STANDARD & POOR'S

RATINGSDIRECT®

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Kensington and Chelsea (Royal Borough of)

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Kensington and Chelsea (Royal Borough of)

Issuer Credit Rating
AAA/Stable/A-1+

Major Rating Factors

Strengths:

- Sound budgetary performance
- Low net debt position by international standards
- Strong financial and regulatory support from the U.K. government
- Flexibility to raise council tax, increase borrowing, or draw on reserves

Weaknesses:

- Reserves set to decline, albeit from a high level, to fund major capital program
- 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 the ongoing spending pressures and the dependence on centrally assessed revenues.

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 2.1% 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 a major capital program. The planned 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 at the current rating level, thanks to its moderate debt levels and significant reserves.

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 frozen for the past two years, and only a moderate 2.3% increase is planned for 2008/09. 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 relating to waste management, social care, and staff costs. In particular, the borough will have to increase its pension contributions to reduce an unfunded pension liability of 20.6% of operating revenues as at financial year-end 2007. This pension liability, added to the borough's direct debt, with free cash and equivalents subtracted, led to moderate net financial liabilities of 36.5% of total revenues in 2007. This represents a strong credit position, even compared with other 'AAA' local governments in Western Europe.

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. 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 eventual land sales. We expect gross debt to rise to about 41% of operating 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 financial liabilities position might reach the higher end for a 'AAA' rated Western European local government, and further borrowing 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 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. local government financing system. Kensington and Chelsea therefore has far higher dependence on central government transfers 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.

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 roughly equivalent to its total debt. This more than offsets the borough's relatively high gross debt level, which is slightly higher than the 'AAA' median.

Table 1

Kensington And Chelsea (Royal Borough Of) 2007 Peer Comparison

	Kensington And Chelsea (Royal Borough Of)	AAA Median	Hauts De Seine (Department Of)	Saskatoon (City Of)	Stockholm (City Of)
Issuer credit rating (LC)	AAA/Stable/A-1+	N/A	AAA/Stable/--	AAA/Stable/--	AAA/Stable/A-1+
Issuer credit rating (FC)	AAA/Stable/A-1+	N/A	AAA/Stable/--	AAA/Stable/--	AAA/Stable/A-1+
National scale ratings	N/A	N/A	N/A	N/A	--/--/K-1
Three-year averages, using actual results only					
Operating balance (% of operating revenues)	2.1	9.3	28.0*	15.7*	0.4
Balance after capital expenditures (% of total revenues)	3.8	3.1	9.5*	(11.6)*	2.1
Capital expenditures (% of total expenditures)	6.4	11.5	23.6*	28.0*	4.2
Transfers received (% of total revenues)	49.7	16.3	26.3*	7.5*	2.4
2007 (£000s)					
Total revenues	705,329.0	8,507,629,267	1,187,904.8*	170,228.1*	3,185,119.6*
Direct debt (at year-end)	224,919.0	1,751,929,261	199,344.8*	19,717.2*	1,876,566.0*

Table 1

Kensington And Chelsea (Royal Borough Of) 2007 Peer Comparison(cont.)					
Direct debt (% of operating revenues)	34.1	28.5	17.6*	12.5*	68.0*
Net financial liabilities (% of total revenues)	36.5	N/A	17.5*	(53.3)*	16.4*
Population	178,000.0¶	787,708.5¶	1,504,697.0§	207,200.0*	782,885.0*

*Figures for 2006. ¶Figures for 2005. §Figures for 2004. N/A--Not applicable.

