

## CREDIT OPINION

20 November 2017

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### RATINGS

#### Aberdeen City Council

Domicile	United Kingdom
Long Term Rating	Aa3
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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# Aberdeen City Council (United Kingdom)

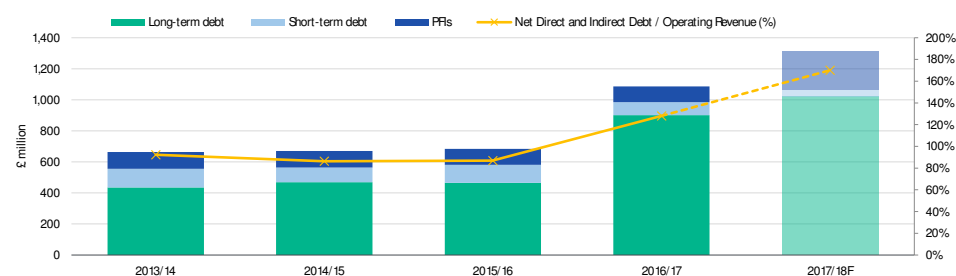
## Update to credit analysis

### Summary

The credit profile of Aberdeen City Council (ACC) (Aa3 stable) reflects a strong institutional framework, a strong track record of operating performance and a wealthy local economy, in addition to consideration of the increase in ACC's debt levels from 2016/17 to finance their capital programme, and key project risk from the development of the Aberdeen Exhibition and Conference Centre (AECC). The credit profile also reflects our assessment of support from the UK government (Aa2 stable) and the high likelihood it would intervene in the event that ACC were to face acute liquidity stress.

Exhibit 1

#### Aberdeen City Council's debt level has risen significantly from 2016/2017



Source: Issuer, Moody's

### Credit Strengths

- » Strong institutional framework for Scottish Local Authorities (LAs), similar to England
- » Wealthy local economy albeit with exposure to oil and gas industries and their supply chains
- » Strong financial performance track record expected to be maintained
- » Slow evolution of Scottish framework brings insulation to fluctuations in key industries

### Credit Challenges

- » Debt has increased in size and complexity in 2016/17
- » Continued achievement of operating surpluses will require implementation of ambitious savings programmes

- » Key project risk associated with the development of Aberdeen Exhibition and Conference Centre

## Rating Outlook

ACC's forecast financial performance metrics remain in-line with peers, underpinning the stable outlook. The stable outlook on the UK sovereign further supports the stable outlook on ACC.

## Factors that could lead to an upgrade

- » Strengthening financial performance
- » Significant reduction of debt level
- » Diminishment of risks associated with ambitious capital project
- » Reduced susceptibility to volatility in key industries

## Factors that could lead to a downgrade

- » Increasing project risks in the short term arising from a failure to deliver capital project as planned, and in the longer term, a failure to realise projected revenues which undermine the viability of the project
- » Worsening financial performance including failure to achieve revenue expenditure savings and/or reduced Scottish government financial support
- » A material increase in size and nature of debt beyond what is currently anticipated
- » Downgrade of the sovereign rating, a change in the relationship between Scotland and the UK, or a dilution of the regulatory framework for Scottish local authorities

## Key Indicators

Exhibit 2

### Aberdeen City Council

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18F
Net Direct and Indirect Debt / Operating Revenue (%)	98.5	92.3	86.3	87.0	128.0	170.1
Interest payments / Operating revenues (%)	4.8	4.7	4.0	4.0	3.6	5.1
Gross Operating Balance / Operating Revenue (%)	8.0	4.6	10.5	8.3	2.9	7.4
Capital Financial Surplus (Requirement) / Total Revenue	3.5	-1.9	2.6	-3.6	-27.6	-40.1
Intergovernmental Transfers / Operating Revenue (%)	60.2	57.0	55.9	55.7	51.2	55.5
Short-Term Direct Debt / Direct Debt (%)	17.9	18.1	14.1	16.9	7.7	3.3
GDP per capita as % of National Average [1]	146.9	147.1	149.8	143.5	143.5	143.5
Usable Reserves / Operating Revenue (%)	15.4	16.3	16.5	12.7	10.3	9.0

