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Transport for London

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Transport for London

Major Rating Factors

Issuer Credit Rating
AA/Stable/A-1+

Strengths:

- Continued positive relationship with the U.K. government.
- Dominant transport provider in London, which has strategic importance for the U.K. economy.
- Strong expenditure flexibility, due to sizable capital program.
- High levels of liquidity, due to significant cash reserves and access to the Public Works Loan Board.

Weaknesses:

- Risks and uncertainties associated with its major capital program, particularly given the complexities of Crossrail (although TfL's Crossrail liabilities are capped).
- Debt (including finance leases) set to exceed 100% of operating revenues by 2013.
- Uncertainties and tensions over the Tube Lines public private partnership.

Rationale

The rating on Transport for London (TfL) continues to reflect Standard & Poor's Ratings Services' opinion of its positive relationship with the central government, the critical nature of its services for the U.K. economy, and its financial flexibilities. The rating is constrained by the risks and debt associated with its substantial capital plans, the uncertainties arising from the disputed Tube Lines public private partnership (PPP), and the fiscal challenges facing the U.K. (AAA/Negative/A-1+).

TfL is responsible for nearly all public transport functions in London. It operates through a number of subsidiaries, the largest of which is London Underground Ltd., which together comprise the TfL Group. For the purposes of our analysis, we have focused on the group as a whole. TfL is also a functional body of the Greater London Authority (GLA; AA+/Stable/--), and as such is responsible for implementing the mayor's transport strategy.

TfL enjoys an extremely strong business position and a near-monopoly over London's public transport and the associated fares. In addition, approximately one-half of its revenues comes from government grant, via the Department for Transport (DfT). Although the fiscal challenges facing the U.K. government may present some uncertainty over the level of future grant for TfL, we believe that the U.K. government will continue to act in a highly supportive manner, given the importance of TfL's services both for London and the U.K. economy.

Although there are risks and uncertainties associated with TfL's investment program, its substantial size--£13.5 billion (excluding Crossrail) from 2010/11 to 2017/18--allows considerable flexibility to defer, reduce, or cancel individual projects. TfL also has responsibility for Crossrail, a £15.9 billion major rail project for London and the southeast of England. Should the start-up costs of Crossrail overrun beyond the contingency provision, TfL's financial obligations are in effect capped under an agreement with DfT, thereby protecting TfL's credit standing.

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Liquidity

TfL has a sufficient level of liquidity, with cash and short-term investments (excluding those earmarked for Crossrail) at £1.0 billion, or 16.9% of estimated operating expenditures, as at March 2010. In addition, it has ready access to the government-funded Public Works Loan Board (PWLB), assuming TfL remains within its prudential borrowing limits.

Outlook

The stable outlook reflects our expectation that TfL will continue to have a positive relationship with the U.K. government (AAA/Negative/A-1+), which could lead to additional support in the event of financial stress. In the unlikely event that such support is not forthcoming, pressure might be put on the rating if the put option on the Tube Lines bonds were exercised, requiring TfL to pay 95% of the agreed debt amount (£1.4 billion–£1.7 billion).

Any positive rating action is likely to be contingent on the satisfactory resolution of the Tube Lines PPP dispute, greater clarity after the U.K. general election around TfL's grant settlement, and progress on the construction and revenue collection associated with Crossrail.

Peer Comparison

TfL is markedly different to most other comparable public transport providers in Western Europe. Like Rostocker Strassenbahn AG (BBB+/Stable/--) and Rheinbahn AG (AA-/Stable/A-1+) in Germany, or Consorcio de Transportes de Bizkaia (AA+/Negative/A-1+) in Spain, we view TfL as performing a vital public policy function, due to the economic importance of transport infrastructure. But as a local government entity, rather than a company owned by shareholders, TfL has a somewhat different funding system and status. For instance, its grant (described as transfers in the table below) is set at the U.K. government's discretion, and TfL (under the GLA's strategic direction) has substantial autonomy over spending. This contrasts with the detailed contracts and formula-based grant allocations that apply to its above-mentioned peers. As a further difference, the chair of TfL's board is an elected official, the mayor of London. Although we believe the U.K. government would act supportively toward TfL in a financial stress scenario, the government would not be legally obliged to meet TfL's liabilities in a timely manner, unlike the Region of Brussels-Capital, which formally guarantees the obligations of Societe des Transports Intercommunaux de Bruxelles (AA/Stable/A-1+).

