MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
28 March 2019

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RATINGS

**Transport for London**

| | |
|---|---|
| Domicile | United Kingdom |
| Long Term Rating | Aa3 |
| Type | Senior Unsecured - Dom Curr |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*


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# Transport for London (United Kingdom)

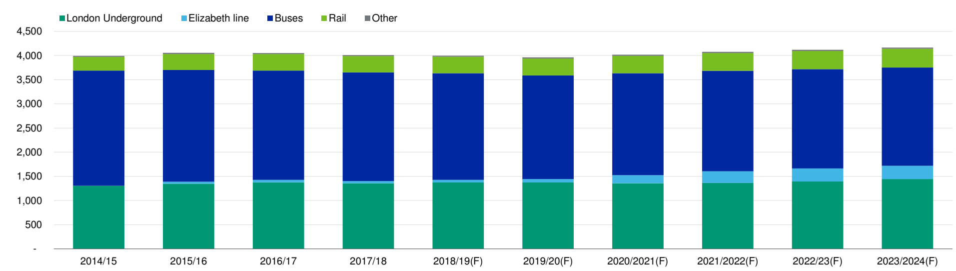
Update to credit analysis

## Summary


Transport for London's (TfL) credit profile reflects its strategic importance as the main public transport provider in London, strong demand and institutional framework, in addition to budgetary pressures from removal of its government operating grant, the key project risk of the Elizabeth Line and high, but predictable, debt levels.


Exhibit 1

**TfL's total ridership fell by 1% in FY2018. It is expected to fall by a further 1% to FY2020 before rising in FY2021 upon the full opening of the Elizabeth line**




TfL projected figures, 2018/19 to 2023/24
*Source: Transport for London Business Plan, 2018*

## Credit Strengths

» Strategic importance for national transport plans

» Capacity improvements will increase ridership, and operating surplus, in medium term

» Strong institutional framework providing a high level of transparency

## Credit Challenges

» Increased budgetary pressures including the removal of government operating grant

» Delayed opening of the Elizabeth Line, crucial to capital and operating plan

» Debt levels will remain high but predictable given borrowing limits

## Rating Outlook

The stable outlook on TfL's rating reflects our assessment that TfL will continue its strong management of its credit challenges. It also reflects the stable outlook on the UK sovereign rating.

## Factors that could lead to an upgrade

We would consider upgrading TfL's rating due to one or a combination of the following: (1) a successful completion of the Crossrail project including achievement of Elizabeth line projections for ridership and revenue growth, (2) an improvement in TfL's financial position, and/or (3) materially improved revenue and spending flexibility.

## Factors that could lead to a downgrade

Negative pressure on the rating could result from one or a combination of the following: (1) underperformance in meeting operational or financial goals, specifically if fare revenue growth is materially slower than projected levels, or planned expenditure savings do not materialise, (2) further delays in the Crossrail project timeline which result in a higher capital expenditure burden and further pressure on TfL's operating budget and/or (3) if the UK government were to signal a clear dilution of its support for TfL's capital plan or the UK sovereign rating was downgraded.

## Key Indicators

Exhibit 2
**Transport for London**

| | 2013/14 | 2014/15 | 2015/16 | 2016/2017 | 2017/2018 |
|---|---|---|---|---|---|
| Own Source Revenues / Total Revenues (%) [1] | 47 | 52.4 | 60.0 | 66.9 | 68.4 |
| Grants / Total Revenues (%) | 52 | 47.4 | 39.8 | 33.0 | 31.5 |
| Operating Surplus (Deficit) / Total Revenues (%)[2] | 8.6 | 2.0 | -2.6 | 6.8 | 5.0 |
| Interest Payables / Total Revenues (%) | 4.2 | 4.4 | 4.9 | 5.3 | 5.6 |
| Direct and indirect debt / Total Revenues (%) | 85.8 | 96.2 | 110.8 | 128.4 | 138.6 |
| Short-term debt / Total Debt (%) | 9.0 | 9.4 | 9.5 | 11.4 | 8.4 |
| Current Assets / Current Liabilities (%) | 172 | 179.1 | 138.6 | 110.1 | 73.2 |

