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Transport for London

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Major Rating Factors

Strengths:

- Continued strong links and good relationship with the U.K. government
- Ten-year funding settlement agreed with government, including funding for Crossrail
- Dominant transport provider in London, which has strategic importance for the U.K. economy
- High levels of liquidity, and consequently relatively low levels of net debt
- Flexibility to increase fares or reduce service and adjust investment program, to achieve a balanced budget
- Stability and oversight provided by the U.K. local authority framework

Weaknesses:

- Potential for unforeseen risks and uncertainties associated with the Metronet London Underground maintenance and refurbishment contracts and Crossrail project
- Direct borrowings to total up to £7.6 billion by 2018, including significant debt associated with Crossrail
- Relatively high levels of short-term fixed operating costs associated with staff and contractual payments
- Political uncertainties relating to the outcome of the Mayoral elections in May 2008

Issuer Credit Rating

AA/Stable/--

Rationale

The rating on TfL continues to reflect its significant fare-generating capacity and its strong links with the U.K. government--through funding by transport grants, and central oversight by the U.K. local authority framework. TfL, a functional body of the Greater London Authority (GLA; AA+/Stable/--), is responsible for most public transport functions in London. TfL's function is to implement the transport strategy for London set by the Mayor, who also chairs TfL.

TfL enjoys an extremely strong business position and a near-monopoly over public transport in the London area, with control over the Underground and bus systems, and the associated fares. Furthermore, it is able to capture additional revenues from private transport through its congestion charge.

TfL's business plan, which underpins a growth in debt, assumes increases in fares in line with inflation. It also assumes increases in passenger numbers on both bus and Underground services. Although demand for public transport services in London historically has not been much affected by fare increases, a decline in London's economy could reduce projected passenger numbers. Consequently, as TfL is required to balance its budget, any reduction in revenues would probably be offset by a decline in operational expenditure. Similarly, any material increase in debt and consequently debt service will be subject to TfL's ability to restore its balance of revenues and operating expenses.

In October 2007, TfL agreed a 10-year funding settlement with the U.K. government, which gives the public transport provider a strong degree of funding certainty for the period, thereby enabling it to manage its longer term

commitments and obligations more effectively. The funding package represents an envelope within which TfL is expected to manage its agreed obligations. TfL is in the process of putting together a more detailed business plan that incorporates its significant new responsibilities with respect to the restructuring of the Metronet public-private partnership (PPP) contracts for maintenance and refurbishment of London Underground assets and the delivery of Crossrail. Although the funding package is a positive credit feature, there is a significant risk of unforeseen costs associated with the Metronet restructuring and the Crossrail project. If such unforeseen costs crystallize to the extent that they cannot be accommodated within the funding envelope, Standard & Poor's Ratings Services expects that the government would provide additional support, assuming good relations between TfL and the central government continue.

The £15.9 billion Crossrail project will be funded by a mix of government grant, TfL borrowing, a supplementary business rate in London, and private sector contributions (most significantly from Network Rail). TfL's own commitment to Crossrail's financing will result in a significant stepping up of TfL's debt obligations by some £2.7 billion, which is expected to be repaid by additional fare revenues generated by Crossrail. TfL will borrow the first £1 billion of this before 2010. The construction risk associated with Crossrail, particularly in the deep-tunneling works, is high. TfL's liabilities have been capped, however, under an agreement with the government.

On July 18, 2007, the Metronet companies responsible for delivering the Metronet London Underground maintenance and refurbishment contracts entered into administration. One consequence of this action was that the put option on Metronet's senior debt became exercisable six months later--on, or after, Jan. 18, 2008. The put option was finally exercised on Feb. 5, 2008, at an agreed price of approximately £1.74 billion. For TfL to meet its associated obligations, the government has provided additional funds of £1.7 billion, consistent with the government's original Letter of Comfort regarding TfL's Metronet obligations.

TfL has also submitted a formal bid to buy the Metronet contracts. No other bids were received from potential commercial buyers before the deadline expired. TfL is currently in negotiations with Metronet's subcontractors to restructure their contracts.

TfL also continues to face the ongoing challenges of managing the relationships and cost pressures associated with its PPP contracts with Tube Lines (Finance) PLC. In addition, TfL has several separate project-specific private finance initiative (PFI) transactions to manage, as well its own program of infrastructure and cost improvements.

