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RESEARCH

# Kensington and Chelsea (Royal Borough of)

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## Major Rating Factors

**Issuer Credit Rating**

AAA/Stable/A-1+

### Strengths:

- Sound budgetary performance to date.
- Very low net debt position by international standards.
- Strong financial and regulatory support from the U.K. government.
- Financial flexibility to raise council tax, increase borrowing, or draw on reserves, if needed.

### Weaknesses:

- Forecast cash flow deficits, as major capital program begins.
- Expenditure pressures, particularly relating to waste management and reducing the pension deficit.
- Dependence on centrally assessed revenues, which limits financial autonomy.

## Rationale

The ratings on the Royal Borough of Kensington and Chelsea in London reflect its sound budgetary performance, substantial reserves, moderate debt, and the supportive U.K. local government regulatory system. These factors more than offset ongoing spending pressures and the dependence on centrally assessed revenues.

Financial performance was strong during the financial year ending March 31, 2006 (financial 2005/2006), generating a cash flow surplus after capital expenditures of 4.2% of total revenues. Over the next few years, however, the borough expects to post deficits as a consequence of a major step-up in capital expenditures. The planned £250 million capital program is diverse, allowing some flexibility to defer individual projects, but also includes two significant school projects. Standard & Poor's Ratings Services believes that Kensington and Chelsea is well-placed to fund its capital program, thanks to its solid financial position, reflected in a net debt position of just 1.8% of operating revenues as at financial year-end 2006.

Due to the U.K. local government system, Kensington and Chelsea is dependent on centrally-assessed revenues for most of its income, but these revenues are generally stable and predictable. Another key source of income--council tax--has been set by the borough within the lowest quartile of council tax levels in London, with annual increases frozen until the financial year ending March 31, 2008. This should allow relative flexibility to raise tax rates in the future, although the council only plans to introduce modest increases.

Like other U.K. local authorities, Kensington and Chelsea is facing increased spending pressures. In particular, spending on waste management could increase by £3.0 million per year, if the council's plans to meet EU targets on reducing the use of landfill sites do not succeed. In addition, the borough will have to increase its pension contributions to reduce a deficit of 20.6% of operating revenues as at financial year-end 2006. Additional spending pressures could also arise from an expected reduction in car-parking revenues, following the recent extension of the congestion charge zone.

## Outlook

The stable outlook reflects our expectation that the borough's creditworthiness will not be significantly affected by the planned step-up in capital expenditures. Small deficits after capital expenditures are being forecast over the medium term, which will be funded by a combination of borrowing, the use of reserves, and eventual land sales. We expect gross debt to rise to about 30% of total revenues over the next few years, while reserves are drawn down before being replenished by income from land sales. If, for some reason, the reserves are not replenished, then Kensington and Chelsea's net debt position might reach the higher end for an 'AAA' rated Western European local government, and further borrowing might put pressure on that position.

## Comparative Analysis

Kensington & Chelsea's economy compares well with its other highly rated international peers in terms of average wealth levels and diversity, although its population is relatively small, particularly compared with France's Department of Hauts de Seine (AAA/Stable/--)(see table 1). As a U.K. local authority, however, Kensington and Chelsea is much less exposed to the performance of the local economy than the majority of its peers. This is due to the highly centralized nature of the U.K. financing system. Kensington and Chelsea therefore has far lower levels of modifiable revenues than its peers such as the Cities of Saskatoon (AAA/Stable/--) in Canada, or Stockholm (AA+/Stable/A-1+; Nordic national scale K-1) in Sweden. A low level of modifiable revenues tends to be a negative credit feature. In Kensington and Chelsea's case, however, this feature is offset by the stable and predictable nature of the borough's centrally-assessed revenues, strong regulatory support provided by the central government of the U.K. (AAA/Stable/A-1+), and Kensington & Chelsea's high level of reserves.

