

CREDIT OPINION

22 November 2018

✓ Rate this Research

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

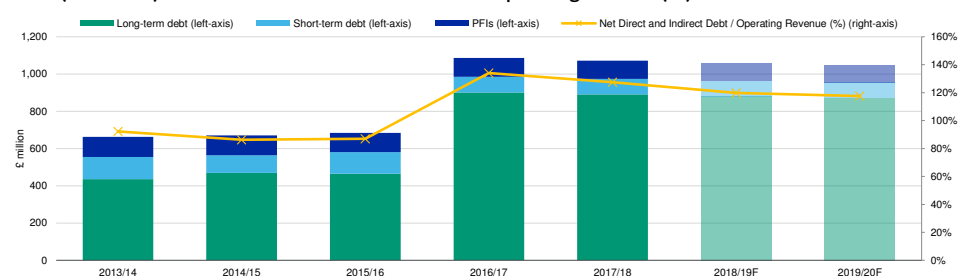
Summary

The credit profile of [Aberdeen City Council \(Aberdeen, Aa3 stable\)](#) reflects a strong institutional framework, a strong track record of operating performance and a wealthy local economy, in addition to a high debt burden, which is likely to gradually decline going forward, to finance their capital programme and key project risk from the development of The Event Complex Aberdeen (TECA). The credit profile also reflects a high likelihood that the [Government of United Kingdom \(Aa2 stable\)](#) would intervene in the event of acute liquidity stress.

Exhibit 1

Aberdeen City Council's debt is expected to decline gradually as its capital programme ramps down

Debt (£ millions) and net direct and indirect debt as % operating revenue (%)



Sources: Issuer, Moody's Investors Service

Credit strengths

- » Strong institutional framework for Scottish local authorities
- » Wealthy local economy, with exposure to oil and gas industries
- » Strong track record of financial performance

Credit challenges

- » Debt has increased in size and complexity in recent years, but is expected to gradually decline from fiscal 2018
- » Implementation of ambitious savings programme to reduce projected operating deficits
- » Exposure to key project risks associated with the development of The Event Complex Aberdeen

Rating outlook

Aberdeen's outlook is stable, consistent with its stable and gradually declining debt metrics and consistently strong operating performance. The stable outlook on the UK's sovereign rating further supports the stable outlook on Aberdeen's credit profile.

Factors that could lead to an upgrade

Factors that could lead to an upgrade include a significant reduction in debt levels, a reduction of the risks associated with its ambitious capital programme and a strengthening of its reserves balance.

Factors that could lead to a downgrade

Factors that could lead to a downgrade include a failure to deliver capital projects as planned and to realise projected revenues in the longer time, worsening financial performance and a material increase in debt levels beyond what is anticipated. In addition, a downgrade of the sovereign rating, a change in the relationship between Scotland and the UK or a dilution of the regulatory and institutional framework for Scottish local authorities could also exert downward pressure on the rating.

Key indicators

Exhibit 2

Aberdeen City Council

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19F	2019/20F
Net Direct and Indirect Debt / Operating Revenue (%)	92.3	86.3	87.0	134.0	127.5	119.8	117.5
Interest payments / Operating Revenue (%)	4.7	4.0	4.0	3.8	5.4	4.7	4.7
Gross Operating Balance / Operating Revenue (%)	4.6	10.5	8.3	3.1	3.3	7.4	5.6
Capital Financial Surplus (Requirement) / Total Revenue (%)	-1.9	2.6	-3.6	-28.8	-10.5	-2.3	6.5
Intergovernmental Transfers / Operating Revenue (%)	57.0	55.9	55.7	53.4	50.9	49.1	49.1
Short-Term Direct Debt / Direct Debt (%)	18.1	14.1	16.9	7.7	7.7	7.8	7.9
GDP per capita as a % of national average	143.0	144.9	137.8	134.6	134.6	--	--
Usable Reserves / Operating Revenue (%)	16.3	16.5	12.7	10.8	7.8	7.2	7.2

Figures adjusted on a cash basis. [1] Gross value-added figures for Aberdeen and Aberdeenshire as a percentage of the UK average (source: Office for National Statistics, "ONS").