TfL's credit standing closely depends on its ongoing strong relationship with the U.K. central government. Any weakening of this relationship, due to political or management reasons, could undermine TfL's strong credit rating.

Outlook

The stable outlook reflects TfL's strengthening relationship with the U.K. government, as shown by the new 10-year funding settlement, and its central role in restructuring the Metronet contracts and delivering the Crossrail project. TfL also continues to maintain a strong cash position, and enjoys a certain degree of flexibility over its investment programs.

That said, any unforeseen costs--particularly in connection with Crossrail and Metronet--that are outside the control of TfL and are not supported by the U.K. government could put pressure on the rating. Furthermore, a major slowdown in the London economy that materially affects fare revenues, or any weakening in the relationship with

government, could also negatively affect the rating.

Key Developments in 2007:

Ten-Year Spending Settlement

The U.K. government's Comprehensive Spending Review in 2007 resulted in a new 10-year funding settlement for TfL, which rolled forward the current five-year settlement beyond 2010 to 2018. This extended period is unique for a U.K. local authority and allows TfL a certain degree of financial planning certainty within which it can deliver its own investment program and Crossrail, as well as the takeover and restructuring of Metronet.

Although government funding over this long period of time cannot be guaranteed, there is a strong degree of cross-party support for the broad objective of improving London's transport infrastructure.

Under the new settlement, TfL receives an additional £1.85 billion in 2008 to cover the Metronet put option repayment and the costs associated with the takeover and restructuring of the contracts. TfL will receive additional grant over the next three years to cover further costs associated with Metronet. This additional grant, however, is significantly less than the amount claimed by Metronet prior to administration.

In 2011, the baseline grant settlement from the government will step up to £3.0 billion, rising to £3.9 billion in 2018 at the end of the 10 year settlement period. This additional funding will help TfL to meet the costs of its increased borrowing to meet its funding commitments for the Crossrail project.

TfL is expected to work within the envelope of the new funding settlement to meet its various commitments. Although there is a certain amount of contingency and flexibility in terms of TfL being able to delay certain projects, any material delays could have a knock-on effect on the wider London and U.K. economy. For this reason, in the event of extraordinary cost overruns, particularly if outside TfL's control, we would expect the government to look favorably on requests to amend the funding arrangements.

Crossrail

Crossrail is major rail project for London and the southeast of England, designed to run from Heathrow and Maidenhead (west of London) to Essex and Kent (east of London). The project will involve a high degree of complexity due to the required tunneling deep under London, and interface with London Underground stations. The total capital cost for the project is estimated to be £15.9 billion, which includes an appropriate degree of contingency, given the significant risk of cost overruns for such a major tunneling project. Various sources, including the government, Network Rail, the Corporation of London, TfL, and the GLA via a new supplementary business rate, will fund the project. The estimated benefit to the U.K. economy of investing in the project according to TfL's analysis is approximately £30 billion.

The Crossrail Bill is currently going through Parliament. The Act will create a subsidiary company, Cross London Rail Links Limited (CLRL) which will be wholly owned by TfL. Unlike other TfL subsidiary companies, however, CLRL will have its own separate board and governance arrangements, and will effectively have autonomy specifically to deliver the Crossrail project. The project will be under the joint responsibility of The Mayor of London, and the Secretary of State for Transport, subject to various governing agreements. Of particular note is the agreement that TfL's funding obligations will be capped under an agreement so that if costs overrun above a certain level, there will be an option to transfer responsibility to the Department for Transport (this is referred to as a "put option"). If the put option is exercised, then the risks associated with completing the project will be with the

government. The government may also control Crossrail's farebox at this stage, but we believe it would be highly unlikely that such a scenario would leave TfL underfunded and unable to service its Crossrail debt obligations.

The details of this Crossrail put option are yet to be finalized, but they will form an important part of the credit analysis. Effectively, the put option will operate in a similar way from a credit perspective as do the Letters of Comfort that enable TfL's contingent obligations associated with the PPPs to be backed out to the government. The potential liabilities associated with Crossrail are of such a significant magnitude that they would have a major impact on the credit standing of TfL in the absence of government support.

