

Credit Opinion: Transport for London

Global Credit Research - 29 May 2014

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured -Dom Curr	Aa2
Commercial Paper -Dom Curr	P-1

Contacts

Analyst	Phone
Jennifer A. Wong/London	44.20.7772.5454
Sebastien Hay/Madrid	34.91.768.8200
David Rubinoff/London	44.20.7772.5454

Key Indicators

Transport for London

	2008/09	2009/10	2010/11	2011/12	2012/13
Own Source Revenues / Total Revenues (%) [1]	51.8	51.8	45.3	46.4	45.1
Grants / Total Revenues (%)	46.5	47.9	54.4	53.4	54.7
Surplus / (Deficit) of the year before capex / Total Revenues (%)	2.9	3.5	20.6	25.2	31.1
Interest Payables / Total Revenues (%)	4.8	6.1	4.8	5.9	3.9
Direct and indirect debt / Total Revenues (%)	94.2	107.6	91.1	90.4	84.4
Short-term debt / Total Debt (%)	5.7	5.3	7.2	27.6	14.3
Current Assets / Current Liabilities (%)	114.0	88.5	97.9	74.2	125.3

[1] For all ratios, Total Revenues include grants, including those ring-fenced for Crossrail.

Opinion

Rating Rationale

The Aa2 debt rating of Transport for London (TfL), with stable 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 institutional and long-term funding frameworks. The rating also reflects TfL's operating risk from the wide scale of its services, its large and expanding investment plans and growing debt. TfL also functions in a highly politicised environment, which may affect the levels at which fares are set, the levels of service that it provides and the amount of investments it undertakes. Moody's also assigns a Prime-1 (P-1) rating to TfL's commercial paper programme.

Credit Strengths

Credit strengths of Transport for London include:

- TfL's strategic importance for national transport plans

- The strong framework within which TfL operates, which provides a high level of transparency
- TfL's record of meeting operational and investment goals and keeping to the financial projections laid out in its published business plan
- Strong demand for TfL's essential services

Credit Challenges

Credit challenges of Transport for London include:

- Limited revenue flexibility and substantial capital expenditure and maintenance costs
- High borrowing levels in line with TfL's significant capital programmes, including the Crossrail project

Rating Outlook

The outlook is stable.

What Could Change the Rating - Up

A significant and sustained improvement in TfL's financial position, including a substantial decrease in its debt burden and lower interest payments could put upward pressure on the rating. Furthermore, materially improved revenue and spending flexibility or an upgrade of the UK sovereign rating could also put upward pressure on the rating.

What Could Change the Rating - Down

A downgrade of the sovereign rating would likely result in a downgrade of TfL's rating given the strong linkages in funding and support. This is however unlikely in the current environment given the stable outlook on the sovereign's rating.

Additionally, TfL's rating could be downgraded 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 under-perform persistently in meeting operational or financial goals.

Issuer Profile

TfL is a statutory corporation established by the Greater London Authority (GLA) Act 1999. It is the dominant provider of urban transport for the UK capital including the tube, bus networks, above-ground rail within London (Overground and Dockland Light Railway) and strategic portions of the road system. TfL also manages the congestion-charging system and wholly owns Crossrail Limited.

Most trips to the central business district (CBD) of London are provided for by TfL's services, which delivered close to 4 billion passenger journeys in 2013-14. 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.

DETAILED RATING CONSIDERATIONS

Transport for London's rating combines (1) a baseline credit assessment (BCA) for the entity of a3 and (2) a very high likelihood of extraordinary support coming from the UK government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

STRATEGIC IMPORTANCE OF TFL FOR NATIONAL TRANSPORT PLANS

Transport for London is a key component of the regional government of greater London (Greater London Authority) and reports to the Mayor of London. Future growth in London and the capacity of the public transport system are closely linked and are significant policy concerns to citizens, businesses and the local and national levels of government.

Since 2003, TfL, the Mayor of London and the Department for Transport have agreed long-term funding and

planning frameworks. These frameworks take into account a combination of TfL's own resources - mostly fare revenues - and grants from the government, which are balanced against spending in the TfL Business Plan. Overall funding stability has allowed for investment stability, which has been matched by good service delivery and, generally, both local and national political support.