Our analysis of the likelihood of extraordinary government support for TfL is based not only on TfL's role and link with the U.K., but also on TfL's unique status, governance, and funding arrangements, and other general features of the U.K. local government system. For these reasons, we have used our local government criteria to assess TfL's creditworthiness (see Methodology And Assumptions: Rating International Local And Regional Governments, published Jan. 5, 2009). We have also used the same criteria to assess France's Sytral (AA-/Stable/--), but for the other peers in the table below we have used our criteria for government-related entities (see "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published June 29, 2009).

Reflecting the size of the London transport network, TfL has significantly greater revenues than those of its peers, while the proportion of government grant it receives is broadly comparable. Its levels of debt as a percentage of revenues are also similar to most of its peers, although substantially less than the higher rated Consorcio de Transportes de Bizkaia, whose rating is more closely linked to those of its regional government owners.

Table 1

Transport for London--Peer Comparison 2010

	Transport for London**	Consorcio de Transportes de Bizkaia	Societe des Transports Intercommunaux de Bruxelles	Sytral	Rheinbahn AG	ATAC SpA
Issuer credit rating*	AA/Stable/A-1+	AA+/Negative/A-1+	AA/Stable/A-1+	AA-/Stable/--	AA-/Stable/A-1+	A/Stable/A-1
Country	U.K.	Spain	Belgium	France	Germany	Italy
Government owners	No shareholders as such, but U.K. government likely to assume ultimate responsibility	Historical Territory of Bizkaia and Autnomous Community of the Basque Country	Region of Brussels-Capital	Lyon (Urban Community of) and Rhône (Department of)	City of Duesseldorf directly 5%, and through holding company 95%	City of Rome
Issuer credit ratings of government owners*	AAA/Negative/A-1+	AA+/Negative/A-1+; AAA/Stable/--	AA/Stable/--	N.R.	N.R.	A+/Stable/--
Link with the government owner	N.A.	Integral	Integral	N.A.	Very strong	N.A.
Role to the government owner	N.A.	Critical	Critical	N.A.	Critical	N.A.
Likelihood of Extraordinary support from the owner government	N.A.	Almost certain	Almost certain	N.A.	Extremely high	N.A.
2008 based on Standard & Poor's estimates						
Revenues (mil. £)	6,754.0	137.0	578.6	461.1	177.0	394.2
Total transfers (% of total revenues)	47.2	48.3	56.7	20.6	21.6	24.5
Fare revenues (% of operating revenues)	50.4	67.4	67.4	67.4	67.4	67.4
Direct debt at year-end 2008 (in million £)	5,211.0	295.4	216.6	1,032.0	150.5	152.1
Direct debt (% of 2008 operating revenues)	77.1	277.1	38.1	187.7	83.1	33.4
Interest (% of operating revenues)	1.7	9.0	1.4	7.8	3.9	1.8
Population in catchment area (000s)	7,600	900	1,100	1,300,000	1,005	2,500

*Ratings as of Feb. 1, 2010. ¶Turnover before loss coverage. §Refers only to the subway operator, Metro de Bilbao (100% subsidiary of CTB). Metro de Bilbao receives capital injection (9.1 million in 2008) which are added to the denominator. Figures for ATAC are based on Standard & Poor's methodology. **Financial data is based on 2009. N.A.--Not available. N.R.--Not rated.

Diversified Economy Underpins Resilient Demand For Transport

London's economic importance to the U.K

London is the U.K.'s economic, financial, and cultural center. With a population of 7.6 million--12.4% of the U.K.'s population--London produces 21.0% of the nation's gross value added (GVA; 2008). Given its status as a major net contributor to the U.K. economy, it is in the strong interest of central government to help the city develop its income-generating potential through the effective provision of public transport.

Diversified and resilient economy

London's economy, with its particular exposure to the financial and business services sector, has suffered in the U.K. recession. Annual output shrunk by 5.3% (as at the second quarter of 2009), and over the same period employment reduced by 1.5%. That said, we believe the city's medium-term prospects are positive given that London's economy remains large and diversified.

Data to December 2009 (source: TfL) showed an annual reduction of 0.6% in passenger journeys on London's transport system. This is an important indicator of the resilience of the demand for TfL's services, in a year of severe recession (the GLA estimates a reduction in London's GVA of 3.5% for 2009). Tube journeys were actually down by 3.6% at December 2009, but the greater number of bus journeys increased by 1.0%, presumably as passengers sought cheaper travel.

