Moody's

Rating Action: **Moody's upgrades Transport for London's ratings to A3 from Baa1; outlook positive**

15 Nov 2023

London, November 15, 2023 -- Moody's Investors Service (Moody's) has today upgraded Transport for London's (TfL) long-term senior unsecured debt ratings to A3 from Baa1 and its long-term MTN programme rating to (P)A3 from (P)Baa1. The outlook has been changed to positive from stable. Moody's has also affirmed TfL's short-term issuer rating and short-term commercial paper rating at Prime-2 (P-2). The Baseline Credit Assessment (BCA) was upgraded to baa2 from baa3.

RATINGS RATIONALE

The upgrade of the BCA and long-term debt ratings reflects the improvement in TfL's operating performance, which in part reflects strong governance, that Moody's expects to be sustained, and removes the need for financial support to achieve operating surpluses from fiscal 2024 (year ending 31 March 2024). The upgrade also reflects the moderate size of TfL's future capital programme following the completion of the Elizabeth line, which contributes to Moody's expectation of a broadly stable leverage, alongside more predictable funding arrangements with the UK government.

The key driver of the improvement in TfL's operating performance is the faster-than-expected recovery in passenger numbers, reaching 90% of pre-pandemic levels since the beginning of fiscal 2024. This is supported by the recovery of traffic on the London Underground, at 85% of pre-pandemic levels, and the opening of the Elizabeth line in May 2022, which recorded 150 million passenger journeys in its first year and exceeded revenue expectations. Coupled with an average fare increase of 5.9% in March 2023, TfL forecasts £5.2 billion of passenger income in fiscal 2024, exceeding pre-pandemic levels. In the next few years, Moody's projects a continued growth in passenger income, sustained by strong passenger trends and annual fare rises.

Moreover, in line with the terms of the current funding agreement with the Department for Transport (DfT), TfL has successfully identified new non-fare income sources, thereby diversifying its revenue. Non-fare income, excluding grants, doubled from fiscal 2019 levels to reach £1.6 billion in fiscal 2023. Moody's expects further growth, particularly following the announcement in November 2022 of the expansion of the Ultra Low Emission Zone (ULEZ), a road user charge, across all of London from August 2023. ULEZ charges generated £480 million of income in fiscal 2023 and TfL estimates that the London-wide ULEZ could generate up to a further £200 million a year of net revenues for the first two years.

TfL exhibits strong governance and management practices. Its focus on cost containment has successfully kept cost growth rates below inflation levels over recent years. Under its current funding agreement, TfL is required to identify £600 million in additional cost savings by fiscal 2026, of which £92 million were delivered in fiscal 2023. TfL plans to deliver those efficiencies through improvements in work practices and the supply chain. Moody's expects TfL to be able to deliver most of the additional savings although likely to fall short of the target, considering the extent of cost savings already achieved and the risk of potential strike actions by its employees. In addition, persistent high inflation continues to exert pressure on operating costs such as staff pay, concessionary contracts and fuel costs. As a result, and despite these further efficiency gains, like-for-like costs will rise over the next two years, although the increase in costs will be offset by stronger revenue growth, leading to growing operating surpluses.

Following the completion of the Elizabeth line, TfL's capital programme will remain moderate over the next few years. Average annual capital expenditures, which stood at £3.3 billion during fiscals 2017 to 2020, were lowered to £2.1

billion in the last three years. This decrease allowed TfL to reduce its debt to £15.2 billion by the end of fiscal 2023, down from £15.6 billion at the end of fiscal 2021. Moody's projects that debt will remain broadly stable at around 1.7x to 1.8x revenue over the next three years.

Governance risks have decreased over the past year, with increased transparency on the UK government's support for TfL. During the pandemic, funding agreements between TfL and the government were often settled at the last minute and covered short time periods. In August 2022, TfL and the DfT entered a longer agreement, in which the DfT committed to cover any passenger income shortfall below £4.5 billion in fiscal 2023 and £5.2 billion in fiscal 2024. This agreement mitigates the risk associated with passenger numbers and enables TfL to balance its budgets for these two years. Given the robust recovery in passenger income, Moody's expects that TfL will achieve an operating surplus in fiscal 2024 even without the top-up grant received to date. Moody's believes that TfL will not rely on operating grants going forward given further increases in passenger and non-fare income.

