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Research Update:

Transport for London 'AA-/A-1+' Ratings Affirmed; Off Watch; Outlook Negative

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Overview

- The U.K. government, the Greater London Authority (GLA) and Transport for London (TfL) have agreed a financial package to cover additional capital costs related to the delayed opening of the central section of the Elizabeth line.
- We expect TfL to absorb the impact of lost fare revenues related to the delay through its saving program and nonfare income, but reach an operating surplus in fiscal 2023, one year later than expected.
- We are affirming our 'AA-/A-1+' long- and short-term ratings on TfL and removing them from CreditWatch negative.
- The outlook is negative, reflecting TfL's stretched financial profile at a time of heightened risk because of economic uncertainty and delivery of large capital projects.

Rating Action

On Dec. 20, 2018, S&P Global Ratings affirmed its 'AA-/A-1+' issuer credit ratings on U.K.-based transport operator Transport for London (TfL). We removed the ratings from CreditWatch negative where we placed them on Sept. 5, 2018. The outlook is negative.

At the same time, we affirmed and removed from CreditWatch our 'AA-' issue rating on TfL's senior unsecured debt.

Rationale

The U.K. government and the Mayor of London have announced a financial package to cover additional costs related to the delayed opening of the central section of the Elizabeth line. The construction project, Crossrail, is currently Europe's largest infrastructure program.

Previously, we assumed extraordinary support would come mainly from the Department for Transport (DfT), channeled through the Greater London Authority (GLA; AA/Negative/A-1+). Now we believe that as part of the devolution process to London, the GLA will have to directly contribute substantially more to the Crossrail project than we anticipated. The GLA will provide a grant of up to £1.4 billion to TfL to complete the remaining construction work on stations and tunnels and safety testing. GLA's contribution is to be financed by £1.3

billion of additional borrowing from DfT as well as a £100 million cash contribution (see "GLA Has Capacity To Absorb Additional Debt For Crossrail; TfL Still On CreditWatch Negative," published Dec. 13, 2018, on RatingsDirect).

As the final costs of the Crossrail project are yet to be confirmed, a contingency arrangement has also been agreed between TfL and the DfT. We understand the department will loan TfL up to £750 million if further financing is required for the project. The financing package supersedes the £350 million interim financing offered by the DfT in October 2018. Total cost overruns are estimated to represent 11%-14% above the estimated cost of £14.8 billion announced in the UK government's 2010 Spending Review.

This agreement supports our view of a very high likelihood that TfL would receive extraordinary support, if needed. We base our opinion on:

- A very important role: we believe that TfL plays a very important role as a near monopoly providing essential transportation services in the U.K.'s capital region.
- A very strong link between TfL and the GLA. The Mayor of London plays a critical role in setting TfL's strategy and objectives and passes on retained business rates from the GLA that represent a significant part of TfL's revenues. The Mayor and the central government, via the DfT, set the incremental borrowing limits for TfL. The central government also provides ready access to reliable liquidity sources via the Public Works Loan Board (PWLB).

We factor the very high likelihood of support into our rating with a two-notch uplift to the stand-alone credit profile (SACP), which we maintain at 'a'. TfL's SACP is driven by its very strong enterprise profile and its adequate financial profile.

In our opinion, TfL's very strong enterprise profile is underpinned by the very low risk associated with the global mass transit industry. Also, TfL benefits from London's still extremely strong and diversified economic fundamentals. The population is growing rapidly, and local per-capita income (gross value added) is significantly higher than the national average. Nearly 5.8 million people now work in the capital, up from 5.1 million in 2012--a five-year historical growth rate of about 13.7%.

However, a subdued economy has slowed down ridership and reduced fare revenues. Ridership fell by 1% to slightly below 4 billion journeys in fiscal 2018 (ended March 31, 2018), driven by a decline in passenger journeys on the London Underground (for the first time since 2008), and on the bus network. TfL estimates a slight decrease in ridership until fiscal year-end 2020. It expects underground journeys to return to growth over our forecast horizon, but bus demand willstill be in decline. The Elizabeth line, which will increase rail capacity in central London by 10%, will support ridership growth when it opens.