[1] For all ratios, Total Revenues include grants, including those ring-fenced for Crossrail.
[2] Operating surplus refers to operating revenues minus operating expenses (not including capital grants or capital expenditures).
*Source: TfL's financial statements, Moody's calculations*

## Detailed credit considerations

The credit profile of Transport for London, as expressed in an Aa3 stable rating, combines (1) a baseline credit assessment (BCA) for the entity of a2 and (2) a very high likelihood of extraordinary support coming from the UK government (Aa2 stable) in the event that the entity faced acute liquidity stress.

### Baseline Credit Assessment

**Strategic importance for national transport plans**

Transport for London is a key functional body of the government of Greater London (Greater London Authority). Its Board is chaired by the Mayor of London, who is also in control of Board appointments. Future economic growth in London and the capacity of its public transportation system are closely linked and are significant policy concerns to citizens, businesses and the local and national levels of government.

Transport for London is the largest urban transit system in the United Kingdom, and one of the largest in the world. It serves a large population (8.8 million in London) and benefits from very strong ridership. TfL's underground, bus and rail network provide 4 billion rides annually. TfL's very strong 460 utilization ratio (annual ridership relative to the service area population) continues to be the highest of any system we rate under the Global Mass Transit Enterprises Methodology, reflecting the pervasiveness of public transport and its importance to the London economy.

**Capacity improvements will improve ridership, and operating surpluses, in the medium term although in the short term passenger numbers will fall**

FY2018 saw a 1% reduction in total ridership for TfL, when compared to FY2017. The decrease was across both London Underground (LU) and bus services. However, this was a small improvement when compared to expectations for FY2018 - in TfL's 2017 business plan it projected total ridership of 3.98 billion whereas the actual outcome was 4.01 billion. Total ridership is expected to decline to FY2020, predominantly driven by the trend of falling demand for bus services. It will then begin to increase from FY2021, when the Elizabeth line is introduced into service. LU ridership is not expected to reach FY2017 levels until FY2023, reflecting a stagnation in demand coupled with an expected shift in demand away from LU and onto the Elizabeth line once the central section of the latter is opened.

Continued growth in total ridership and, subsequently, fare income, is critical to TfL's ability to produce balanced budgets - a legal requirement. As set out in TfL's 2018 business plan, TfL's funded capacity improvements to FY2023 will contribute to TfL's planned reversal of its net cost of operations from a forecast of £500 million in FY2019 (based on TfL's budget published on 20th March 2019) to £47 million in FY2022 and towards an operating surplus of £144 million in FY2023. These include the Elizabeth line (which will increase central London's rail capacity by 10%), signalling upgrades on the Circle, District, Hammersmith & City and Metropolitan lines, new trains on the London Overground and the extension of the London Overground to Barking Riverside.

**Strong institutional framework provides a high level of transparency**

Since FY2003, TfL, the Mayor of London and the Department for Transport (DfT) 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. In March 2017, the Secretary of State for Transport set out a new multi-year funding agreement for TfL for the years FY2018 to FY2021 which sets out DfT grant and TfL's annual borrowing limit. The funding agreement confirms the removal of the general operating grant from FY2019 and the passporting of the investment grant through the GLA's 100% business rates retention pilot from FY2018. The 100% business rates retention pilot has been continued in FY2019, and in FY2020 it has been confirmed at the lower rate of 75%. In FY2020, TfL will receive some £1.9 billion in business rates and another £300 million in grants from the GLA and central government (excluding Crossrail funding). However, there is currently no funding certainty post-FY2021, although we expect TfL will continue to be resourced appropriately due to its importance to strategic transport in London.

Although TfL's day-to-day funding arrangements for operating and capital expenditure purposes will now be the responsibility of the Mayor via the GLA, we expect that any nationally significant infrastructure projects such as Crossrail 2 will continue to be part-funded by central government.

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 the 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 appoints the Commissioner of Transport for London, 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 Committee, the Programmes and Investment Committee and the Audit and Assurance Committee. TfL also has an external body providing independent assurance and expert advice to the Mayor, the Independent Investment Programme Advisory Group.