Figures adjusted on a cash basis. [1] Figures restated from GDP to GVA and compare Aberdeen City and Aberdeenshire to the UK average (source: ONS)  
Source: Issuer, Moody's

## Detailed Credit considerations

The credit profile of Aberdeen City Council, as expressed in a Aa3 stable rating, reflects (1) a baseline credit assessment (BCA) of a2, and (2) a high likelihood of extraordinary support from the UK government in the event that the entity faced acute liquidity stress.

## Recent Developments

On September 26th 2017, MPSE downgraded all UK local authorities (LAs), reflecting the sector's institutional and financial ties with the UK sovereign. While the proportion of LA revenues stemming from local sources has increased over the last five years, central government transfers still comprise about half of local authorities' revenues for the sector overall. Furthermore, LAs remain tightly

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bound to fulfill statutory responsibilities determined by national policy. There is a close link between the policies and resources of the UK sovereign government and the LAs', which is reinforced by the monitoring and control mechanisms in place.

### Baseline credit assessment

#### **Strong institutional framework for Scottish local authorities, similar to England**

The institutional framework for UK local authorities is mature and highly developed, underpinned by a number of key pieces of legislation. The UK LA system is one of the most centralised in Europe and as such the ratings of LAs are significantly driven by the sovereign rating, and central government policy.

In Scotland, the responsibility for funding is devolved with the Scottish Government being allocated a block grant from the UK sovereign which currently amounts to some 85% of the total budget. Scottish Government then allocates a block grant to Scottish LAs in the form of a general revenue grant, non-domestic rates income (business rates), and a general capital grant. As in England, Scottish LAs' main sources of non-block grant revenue are council taxes, fees, charges and trading income. Intergovernmental transfers are expected to remain above 50% of ACC's budget for the foreseeable future, which therefore insulates the council from volatility in the local economy. Similarly to English LAs, Scottish LAs have to prepare an annual balanced budget and any failure to meet this requirement means government must be notified by the designated financial officer at the Council. The history of formal intervention by central government into Scottish local government is limited due to few cases of financial distress, but interventions have occurred in relation to PPP schemes, equal pay settlements and following the collapse of Landsbanki and its impact on the investments in the sector.

ACC internal governance and scrutiny is strong, supported by recent assessments from the Accounts Commission. The financial planning process includes a strategic review underpinned by a Medium Term Financial Plan, a Corporate risk register, and monitoring of the financial position which is reported quarterly to the Finance and Resources Committee. Similar to other LAs, ACC manages a number of partnerships with other public bodies in order to deliver its social mandate. In addition to this ACC has shareholdings in a number of entities and subsidiaries in order to support the delivery of its objectives. All are financed by ACC so their funding and savings plans are considered in the Council's Medium Term Financial Plan. None have any debt on their balance sheets.

#### **Wealthy local economy with exposure to oil and gas industries**

ACC is located in the north east of Scotland with a population of 230,000 people. Population growth has been healthy, increasing by close to 10% between 2006 and 2016 in Aberdeen City. ACC is wealthy when compared to the rest of the UK and Scotland. GVA per capita in Aberdeen City and Aberdeenshire is GBP36,726, over 150% of the Scottish average of GBP23,685 in 2015. The city's unemployment rate was 4.8% in 2016/17, marginally higher than the Scottish average of 4.5%. It had a job density of 1.2 in 2015, meaning it is a net attractor of jobs. It also has a highly-skilled population, with 53% educated to NVQ4 and above, compared to 44% in Scotland as a whole.

Key industries include oil and gas, health, and research and development. The oil and gas sector remains the primary driver of employment in the Aberdeen and North East economy through direct and indirect employment. ACC has seen a downturn in the local economy, due to recent falls in commodity prices. This has led to a corresponding fall in employment rates from a high of 77% in 2015/16 to 73% in 2016/17. In addition, the oil and gas industry is particularly exposed to Brexit and therefore may suffer further depending on the final trade deal that is agreed between the UK and the EU. However, the current funding framework, as described in the previous paragraph, shelters ACC from any downturn - or indeed upturn - in the local economy. Non-domestic rates are centralised and redistributed with any shortfall compensated by central government.