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. This has enabled it to build on an unusually high level of cash and short-term investments that is almost equivalent its total debt. This gives it a minimal net debt profile, although it will increase over the next few years to fund a large capital program. Within a few years, however, we expect that Kensington and Chelsea's reserves will be replenished by some significant proceeds from land sales. If, for some reason, the reserves were not replenished in line with current expectations, then Kensington and Chelsea's net debt position could reach the higher end for an 'AAA' rated Western European local government, and further borrowing might put pressure on this position.

**Table 1**

**Royal Borough of Kensington And Chelsea 2006 Peer Comparison**

| | **Kensington And Chelsea (Royal Borough of)** | **'AAA' Median** | **Hauts De Seine (Department of)** | **Saskatoon (City of)** | **Stockholm (City of)** |
|---|---|---|---|---|---|
| Issuer credit rating* | AAA/Stable/A-1+ | N/A | AAA/Stable/-- | AAA/Stable/-- | AA+/Stable/A-1+ |
| | **Kensington And Chelsea** | **AAA' Median¶** | **Hauts De Seine¶** | **Saskatoon¶** | **Stockholm¶** |
| **Three-year averages, actual results** | | | | | |
| Operating balance (% of operating revenues) | 2.6 | 11.9 | 27 | 18.9 | 0.1 |
| Balance after capital expenditures (% of total revenues) | 4.4 | 0.5 | 9.5 | (4.6) | (1.2) |
| Capital expenditures (% of total expenditures) | 4.5 | 16.6 | 22.2 | 25.1 | 5.1 |
| **2006** | | | | | |
| Total revenues (€000s) | 1,280,564.0 | 1,949,528,000.0 | 1,529,800.0 | 207,828.0 | 4,010,058.5 |
| Modifiable revenues (% of operating revenues) | 29.1 | 56.3 | 43.6 | 83.1 | 91 |
| Direct debt (% of operating revenues) | 28.9 | 25.7 | 30.4 | 15.2 | 67.5 |
| Interest (% of operating revenues) | 2.1 | 1.6 | 1.6 | 1.3 | 2.5 |
| Population | 184,100§ | 918,383 | 1,516,650 | 206,500 | 771,038 |

*Ratings at June 5, 2007. ¶Figures for 2005. §Figures for 2004. N/A--Not applicable.

## System Support And Predictability

The U.K. intergovernmental system is highly centralized, and this provides a highly stable, supportive, and predictable structure. Compared with their European peers, U.K. local governments have low levels of autonomy and are heavily supervised by central government. About two-thirds of local authorities' income is centrally allocated through grants and business rates, with much of it earmarked for specific purposes.

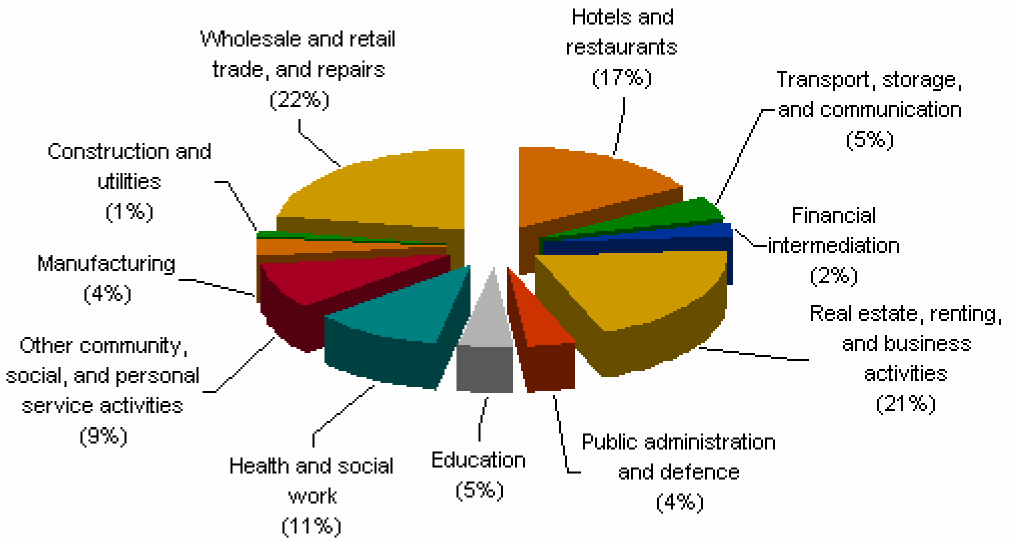
The U.K. government is currently considering reforms to the local authority financing system, following the recent report of the Lyons Inquiry. We believe, however, that the consequent reforms are unlikely to undermine the high investment-grade credit characteristics of U.K. local authorities. (For more on the implications on the Lyons Inquiry, see the article entitled, "Report Card: U.K. Local Authorities Debt Beginning To Rise, But Financial Flexibility Still Constrained," published on May 1, 2007, on RatingsDirect.)

