

Credit Opinion: Transport for London

Global Credit Research - 16 Feb 2012

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Negative
Senior Unsecured -Dom Curr	Aa1
Commercial Paper -Dom Curr	P-1

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Key Indicators

Transport for London

	2006/07	2007/08	2008/09	2009/10	2010/11
Own Source Revenues / Total Revenues (%)	54.1	54.6	51.8	53.1	52.9
Grants / Total Revenues (%)	44.4	47.6	46.5	46.6	46.8
Surplus / (Deficit) for the year / Total Revenues (%)	0.0	-0.6	2.9	1.1	7.4
Interest Payables / Total Revenues (%)	3.6	4.8	4.8	6.2	5.6
Direct and indirect debt / Total Revenues (%)	71.5	87.6	94.2	110.3	106.3
Short-term debt / Total Debt (%)	13.5	10.6	5.7	5.3	7.2
Current Assets / Current Liabilities (%)	133.1	128.0	114.0	88.5	97.9

Opinion

Rating Rationale

The Aa1 debt rating of Transport for London (TfL), with negative outlook reflects the essential nature of TfL's services as the dominant provider of urban transport in London and its strong practical links to the government via its long-term funding frameworks, integrated into its own business plan to 2015. The rating also reflects TfL's significant operating risk from the wide scale of its services, its large and expanding investment plans and growing debts. TfL also functions in a highly politicised environment, which may affect the levels at which it may set fares, the levels of service that it provides and the amount of investments it undertakes.

TfL's operating and institutional frameworks are unique to the United Kingdom; the authority does, however, bear comparison to other world-leading transport entities. It does not enjoy direct legal integration into sovereign financial policy, as granted through EPIC status to the RATP in Paris. As a result, its rating is not equivalent to the sovereign rating (Aaa negative for both the UK and France). Compared to the Metropolitan Transportation Authority of New York, TfL benefits from a more tightly

integrated operational structure across its services. It also has more direct lines of financial management, with a single source for grant, the Department of Transport, and a single direction on fares and spending from the Mayor of London.

Credit Strengths

Credit strengths of Transport for London include:

The strategic importance of TfL to national transport plans, as the major provider of transport within the capital;

The framework between TfL, the Mayor of London, and the Department for Transport of funding settlements and their inclusion in multi-year business plans;

TfL's record of meeting operational and investment goals and keeping to the financial projections laid out in its published business plan;

The comprehensive governance structures of TfL, which provide a high level of transparency in the authority's finances and operations to the GLA, to major stakeholders (primarily the Department for Transport) and to passengers.

Credit Challenges

Credit challenges of Transport for London include:

Over the long-term, the share of internally generated revenues is expected to climb to levels of operating income that are high compared to those of other major urban transport authorities internationally, which may be difficult to sustain politically;

Whilst fares and congestion charges are fully under the control of the Mayor of London, the need to provide services at politically acceptable prices limits how much can be raised;

Substantial cost and reputational risks related to operating, maintaining and expanding the urban transport infrastructure;

High borrowing levels and substantial contingent liabilities from investment/financing contracts (PFI) and involvement with the Crossrail project.

Rating Outlook

The outlook on TfL's issuer rating is negative, reflecting the negative outlook of the sovereign rating of the United Kingdom.

What Could Change the Rating - Up

Given the range of operating, investment, and political risk that TfL faces within the political environment of urban public transport, is unlikely that TfL will achieve the same rating on its debt as that of the UK government without the support of provisions which approach an effective guarantee on its obligations.

What Could Change the Rating - Down

TfL's rating could be lowered were it to take on a substantially higher financial burden in its financial projections, were the UK government to signal a clear dilution of its support for TfL or were TfL to underperform persistently in meeting operational or financial goals. Furthermore, a downgrade in the sovereign rating would likely result in a downgrade for TfL given the strong linkages in funding and supportive structure discussed.

Recent Developments

On 13 February 2012, Moody's placed the Government of the United Kingdom's issuer rating on negative outlook. As a consequence, Moody's placed the outlook on TfL's issuer rating on negative outlook on 15 February 2012. This rating action was driven by the strong link between the sovereign and TfL, given (i) the government's strong policy and economic interest in transport in London and (ii) TfL's strong reliance on government funding via transport grant, support for shared projects (such as Crossrail) as well as borrowing limits, all of which result from departmental discussions noted in funding letters published by the Department of Transport.

DETAILED RATING CONSIDERATIONS

The rating assigned to Transport for London reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for Government-Related Issuers. In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for TfL and then considers the likelihood of support coming from the UK government to avoid an imminent default by TfL, should this extreme event ever occur.