However, ongoing uncertainty surrounding TfL's long-term capital funding framework continues to impact its credit strength. While the government has expressed its willingness to support TfL's capital programme through a multi-year funding agreement, no agreement has been reached yet. Moody's expects that a funding agreement will be finalised by 31 March 2024, when the existing agreement expires, but the terms and length of a new agreement remain uncertain. If government funding does not meet the expectations set out in TfL's business plan, TfL will either need to increase its borrowing beyond current expectations or make cuts to critical projects such as line upgrades, potentially leading to a gradual degradation of service quality.

The A3 ratings incorporate a BCA of baa2 and a two-notch uplift based on Moody's assessment of a strong likelihood of support from the UK government. The strong support assessment for TfL reflects the importance that the transport system and infrastructure improvement in London has for the UK, as evidenced by the funding agreements with the government.

The P-2 ratings were affirmed. TfL benefits from a strong access to liquidity, supported by a diverse investor base and the ability to borrow from the from the Public Works Loan Board (PWLB), a statutory body operating within the UK Debt Management Office. PWLB could also serve as a potential lender of last resort, effectively reducing the risk of liquidity shocks. Furthermore, TfL has a policy of maintaining minimum cash levels to an average of 60 days of operating costs.

RATIONALE FOR THE POSITIVE OUTLOOK

The positive outlook reflects Moody's forecast that risks around TfL's financial performance are skewed to the upside, driven by potentially stronger passenger and non-fare income than currently assumed. Passenger traffic is still adjusting to post-pandemic ways of living and working. Meanwhile, as mentioned, TfL is building its non-fare income with potentially stronger results in the next few years. Combined with a consistent focus on cost savings, as well as a moderate capital programme, this would result in larger operating surpluses and stable leverage.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) CONSIDERATIONS

The overall impact of ESG risks on TfL's ratings is moderately negative (CIS-3).

Environmental considerations are material to TfL's credit profile (E-3). TfL is required to expand the scope of road user charging to reduce pollution, fully upgrade its bus fleet and transition to fully renewable energy for all rail services to meet the London Mayor's vision for a carbon-neutral city by 2030.

Social considerations are material to TfL's credit profile (S-3). TfL is impacted by hybrid working models and high inflation affecting ridership trends, the politically-sensitive nature of fare increases and a unionised workforce.

Governance considerations are material to TfL's credit profile (G-3). TfL has strong management practices, characterised by a clear strategy, comprehensive budgets and business plans and a high level of transparency.

However, government control and oversight have intensified as part of the extraordinary funding arrangements, resulting in TfL having to comply with numerous stringent conditions which require resource allocation and influence strategic decisions.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Upward pressure on the ratings could result from a sustained improvement in operating performance, leading to growing operating surpluses, without resort to reductions in key capital enhancements that would be detrimental to the quality of service over the longer term. A multi-year funding agreement to finance TfL's capital programme with minima conditions could also exert upward pressure on the ratings.

The positive outlook indicates that a downgrade is unlikely in the near term. Downward pressure on the ratings could result from weaker than anticipated operating performance which looked likely to last and would prevent TfL from achieving the projected financial sustainability. A decrease in government support, including significant underfunding of TfL's capital funding or an agreement which imposes unachievable conditions on TfL, leading to a deterioration in the quality of services, could also negatively impact the ratings.

PRINCIPAL METHODOLOGY

The methodologies used in these ratings were Government-Related Issuers Methodology published in February 2020 and available at https://ratings.moodys.com/rmc-documents/64864, and Mass Transit Enterprises Methodology published in December 2017 and available at https://ratings.moodys.com/rmc-documents/64385. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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