The GLA's own forecast (as published in autumn 2009) are that London's economic output will reduce by 0.2% in 2010, before returning to growth of 1.5% in 2011. In relation to Standard & Poor's forecast of growth in U.K. GDP of 1.2% and 2.2% in 2010 and 2011, we believe the GLA's forecasts for London are on the conservative side, even allowing for London's exposure to the financial sector. (For more on our forecasts for the U.K. economy as a whole, see "European Economic Forecast: The Glass Is Looking More Than Half Empty," published on Jan. 21, 2010.)

By 2021, the GLA forecasts that London's population will have grown by more than 10%. 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.

Crossrail

In order to meet this long-term demand for increased public transport capacity, the U.K. government has now approved the funding for Crossrail, which should increase rail-based transport capacity in London by approximately 10%. Crossrail is a major rail project for London and the southeast of England, set to run from Heathrow and Maidenhead (west of London) to Essex and Kent (east of London). The project will involve a high degree of risk and complexity, due to the required tunneling and interface with the London Underground, and has a budget of £15.9 billion. Various sources are contributing to the project, including the DfT via direct grant (£5.1 billion), London businesses via the GLA's supplementary business rate (£3.5 billion), TfL via prudential borrowing (£2.4 billion), and Network Rail (£2.3 billion). (TfL and Network Rail expect to recover their contributions through future fare revenues and charges.) The sponsors of the project are both TfL and DfT, although TfL is the sole shareholder of Crossrail Ltd. (CRL), the company charged with delivering the project. (For more on Crossrail's financing, see below.)

Management Capacity And Government Support

The TfL board is chaired by the Mayor of London, Boris Johnson (Conservative Party). Despite political differences with the U.K. Labour government, overall there appears to be a positive working relationship. DfT, the main source of TfL's grant funding, appears to have a positive view of the team's capacity, as demonstrated by its support for TfL's takeover of the Metronet contracts, and the responsibility given to it to deliver the Crossrail project. Given this positive relationship, and the importance of London's transport system to the U.K. government, we believe that DfT will continue to act supportively, despite the fiscal challenges facing the U.K.

Overall, we view TfL's financial management as excellent from a credit perspective. Its financial policies are very prudent, particularly in relation to its low debt-service costs, and it maintains a very high degree of transparency. The mayor has also shown himself willing and able to impose unpopular fare rises, although other decisions, such as the planned abolition of the Western congestion charge zone, will reduce TfL's potential revenues.

The mayor is supported by a strong and experienced TfL management team, which has successfully delivered a number of important projects to date, demonstrating a good ability to forecast and control costs. The transport commissioner, Peter Hendy, and much of his senior management team (which is recruited on an international basis), have been in place for a number of years, ensuring a degree of continuity.

Financial Flexibility

Fare revenues broadly stable despite recession

TfL's own-source operating income (from fares, congestion charging, etc) is set to total £3.4 billion, or 51.7% of total revenues, in financial 2009/10. Due to the effects of the U.K. recession, this is only slightly up on 2008/09. Looking ahead, TfL expects fares to rise to £3.6 billion for 2010/11. This is driven both by an uptake in demand, as well as above-inflation fare rises from January 2010, which on average have been 12.7% on buses and 3.9% on the tube. Due to TfL's effective monopoly over public transport, fares could in theory be increased without materially dampening demand. In reality, however, it would be politically very difficult for the mayor to repeat such large annual increases in the near future.

Grant settlement and prospects for additional finance

DfT has agreed a grant settlement with TfL up to 2017/18, a length of time that is unprecedented for a local government body. Despite the U.K. government's fiscal challenges, we would expect it at least to largely abide by this settlement, due both to the government's general practice in honoring such settlements, and to the importance of public transport provision to London and therefore the U.K. economy.

Under its own direct borrowing plans, TfL's debt service in the period to March 2018 will not exceed 4%-5% of recurring revenues, so there should in theory be some flexibility to increase debt without compromising credit quality. In reality, however, the government is likely to restrict borrowing to the levels set out in the business plan. In any case, TfL's management has indicated that they intend to stay within the borrowing levels.