Baseline Credit Assessment

TfL's BCA of 10 (equivalent to Baa3) on a scale of 1-21, where 1 represents the lowest credit risk, reflects the following factors:

Institutional Framework

Established in July 2000 under national legislation, TfL is the key component of the regional government of greater London. TfL is the dominant provider of urban transport for the UK capital including the tube, the bus networks, strategic portions of the road system and the congestion charging system and substantial above-ground rail within London.

More than two thirds of trips to the central business district (CBD) of London are provided for by TfL's services. In practice, the segments not under TfL control are either very small or, like the large share of surface rail outside of TfL's control, are effectively at-or-close-to capacity and cannot strongly compete with TfL's services. Future growth in London and the capacity of the public transport system are closely linked and are significant policy concerns to citizens, business, and the local and the national government.

Since 2003, TfL, the Mayor of London and the Department for Transport have agreed long-term funding and planning frameworks. These frameworks are then filled by a combination of TfL's own resources - mostly fare revenues - and grant from government and balanced against spending in the TfL Business Plan. Funding stability has allowed for stable investment, which has been matched by stable or improved service delivery and generally good political support within local and national political policies. Previous agreement of a plan through 2017/18 has been shortened to 2014/15, reflecting the unpredictability of the current economy and the need for flexibility in the national government funding environment. Despite this shortening of the agreement by three years, the virtuous cycle of service delivery reinforcing political-financial support has been highlighted by government's agreement to assure TfL has sufficient resources to continue the Tube upgrades and Crossrail (together representing a 30% increase in rail capacity for London), whilst maintaining London's extensive bus network throughout the period of the Comprehensive Spending Review.

Financial Performance

The demand for TfL's service during fiscal year 2010/11 has continued to strengthen, with passenger journeys increasing 4.0% for London Underground, 1.4% for London Buses and 12.8% for Docklands Light Railway compared to the previous fiscal year. Underground traffic is at an all-time record, whilst bus service is its highest in 50 years. Rising demand, coupled with the effects of the January 2011 fare

increase, has contributed to an increase of 9.7% of TfL's 2010/11 income from fares compared to the previous fiscal year, 5.9% ahead of the budgeted revenues.

Operating expenditure for the fiscal year 2010/11 has been 8.4% below the previous year expenditure, and 8.0% below budget. The main savings have been from lower staff costs, overhead reductions and cost efficiencies related to the 2010 acquisition of Tube Lines.

In total, TfL completed the 2010/11 budget ahead of projections, making an additional GBP1.0 billion of grant and other sources available for capital spending, which is now included in the current 2011/12-14/15 plan and which reflects the CSR 2010.

Capital expenditures, including Crossrail, have been 14.5% lower than the previous year, and 9.5% below the budget. While most of the savings from re-phasing the upgrade works of Tube Lines were already included in the budget, the additional under-spend against budget is mainly due to the deferred purchase of the new Piccadilly line rolling stock. Whilst this provides additional margin to help deliver the spending reforms, over the long-term core costs such as rolling stock cannot be eliminated.

Mid-year results in 2011 show further gains in passenger levels; budgets look to surpass both revenue (3%) and spending targets (3%); and headcount reductions are proceeding ahead of schedule. Capital spending against budget appears in line with targets. Overall, financial results are being delivered against a backdrop of stable service and continuing control of the complex operations and capital investments, all within what is a difficult economic environment.

Over the longer term, the impact of the funding cuts in future years of its funding envelope with the government, coupled with the substantial capital works that TfL will have to deliver, including the infrastructures for the 2012 Olympics, Crossrail and the tube upgrade works will provide ongoing challenges. Delivering these works and effective service remain critical for matching benefit for passengers and the London and UK economy against continuing government funding needs and fare increases.

TfL has managed its finances well over local- and parliamentary-political cycles, meeting targeted spending and fare levels. This success is particularly significant when taking into account the impacts of disruptions of terrorist attacks on the underground in 2005, the current recession, civil disturbances in the Summer of 2011, and the substantial construction work over the years and which continues to gain pace. But achieving future revenue projections beyond the current 2014/15 end date for the business plan will depend increasingly on the successful delivery of capacity improvements from particularly large capital projects, most notably Crossrail, even after caps on exposure agreed with the government.

Debt & Liquidity

As a local government entity, TfL must issue debt within the restrictions of Section 13 (3) of the Local Government Act of 2003. TfL may borrow from the government controlled Public Works Loan Board (PWLB), which effectively acts as a lender of last resort and mitigates the threat of liquidity shocks.

Debt levels are high, but are anticipated and provided for within the multi-party funding settlements. Within the funding agreements, the Department for Transport approves and establishes limits for TfL's debt projections, subject to requirements of prudence and affordability required under the Prudential Code.

TfL's debt has risen from GBP3.9 billion as of year-end 2009 to GBP6.4 billion (including GBP1.6 billion of acquired debt from Tube Lines which had been incurred for PPP financing), equal to approximately 72% of total revenue and grant of GBP8.8 billion and 115% of the operating cost base in the revised Q2 forecasts for 2011/12.