Sources: Issuer, Moody's Investors Service

Detailed credit considerations

The credit profile of Aberdeen, as expressed by the 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 faces acute liquidity stress.

Baseline credit assessment

Strong institutional framework for Scottish local authorities

The institutional framework for UK local authorities (LAs) 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 rating 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. The 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 around 50% of Aberdeen's budget for the foreseeable future, which insulates the council from volatility in the local economy. Similar to English LAs, Scottish LAs have to prepare an annual balanced budget and any failure to meet this requirement means the government must be notified by the designated financial officer at the council. Central government has powers to intervene in the governance of a local authority, if necessary, and these powers have been used recently - in May 2018 - at Northamptonshire County Council to take-over their financial management and governance.

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Aberdeen's 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 City Growth and Resources Committee). Similar to other LAs, Aberdeen manages a number of partnerships with other public bodies to deliver its social mandate. In addition to this, Aberdeen holds shares in a number of entities and subsidiaries to support the delivery of its objectives. All are financed by Aberdeen, so their funding and savings plans are considered in Aberdeen's medium-term financial plan. None have any debt on their balance sheets.

Wealthy local economy, with exposure to oil and gas industries

Aberdeen is located in the north east of Scotland, with a population of 230,000. Aberdeen is wealthy compared with the rest of the UK and Scotland. Gross value added per capita in Aberdeen City was £36,292 in 2016, or 145% of the Scottish average of £24,876. Aberdeen's unemployment rate was 4.3% in fiscal 2018, marginally higher than the Scottish average of 3.8%. It had a job density of 1.2 in 2016, which means it is a net attractor of jobs. It also has a highly skilled population, with 52% educated to National Vocational Qualifications level 4 and above in 2017, compared with the Scottish figure of 44%.

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 Scotland's economy through direct and indirect employment. The recent oil price crash corresponded to a downturn in the local economy in Aberdeen with employment rates falling from a high of 77% in 2015-16 to 73% in fiscal 2017 - showing the sensitivity of the health of the local economy to the oil and gas sector. In addition, the oil and gas industry is particularly exposed to the Brexit, and therefore may suffer further depending on the final trade deal that is agreed between the UK and the European Union. However, the current funding framework, as described in the previous paragraph, shelters the council from much of the negative impacts of the downturn — or indeed upturn — in the local economy. Non-domestic rates are centralised and redistributed with any shortfall compensated by central government.

While the 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 government, the Scottish government and in turn the LA sector.

Strong track record of financial performance

Aberdeen has demonstrated a solid financial record for the last five years, maintaining a net budget surplus for the last five years with previous forecasts on expected out-turns being realistic. Aberdeen projects continued surpluses up to fiscal 2023, which are dependent on the realisation of a £125 million savings programme between fiscal years 2019 to 2023.

The savings programme relates to the council-approved Target Operating Model which includes a new organisational design aimed at re-organising the council's functions including incorporating digitalisation of processes when appropriate, reviewing all commissioning activities and improving asset management.

The ratio of gross operating balance to operating revenue was 3.3% in fiscal 2018 and is projected to average around 5.6% over the next three years if savings are delivered as planned.

Aberdeen has £66 million of usable reserves, which we expect to remain stable over the next three years. However, key credit risks such as the development of the TECA project and the savings programme could have a material impact on reserves if revenue or operating savings do not materialise as planned and is insufficient to meet debt servicing costs.

The Housing Revenue Account (HRA), similar to that in England, is ring fenced and primarily funded through rents. Aberdeen currently has around 22,000 council houses, which are covered by a 30-year HRA business plan. As is the case in England, in Scotland, the HRA cannot subsidise the general fund or vice versa (Housing Act 1987). We consider the consolidated position of the council - including the HRA revenue and debt which adds around £187 million of debt and £920 million of assets (or about 40% of consolidated Aberdeen City Council's total property, plant and equipment). This approach is similar to that taken for English LAs.