Crossrail funding

In addition to the general grant settlement described above, DfT has contractually agreed to provide £5.1 billion in grant funding for Crossrail. Through being a legally enforceable contract, this should provide investors with some comfort that the DfT would be unlikely to abandon their commitment to the project. If the project were to be abandoned, DfT would be liable to relieve TfL of 75% of its outstanding principal and interest on TfL's Crossrail-related debt (which is expected to be £2.4 billion), and to relieve 100% of the GLA's Crossrail-related debt.

The GLA is set to raise £3.5 billion through borrowing, to be serviced by a business rate supplement (BRS) levied on London's businesses. This £3.5 billion, in addition to any surplus BRS, will then be transferred as a grant to TfL. (For more information on the GLA's contribution, see the full analysis entitled "Greater London Authority," published on March 25, 2010, on RatingsDirect.) The other major contributor to Crossrail is to be Network Rail, which has agreed to fund £2.3 billion of enabling works on its network (to be recouped from future track access charges). We understand that this arrangement is covered by a Regulatory Protocol, agreed between CRL, DfT, TfL, and the Office of the Rail Regulator (ORR). We also understand that DfT will assume the risk of the enabling works costing Network Rail more than the £2.3 billion.

Substantial expenditure flexibility, particularly with capital program

Large and diversified capital expenditure program. The nature of TfL's capital expenditure program, which is about 20% (excluding Crossrail) of total expenditures up to 2018, allows for considerable flexibility. Much of the planned program is currently uncommitted, particularly in later years of the plan. Should, for instance, fare revenues decline due to lower passenger numbers (which they did by £100 million in the recession of the 1990s), then TfL has substantial flexibility to reduce the scope of the program or defer individual elements, although such measures would generally be viewed as a last resort. That said, one area where it would be particularly difficult to defer expenditure is on infrastructure related to the 2012 Olympics. We understand that this only constitutes about 10% of planned capital expenditure up to 2012.

Operating expenditures. Although most of TfL's expenditure flexibility relates to its capital program, it does have some scope to find efficiency savings in its operating expenditure. For instance, it plans to find £5 billion of savings over the course of its business plan, representing a 27% reduction in back office and support costs. Given the ambition of this program, however, it may be difficult for TfL to find further operating savings in response to a financial stress scenario.

Much less flexibility exists in relation to TfL's obligations under its PPP/PFI (private financial initiative) contracts, which is set to comprise about 18% of operating expenditure in 2010/11. Its only PPP contract with Tube Lines is due for renewal in 2010, and the new cost appears to be some £400 million more than anticipated in TfL's business plan. The various parties have yet to agree how this will be met.

Crossrail expenditure. Capital expenditure on Crossrail will be handled separately through CRL, a wholly owned subsidiary of TfL. Progress will be time-sensitive, as the funding model assumes a fare revenue stream starting in 2017. Severe construction delays would therefore not only generate their own additional expense, but lead to a loss of expected fare revenues.

Given the complexity of the Crossrail interface with the underground network, and the potential hazards of tunneling through London, the project could encounter significant unforeseen costs. Importantly, however, if costs overrun beyond a certain contingency that has been set aside, or if DfT is in material breach of contract, then TfL has an option to transfer the ownership of CRL to DfT, which would then become the lead sponsor (this is referred to as a "put option"). If this put option is exercised, then the risks associated with completing the project would be with DfT. DfT may also control Crossrail's future ticket revenues at this stage, but we believe it would be highly unlikely that such a scenario would leave TfL under-funded and unable to service its Crossrail debt obligations. That said, the U.K. government's exposure in the event of cost overruns could become a source of political friction between it and the GLA Group.

Budgetary Performance

TfL has demonstrated its ability over a number of years to forecast and control revenues and expenditure. As its business plan shows (see table), TfL's revenues (including precepts and government grant) easily cover its operating expenditures, generating operating surpluses of about 10% of revenues. Its high level of capital expenditures, however, leads to a consistent increase in borrowings. Debt is forecast to increase over the life of the business plan, although debt-service costs (excluding PPP/PFI obligations) are set to remain low. By 2013, debt service is forecast to rise to about 4.5% of recurring income.

Liquidity And Debt Management

TfL has a high level of liquidity, given the predictability of its main revenues and operating expenditures, with cash and short-term investments at more than 25% of operating expenditure, or £1.5 billion as at March 2010. Excluding the cash and short-term investments earmarked for Crossrail, this would be £1.0 billion. TfL holds its short-term investments according to a highly prudent treasury management approach.