#### **Strong financial performance track record expected to be maintained**

The Council has demonstrated a solid financial record for the last 5 years maintaining a net surplus against budget for the last 5 years with previous forecasts on expected outturns being realistic. ACC projects continued surpluses to 2022/23, these being dependent on the realisation of a GBP125 million savings programme between fiscal years 2018/2019 to 2022/2023. We expect surpluses to be maintained, although note the potential impact of the key project risk described below.

Gross operating balance to operating revenues was 2.9% in 2016/2017 and projected to average around 8.2% over the next 3 years if savings are delivered as planned.

ACC has GBP87 million of usable reserves, expected to decrease to GBP64 million by 2018/19. This is a deliberate decision by ACC as they consider the lower level to be a sufficient liquidity cushion. However, key credit risks such as the development of the AECC project could have a material impact on reserves if the construction programme is delayed or experiences cost overruns, or if revenues do not materialise as planned and are insufficient to meet debt servicing costs.

The Housing Revenue Account (HRA), similar to in England, is ring fenced and primarily funded through rents. The Council currently has 22,295 council houses which are covered by a 30 year HRA business plan. As in England, in Scotland the HRA cannot subsidise the general fund or vice versa (Housing Act 1987). We consider the whole of ACC, including the HRA revenues and debt – i.e. the consolidated position, adding around GBP149 million of debt and GBP1,000 million of assets (or about 34% of consolidated ACC total assets). This is a comparable approach to that taken for English LAs.

### **Slow evolution of Scottish framework brings insulation to fluctuations in key industries**

There are slowly evolving institutional changes taking place in Scotland but these should have limited impact on the operating environment for ACC. While results of the Brexit referendum initially brought renewed impetus to the arguments for a second Scottish Independence referendum, we view this as currently having little bearing on the strong ties between the UK Sovereign, the Scottish Government in turn the LA sector.

### **Debt has increased in level and complexity**

ACC issued a GBP370 million index-linked bond in November 2016, maturing in 2054. The bond is intended to support the development of its ambitious capital programme, in particular financing the new Aberdeen Exhibition and Conference Centre (AECC). This has contributed to an increase in ACC's debt level to 128% of operating revenues, rising to 170% in 2017/18.

The benefits of the debt issuance are that it diversifies financing sources and reduces the dominance of the Public Works Loan Board (PWLb) in ACC's Treasury strategy. The bond issuance also allows the council to delay debt service repayment until 2020, when AECC is projected to generate revenues. In addition, the bond issue enables the Council to reduce their reliance on short term funding which will fall to 3.3% in 2017/18 compared to 16.9% in 2015/16.

The drawbacks of the debt issuance are that it increases the complexity of ACC's debt structure as well as increasing their overall debt levels. In addition, while interest on the issuance is relatively low, there is also indexation on the capital. As currently limited ACC revenues are linked to inflation, the issuance of index-linked debt raises the possibility of a potential mismatch between revenues and the indexation on the capital. However, the interest and debt servicing costs (amortising) on the index-linked bond is projected to be covered by the anticipated revenues from the AECC development, if realised as planned.

The remainder of the debt portfolio is simple, with some exposure to LOBOs although these are all held at fixed rates. There is no use of derivatives with respect to interest rate or exchange rate. The Council's current treasury policy states it can have up to 30% variable rate debt, this is currently at 5%.

The treasury policy is straightforward reflecting the uncomplicated debt and treasury arrangements. The investment policy is risk averse with an approved counterparty list with the highest rated entities maintained and adhered to, investments are currently held and planned to be held in highly rated money market funds. Clydesdale Bank plc (Baa2 RUR) is responsible for day-to-day banking facilities and offers an overdraft facility of GBP1.5 million.

