STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Research

Research Update:

Transport for London 'AA+/A-1+' Ratings Affirmed Despite Ongoing Grant Reductions; Outlook Stable

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Overview

- Transport for London (TfL) continues to perform in line with our expectations.
- Operating balances and balances after capital accounts are beginning to weaken, as government grants reduce, but growth in fare revenues is proving robust.
- We are therefore affirming the 'AA+/A-1+' issuer credit ratings on TfL.
- The stable outlook reflects our expectation that TfL's credit strengths, particularly its flexibility, financial management, liquidity, and supportive institutional framework, will be sufficient to maintain its rating, despite the weakening of its financial profile.

Rating Action

On May 9, 2014, Standard & Poor's Ratings Services affirmed its 'AA+' long-term and 'A-1+' short-term issuer credit ratings on U.K. transport provider Transport for London (TfL). The outlook is stable.

Rationale

The ratings on TfL reflect the predictable and supportive institutional framework within which it operates as a U.K. local authority, its very positive liquidity position, and the strong growth of London's economic output and population, which underpins demand for TfL's services. Although TfL has a major capital program, the U.K. government effectively underwrites much of the exposure to cost overruns on TfL's largest capital project, Crossrail, thereby limiting TfL's contingent liabilities. In addition, TfL has considerable flexibility to defer many elements of its capital program. Although its ability to increase fares can be subject to political constraints, we view TfL's overall commitment to fiscal discipline, and the quality of its financial management, as being very positive for its credit profile.

Constraining factors for the rating include the prospect of deficits after capital accounts and rising debt levels as grant funding reduces and as TfL continues its planned investments in infrastructure. That said, as we noted in our previous outlook statement, we believe that TfL's credit strengths will be sufficient to maintain the rating, even though its financial profile is set to weaken (see "Transport for London 'AA+/A-1+' Ratings Affirmed Despite Ongoing

Grant Reductions; Outlook Stable," published on Nov. 15, 2013).

TfL is a functional body of the Greater London Authority (GLA) and is responsible for implementing the mayor's transport strategy in London. TfL has many subsidiaries that together comprise the TfL Group. In our analysis, we focus on this consolidated group.

We continue to view the U.K. institutional framework, within which TfL operates as a local authority, as stable and predictable. Although many local authorities will face continued spending pressures over the coming years, as the U.K. seeks to reduce its fiscal deficit, we anticipate that they will have the capacity to properly plan and reduce expenditures without threatening their mandatory responsibilities. Reflecting the austerity in the U.K. public sector, TfL is experiencing reductions in its grant income, but these have been small for the sector. And unlike other local authorities, TfL has been allocated a substantial multiyear capital grant up to 2020/21. This reflects the ongoing central government support for investment in the London transport network, which is vital to London's economy.

The strength of London's economy, the growth in its population, and the consequent demand for public transport, are key to TfL's creditworthiness. These factors support both its ability to generate fare revenues, and the rationale for continued central government funding. We estimate that London's gross value added (GVA) per capita was £37,232 in 2012, and we forecast growth in GVA will continue to gather pace, rising to 2.9% in 2014, supported by rising employment levels. We expect London will grow faster than the U.K. average, reflecting the more-flexible and service-oriented nature of London's economy, in which financial services play a key role. London is both pivotal to the U.K.'s economic growth and a major net contributor to the U.K.'s fiscal position.

Supported by London's economy, the growth in TfL's fare revenues has proved buoyant. Combined with its grant income, this has led to strong overall financial performance in previous years. Over the past three years, for instance, TfL has posted operating balances averaging in excess of 20% of operating revenues and surpluses after capital accounts averaging about 5% of total revenues. In the year ended March 31, 2014, TfL outperformed our previous forecast, posting an operating surplus of about 20% and a 3% surplus after capital accounts (where we had previously forecast a deficit). Looking ahead, however, we forecast a structural decline in financial performance that primarily reflects a reduction in government grants combined with substantial investment in capital infrastructure. Consequently, we expect TfL to post deficits after capital accounts over the next three years averaging 13% of total revenues and lower operating surpluses of about 5% on average.

We expect the decline in operating balances from 2015 to be more marked than the fall in balances after capital accounts. We forecast that TfL will even post a temporary operating deficit in 2015/2016. That said, the size of this fall is largely due to a change in the way that some government grant will be classified, and has limited significance from a credit perspective.

