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Transport for London

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Table Of Contents

Transport for London

Major Rating Factors

Issuer Credit Rating
AA/Stable/--

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 sizeable 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)
- Direct debt to rise to about 100% of revenues, although debt-service costs set to remain affordable

Rationale

The rating on TfL continues to reflect its positive relationship with the central government, the importance of its services to the U.K. economy, and its financial flexibilities. The rating is constrained by the risks and debt associated with its substantial capital plans. TfL is a functional body of the Greater London Authority (GLA; AA+/Stable/--), and is responsible for nearly all public transport functions in London.

Following elections in May 2008, the TfL board is now chaired by the new Mayor of London, Boris Johnson (Conservative Party). The new mayor's priorities will have various financial implications: he has already announced that the congestion charge zone will be reduced in size, thereby reducing revenues, but has also placed an emphasis on finding efficiency savings. We believe that any reductions in planned revenues will lead to corresponding adjustments in TfL's nine-year business plan, and that TfL will retain a prudent financial strategy.

TfL enjoys an extremely strong business position and a near-monopoly over London's public transport, and the associated fares. In addition, almost half of its revenues come from government grant, via the Department for Transport (DfT). Given the importance of TfL's services both for London and the U.K. economy, we would expect TfL to continue receiving substantial grant settlements, and to enjoy the prospect of additional support, if necessary, for the foreseeable future.

TfL has a high level of liquidity, with cash and short-term investments at about 30% of operating expenditures, and only slightly less than its £1.95 billion direct debt (at financial year-end 2008). The majority of TfL's debt is sourced from the government-funded Public Works Loan Board (PWLB). TfL's access to the PWLB is an important credit feature, substantially limiting refinancing and liquidity risk.

Although there are risks and uncertainties associated with TfL's investment program, its substantial size--£15.7 billion (excluding Crossrail) over nine years--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.

TfL continues to face the ongoing challenges of managing the relationships and cost pressures associated with its public private partnership (PPP) contracts with Tube Lines, integrating the operations formerly run by Metronet, and pursuing efficiencies across the group.

Outlook

The stable outlook reflects our expectation that TfL will continue to have a positive relationship with the U.K. government (AAA/Stable/A-1+), demonstrated by the latter's willingness to provide additional support in the event of financial stress. Pressure might be put on the rating if conflict between the Conservative mayor and Labour central government led to a diminution of this potential supportiveness, but we believe such a scenario is unlikely.

TfL forecasts that its debt is set to increase substantially, rising by £5.69 billion between financial year-end 2008 and 2018. Given TfL's strong financial flexibilities, we believe that this borrowing will be sustainable at the current rating level, assuming that debt-service costs remain low in accordance with forecasts, and that TfL continues to have ready access to the PWLB. We do not expect to lower the rating.

Diversified Economy Underpins 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 7.5 million--about 12% of the U.K.'s population--London produces 18.9% of the country's gross value added (GVA; 2007). 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, is likely to continue to suffer during the current U.K. recession. But its economy remains large and diversified, and its medium-term prospects positive. The GLA's own forecasts are that London's economic output will grow by just 0.2% in 2009, before picking up speed in 2010 and 2011, with growth at 1.9% and 3.2% respectively. Although we believe the GLA's 2009 projection to be overly optimistic, we expect that the size and diversity of London's economy will contribute to its resilience, and that both London and the U.K. will have come out of recession by the end of 2010.

London's population is approximately 7.5 million, and the catchment area for commuting into the city covers a significantly larger number of people. By 2025, the city's population is forecast to grow by 0.8 million, and the number of jobs by 0.9 million. 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. TfL estimates that peak public transport demand will grow by 25% from 2006 levels.

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 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 will contribute to the project, including the Department for Transport 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.

Management Capacity And Government Support

Following elections in May 2008, the TfL board is now chaired by a new 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. The new mayor's priorities will have various financial implications: he has already announced that the congestion charge zone will be reduced in size (thereby reducing revenues from 2010) and placed an emphasis on finding efficiency savings, including cutting planning work for projects that are not funded in the business plan. We believe that any reductions in planned revenues will lead to adjustments in expenditure, and that TfL will retain a prudent financial strategy.

The mayor is supported by a strong and experienced TfL management team, which has successfully delivered a number of important projects to date, demonstrating an 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. (That said, the managing director of London Underground, Tim O'Toole, has recently announced his resignation.) The challenges of delivering such a complex capital program 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.

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 is likely to act supportively, should TfL encounter financial difficulties.

Financial Flexibility

Stable revenues streams, constrained by political considerations

TfL's own-source operating income (from fares, congestion charging, etc) is set to total £3.4 billion in financial 2008/2009, which is slightly more than the £3.0 billion it expects in grant from the Department of Transport. This distribution of revenue sources is a positive credit feature, allowing TfL the stability and predictability of government grant, together with a degree of autonomy over its own operating revenues.

Demand for transport remains strong to date.

Despite the current U.K. recession, demand for public transport in London has remained strong even in recent months. For instance, data up to December 2008 shows that passenger journeys on London's Underground and buses (an underlying indicator of economic activity, and important revenue source for TfL) continued to grow at 3.3% on an annual basis, albeit at a slightly slower rate than previously. As the recession continues, however, it is likely that passenger numbers, particularly on the underground, could decline.