Debt has increased in level and complexity in recent years, but is expected to decline gradually from fiscal 2018

Aberdeen issued a £370 million index-linked bond in November 2016, maturing in 2054. The bond was intended to support the development of its ambitious capital programme, in particular, financing TECA. This has contributed to an increase in Aberdeen's debt level to 134% of operating revenue in fiscal 2017 and 127.5% in fiscal 2018. As the new capital programme does not require significant external borrowing, we expect the debt level to gradually decline over the next few years. The bond issuance allowed Aberdeen to delay debt service repayment until fiscal 2020, when TECA opens to the public. The bond is index-linked on the capital repayments - this increases the council's inflation-related risk as a limited proportion of Aberdeen's revenue is index-linked and raises the risk of a potential mismatch between revenue and indexation on the capital. The financing costs on the index-linked bond are projected to be covered by anticipated revenues from the TECA development, if realised as planned.

The remainder of the council's debt portfolio is simple, with some exposure to Lender Option Borrower Option (LOBOs) although these are all held at fixed rates. There is no use of derivatives with respect to interest rate or exchange rate. Aberdeen's current treasury policy states that it can have up to 30% variable rate debt, which 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 \(LT Bank Deposits, Baa1 RUR\)](#) is responsible for day-to-day banking facilities and offers an overdraft facility of £1.5 million.

Aberdeen also has a number of other existing indirect obligations, the largest of these being the pensions fund, which is showing an actuarial deficit of £310 million. A 19-year recovery plan has been agreed with the trustee to make up the difference. There is one Public Private Partnership (PPP) in which ACC is currently involved. It includes a 30-year PPP contract for the construction, maintenance and operation of 10 schools. The scheme came into operation between May 2009 and April 2011. This represents a liability of £101 million, which is on the balance sheet in fiscal 2018.

Key project risk associated with the development of TECA

TECA is the cornerstone of Aberdeen's capital spending programme. The project comprises a new 12,500 capacity seated/standing 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 operational by the first half of 2019. The total construction cost is £333 million, and some £119 million is expected to be spent on the project in fiscal 2019, and £45 million in fiscal 2020, before construction is complete.

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.

TECA will be operated by SMG Europe which has considerable experience running other major event and conference venues in the UK and globally, and hotel franchise agreements with [Hilton Hotels Corporation](#) (unrated) and [Marriott International, Inc \(Baa2 stable\)](#). 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 mitigation measures for the construction programme are in place, such as (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, Aberdeen remains exposed to significant revenue risk once TECA 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 TECA development and Aberdeen's borrowing to finance it as demonstrating the council's higher risk appetite than a typical local authority, although the project is intended to boost Aberdeen's long-term economic performance.

Extraordinary support considerations

We consider ACC to have a high likelihood of extraordinary support from the UK government, 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 assigned BCA of a2 is the same as the scorecard-indicated BCA. The matrix-generated BCA of a2 reflects (1) an Idiosyncratic Risk score of 4 (presented below) on a scale of 1 to 9, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Aa2, as reflected by the sovereign bond rating for the UK.

For details about our rating approach, please refer to our [Regional and Local Governments](#) rating methodology, published 16 January 2018.

Exhibit 3

Aberdeen City Council

[Regional and Local Governments](#)

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub- factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	1	135.07	70%	2.20	20%	0.44
Economic volatility	5		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	3.00	20%	0.60
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	5	3.97	12.5%	3.50	30%	1.05
Interest payments / operating revenues (%)	5	4.74	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	127.47	25%			
Short-term direct debt / total direct debt (%)	1	7.71	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			5.00	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						3.59 (4)
Systemic Risk Assessment						Aa2
Suggested BCA						a2

Sources: Issuer, Moody's Investors Service

Ratings

Exhibit 4

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

Source: Moody's Investors Service

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