MOODY'S INVESTORS SERVICE

Credit Opinion: Transport for London

Global Credit Research - 03 Jun 2010

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured -Dom Curr	Aa1

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Key Indicators

Transport for London

	2004/05	2005/06	2006/07	2007/08	2008/09
Transport Grant / Total Revenues (%)	**46.8**	**44.2**	**44.6**	**57.4**	**46.6**
Own Source Revenues / Total Revenues (%)	**53.2**	**55.8**	**55.4**	**42.6**	**53.4**
Surplus / (Deficit) for the year / Total Revenues (%)	**0.5**	**-0.1**	**-0.8**	**0.2**	**4.2**
Current Assets / Current Liabilities (%)	**116.2**	**117.3**	**133.1**	**128.0**	**131.9**
Long-Term Borrowings / Fixed Assets (%)	**1.5**	**5.3**	**8.8**	**11.7**	**16.4**
General Fund & Earmarked Reserves / LT Borrowings (x)	**5.7**	**1.8**	**1.1**	**0.8**	**0.4**
General Fund & Earmarked Reserves/Interest Payable (x)	**109.0**	**24.0**	**11.2**	**9.1**	**7.8**

Opinion

Rating Rationale

The Aa1 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 long-term funding frameworks, integrated into its own business plan to 2018. The rating also reflects TfL's significant operating risk from the wide scale of its services and 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 stable 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;

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;

Potential exposures to political stresses in the future on fare and service levels, contributing to a weakening of institutional support for long-term funding agreements;

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 (PPP and PFI).

Rating Outlook

The rating outlook is stable.

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 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 under-perform persistently in meeting operational or financial goals.

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 (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.

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. Maintaining the virtual cycle of stable funding and service delivery has been a key support of the credit.

Financial Position and Performance

TfL has managed its finances well over 'medium-term' periods of 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 and the substantial construction work over the years. But achieving future revenue projections in the later years of the plan to 2018 will depend increasingly on the successful delivery of capacity improvements from particularly large capital projects, such as the East London line (just opened) and Crossrail.

The plan also builds in an increasing and eventually high ratio of own-source-revenue-to-implied subsidies by 2018 (deficit of operating costs to own-source revenues). The need to depend on fares and other revenues for more than 75% of operating costs may ultimately be strained by the challenges of meeting tightly constrained spending on costs and the potential for political friction as fare levels rise. At the same time lower programmatic reserves will reduce margin to manoeuvre within the programme and resistance to shocks, all whilst the large investment programme is underway. Significant downward revisions to TfL's grant funding from currently agreed levels and which now appear likely within the scope of government-wide cuts anticipated in the UK, would further increase these stresses and could have negative implication for the rating.

Whilst the costs of large capital projects have already been built into TfL's funding plans, the rise in TfL's direct responsibility for project delivery raise risks on outturns and to TfL's reputation as a delivery partner. The decision to go forward with Crossrail, the transfer of the approximately GBP7 billion in costs for Metronet projects and staff (already funded by TfL in its payments for the former Metronet PPP agreement) and the potential addition of Tubelines costs to direct TfL control, under the recently announced intention to buy out Tubelines shares, further increase TfL's direct exposure to variances in capital costs. Keeping outturns of these projects on-target to 2018 will remain a significant challenge, even with the flexibility TfL has gained from bringing PPP works in house and TfL's costs on Crossrail being capped as per agreement with the government.

Debt & Liquidity

Debt levels are high, but are anticipated and provided for within the multi-party funding settlements. TfL's debt will rise from GBP3.9 billion as of year-end 2009 to GBP8.4 billion, or approximately 118% of the operating cost base by 2018.

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, to other contractual agreements and to debt itself. The Department for Transport approves and establishes limits for TfL's debt projections, subject to TfL meeting requirements of prudence and affordability required under the Prudential Code. TfL's access to Public Works Loans Board (PWLB) for borrowing, which is funded directly by the UK Treasury, means that TfL has minimal liquidity risk. Despite the linkage of debt to essential services and to strong oversight, TfL's debt is not guaranteed by government.

Substantial contingent liabilities. TfL is likely to continue to use PFI or PFI-related financing in various investment projects. These investment and financing contracts contain a significant level of contingent liabilities.

Liquidity strong, but falling, reducing room to manoeuvre on total financial risks. TfL has approximately GBP1.5 billion of liquid investments as of 31 March 2010, 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 at any time for debt service payments or other costs of TfL and its operating subsidiaries. These funds are projected to be drawn down to GBP250 million by the end of the next financial year, excluding funds allocated for Crossrail, which are programmatically separate. The TfL dedicated funds, anticipate a later recovery to around GBP400 million. These levels offer a buffer of roughly 2.7% against the combined totals of annual fare revenues, operations and capital expenditures including TfL's share of Crossrail as of 2018.

Governance and Management Factors

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 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 audited by the Audit Commission, which also reviews `best value' procedures.

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

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 ten-year funding settlement and the agreement to proceed with Crossrail. High support also reflects the continuing high profile of transport for the Olympics in 2012 and the comfort letter for the Tubelines PPP.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings. 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, for foreign-currency denominated securities benefiting from special characteristics that 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%), medium (31% - 70%) or high (71% - 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, the close economic links and/or close intergovernmental fiscal arrangements between a GRI and its associated government result in a medium to high degree of default dependence.

Default dependence is described as either low (0% - 30%), medium (31% - 70%) or high (71% - 100%)