As a local government entity, TfL's borrowing ranks pari passu with all other existing obligations. This in practice links payment for essential operations, including payroll and other contractual agreements and to

debt itself. The Department for Transport and the Mayor of London approve and establish limits for TfL's debt projections, subject to TfL meeting requirements of prudence and affordability under the Prudential Code. Despite the strong linkage of credit quality on TfL's debt to its provision of essential services and to strong oversight by both the Mayor and government, TfL's debt is not guaranteed by government.

TfL also guarantees PFI or PPP contracts for some of its subsidiary companies, which may relate to significant debts that TfL funds via service charges. Counting the impact of these contracts, Moody's assesses TfL's current total financing burden at approximately GBP7.5 billion, or 134% of the operating cost base, rising to approximately GBP9.3 billion, or 146% of operating costs by 2014.

Whilst this exposure is high, it is not extraordinary by UK local government standards; and TfL's control over a broader range of revenues on a relatively robust passenger base partially offsets the substantial risks of project management. Whilst debt has risen against earlier years' projections, largely the result of capital expenditures for Crossrail, interest costs are below projections and remain affordable within the original rating range.

TfL's total retirement benefit obligations are GBP1.6 billion, and has varied between GBP1.2 and GBP2.2 billion since 2009. The current balance is provided for by TfL contributions through 2020.

TfL has approximately GBP2.1 billion of liquid investments as of 30 September 2011, which are held as funding for capital expenditures in the business plan, and which include a modest level of operating and capital reserves. The reserves are not ring-fenced and may be used for debt service payments or other costs of TfL and its operating subsidiaries. Internal liquidity has historically been strong, particularly as funds are generally secured in advance of major project approvals. Over the medium term, reserves are expected to remain under pressure to meet post period completion costs of the 2011/12-14/15 projects and for spending on new 'post-plan' projects. This pressure may become more acute in what is likely to remain an austere funding environment for UK governments and related entities.

Governance and Management

TfL's controls are detailed and pervasive. Historically, the links between the Mayor and TfL have been very strong and well co-ordinated on key matters of operations and funding. The Mayor provides the Transport Strategy, which is the guiding document for TfL's specific programmes of operation and investment. The Mayor also appoints the Board and sets fare levels. The Board approves the Commissioner for Transport, the executive head of TfL. The Board also oversees the creation and delivery of the multi-year business plan and annual budgets through various committees, including operations, the Finance & Policy Committee and a separate audit committee.

Under the Prudential Code, TfL may borrow for capital purposes up to a level agreed with the Mayor, subject to reserve powers retained by the government. Borrowing limits are also agreed within the multi-year funding agreements with the national government. TfL's accounts are subject to audit under the Audit Commission Act 1998, although the abolishment of the Audit Commission itself will provide potentially less oversight on issues of value for money and best practice, which have formed part of the group's success in demonstrating its ability to meet its public mission.

Local finance law imposes statutory obligations upon officers and permits government intervention in cases of mismanagement or financial failure.

Accounting standards are high. Audited financials are produced under IFRS accrual formats, but, as with UK local authorities also using this system, are difficult to reconcile to the more cash-based systems used for budgets and long-term planning, which more clearly tie to the cash resources of near-and medium-term government budgets.

Extraordinary support considerations

The very high support assessment for TfL reflects the importance of the transport system and infrastructure improvement in London by the UK government, as reflected in the multi-year funding settlement and the agreement to proceed with Crossrail and the tube upgrades. Very high support also reflects the continuing high profile of transport for the Olympics in 2012.

Moody's also assigns a very high default dependence between TfL and the UK government, reflecting the high portion of central government funding to TfL and its historical co-ordination with national investment policies.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in March 2011 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, in cases where foreign-currency denominated securities benefiting from special characteristics are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the Government Related Issuer's (GRI) intrinsic credit strength and accounts for all aspects of the entity's existing (or anticipated) activities, including benefits (such as regular subsidies or credit extension) and/or detriments associated with the government relationship. In effect, the baseline credit assessment reflects the likelihood that a GRI would require extraordinary support.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a Government Related Issuer (GRI) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0 - 30%), moderate (31 - 50%), strong (51 - 70%), high (71 - 90%) and very high (91 - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to GRIs, default dependence reflects the tendency of the GRI and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the government to provide extraordinary support and prevent a default by a GRI is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' credit profiles, the lower the benefits achieved from joint support. In most cases GRIs demonstrate moderate to very high degrees of default dependence with their supporting governments, which reflects the existence of institutional linkages and shared exposure to economic conditions that draw credit profiles together.

Default dependence is described as either low (30%), moderate (50%), high (70%) and very high (90%).



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