**Increased budgetary pressures including the removal of its government operating grant**

TfL faces a number of medium term budgetary pressures, including the removal of its government operating grant, the Mayoral fare freeze and the delayed opening of the Elizabeth line. The latter is discussed in the following section.

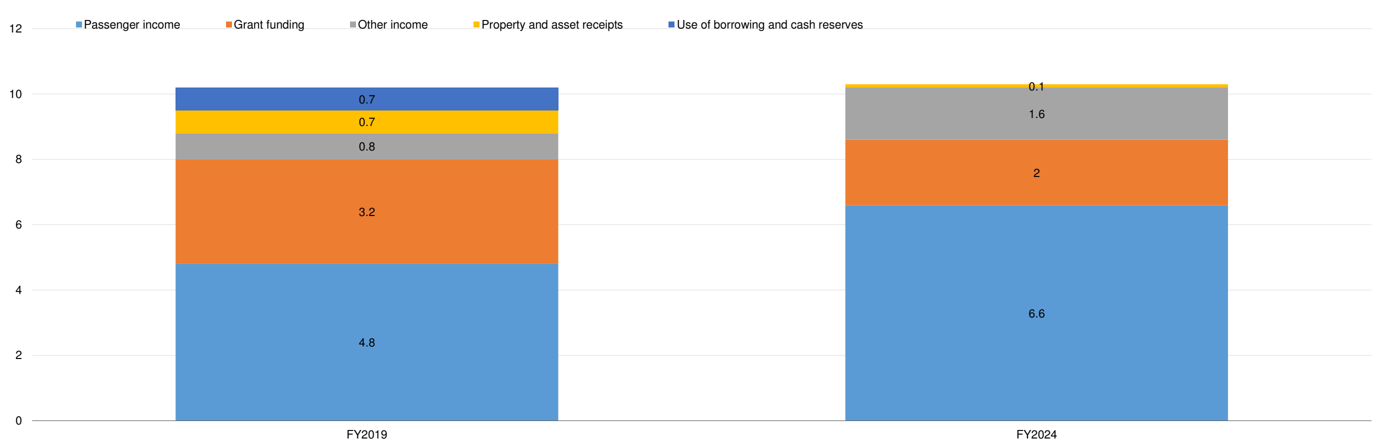
TfL is now more reliant on its operational performance to fund its activities than it was in the past, with operating grant levels falling from 29% of total operating income in FY2014 to 18% in FY2018. In the March 2017 funding agreement the Secretary of State for Transport confirmed the removal of the general grant - the general operating grant that TfL has used historically to subsidise its operations. However, its operating grant has to some extent been replaced by non ring-fenced business rates from the GLA. As its operating grant and investment grant are now paid using retained business rates, it gives TfL more financial flexibility as business rates receipts are not ring-fenced and can therefore be used for capital or operating purposes as required. This flexibility has been used to partially offset the operating pressures of the delayed opening of the Elizabeth line on TfL's operating budget.

The freeze on passenger fares set by TfL commenced in January 2017 and is expected to last until December 2020. This does not affect all of TfL's passenger income, about half of it is linked to national rail fares which are not directly controlled by TfL. These fares are set by DfT and do not fall within TfL's fare freeze. The true impact of the fare freeze is difficult to estimate - it is likely that it will have depressed and continue to depress some fare revenue, however it is equally likely that it is helping to mitigate some of the decrease in demand caused by the economic slowdown in London.

TfL's fare income projections in its 2018 five-year Business Plan are ambitious. The removal of operating grant means that they also increase in importance in TfL's budget: they are expected to increase from 47% (£4.8 billion) of its total budget (including its capital programme) in FY2019 to 63% (£6.6 billion) in FY2024. Some £0.9 billion of the £1.8 billion projected increase in fare income is expected to be delivered by the Elizabeth line, and the remainder relates to increases in passengers driven by population growth, and increased capacity and services on LU lines, London Overground and the DLR, as well as fare increases over the period. Achievement of fare income projections is critical to the financial performance of the organisation and is reliant on elements within TfL's control including successful realisation of upgrades on a number of LU lines, in addition to the Elizabeth line, as well as elements outside TfL's control such as population and economic growth in London and the wider South East.