To reflect the weaker economic environment in the UK and the need for greater flexibility in the national government's funding environment, the previous agreement of a plan through 2017-18 was shortened to 2014-15. In the 2013 Spending Review, the general grant was set out to 2015-16. At the same time, the government continued to provide clarity on capital funding commitments through 2020-21 (though capital grants will be flat in real terms over this period). We view positively the government's commitment to continue to ensure that TfL has sufficient resources to pursue its tube lines upgrade and Crossrail project, whilst maintaining London's extensive bus network.

STRONG FRAMEWORK WITHIN WHICH TFL OPERATES, WHICH PROVIDES A HIGH LEVEL OF TRANSPARENCY

TfL's governance structure is comprised of strong control mechanisms. 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 develops London's Transport Strategy, which is the guiding document for TfL's specific programmes of operation and investment, appoints TfL's Board and sets fare levels. The London Assembly, in turn, holds the Mayor democratically accountable and oversees the Mayor's budget. TfL's Board approves the Commissioner for Transport, the executive head of TfL. It also oversees the creation and delivery of the multi-year business plan and annual budgets through various committees, including the Remuneration Committee, the Finance and Policy Committee and the Audit and Assurance committee. TfL also has an external benchmarking body involved at all levels, the Independent Investment Programme Advisory Group.

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.

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, can be difficult to reconcile to the more cash-based systems used for budgets and long-term planning.

TFL'S RECORD OF MEETING OPERATIONAL AND INVESTMENT GOALS AND KEEPING TO THE FINANCIAL PROJECTIONS LAID OUT IN ITS PUBLISHED BUSINESS PLAN

The demand for TfL's services over the past years has continued to strengthen, with passenger journeys in fiscal year 2013-14 expected to have increased by 3.3% for the London Underground, 2.4% for London buses, 0.9% for the Docklands Light Railway and 12.3% for the London Overground, compared to the previous fiscal year. In fiscal year 2012-13, rising demand including during the 2012 Olympics, coupled with the effects of the January 2012 fare increase, contributed to an increase of 8.2% year-on-year of TfL's income from fares (versus an 11.2% increase the previous fiscal year).

We believe that TfL has managed its finances very efficiently in the last few years, meeting targeted spending and fare levels. This success is particularly significant when taking into account civil disturbances in the Summer of 2011, the 2012 Olympic Games and more generally the substantial construction work having occurred over the years, and which continues to gain pace. Going forward, we believe that TfL's future revenue growth will largely depend on the successful delivery of capacity improvements from particularly large capital projects, including Crossrail.

STRONG DEMAND FOR TFL'S ESSENTIAL SERVICES

Transport for London is the largest transit system in the United Kingdom, and one of the largest ones in Europe. It serves a large population (8.3 million in London) and benefits from very strong ridership. TfL's tube, buses and overground network provide almost 4 billion rides annually, and ridership has grown at an estimated compound annual growth rate (CAGR) of 2.6% in the five years through 2013-14. The population in London is growing and projected to continue to grow robustly, with the Office for National Statistics projecting a 12.5% population increase between 2012 and 2021, according to September 2012 sub-national population projections. Crossrail will add further capacity to absorb growing demand and will represent a 10% increase in London's rail capacity; it will

increase the number of people within a 45 minute commuting distance of London's key business districts by 1.5 million.

LIMITED REVENUE FLEXIBILITY AND SUBSTANTIAL CAPITAL EXPENDITURE AND MAINTENANCE COSTS

Operating expenditure (excluding interest costs) for fiscal year 2012-13 increased by 4% year-on-year, while own-source revenue increased by 7.5%. Overall, total revenue, which includes both own-source revenue and operating and capital grants, increased by 10.6% year-on-year. As a result, Transport for London's budgetary surplus, including government grants and before undertaking capital expenditure, was GBP3.1 billion, representing 31.1% of TfL's total revenues (from 25.2% of total revenue in fiscal year 2011-12). The increase seen over the last three fiscal years (surplus before capital expenditure averaging 26% of total revenue, versus 3.5% in 2009-10) reflects higher government grants, particularly those related to the Crossrail project. In 2012-13, total government grants represented GBP5.5 billion, up from GBP3.3 billion in 2009-10 (including GBP2.0 billion in Crossrail capital grants in 2012-13). Much of this is allocated to capital spending on projects such as Crossrail; capital expenditure in 2012-13 represented GBP3.1 billion, up from GBP2.7 billion in 2011-12.

