Finance and Policy Committee

Date: 12 March 2014

Item 11: Exchange Rate, Commodity Rate and/or Price and Interest Rate Derivative Programmes – Part 1

This paper will be considered in public

1 Summary

1.1 The purpose of the paper is to seek approval for derivative programmes proposed to mitigate TfL's exposure to exchange rate and commodity rate and/or price risks when these risks are encountered in the ordinary course of business and to interest rate risk on imminent and future borrowings.

1.2 A paper is included on Part 2 of the agenda, which contains exempt supplemental information on exchange rate, commodity and interest rate risks. The information is exempt by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the financial affairs of TfL. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

2 Recommendations

2.1 **That the Committee:**

(a) note this paper;

(b) approve, pursuant to Section 49 of the Transport for London Act 2008 (the Act) and the TfL Group Policy Relating to the Use of Derivative Investments (the "Derivatives Policy") for 2013/14 (or 2014/15 as maybe applicable at such time), Transport for London Finance Limited (as a qualifying TfL subsidiary for the purposes of the Act) entering into derivative investment(s) in relation to:

(i) mitigating exchange rate risk related to specific currency exposures arising from the procurement of goods or services by any member of the TfL Group in the ordinary course of business as soon as practicable once the quantum of exchange rate risk to any member of the TfL Group is established; and

(ii) mitigating exchange rate risk exposures arising from any TfL investments in foreign currencies as permitted by the proposed Treasury Management Strategy (TMS) 2013/14 (or 2014/15 as may be applicable at such time); and

(iii) mitigating commodity rate and/or price risk related to specific commodity (including oil and electricity) exposures arising from the procurement of goods or services by any member of the TfL

Group in the ordinary course of business as soon as practicable once the quantum of commodity risk to any member of the TfL group is established; and

(iv) mitigating interest rate risk related to any imminent TfL borrowing, once the borrowing has become certain and authorised according to relevant TMS 2013/14 (or 2014/15 as maybe applicable at such time) provisions; and

(v) mitigating interest rate risk related to planned future TfL borrowing forecast in TfL's Business Plan approved by the Board in December 2013 in accordance with the TMS and the Derivatives Policy 2013/14 (or 2014/15 as maybe applicable at such time);

for the purposes of the prudent management of the financial affairs of TfL and its subsidiaries and limiting the extent to which one or more TfL bodies will be affected by changes in exchange rates, commodity prices or interest rates as applicable;

(c) delegate authority to any of the Commissioner, Managing Director Finance, General Counsel, Chief Finance Officer, and Director of Group Treasury to agree and execute any documentation (including without limitation all agreements, deeds, guarantees, announcements, notices, contracts, certificates, letters or other documents) to be entered into in connection with the derivative investments referred to in paragraph 2.1 (b).

3 Background

3.1 TfL's Risk Management Strategy (RMS) is expected to be approved by the Board at its meeting on 26 March 2014, as part of the 2014/15 Treasury Management Strategy (TMS). As with the RMS 2013/14, the RMS 2014/15 provides for measures to address identifiable financial risks, including exchange rate, commodity price and interest rate risks.

3.2 The high level principles established by the RMS are to:

(a) achieve greater value for money through reducing costs or protecting revenues;

(b) reduce volatility/increase certainty relating to the impact of financial risks upon the Business Plan; and

(c) holistically manage financial risk across the whole of TfL.

3.3 Under the TfL Group Policy relating to the use of Derivative Investments (the "Derivatives Policy"), the Committee delegates authority to approve derivative transactions.

4 Governance and Reporting

4.1 Under section 49 of the Transport for London Act 2008 (TfL Act), TfL has the power to enter into certain financial derivatives investments (derivative instruments) through a qualifying TfL subsidiary. Transport for London Finance Limited (TfLFL) has been set up to act as the main qualifying TfL subsidiary for this purpose. These powers may only be used to manage the financial risks set out in section 49 of the TfL Act, for example exposure to exchange rate risk.

4.2 At its meeting on 26 March 2014, the Board will be asked to approve the Derivatives Policy for 2014/15 (and as with the Derivatives Policy 2013/14), which delegates to the Committee the authority to give consent on behalf of TfL to the entry into of certain derivative instruments.