In order to improve the long-term financial sustainability of the organisation, TfL is implementing a major transformation programme that is aimed at removing £1.2bn of annual operating costs from the organisation by FY2023. This will help to limit the increase in operating costs (before capital renewals and financing costs) to £7.3 billion by FY2024 from £6.4 billion expected in FY2019 - with the increase being predominantly due to the costs of operating the Elizabeth line and inflation. The transformation programme follows a comprehensive TfL-wide cost review in order to maximise value for money and improve efficiency of operations and support functions. The different internal workstreams have already lead to more than 600 individual initiatives and projects, including reduced layers in the organisation, merged functions and eliminated duplications as well as commercial contracts renegotiations, that should help reach the savings target. The transformation programme is progressing well. TfL's third quarter results from FY2019 demonstrate operating costs £189 million lower than budget year-to-date and TfL's recently published budget forecasts that the full year net cost of operations will be £468 million lower than initially budgeted, indicating that savings are being generated earlier than anticipated.

Exhibit 3
**TfL's changing funding environment**
**TfL's funding sources, £billion FY2019 to FY2024**




Other income includes congestion charge, ULEZ receipts and commercial income. Property and asset receipts in FY2019 includes the now completed sale and leaseback of the Elizabeth line rolling stock.
*Source: Transport for London, 2018 Business Plan*

**Successful opening of the Elizabeth line, crucial to capital and operating plan**
TfL is the joint sponsor of the Crossrail project (operational name: Elizabeth line) with DfT. The Elizabeth line is a new 118 kilometre railway line for London and the South East. In August 2018, it was announced that the opening of the central section of the Elizabeth line (which runs through central London) would be delayed from December 2018, to an unspecified date in autumn 2019. The confirmation of the opening timetable is expected later this spring. The delay has an impact on both the capital cost of the Crossrail

project and TfL's operating budget, primarily through delayed receipts of passenger income. In respect of the capital impact of the delay - this has been estimated to be between £1.6 to £2.0 billion following an independent review by KPMG (including an amount of £300 million which was agreed to be provided to the project equally by TfL and DfT in July 2018 in respect of pre-delay cost escalation). The majority of the cost of the capital overrun will be provided by the GLA to TfL in the form of a grant of £1.4 billion. If the cost overrun exceeds £1.7 billion (£1.4 billion grant plus £300m agreed to be provided in July 2018), DfT will provide a loan facility of up to £750 million to TfL which will be incremental to the previously agreed borrowing limit.

Regarding lost passenger income - the net operating impact of the delay is expected to be approximately £600 million to FY2022, with a peak negative impact of some £300 million in FY2021, which was previously expected to be the first full year of full operation of the line. Since the delay was announced, TfL has prepared a mitigation plan to counteract these pressures. This includes delaying some parts of its capital programme (including the Camden Town station upgrade and the signalling upgrade of the Piccadilly line), and apportioning more of its investment grant business rates towards its operating budget. Although the delay certainly contributes to negative credit pressures, we consider that TfL will manage them appropriately and retains a number of different flexibilities to counteract budgetary pressures. Our detailed assessment of the Crossrail delay's impact on TfL's budget can be found in: Transport for London: Crossrail delay adds to budgetary challenges, but project remains critical to TfL's financial sustainability.

Other major ongoing capital projects include signalling, modernisation and rolling stock upgrades to the 11 LU lines aiming to improve service and capacity across the existing LU network, and the Northern Line Extension to Nine Elms and Battersea. The latter project is being funded by the GLA, through a hypothecation of future business rate revenues and developers' contributions, up to £1 billion. However, any cost increases above this level would be the responsibility of TfL. The tunneling work is now complete, however there are still some station fit-out testing and commissioning works which remain to be completed.