The change relates to the investment grant that TfL is set to receive from 2015. TfL currently receives an equivalent grant that can be used for either operating or capital expenditure, but the investment grant allocated from 2015 will be restricted for general capital expenditure only. Our forecasts for 2015 onward therefore assume that we will reclassify this portion of TfL's grant as a capital revenue, rather than an operating revenue. This change will affect a number of our key ratios for assessing budgetary performance, budgetary flexibility, and debt, but we do not anticipate that it will have any rating implications. This investment grant is set to be highly predictable, and its restricted nature will have little effect on TfL's flexibility to ease financial pressure by deferring capital expenditure, given that annual capital expenditures are typically 3x the level of this investment grant.

As a consequence of its capital program, we forecast that TfL's debt (including lease obligations) will increase from £8.9 billion to £10.5 billion. The change in our ratio of tax-supported debt to operating revenues implies a more marked increase in TfL's debt burden, from 115% in March 2014 to about 145% in 2017, due to the decrease in the operating-revenue denominator, as described above.

We understand that TfL is willing and able to defer or cancel many aspects of its large and diverse capital program, if necessary. We view TfL's ability to control these expenditures as its main source of budgetary flexibility. Although TfL has significant flexibility to raise its transport fares in theory, given its near-monopoly position over public transport in London, we believe that this is tempered in reality by political constraints, particularly nearing mayoral and general elections. Therefore, in our base-case scenario, we forecast that TfL will increase fares less than is assumed in its business plan.

We view TfL's overall commitment to fiscal discipline, and the quality of its financial management, as being very positive for its credit profile. This reflects our view, in particular, of TfL's detailed long-term planning, clear budgetary procedures, and high level of transparency.

Liquidity

We view TfL's liquidity position as very positive. It has a very positive debt service coverage of 3.2x, supported by strong and predictable cash flows. TfL also has ready access to external liquidity, which we view as exceptional in international terms, based on its ability to borrow from the U.K. government's Public Works Loan Board (PWLB). TfL also has an established track record of issuing on the capital markets.

We estimate that, on average, TfL will have cash and short-term investments that cover the next 12 months' debt service by 3.2x, after allowing for some loss of value in a stress scenario. We calculate debt service to include repaying commercial paper. (TfL also has access to an undrawn overdraft of

£200 million and has arranged an undrawn £500 million term loan related to Crossrail, which we do not include in this 3.2x calculation.)

Beyond the next 12 months, we see TfL's levels of free cash and equivalents continuing to diminish to fund its planned capital program. TfL has effectively been prefunding its capital program by raising debt in advance of the associated capital expenditure.

We view TfL as having exceptional access, in international terms, to external liquidity. This is primarily due to the U.K. government's PWLB, which can provide funding to TfL within 48 hours of an application, as long as TfL is operating according to the Prudential Code. In addition, TfL has an established track record of issuing commercial paper and medium-term notes on the capital markets.

Outlook

The stable outlook reflects our expectation that TfL's credit strengths, particularly its flexibility, financial management, and liquidity, will be sufficient to maintain its rating, even though its financial profile is set to weaken as grant reduces and capital investment continues, resulting in deficits of capital accounts.

We may consider raising the rating within the next two years if TfL's total revenues rise such that deficits after capital accounts shrink to an average of less than 5% of revenues. This increase could be supported by higher income from fares, charges, other commercial sources, and the general revenue grant. Such a scenario would also likely involve TfL demonstrating increased autonomy over its revenues, which could also improve our assessment of budgetary flexibility.

Conversely, we could consider lowering the rating in the next two years if TfL substantially increases its capital expenditure, whether as a result of cost overruns or a shift in financial strategy, resulting in financial performance deteriorating more sharply than we expect. In such a scenario, we might consequently revise downward our view of TfL's financial management, and its willingness to use its expenditure flexibilities.

Published Rating Factor Scores

Table 1

Transport for London--Summary Of Published Rating Factor Scores*

RATING FACTOR	SCORE
Institutional framework	Predictable and supportive
Financial management	Very positive
Liquidity	Very positive

Table 1

Transport for London--Summary Of Published Rating Factor Scores* (cont.)