TfL's revenues primarily consist of fares and government grants. While its farebox recovery ratio (fare revenues/operating expenditures) is relatively high at over 50% and government grants tend to come through multi-year settlements, TfL's revenue sources remain relatively limited. TfL has, however, started to diversify its revenue base somewhat. Part of the previous general grant provided by the GLA has been replaced by Business Retention Rates; though this could mean greater variability in these revenues, the GLA has made a commitment to grow these transfers in line with RPI. TfL also plans to increase revenues from commercial activities to leverage its considerable property portfolio, including through a joint venture at Earl's Court. We will continue to monitor the impact of these revenues on TfL's budget planning, though TfL has not incorporated very large increases in revenues from commercial activities.

HIGH BORROWING LEVELS IN LINE WITH TFL'S SIGNIFICANT CAPITAL EXPENDITURE PROGRAMMES, INCLUDING CROSSRAIL PROJECT

While the credit quality of TfL's debt is undeniably linked to its provision of essential services and to the strong oversight of the central government, its debt is not guaranteed by the central government. TfL's debt levels are relatively high, but are anticipated and provided for within the multi-year funding settlements with the Department for Transport (DfT). As a local government entity, TfL must issue debt within the restrictions of Section 13 (3) of the Local Government Act of 2003. Within the funding agreements, the DfT approves and establishes limits for TfL's debt projections, subject to requirements of prudence and affordability required under the Prudential Code.

TfL's debt levels rose to GBP8.4 billion at the end of fiscal year 2012-13, or 84.4% of total revenue, from GBP7.8 billion the previous year (90.4% of total revenue). We note that while in the past, TfL guaranteed a number of loans linked to Public-Private Partnership (PPP) contracts, in the last few years its policy has been to bring these PPP contracts back "in-house." TfL's project management exposure has substantially decreased as a result. TfL's debt figures include this project-related debt. TfL's total retirement benefit obligations, which currently are not included in TfL's debt stock, were GBP2.8 billion at fiscal year-end 2012-13, and have varied between GBP1.2 billion and GBP2.8 billion since 2009.

Together with the Department for Transport, Transport for London is a sponsor of the Crossrail project, which is funded from a mix of government grants, new borrowing and other contributions. The project is currently half-way through completion and is on track to run its first trains by 2018. A wholly owned subsidiary of TfL, Crossrail Ltd's cash is managed by TfL. TfL's direct funding for Crossrail represents GBP2.4 billion, and its total funding contribution for the project is capped at GBP7.1 billion. While TfL has conservatively budgeted cost commitments for Crossrail and costs have so far remained within budget, should costs for Crossrail exceed GBP14.8 billion during the construction period, TfL has the option to transfer the project ownership to the Department for Transport, thereby mitigating risks for TfL.

TfL has various sources of funding available. It may borrow from the Public Works Loan Board (PWLb, statutory body operating within the UK Debt Management Office and an executive agency of the UK Government's Treasury Department), which could also act as a lender of last resort for the entity and hence mitigate the threat of liquidity shocks. TfL may also borrow from the European Investment Bank for long-term projects, and it signed a GBP500 million facility with the EIB in December 2013 to fund Crossrail rolling stock. In addition, it also has a GBP5 billion European Medium Term Note programme, updated in 2013, of which GBP2.6 billion was outstanding as of March 2014. For short-term liquidity needs, its European Commercial Paper programme of GBP2 billion allows for rapid and flexible access to liquidity at rates under LIBOR. TfL also benefits from a GBP200 million

overdraft facility agreement with HSBC (which, as of April 2014, had not been drawn in the past twelve months).

TfL had approximately GBP2.4 billion of liquid investments as of March 2013, 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. In addition, TfL holds GBP1.2 billion of ring-fenced cash for Crossrail. Internal liquidity has historically been strong, particularly as funds are generally secured in advance of major project approvals. We expect reserves to increase in 2013-14 with higher capital grants before decreasing as TfL implements its capital expenditure projects. Furthermore, TfL has a policy of maintaining a minimum of GBP250 million in cash available on any business day.

Extraordinary support considerations

Moody's assigns a very high likelihood of extraordinary support from the UK government (Aa1 stable), reflecting Moody's assessment of the importance of the transport system and infrastructure improvement in London by the UK government. This is reflected in the multi-year funding settlements and the agreement to proceed with and support of Crossrail and the tube upgrades. The very high support also reflects the reputational risk for the central government should TfL face acute liquidity tensions, given the overall funding of the system and close oversight from the sovereign. Such event could also call into question government support for other sectors (such as local authorities) that the national government tightly controls and funds.

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 Methodology published in October 2012 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.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

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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