4.3 The high level principles adopted as part of the RMS include the management of specific, identified financial risk, including:

(a) interest rate risk related to TfL's planned future borrowing requirements;

(b) exchange rate risk related to specific currency exposures arising from the procurement of goods or services by the TfL Group; and from receipts of European Union subsidies or other grants/revenues payable other than in Sterling; and

(c) commodity rates and/or price risk related to specific commodity exposures arising from the procurement of goods or services by the TfL Group.

4.4 In accordance with the Derivatives Policy and practices, the following reporting and governance arrangements apply:

(a) approval from Managing Director Finance and Chief Finance Officer will be obtained before any derivative instrument or series of derivative instruments is entered into;

(b) daily monitoring by Group Treasury of derivative and counterparty credit risk exposures;

(c) weekly collateral monitoring and settlement with counterparties;

(d) weekly Group Treasury Flash Reports to the Treasury Group, comprising the Managing Director Finance, the Chief Finance Officer and the Group Treasurer;

(e) biannual reports to the Committee on the status of the hedges in place, on the strategy to be pursued in the coming months, on the effects of decisions taken and the derivatives transactions executed over the review period, and on any non-compliance with this policy and practices described; and

(f) an annual report to the Board on the strategy to be pursued in the coming year.

4.5 The derivatives proposed in this paper fall within the scope of section 49 of the TfL Act.

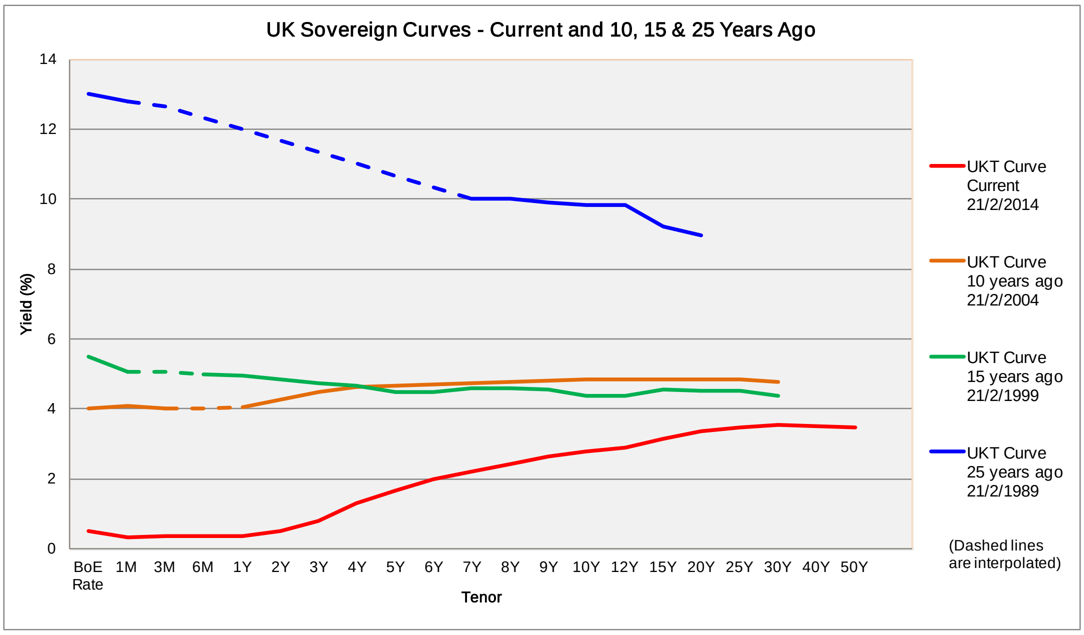
4.6 The proposal is made for the purposes of the prudent financial management of the financial affairs of TfL and its subsidiaries.

5 Interest Rate Risk

Background

5.1 As it has been for some time now, the present market environment in the United Kingdom is one of historically low interest rates as illustrated in Chart 1.

Chart 1



5.2 However, the market expects both short and long term interest rates to rise in coming years as shown in Charts 2 and 3. Chart 2 is an extract from the Bank of England Inflation Report, published on 13 November 2013, and shows short term interest rates are expected to rise quicker than forecast in the previous reports from earlier in the year. Additionally, in a more recent interview on 20 February 2014, Monetary Policy Committee member, Martin Weale, expressed the view the first interest rate rise will come perhaps in the Spring of next year. Chart 3 shows the current market implied probability distribution of future 30 year swap interest rates as being skewed upwards, forecasting a rise in this long term rate.