## Economy

**Wealthy, well-diversified economy**
Kensington and Chelsea is a wealthy, densely populated area, with a residential population of 184,100. A significant number of nonresidents also enter the area during the day to visit the well-known shops and museums. This places significant demands on the borough's infrastructure and, in particular, on transportation and highways, which are partly the borough's responsibility.

The local economy is well diversified across more than 10,000 companies covering a number of sectors (see chart). Major local employers include Harrods, Associated Newspapers Ltd., the Virgin Group, and the borough itself.

Royal Borough Of Kensington And Chelsea Employment By Sector






Kensington and Chelsea's overall economic structure is well developed and wealth levels are high, with gross value added growth in the surrounding area forecast to continue at about 2.5% per year. Growth in the borough itself, however, 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.

London's congestion charge zone has been recently extended to include most of the area. The borough had opposed the extension, concerned that it might have an adverse effect on the local economy. It is too early to say, however, whether traffic flows have actually declined significantly enough to have a material effect on local businesses. Another development that could affect the local economy is a major project to construct a large complex, including associated transport infrastructure, in White City, which is within the boundaries of a neighboring borough. This is likely to create new work opportunities, but could also lead to a more competitive environment for certain businesses in Kensington & Chelsea.

## 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. This high level of political continuity, together with a strong level of continuity among senior management, is reflected in a consistency of policy in both the provision of services and financial management. The councilors, a number of who bring an expertise in finance, exercise their influence either as members of Cabinet or of a number of Overview and Scrutiny Committees. In addition, a new audit committee, including people from outside the council, has recently been formed.

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 & Chelsea awarded it the top four-star rating.

## Financial Flexibility

**Revenues dominated by central government grant settlements**

Kensington and Chelsea's revenue profile is dominated by the allocation of central government grant. Recent settlements have been favorable for Kensington & Chelsea in that they have been above inflation, although they have varied from year to year as funding formulae have changed. Future grant settlements are subject to the outcome of the 2007 Comprehensive Spending Review (CSR), which will announce settlement for three years in advance. The CSR settlements are likely to be tight across government. As a local authority, however, Kensington & Chelsea's settlements are likely to continue to be protected by a minimum floor. This should ensure at least nominal annual increases, or at least restrict significant reductions, thereby providing a degree of financial stability.

**Council tax remains low**

Kensington and Chelsea has frozen its council tax rates for financial 2006/2007 and 2007/2008, ensuring that its rate remains one of the lowest in London. This should allow the borough relative flexibility to raise rates in the future, albeit within the capping parameters outlined by the central government, which can limit increases to as little as 5%. The borough's policy, however, will be to maintain council tax in the bottom quartile for London.

