borough, while the Church of England, the co-sponsor, has also agreed to make a contribution should costs overrun.

Budgetary Performance

Sound operating performance expected to continue

The borough's budgetary performance has been sound over the past few years, demonstrating good control over budgeted costs. Operating surpluses have been small, averaging 0.4% of cash flow operating revenues over the past three years, but surpluses of this level are not unusual for a U.K. local authority with such high visibility over revenues. (The cash flow operating deficit shown in table 2, at the end of this document, is due to various timing issues, and does not represent a deficit on an accruals basis.) On an accruals basis, the borough's operating position is expected to remain in surplus for the foreseeable future, although this may involve some drawing on reserves (which would be earmarked for projects to reduce recurrent expenditure). For a local authority to budget on an accruals basis for an operating deficit would be against U.K. law.

Over the past few years, the borough has also posted surpluses after capital expenditures. This has enabled it to build on an unusually high level of cash and short-term investments, although this level may decline by as much as half between 2008 and 2011, to fund the borough's capital program, assuming the borough continues to reduce its debt levels.

Liquidity And Debt Management

The borough's strong liquidity position is demonstrated by its high level of cash and short-term investments--£223.5 million as at financial year-end 2008--which are currently invested according to a highly risk-averse strategy. After deducting reserves set aside for the capital program, or restricted for other reasons, we calculate that actual free cash is still in excess of £100 million. This is a significant credit strength, representing nearly half of the borough's debt, and gives the borough an important flexibility to take advantage of current prices when finally deciding whether to fund its capital program through selling land, taking out fixed-rate borrowing, or drawing on reserves.

A further source of liquidity is the Public Works Loan Board (PWLB), the government-funded main lender to the

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sector. The PLWB has an obligation to provide loan finance for capital investments on request, provided the borough is within its Prudential Code borrowing limits and is acting legally.

Debt Burden

Moderate debt set to increase only slightly, despite significant capital expenditures

The borough's net financial liabilities (comprising its pension liability, direct debt, and free cash and equivalents) were a moderate 32% of total revenues at financial year-end 2008. This represents a strong credit position, even compared with other 'AAA' local governments in Western Europe.

Outstanding debt at financial year-end 2008 totaled £224.7 million, or 34.6% of operating revenues. Over the next few years, the borough plans to reduce debt gradually to less than 30% of operating revenues by 2011, assuming that it proceeds with planned land sales. In the event that it cannot achieve these in line with its capital expenditure needs, it may increase borrowing temporarily.

As is typical of U.K. local authorities, virtually all the borough's debt is from the Public Works Loans Board. The debt is long-term, fixed-rate, denominated in British pound sterling, and the majority is due to mature in more than 10 years' time.

Pension deficit

At year-end 2008, the borough's two pension schemes had a combined net liability of £86.3 million. This represented just 13.3% of operating revenues, but the net liability is likely to be much larger at year-end 2009, due to the performance of the financial markets. The borough aims to have fully funded its liability by 2018.

Minimal contingent liabilities

The borough has very low exposure to contingent liabilities, given that it has issued only a small number of guarantees amounting to £2.4 million, the largest of which relates to Notting Hill Housing Trust Commercial Properties (£1.6 million).

Table 2

Kensington And Chelsea (Royal Borough Of)--Financial Statistics

	--Financial year ended March 31--				
(£ 000s)	**2008**	**2007**	**2006**	**2005**	**2004**
Operating revenues	648,909.0	658,900.0	629,821.0	602,432.0	560,456.0
Operating expenditures	655,914.0	647,162.0	627,478.0	574,113.0	533,565.0
Operating balance	(7,005.0)	11,738.0	2,343.0	28,319.0	26,891.0
Operating balance (% of operating revenues)	(1.1)	1.8	0.4	4.7	4.8
Capital revenues	45,679.0	46,429.0	75,317.0	44,017.0	32,384.0
Capital expenditures (capex)	42,689.0	56,278.0	41,362.0	33,543.0	29,121.0
Balance after capex	(4,015.0)	1,889.0	36,298.0	38,793.0	30,154.0
Balance after capex (% of total revenues)	(0.6)	0.3	5.2	6.0	5.1
Debt repaid	8,763.0	5,052.0	30,825.0	9,622.0	4,720.0
Gross borrowings	0.0	0.0	26,190.0	10,690.0	10,101.0
Capex (% of total expenditures)	6.1	8.0	6.2	5.5	5.2
Direct debt (debt outstanding at year-end)	224,703.0	224,919.0	230,085.0	234,955.0	234,344.0
Direct debt (% of operating revenues)	34.6	34.1	36.5	39.0	41.8

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Table 2

Kensington And Chelsea (Royal Borough Of)--Financial Statistics (cont.)					
Interest (% of operating revenues)	2.6	2.6	2.7	2.8	2.9

f--Forecast. b--Budgeted. e--Estimated. p--Planned. N.A.--Not available

Ratings Detail (As Of July 8, 2009)*	
Kensington and Chelsea (Royal Borough of)	
Issuer Credit Rating	AAA/Negative/A-1+
Issuer Credit Ratings History	
21-May-2009	AAA/Negative/A-1+
05-Mar-2001	AAA/Stable/A-1+
Default History	
None	
Population	201,000 (2009-2010 Office for National Statistics projection)
Current Government	
The borough council has been under continuous majority leadership of the Conservative Party since the formation of the borough in 1965.	
Election Schedule	
Last council elections…2006 Next council elections…2010	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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