ACC also has a number of other existing indirect obligations, the largest of these being the pensions fund which is showing an actuarial deficit of GBP250 million. A 19-year recovery plan has been agreed with the trustee to make up the difference. There is one Public Private Partnership in which ACC is currently involved. It includes a 30 year PPP contract for the construction, maintenance and operation of ten schools. The scheme came into operation between May 2009 and April 2011. This represents a liability of GBP103.6 million which is on balance sheet.

### **Key project risk associated with the development of Aberdeen Exhibition and Conference Centre**

The cornerstone of ACC's capital expenditure programme is the AECC. The project is comprised of a new 12,500 capacity seated/standed arena, exhibition and conference centre, three hotels, car parking facilities and an energy centre. Construction started in July 2016 and is currently anticipated to be complete in the summer of 2019.

The project is intended to consolidate Aberdeen's ability to compete globally with other cities in the energy sector, as well as support the diversification of Aberdeen's economy through leisure and business tourism.

Positive developments this year include securing SMG Europe as the operator of the AECC, and hotel franchise agreements with Hilton and Starwood Hotels. SMG Europe has significant experience as an operator of international conference and event venues, in particular Manchester Arena and the First Direct Arena in Leeds. Construction is currently on schedule and in line with contractual milestones. It should be noted that strong governance and oversight over the project is being maintained, and a number of risk mitigants for the construction programme are in place including: 1) fixed price construction contracts with maximum guaranteed price; 2) developer contracts with incentivisation for delivery on time; 3) an insurance bond; 4) debt servicing delayed until completion of construction.

However, ACC remains exposed to significant revenue risk exposure once the AECC is in operation. As a prominent civic project, its success is likely to be scrutinised and therefore bears significant political and reputational risk for the Council. We also view the AECC development, and ACC's borrowing to finance it, as demonstrating ACC's higher risk appetite than a typical local authority, despite the fact that the project is intended to boost Aberdeen's long term economic performance.

Project delivery, and therefore peak capital expenditure, will take place over the next 2 years, with a capital expenditure programme of GBP240 million in 2017/18 and GBP214 million in 2018/19, falling thereafter. Ability to manage this scale of capital project in a relatively short timescale will remain critical for the delivery of the AECC and ultimately for the capital programme as a whole.

#### **Extraordinary support considerations**

We assign a high likelihood of extraordinary support from the national government (Aa2 stable), reflecting our assessment of the reputation risk to the state were a local government's financing to fail within such a tightly designed and monitored system, in addition to the UK Debt Management Office Public Works Loan Board's stated intention to act as a lender of last resort.

## Rating Methodology and Scorecard Factors

The BCA matrix generates an estimated BCA of a2, the same as the BCA assigned by the rating committee.

The matrix-generated BCA of a2 reflects (1) an idiosyncratic risk score of 4 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aa2, as reflected in the sovereign bond rating (Aa2 stable).

Exhibit 3

### Aberdeen City Council

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub- factor Total	Factor Weighting	Total
<b>Scorecard</b>						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	1	144.36	70%	2.2	20%	0.44
Economic volatility	5		30%			
<b>Factor 2: Institutional Framework</b>						
Legislative background	1		50%	3	20%	0.60
Financial flexibility	5		50%			
<b>Factor 3: Financial Performance and Debt Profile</b>						
Gross operating balance / operating revenues (%)	3	5.55	12.5%	3.25	30%	0.98
Interest payments / operating revenues (%)	5	3.77	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	128.04	25%			
Short-term direct debt / total direct debt (%)	1	7.73	25%			
<b>Factor 4: Governance and Management - MAX</b>						
Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						3.52(4)
<b>Systemic Risk Assessment</b>						Aa2
<b>Suggested BCA</b>						a2

Source: Issuer, Moody's

## Ratings

Exhibit 4

Category	Moody's Rating
<b>ABERDEEN CITY COUNCIL</b>	
Outlook	Stable
Issuer Rating -Dom Curr	Aa3
Senior Unsecured -Dom Curr	Aa3

Source: Moody's Investors Service

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