*Standard & Poor's ratings on local and regional governments are based on, among other things, a scoring system that covers eight main rating factors, as further explained in our criteria (see below). We publish our scores for the three rating factors above.

Key Statistics

Table 2

Transport for London--Economic Statistics

	--Year ended Dec. 31--					
	2010	**2011**	**2012**	**2013bc**	**2014bc**	**2015bc**
Population	8,061,511	8,204,484	8,308,417	8,399,810	8,483,808	8,577,130
Population growth (%)	N.M.	1.77	1.27	1.10	1.00	1.10
GDP per capita (£)	35,896	36,976	37,232	38,464	40,025	41,609
Real GDP growth (%)	1.7	4.4	1.5	1.9	2.9	2.8
Unemployment rate (%)	8.9	9.1	10.0	8.9	7.8	7.5

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. Sources typically include national statistical offices, Eurostat, and Experian Limited. N.M.--Not meaningful.

Table 3

Transport for London--Financial Statistics

	--Year beginning April 1--						
(Mil. £)	**2010**	**2011**	**2012**	**2013bc**	**2014bc**	**2015bc***	**2016bc**
Operating revenues	7,198	7,522	7,954	7,809	7,637	6,896	7,293
Operating expenditures	5,385	5,606	5,873	6,284	6,723	6,914	7,143
Operating balance	1,813	1,916	2,081	1,525	914	(18)	150
Operating balance (% of operating revenues)	25.19	25.48	26.16	19.53	11.97	(0.26)	2.06
Capital revenues	1,272	1,468	2,046	2,056	1,416	3,157	1,523
Capital expenditures (capex)	2,937	2,776	3,237	3,280	3,707	3,787	3,199
Balance after capital accounts	148	609	890	301	(1,377)	(648)	(1,526)
Balance after capital accounts (% of total revenues)	1.75	6.77	8.90	3.05	(15.21)	(6.44)	(17.30)
Debt repaid	654	3,407	1,255	1,274	823	837	871

Table 3

Transport for London--Financial Statistics (cont.)							
Balance after debt repayment and onlending	(506)	(2,798)	(365)	(974)	(2,200)	(1,485)	(2,397)
Balance after debt repayment and onlending (% of total revenues)	(5.98)	(31.13)	(3.65)	(9.87)	(24.30)	(14.77)	(27.19)
Gross borrowings	2,658	2,637	1,533	1,538	1,375	1,325	1,425
Balance after borrowings	2,152	(161)	1,168	564	(825)	(160)	(972)
Operating revenue growth (%)	N.M.	4.50	5.75	(1.82)	(2.20)	(9.70)	5.75
Operating expenditure growth (%)	N.M.	4.09	4.77	7.00	6.99	2.84	3.31
Modifiable revenues (% of operating revenues)	49.22	51.06	51.89	56.26	60.77	71.96	72.24
Capital expenditures (% of total expenditures)	35.29	33.12	35.53	34.29	35.54	35.39	30.93
Direct debt (outstanding at year-end)	6,350	7,129	7,564	7,898	8,526	9,100	9,747
Direct debt (% of operating revenues)	88.22	94.78	95.10	101.14	111.63	131.96	133.65
Tax-supported debt (% of consolidated operating revenues)	112.08	112.29	109.44	115.01	124.99	145.61	145.15
Interest (% of operating revenues)	5.66	4.85	4.60	5.14	5.52	6.68	6.86
Debt service (% of operating revenues)	14.75	50.14	20.38	21.46	16.30	18.82	18.80

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. *In 2015, we assume that some of the grant that TfL receives is re-classified from operating revenues to capital revenues, as explained above. This largely explains the sharp move in the ratios showing operating balance, modifiable revenues, and tax-supported debt as a percentage of operating revenues. bc--Base case, reflecting Standard & Poor's expectations of the most likely scenario. N.M.-Not meaningful.

Key Sovereign Statistics

- Sovereign Risk Indicators, March 24, 2014. Interactive version available at http://www.spratings.com/sri

Related Criteria And Research

Related Criteria

- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009

Related Research

- Public Finance System Overview: U.K. Local and Regional Governments, April 5, 2011
- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts. The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook.

Ratings List

Ratings Affirmed

Transport for London	
Issuer Credit Rating	AA+/Stable/A-1+
Senior Unsecured	AA+
Commercial Paper	A-1+

Additional Contact:
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Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.