System Support And Predictability

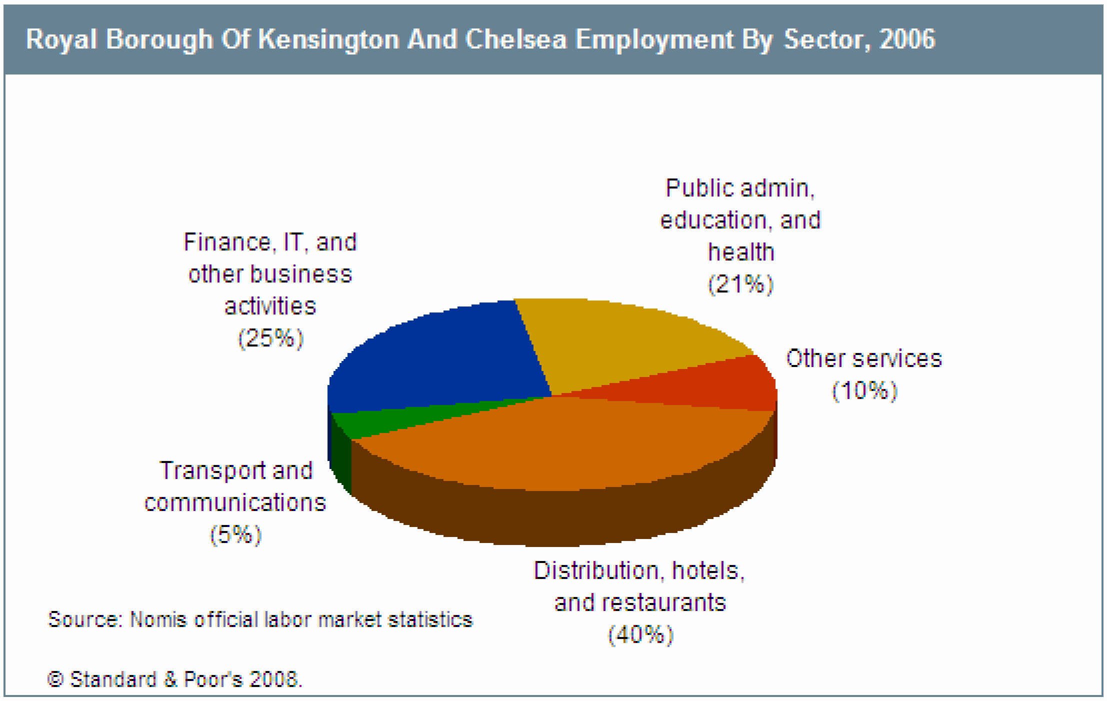
The U.K. intergovernmental system is highly centralized, and this provides a highly stable, supportive, and predictable structure. Compared with their European peers, U.K. local governments have low levels of autonomy and are heavily supervised by central government. About two-thirds of local authorities' 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 178,000. 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.



Kensington and Chelsea's overall economic structure is well developed and wealth levels are high, with gross value added (GVA) 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.

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 CFO, Sue Beauchamp, has resigned in the past year to pursue other opportunities, and her replacement has yet to be appointed. We do not expect the appointment of her successor to result in any major policy change in the provision of services or financial 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.

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, given its flexibility to raise council tax, reduce expenditures, and its track record of controlling costs and posting recurrent surpluses.

(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, and represents a change from our previous practice.)

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 recently announced three-year settlement for the largest of these grants is below inflation, with annual increases of just 2.0%, 1.75%, and 1.5%. Although this grant is calculated according to a funding formula, settlements in the years ahead are likely to continue to be protected by a minimum floor that will probably ensure nominal annual increases, or at least restrict significant reductions, thereby providing a degree of financial stability.

Council tax remains low

Council tax, a highly predictable revenue source, is set to decline slightly as a share of Kensington and Chelsea's cash flow operating revenues from 15.9% in 2006 to 14.5% in 2008. This reflects the borough's decision to freeze its council tax rates over the past two years, and introduce a nominal rise of just 2.3% for financial 2008/09. 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 5% per annum. (Such an increase would still increase Kensington and Chelsea's revenues by about £5 million.) The borough's policy, however, will be to maintain council tax in the bottom quartile for London.

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 recent extension of the congestion charge zone, however, revenues from this source are likely to decline. To replace this, 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 has received approximately £8 million spread over financial 2005/06 and 2006/07. Although a further amount is expected in 2008/09, the borough does not regard this as an ongoing revenue source, and it has invested the money in a strategic reserve account.

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 that an increasingly elderly population 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 expenditure.