**Other income sources**

Car-parking income is an important revenue source for the borough, generating net income of about 3% of total operating revenues. Following the recent extension of the congestion charge zone, however, revenues from this source are likely to decline. The borough had forecast a decline in annual revenues by as much as £4 million (0.5% of total operating revenues), but evidence to date indicates the fall is unlikely to be that much, as traffic flow has not declined as significantly as expected. Furthermore, car-parking revenues have recently been supplemented by an increase in the penalty charge rate. Looking forward, the borough is considering other trading activities that might generate additional revenues.

The U.K. government has recently introduced a scheme to reward local authorities that experience growth in their local business tax bases. Through this scheme, Kensington and Chelsea recently received £7 million (0.9% of operating revenues). This is not, however, expected to be a stable revenue source over the medium term.

**Various expenditure pressures**

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

For local authorities in general, the rising costs of social care are a major expenditure issue. Demographic trends indicate that an increasingly elderly population will increase 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 expenditure.

Due to various EU directives, another important expenditure pressure for most local authorities is likely to be waste management. If certain targets relating to the use of landfill sites are not met, then this could result in significant EU-imposed fines. To reduce landfill, Kensington and Chelsea has made plans with other local authorities to build a new incinerator at Bexley. Construction, however, is being delayed due to various planning objections. Continued delays could mean fines, or additional annual expenditures of about £3 million to purchase transferable credits.

### Capital program will involve significant expenditures

Kensington and Chelsea has embarked on a significant £250 million capital program up to 2010, of which the first year has been completed under budget. Of the total program, approximately £100 million will be funded from central government grants, capital contributions, and capital receipts. 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 eventual 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 by 2008--two years before the deadline.

**Schools.** The borough is exposed to cost overruns related to Holland Park School. This could be significant, given that construction is already being delayed by some objections from local residents. In contrast, the borough has shared its exposure to cost overruns on the new academy school. The Department for Education and Skills has agreed to share exposure equally with the borough, while the Church of England, the cosponsor, 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 strong over the past few years, based as it is on strict budgetary control over expenditures and efficient revenue collection. In cash flow terms, surpluses after capital expenditures were 4.2% of total revenues in financial 2005/2006. Overall budgetary performance is expected to remain strong relative to the sector, but the borough is forecasting small deficits after capital expenditures in the medium term. This will reflect the significant capital program, as well as the strategic decision to reduce the overall level of reserves. Within about five years, however, the reserves should be replenished by substantial capital revenues resulting from the sale of land that is currently part of the Holland Park School site.

On an accruals basis, the borough has remained well within its overall budget in recent years, and was about £11.2 million below budget in financial 2005/2006, partially due to higher-than-expected car parking revenues and investment income. Despite the upcoming capital program, and the loss of interest income as reserves diminish, the borough's operating position is expected to remain in surplus for the foreseeable future. Indeed for a local authority to budget for an operating deficit would be against U.K. law. This legal framework is an important credit factor. Offering further comfort from a credit perspective, the borough financial position is regularly reviewed internally, with budgets monitored by councilors on a quarterly basis, and senior management on a monthly basis.

The variance between the small £179,000 operating surplus shown in table 2, and the £11.2 million underspend referred to above, which generated a substantial cash surplus, is due to various technical accounting reasons. For instance, on the cash flow statement, some of the surplus has been entered as additional operating expenditure where it represented a transfer to reserves.

## Liquidity And Debt Management

The borough's strong liquidity position is demonstrated by its high level of cash and short-term investments--£215.6 million as at financial year-end 2006--which is equivalent to 93.7% of the borough's total debt. A major credit strength is the borough's flexibility to choose between funding its capital program through selling its short-term investments, or increasing debt. This flexibility enables the borough to defer borrowing when, for instance, interest rates are relatively high.

Of the borough's cash and short-term investments, up to £50 million could be managed externally in financial 2005/2006, increasing to £60 million in 2006/2007; the remainder is managed in-house. The borough has adopted an appropriate risk-averse treasury management strategy regarding these investments. For example, it has invested in gilts and made deposits with highly rated banks, the key objective being to preserve capital value.

