MOODY'S
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# Credit Opinion: Transport for London

Global Credit Research - 06 Mar 2013

*United Kingdom*

## Ratings

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

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## Key Indicators

**Transport for London**

| | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|---|---|
| Own Source Revenues / Total Revenues (%) | 54.6 | 51.8 | 53.1 | 52.9 | 54.8 |
| Grants / Total Revenues (%) | 47.6 | 46.5 | 46.6 | 46.8 | 45.0 |
| Surplus / (Deficit) for the year / Total Revenues (%) | -0.6 | 2.9 | 1.1 | 7.4 | 11.7 |
| Interest Payables / Total Revenues (%) | 4.8 | 4.8 | 6.2 | 5.6 | 7.0 |
| Direct and indirect debt / Total Revenues (%) | 87.6 | 94.2 | 110.3 | 106.3 | 106.8 |
| Short-term debt / Total Debt (%) | 10.6 | 5.7 | 5.3 | 7.2 | 27.6 |
| Current Assets / Current Liabilities (%) | 128.0 | 114.0 | 88.5 | 97.9 | 74.2 |

## 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 debts. 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.

On February 25, 2013 Moody's downgraded TfL's issuer rating to Aa2 from Aa1, and changed its outlook to stable from negative. This reflected the downgrade on 22 February 2013, of the Government of the United Kingdom's issuer rating to Aa1 from Aaa, and its change in outlook to stable from negative. 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 for Transport.

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 (Etablissement Public à caractère Industriel et Commercial) status to the RATP (Régie Autonome des Transports Parisiens) in Paris. As a result, TfL's rating is not equivalent to the sovereign rating as is RATP. 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 for 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:

- Inherent operating risk related to a transportation company when compared to Local Authorities in the UK

- 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 the extent to which prices can be raised;

- Substantial costs related to operating, maintaining and expanding the urban transport infrastructure;

- High borrowing levels in line with TfL's significant capital programmes (including Crossrail project)

**Rating Outlook**

The outlook on Transport for London's issuer rating is stable, reflecting the stable outlook of the Government of the United Kingdom's issuer rating.

**What Could Change the Rating - Up**

An upgrade of the UK national government's rating would positively impact TfL's rating.

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

**What Could Change the Rating - Down**

A further downgrade of the sovereign rating would likely result in a downgrade for TfL given the strong linkages in funding and supportive structure discussed. 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 the dominant provider of urban transport for the UK capital including the tube, the bus networks, the above-ground rail within London (Overground and Dockland Light Railway) and strategic portions of the road system; TfL also manages the congestion-charging system.

Most trips to the central business district (CBD) of London are provided for by TfL's services which delivered close to 3.8 billion passenger journeys in 2011-12. 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

The rating assigned to Transport for London reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for Government-Related Issuers (GRIs). In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for the entity and then considers the likelihood of support coming from the UK government in the event that the entity faces acute liquidity stress.

### Baseline Credit Assessment

TfL's BCA of a3 reflects the following factors:

Institutional FrameworkEstablished in July 2000 under national legislation, Transport for London is a key component of the regional government of greater 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. However, 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. Additionally, in both November 2011 and 2012, the plan was updated to reflect additional funding from the government in order to limit the January 2012 and January 2013 fare increases. Given the current comprehensive spending review 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 (the latter of which will represent a 10% increase in London's rail capacity and increase the number of people within a 45 minutes commuting distance of London's key business districts by 1.5 million), whilst maintaining London's extensive bus network.

Financial Performance

The demand for TfL's services over the past years has continued to strengthen, with passenger journeys in fiscal year 2012/13 expected to increase by 3.8% for the London Underground, 0.2% for London buses, 16.7% for the Docklands Light Railway and 18.5% for the London Overground, compared to the previous fiscal year. In fiscal year 2011/12, rising demand, coupled with the effects of the January 2012 fare increase, contributed to an increase of 11.2% year-on-year of TfL's income from fares (versus a 10.5% increase the previous fiscal year).

Operating expenditure (excluding interest costs) for fiscal year 2011/12 increased by 2.7% year-on-year, while total revenue, including both own-source revenues and governmental grants, increased by 3.9%, thus contributing to a budgetary surplus of GBP 890.6 million, representing 11.7% of TfL's total revenues (from 7.4% of total revenue in fiscal year 2010/11).

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 future revenue growth will largely depend on the successful delivery of capacity improvements from particularly large capital projects, including Crossrail, which is expected to start operations in 2018.

Debt and Liquidity

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 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 (See Governance and Management section).

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. In addition, it also has a GBP5 billion European Medium Term Note programme, updated in 2012, of which GBP2.2 billion were outstanding as of January 2013. For short-term liquidity needs, its European Commercial Paper programme of GBP2 billion allows for rapid and flexible access to liquidity at rates under the LIBOR's. TfL also benefits from a GBP200 million overdraft facility agreement with HSBC (which, as of February 2013, had not been drawn in the past twelve months).

TfL's debt levels rose to GBP8.1 billion at the end of fiscal year 2011/12, or 107% of total revenue, from GBP7.8 billion the previous year. We note that while in the past, TfL guaranteed a number of loans linked to Public-Private Partnership contracts, its new 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 GBP2.3 billion at fiscal year-end 2011/12, and have varied between GBP1.2 billion and GBP2.3 billion since 2009.

TfL had approximately GBP2.6 billion of liquid investments as of March 2012, 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 (including tube lines upgrades) 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 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, are difficult to reconcile to the more cash-based systems used for budgets and long-term planning.

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. 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 would also call into questions 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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