We understand that levels of cash and short-term investments are due to fall to £251 million by financial year-end 2011 (excluding cash earmarked for Crossrail), but that TfL will have access to additional liquidity by issuing commercial paper for its short-term needs. We understand that total issuance at any one time will remain within the prudent borrowing limits that TfL has assessed as being affordable. As a further source of liquidity, the PWLB provides loan finance on request to TfL, providing that TfL is within its prudential borrowing limits. TfL's access to the PWLB is an important credit feature, substantially limiting refinancing or liquidity risk.

The majority of TfL's £3.9 billion direct debt (as at December 2009) is sourced from the government-funded Public Works Loan Board (PWLB). TfL has fixed all of the interest payments on its borrowings to date. Going forward, it plans to use derivatives to enhance protection against movements in both interest rates and commodity prices.

TfL's other borrowing is through bonds issued on the capital market, loans from the European Investment Bank, and finance leases (£2.2 billion) primarily relating to TfL's PPP/PFI obligations. Consolidating its cash, short-term investments, debt-like obligations, and net pension liability, we calculate that TfL's net financial liabilities at financial year-end 2009 are £4.8 billion, or 72.5% of total revenues, rising to about 90% over the next few years. Due to a long amortization profile and low interest costs, however, direct debt-service costs will remain a small proportion (4%-5%) of recurring revenues. Given this low level, and TfL's financial flexibilities, we believe that the borrowing as set out in the business plan will be readily sustainable at the current rating level.

Contingent Liabilities

TfL's major contingent liability relates to about £1.4 billion-£1.7 billion of senior debt issued by Tube Lines (Finance) PLC. According to the terms of its PPP contract with Tube Lines, TfL is liable, in the event that a put option is exercised, to pay 95% of the agreed amount of outstanding debt. When such an option was exercised in relation to Metronet in 2007, TfL received additional grant funding from DfT of £1.7 billion, in time to meet its £1.74 billion obligation. Should the put option be exercised for the Tube Lines debt, we would expect DfT to act again in a supportive way to TfL, in accordance with its Letter of Comfort.

Table 2

Transport for London Financial Summary and Business Plan 2008-2013

(Mil. £)	2013	2012f	2011f	2010f	2009	2008
Operating income (exc. grants and precept)	4,016	3,716	3,586	3,443	3,406	3,258
Operating costs (exc.debt service)	(6,254)	(5,994)	(6,050)	(5,744)	(5,763)	(5,578)
Debt service	(313)	(258)	(207)	(168)	(113)	(75)
Net capital expenditure	(1,848)	(1,596)	(2,080)	(1,956)	(2,041)	(837)
Contribution to Crossrail expenditure	(2,049)	(1,410)	(1,052)	(694)	--	--
Other	(16)	(35)	(50)	(24)	108	(142)
Funding required	(6,464)	(5,577)	(5,853)	(5,143)	(4,403)	(3,374)
Funded by						
DfT transport grant	3,174	3,028	3,314	2,887	3,103	4,301
Other grant items	451	439	397	150	233	139
GLA precept	12	12	12	12	12	12
TfL borrowing and other financing	652	575	405	1,100	1,067	600
Crossrail funding sources	2,150	1,547	1,237	172	N.A.	N.A.
Total funding	6,439	5,601	5,365	4,321	4,415	5,052
Closing cash position	N.A.	N.A.	N.A.	N.A.	2,002	1,908
Direct debt (exc. finance lease obligations) (from Group financial statements)	N.A.	N.A.	N.A.	N.A.	3,018	1,950
Finance lease obligations	N.A.	N.A.	N.A.	N.A.	2,193	3,311
Net pension liabilities	N.A.	N.A.	N.A.	N.A.	1,148	607
Net financial liabilities	N.A.	N.A.	N.A.	N.A.	4,357	3,960

e--Estimate. f--Forecast. Note: Operating income and costs in 2009 are net of transactions relating to Metronet. N.A.--Not available.

Ratings Detail (As Of April 14, 2010)*

Transport for London	
Issuer Credit Rating	AA/Stable/A-1+
Senior Unsecured (5 Issues)	AA
Issuer Credit Ratings History	
29-Mar-2010	AA/Stable/A-1+
12-Mar-2003	AA/Stable/--
18-Oct-2001	AA/Negative/--

*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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