## Debt Burden

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

Outstanding debt at financial year-end 2006 totaled a low £230.1 million, or 28.9% of operating revenues, at financial year-end 2006. Although the borough borrowed during the year to fund its capital program, overall debt levels decreased due to a loan of £30 million being repaid to the borough by the Higher Education Funding Council for England. The borough used the £30 million to repay debt.

To part-fund its capital program up to 2010, the borough plans to increase debt to about 30% of operating revenues. The remainder of the capital funding will come from grants, capital receipts, and reserves and revenue funding--unless the borough chooses to increase borrowing instead. In any event, Kensington and Chelsea plans to stay well within its authorized borrowing limits according to the Prudential Code.

By 2010, the level of cash reserves is likely to decrease to about £64.6 million. Soon after this, however, the sale of land associated with the Holland Park school development is expected to generate substantial revenues that will boost reserves.

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.

## Contingent Liabilities

The borough has issued guarantees amounting to £2.4 million, the largest of which relates to Notting Hill Housing Trust Commercial Properties (£1.6 million).

### Pension deficit

At year-end 2006, the borough's two pension schemes had a combined deficit of £163.6 million, a sizable 20.6% of operating revenues. This is based on the FRS17 valuation. The next actuarial revaluation, which uses less conservative assumptions than FRS17, is due 2007, and this will lead to recommendations on the future employer's contribution rate. Contribution rates on the two schemes are currently 16.4% and 20.5% of pensionable pay, or £12.2 million, designed to close the pension deficit by 2018.

**Table 2**

**Royal Borough of Kensington and Chelsea Financial Statistics**

| (£000s) | 2007e | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| **Budget indicators** | | | | | |
| Operating revenues | 828,000.0 | 795,925.0 | 738,446.0 | 696,470.0 | 690,516.0 |
| Operating expenditures | 855,000.0 | 795,746.0 | 710,127.0 | 669,579.0 | 667,456.0 |
| Operating balance | (27,000.0) | 179.0 | 28,319.0 | 26,891.0 | 23,060.0 |
| Operating balance (% of operating revenues) | (3.3) | 0.0 | 3.8 | 3.9 | 3.3 |
| Capital revenues | 28,000.0 | 75,317.0 | 44,017.0 | 32,384.0 | 39,667.0 |
| Capital expenditures (capex) | 61,000.0 | 39,198.0 | 33,543.0 | 29,121.0 | 28,844.0 |
| Balance after capex | (60,000.0) | 36,298.0 | 38,793.0 | 30,154.0 | 33,883.0 |
| Balance after capex (% of total revenues) | (7.0) | 4.2 | 5.0 | 4.1 | 4.6 |
| Debt repaid | 5,165.0 | 30,825.0 | 9,622.0 | 4,720.0 | 6,392.0 |
| Gross borrowings | 0.0 | 26,190.0 | 10,690.0 | 10,101.0 | 3,280.0 |
| Capex (% of total expenditures) | 6.7 | 4.7 | 4.5 | 4.2 | 4.1 |
| **Debt and liquidity** | | | | | |
| Direct debt (debt outstanding at year-end) | 224,918.0 | 230,085.0 | 234,955.0 | 234,344.0 | 229,505.0 |
| Direct debt (% of operating revenues) | 27.2 | 28.9 | 31.8 | 33.7 | 33.2 |

e--Estimated.

| **Ratings Detail** (As Of 05-Jun-2007)* | |
|---|---|
| **Kensington and Chelsea (Royal Borough of)** | |
| Issuer Credit Rating | AAA/Stable/A-1+ |
| **Issuer Credit Ratings History** | |
| 05-Mar-2001 | AAA/Stable/A-1+ |
| **Default History** | |
| None | |

| **Population** | 184,100 (2004) |
|---|---|

**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.

**Additional Contact:** International Public Finance Ratings Europe; PublicFinanceEurope@standardandpoors.com