Chart 2: Bank Rate and Forward Market Interest Rates[1]

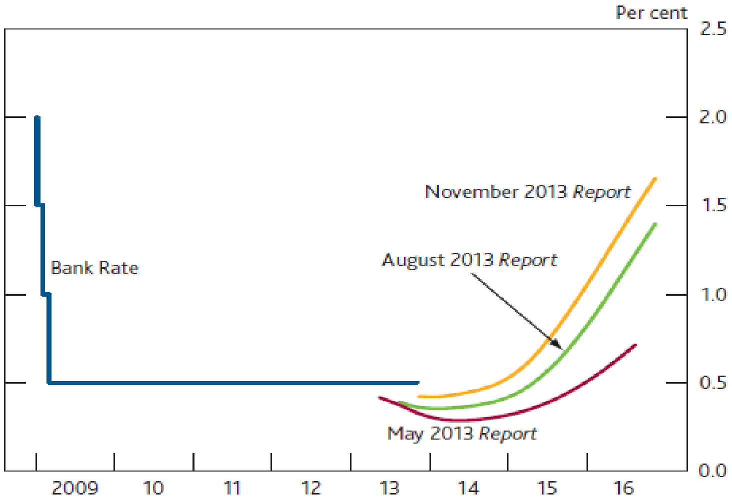
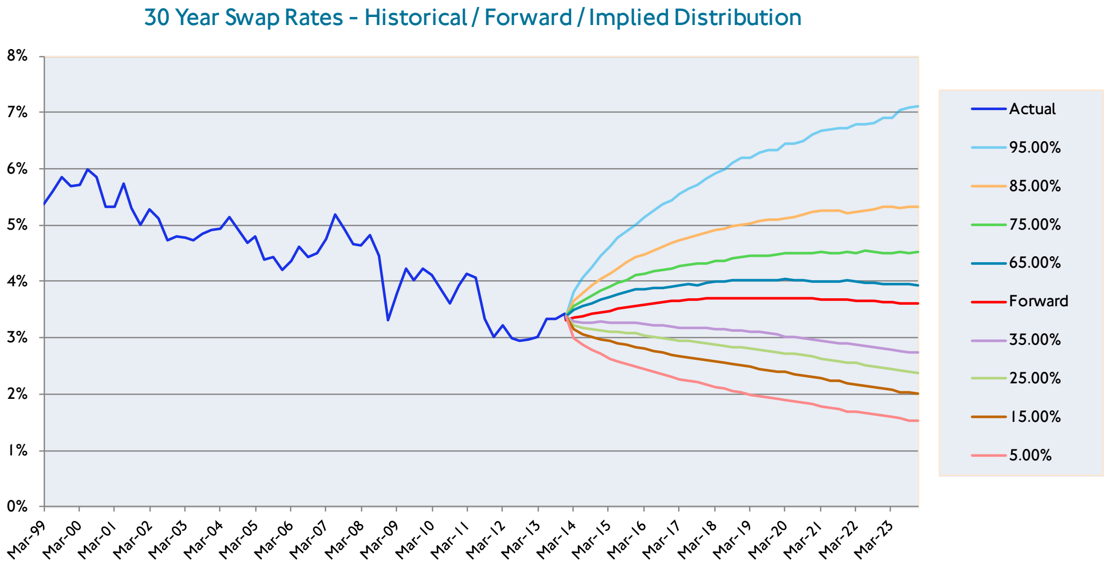


Chart 3: 30 Year Swap Rates - Historical / Forward / Implied Distribution



5.3 A paper on Part 2 of the agenda contains discussion of interest rate risk in relation to TfL's planned future borrowing requirements.

List of appendices to this report:

Exempt supplemental information is included in a paper on Part 2 of the agenda.

List of Background Papers:

None

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[1] Sources: Bank of England and Bloomberg. The May 2013, August 2013 and November 2013 curves are estimated using the overnight index swap (OIS) rates in the fifteen working days to 8 May 2013, 31 July 2013 and 6 November 2013 respectively.