Metronet Administration

Since our surveillance report last year, the Metronet companies (Metronet Rail SSL and Metronet Rail BCV) continued to be behind on their work program. In June 2007, Metronet BCV called for an extraordinary review under the terms of its PPP agreement. The PPP arbiter stated that the amounts claimed by Metronet for work Metronet believed to be outside the scope of the contract would not be forthcoming, and consequently the company estimated that its costs would overrun by some £2 billion by 2010. On July 18, 2007, both Metronet BCV and SSL entered into PPP administration.

As a consequence of the PPP administration, the put option on Metronet's senior debt was exercised on Feb. 5, 2008, at an agreed price of approximately £1.74 billion. For TfL to meet its associated obligations, the government provided additional funds of £1.7 billion, consistent with its original Letter of Comfort regarding TfL's Metronet obligations. Following the payment of the put option, the underlying bond ratings on the Metronet companies stand at CC/Watch Pos, while the bank loan rating stands at CC/Watch Neg. (For more information, see article titled "Metronet 'CC' Underlying Ratings Now On Watch Pos; 'CC' Bank Loan Ratings Still On Watch Neg," published Feb. 19, 2008, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.)

The put option payment amount was incorporated into the recent 10-year grant funding settlement with the government. The settlement also replenishes the reserves that TfL has used to date to support the costs associated with Metronet's PPP administration. Furthermore, the grant settlement will provide funding for the undrawn Metronet facility for the first review period, and borrowing coverage for the £1.3 billion Metronet would have borrowed in the second review period.

On Oct. 25, 2007, TfL submitted a formal bid to buy the Metronet contracts. TfL was the only bidder, and its bid is supported in principle by the Secretary of State. It is expected that TfL will seek to restructure the contracts and work with private sector partners to outsource significant elements of the projects. To this end, a joint steering committee comprising of representatives of TfL, HM Treasury, and the Department for Transport has been established to review options for restructuring the Metronet contracts.

The takeover of the Metronet contracts is being delayed slightly because TfL and London Underground are in discussions with Bombardier and Westinghouse to renegotiate a contract agreed with Metronet for the delivery of new rolling stock and signaling equipment.

Transport Demand Remains Strong

TfL's business plan and borrowing strategy are set against a background of very strong demand. TfL has a near-monopoly in its specific transport markets in London. London's population is approximately 7.5 million, and

the catchment area for commuting into the city covers a significantly larger number of people. The city's population is forecast to grow by about 0.8 million over the next 10 years, which makes it different from most other major cities in the developed world where city populations are declining. London has a major financial and business services industry and is a major administrative and tourism center. The vast majority of commuters working in central London travel by public transport. Since the potential for increased road use is severely limited, significant increases in transport capacity, both bus and Underground, are therefore required to deal with the forecast growth.

Demand for London Underground services increased by 7% in 2007, and ticket revenue is forecast to be approximately £56 million ahead of budget. The rise in demand reflects increased usage of the system at weekends, some further spreading of peak time travel, and a more general strengthening of the London economy than was expected. Furthermore, track closures related to weekend PPP maintenance work have not affected demand as much as expected, neither has the situation surrounding the Metronet administration had any adverse effect on passenger numbers.

The higher levels of demand and revenues give a certain degree of flexibility to reduce the rate of fare increase in 2008. Ticket prices have generally increased with inflation only for 2008, which is below the rate of increase set out in the original plan that underpinned the initial borrowing program. Fare rises on the Underground for the following two years will be at RPI.

Given the monopoly situation, there is scope to further increase fares in the event that TfL needs to secure additional revenues, although such action carries an associated political risk. Equally, any slowdown in the London economy is likely to make higher fare increases more difficult.

Senior Management Changes in 2007

TfL has a strong and experienced management team, which has successfully delivered a number of important projects to date. The strength of the team is further demonstrated by the government support for TfL's takeover of the Metronet contracts, and the responsibility given to it to deliver the Crossrail project. The other new responsibilities, such as development work ahead of the Olympics and developing the London Overground network, are also being delivered.

The major new addition to the TfL Group following legislation currently going through parliament is the Crossrail subsidiary, CLRL. Mr. Douglas Oakervee, the Executive Chairman of CLRL, will report directly to Mr. Peter Hendy, the Transport Commissioner. Other senior executive and non-executive positions at CLRL are currently being recruited.

After the departure of Mr. Jay Walder in April 2007, Mr. Steve Allen was appointed Finance Director of TfL. Mr. Allen's former position was as Director of Corporate Finance--a post now occupied by Mr. Peter Regan, also an internal appointment.