Capital program will involve significant expenditures

Kensington and Chelsea is currently in the midst of a significant £206 million capital program. Of the total program, approximately £43 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 well within the deadline of 2010.

Schools

The borough has some exposure to cost overruns related to Holland Park School. This could be significant, given that construction has already been delayed by objections from local residents. The borough is confident, however, that their revised plan will proceed without any material increase in costs. 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 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 2.1% 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 borough's operating position is expected to remain in surplus for the foreseeable future. Indeed, 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 will reduce over the next few years to fund its capital program. By 2012, however, we expect that Kensington and Chelsea's reserves may be replenished by significant proceeds from land sales.

Liquidity And Debt Management

The borough's strong liquidity position is demonstrated by its high level of cash and short-term investments--£255 million as at financial year-end 2008. After deducting reserves set aside for the capital program, or restricted for other reasons, we calculate actual free cash and equivalents of £156 million. This is still a significant credit strength, representing 73.0% of debt outstanding, and gives the borough flexibility to choose between borrowing and using reserves to fund its capital program.

Of the borough's cash and short-term investments, up to £60 million can be managed externally; the remainder is managed in-house. The borough has adopted a 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.

A further source of liquidity is the Public Works Loan Board (PWLB), the government-funded main lender to the 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 36.5% of total revenues at financial year-end 2007. This represents a strong credit position, even compared with other 'AAA' local governments in Western Europe.

Outstanding debt at financial year-end 2007 totaled £224.9 million, or 34.1% of operating revenues. To part-fund its capital program, the borough plans to increase debt between financial year-end 2007 and 2010 by £63.0 million to about 41% of revenues. Over the same period, the borough plans to draw down about £90 million of cash and short-term investments--unless the borough chooses to increase borrowing instead. The remainder of the capital funding will come from grants, capital receipts, and revenue funding.

By 2012, the sale of land associated with the Holland Park School development is expected to generate capital revenues that will in effect fund the building of the school and, depending on market conditions at the time of sale, may provide a surplus that will be reinvested in other education and sporting facilities within the borough.

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 2007, the borough's two pension schemes had a combined unfunded liability of £136.0 million, representing 20.6% of operating revenues. Although this liability has been reduced by £27.6 million over the past year, the borough has decided to increase its employer's contribution by about £1 million per year, with a view to fully funding the 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

	--Year ended Dec. 31--					
	2010f	2009f	2008e	2007	2006	2005
(£000s)						
Operating revenues	698,000.0	682,000.0	662,000.0	658,900.0	629,821.0	602,432.0

Table 2

Kensington and Chelsea (Royal Borough of) Financial Statistics(cont.)						
Operating expenditures	689,000.0	675,000.0	663,000.0	649,297.0	629,642.0	574,113.0
Operating balance	9,000.0	7,000.0	(1,000.0)	9,603.0	179.0	28,319.0
Operating balance (% of operating revenues)	1.3	1.0	(0.2)	1.5	0.0	4.7
Capital revenues	13,000.0	23,000.0	27,000.0	46,429.0	75,317.0	44,017.0
Capital expenditures (capex)	69,000.0	61,000.0	36,000.0	54,143.0	39,198.0	33,543.0
Balance after capex	(47,000.0)	(31,000.0)	(10,000.0)	1,889.0	36,298.0	38,793.0
Balance after capex (% of total revenues)	(6.6)	(4.4)	(1.5)	0.3	5.2	6.0
Debt repaid	10,000.0	11,000.0	11,000.0	5,166.0	30,825.0	9,622.0
Gross borrowings	15,000.0	16,000.0	0.0	0.0	26,190.0	10,690.0
Capex (% of total expenditures)	9.1	8.3	5.2	7.7	5.9	5.5
Direct debt (debt outstanding at year-end)	287,920.0	271,920.0	247,920.0	224,919.0	230,085.0	234,955.0
Direct debt (% of operating revenues)	41.3	39.9	37.5	34.1	36.5	39.0

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

Ratings Detail (As Of June 19, 2008)*	
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	178,000 (2005)
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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