TfL also has a number of other large planned and proposed capital projects including the Overground extension to Barking Riverside which will enter construction in FY2020, Bakerloo Line Extension, a number of river crossings and Crossrail 2.

Total capital expenditure is expected to be £11.0 billion between FY2019 and FY2024, including £2.6 billion on Crossrail and excluding capital renewals. This is expected to be funded by £5.8 billion investment grant, £1.6 billion from property and asset receipts (a significant proportion of this will be funded by the sale of the Elizabeth Line rolling stock to a lessor through a sale and leaseback transaction), £3.2 billion of new borrowing, £2.16 billion related to Crossrail funding sources and the remainder by other capital grants.

**Debt levels will remain high but predictable given borrowing limits**

TfL's debt level is high, but relatively stable and predictable. TfL's debt rose to £10.9 billion at FYE2018 (including £488 million of finance lease liabilities) or 139% of total revenues from £10.4 billion and 128% of total revenues at FYE2017.

Under the Prudential Code, TfL may borrow for capital purposes up to a level approved by the Mayor, subject to reserve powers retained by the government. In practice, increases in debt are agreed in the multi-year funding settlements with DfT. DfT approves and establishes limits for TfL's debt projections, subject to requirements of prudence and affordability required under the Prudential Code. Between FY2018 and FY2021, TfL can increase its debt by up to £2.55 billion. The £750 million loan facility granted to TfL with respect to the Crossrail cost overrun will be incremental to this amount. Favourably, the 2016 funding settlement gave TfL flexibility to roll borrowing capacity into future years, meaning debt will grow only when funds are required. Local government 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, can be difficult to reconcile to the more cash-based systems used for budgets and long-term planning.

TfL has guaranteed a number of loans linked to Public-Private Partnership (PPP) contracts. In the last few years most of these PPP contracts were brought back “in-house.” TfL's total retirement benefit obligations, which currently are not included in TfL's debt stock, were at £4.7 billion at FYE2018, or 60% of total revenues. The latest full actuarial valuation of the TfL Pension Fund was carried out as at 31 March 2015, which showed a deficit for funding purposes of £396 million.

TfL benefits from a diverse investor base and may borrow from the Public Works Loan Board (PWLB, statutory body operating within the UK Debt Management Office, 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 has a £5 billion European Medium Term Note (EMTN) programme, last updated in July 2015, of which £3.3 billion was outstanding as of February 2019. In April 2015, TfL issued its first green bond (£400 million) under the EMTN programme. For short-term liquidity needs, its European Commercial Paper programme of £2 billion allows for rapid and flexible access to liquidity at rates close to LIBOR. TfL has £750 million corporate loan facilities with Export Development Canada; £250 million was drawn down in FY2017, £150 million in FY2018 and £150 million in FY2019; £200 million remains available for future drawdowns.. TfL had £3.4 billion debt outstanding under various facilities with the European Investment Bank (EIB) as of February 2019; £500 million was drawn down in FY2017, £800 million in FY2019 and £200 million in FY2019; all EIB facilities are now fully drawn.

TfL had approximately £1.3 billion of cash and cash equivalents as of Q3 FY2019, including £169 million of Crossrail cash balances. Its cash balances have fallen by £656 million over the year-to-date as they are primarily used to fund capital expenditure. The reserves are not ring-fenced and may be used for debt service payments or other costs of TfL and its operating subsidiaries. TfL has a policy of maintaining a minimum level of cash of 30 days of operating cost on average (representing approximately £550 million for FY2019).

### Extraordinary Support Considerations

The very high support assessment for TfL reflects the importance of the transport system and infrastructure improvement in London for the UK government (Aa2 stable), as reflected in the multi-year funding settlement and the agreement to proceed with Crossrail and the London Underground 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 question 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 ongoing assurance over funding of its capital programme and its historical co-ordination with national investment policies.

## Rating Methodology

Mass Transit Enterprises Methodology, December 2017

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **TRANSPORT FOR LONDON** | |
| Outlook | Stable |
| Senior Unsecured -Dom Curr | Aa3 |
| Commercial Paper -Dom Curr | P-1 |

*Source: Moody's Investors Service*

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