The challenges of delivering major complex projects could pose certain capacity constraints on senior management. That said, the sequencing of the different major projects over a 10-year period should help smooth out capacity considerations.

Balanced Business Plan To 2010

TfL has produced a balanced business plan reflecting its program of investment, the levels of grant funding, increases in fare revenues, and its borrowing plans prior to the new ten year funding settlement agreed in 2007. The current business plan therefore does not reflect the effects of the restructuring of the Metronet contracts, or those associated with Crossrail. The details of the costs, and the scope of outstanding work relating to the Metronet contracts will be clearer once TfL has taken over ownership.

TfL is obliged to set a balanced plan every year. In the event that fare revenue is not as much as expected or cost increases are above expectations, then TfL must adjust parts of its plan to accommodate this. In 2007, TfL outperformed its business plan, in part due to lower-than-expected operating and capital costs.

Borrowing Strategy And Projections Provide Flexibility

Total direct borrowing at the end of the current business plan period in 2010 is forecast to rise to £4.1 billion, or about 65.4% of recurring income (less money received for PPP payments) from 33.5% as at financial year-end 2008. Debt service, meanwhile, is set to rise to 2.8% from 1.3% of recurring income.

The proposed debt to be raised will not be earmarked for specific projects; instead, it will be used to finance a range of projects set out by TfL that reflect the Mayor's transport priorities. The variety and range of projects will give TfL good flexibility to adjust the investment program in response to unforeseen events.

Future borrowing will continue to be a mix of funding types and maturities. The overall objective of the strategy is to match maturities with the asset lives of the investments in the program. Meanwhile, TfL's cash balances of about £2 billion provide a buffer against unforeseen variations and significantly affect the level of net debt which stands at about £0.5 billion. However, TfL plans to reduce the amount of total cash to about £1 billion by 2010, while increasing debt simultaneously.

TfL's borrowing for the financial year 2006/2007 was £604 million. In financial 2007/2008, TfL has an approved borrowing limit of £600 million, consistent with its business plan. In 2008/2009 and 2009/2010, its borrowing limits will be £1.25 billion and £1.1 billion, respectively, reflecting TfL's additional debt requirement for Crossrail.

Financial Summary

The following data shows TfL's historic financial performance over the past few years. Forecasts are currently being updated to reflect the recently announced 10-year funding settlement.

Transport for London Financial Summary 2004-2007*				
(Mil. £)	2007	2006	2005	2004
Income				
Fares and Congestion Charge	2,724.0	2,544.5	2,399.3	2137.5
Other income	293.0	280.8	180.6	172.7
Investment income	69.0	55.0	52.6	12.8
Total income	3,086.0	2,880.3	2,632.5	2,323.0

Transport for London Financial Summary 2004-2007*(cont.)

Expenditures

Operating costs¶	(3,714.0)	(3,584.1)	(3,239.0)	(2,878.9)
Capital projects through PFI/PPP schemes	(1,484.0)	(1,410.9)	(1,215.6)	(1,292.6)
Other capital expenditures§	(740.0)	(712.9)	(558.9)	(393.3)
Third-party funding	169.0	174.7	123.9	169.0
Contingency	0.0	0.0	0.0	0.0
Debt service	(37.0)	(10.6)	(3.5)	0.0
Net expenditure	(2,720.0)	(2,663.5)	(2,260.5)	(2,072.8)
Working capital and reserve transfers	(145.0)	(102.5)	(193.3)	(522.1)

External funding sources

Total transport grant	2,389.0	2,196.0	2,232.0	2,537.1
Precept	12.0	20.0	25.8	57.8
Borrowings	464.0	550.0	196.0	0.0
Balance	0.0	0.0	0.0	0.0

*On a cash basis. ¶Net of PFI/PPP and support payments. §Net of overprogramming (that is, a provision which allows TfL to utilize total funds allocated despite delays due to consultation, planning, and authorization). PFI--Private finance initiative. PPP--Public-private partnership.

Ratings Detail (As Of February 22, 2008)*

Transport for London

Issuer Credit Rating	AA/Stable/--
Senior Unsecured	
Local Currency	AA

Issuer Credit Ratings History

12-Mar-2003	AA/Stable/--
18-Oct-2001	AA/Negative/--
05-Jun-2000	AA/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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