TfL's business plan assumes fare increases at the retail price index (RPI) plus 1%, so there may be some scope to increase these further. Historically, moderate above-inflation fare increases have not weakened overall demand for public transport services, and would be unlikely to do so in the future, largely because of TfL's near-monopolistic position. That said, significant fare rises could represent a political risk for the directly elected mayor, particularly in a time of economic recession. (In the lead-up to the last mayoral election, for instance, the former mayor actually stopped increases that had previously been anticipated in the planning process.)

Grant settlement and prospects for additional finance.

DfT has agreed a grant settlement with TfL up to 2017/2018, a length of time that is unprecedented for a local government body. Although not legally binding, we would expect government to 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. That said, due to increasing fiscal pressure on the U.K.'s finances, additional grant is unlikely in the medium term, unless it is perceived as critical to London's infrastructure. Should TfL require more revenues, its most likely source would be from prudential borrowing, either via the GLA, or on its own balance sheet. Under its own direct borrowing plans, TfL's debt service will peak in 2017 at only 4.3% of revenues (inc. government grant), so there should be some flexibility to increase debt without compromising credit quality. At present, however, TfL's management indicate that they intend to stay within the borrowing levels as set out in their business plan.

Crossrail funding.

In addition to the general grant settlement described above, DfT have 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 (expected to be £3.5 billion).

Similarly, if there are delays in setting up the GLA's proposed supplementary business rate, then DfT has indicated it would pay additional grant to the GLA, enabling it to proceed with £3.5 billion Crossrail-related borrowing as planned. (For more information on the GLA's contribution, see the full analysis entitled "GLA," published on Feb. 25, 2009, 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). Although not a contractual obligation to Crossrail Ltd. (CRL), we understand that this work will be written in to Network Rail's funding agreement with the rail regulator.

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% of total expenditures (exc. Crossrail) over the next nine years, 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 constitutes less than one-third 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, and plans to find savings of 14% of relevant expenditure over the course of its business plan. This will include savings from integrating the operations previously run by Metronet.

Less flexibility, however, exists in relation to TfL's obligations under its PPP/PFI contracts, which are set to comprise 25.5% of operating expenditure in 2008/2009. Its only PPP contract with Tube Lines is due for renewal from 2010, and this is likely to lead to a cost increase higher than anticipated in TfL's business plan. Initial guidance from the PPP arbiter suggests TfL may have to increase in real terms its PPP payments to Tube Lines by £1.0 billion-£1.5 billion more than anticipated by TfL. This would represent about 20% of annual revenues, albeit spread over seven years. The guidance, however, only gives an indicative figure, and the detailed scope of the future contracts has yet to be decided.

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, who 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 (inc. precepts and government grant) easily cover its operating expenditures, while its high level of capital expenditures depend on a consistent increase in borrowings. Debt is forecast to increase over the life of the business plan, although debt-service costs (exc. PPP/PFI obligations) are set to remain low. Between 2008 and 2012, debt service is forecast to rise from about 1% to about 3% of revenues (that is, operating income, grant, and precept), rising to 4.3% of revenues by 2017.

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 about 30% of operating expenditure, or £1.9 billion at financial year-end 2008. Up to £40 million of these investments are at risk with Kaupthing Singer & Friedlander, a U.K. subsidiary of Kaupthing, which is in administration. Since making that investment, TfL has adopted a more conservative treasury management approach.

The majority of TfL's £1.95 billion direct debt (as at financial year-end 2008) is sourced from the government-funded Public Works Loan Board (PWLB). The PWLB is obliged to provide loan finance on request to TfL, providing that TfL is acting legally. TfL's access to the PWLB is an important credit feature, substantially reducing any refinancing or liquidity risk. TfL has fixed all of the interest payments on its debt, and has recently gained powers 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 (£3.3 billion) primarily relating to TfL's PPP/PFI obligations. Consolidating its cash, short-term investments, debt-like obligations, and net pension liability, TfL's net financial liabilities at financial year-end 2008 were a manageable £3.96 billion, or 55.0% of revenues. We would expect this to increase substantially, with direct debt set to rise by a further £5.69 billion by 2018. Due to the long amortization profile, however, debt-service costs will remain low at 4.3% of revenues. Given TfL's financial flexibilities, we believe that this borrowing will be sustainable at the current rating level.

Contingent Liabilities

TfL's major contingent liability relates to about £1.4-£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 (and we have no reason to believe it will be), we would expect DfT to be similarly supportive to TfL, in accordance with its original Letter of Comfort.

Transport for London Financial Summary 2008-2012

	--Year ending March 31--				
(Mil. £)	**2012f**	**2011f**	**2010f**	**2009e**	**2008**
Operating income (exc. grants and precept)	4,073	3,874	3,669	3,429	3,295
Operating costs (exc.debt service)	-6,406	-6,318	-5,940	-5,783	-5,744
Debt service	-227	-207	-166	-116	-74
Net capital expenditure	-1,797	-1,942	-1,989	-1,893	-939
Other	-475	-702	-618	36	-1,737
Funding required	-4,832	-5,295	-5,044	-4,327	-5,199
Funded by					
DfT transport grant	3,040	3,300	2,897	3,013	4,382
Other grant items	17	81	139	75	56
GLA precept	12	12	12	12	12
TfL borrowing and other financing	718	507	1,100	1,067	740
Crossrail funding	875	990	8	0	0
Reserve transfers	170	405	889	160	9
Total funding	4,832	5,295	5,044	4,327	5,199

e--Estimate. f--Forecast.

Ratings Detail (As Of March 13, 2009)*	
Transport for London	
Issuer Credit Rating	AA/Stable/--
Senior Unsecured (5 Issues)	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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