Bus services account for the largest passenger volume--exceeding 2.2 billion journeys in fiscal 2018. However, since 2015, bus ridership has declined yearly, in part due to traffic delays and road congestion, although conditions have eased recently due to improved traffic management and signal timings, together with a lower volume of roadworks . TfL expects further decline due to the uncertainty relating to the U.K.'s exit from the EU and the continuing squeeze on incomes, despite its efforts to make the bus network more attractive. We understand that TfL plans to reshape the bus network by reducing the number of routes where demand has fallen and where there are more sustainable alternatives available (central London), and by increasing the number of routes in parts of London where additional bus services will have the biggest impact.

TfL's near-monopoly status supports our view of the company's very strong market position. Oyster card (TfL's travel card) can be used to travel on most of the transport services in and around London. We do not view suburban rail services (which are not controlled by TfL) to be direct competitors as they bring people from surrounding areas closer to TfL's system and act as a complement.

We have reassessed our view of TfL's management and governance to fair from satisfactory previously, due to the management of Crossrail. While delays and cost overruns are to be expected on a decade-long, £14.8 billion project, we note that TfL was not able to identify earlier governance and management difficulties at Crossrail Ltd., its subsidiary in charge of delivering the Elizabeth line. The delay was announced only three months ahead of the planned inauguration date. The Elizabeth line is key for TfL to eliminate its operating deficit. We view positively, though, that TfL and DfT, the joint sponsors of the Crossrail project have replaced the leadership team at Crossrail Ltd., appointing a new Chair and Deputy Chair of the board, and a new CEO and CFO. Also, sponsors have strengthened their representation on Crossrail Ltd.'s board, with three TfL and two DfT non-executive directors now on the board.

We will continue to monitor management's ability to adapt and respond to the pressures on TfL's financial profile. We view positively TfL's high levels of transparency. Public stakeholders are able to access detailed financial and operational information that is updated on a regular basis, which TfL releases as per the Local Government Transparency Code.

We understand that TfL will have to absorb the net impact of lost fare revenue caused by the delayed opening of the Elizabeth line, which is estimated at £600 million to fiscal year-end 2023. This adds to the loss of the general grant from government from fiscal 2019, the fare freeze that will remain in place until 2020, and a subdued economy, which is affecting passenger numbers. Consequently, we expect TfL's EBITDA (adjusted for operating lease costs) generation to decline significantly, from about £700 million in fiscal 2017 to about £200 million in fiscal 2020. In our base case, we exclude the portion of business rates that replace the investment grant (£976 million in fiscal 2019) to calculate TfL's EBITDA. Due to the delay of the Elizabeth line, TfL now

expects to achieve an operating surplus (after capital renewals and financing costs) in fiscal 2023, one year later than expected in its previous business plan.

On the capital side, TfL's business plan forecasts about £2 billion of capex annually (excluding Crossrail), out of which £1.4 billion is for new capital investment and £600 million for capital renewals. TfL relies on steady and sustained investment from the government to support major capital projects.

At the same time, TfL has strengthened its debt service capacity to about 1.5x on average over our forecast horizon through fiscal 2020 from slightly above 1x in fiscal 2017. This is due to TfL receiving a higher portion of retained business rates that, if required, can be used for debt service, replacing investment grants (we add the £976 million of business rates replacing the investment grant in our calculation of debt-service coverage). However, business rates can potentially be more volatile, and politically influenced.

In our opinion, TfL's debt burden remains very high and is likely to increase as the company invests in its large capital program including the Elizabeth line, tube modernization, and capacity upgrades to support demand. Therefore, we expect total debt (including finance leases and operating leases, the latter of which we capitalize) to reach £13.3 billion, or 1.5x total revenues by fiscal 2019; increasing further to 1.7x by fiscal 2021. A significant proportion of capital spending is on large-scale projects that have strategic importance--both to London and the national economy--thereby limiting TfL's ability to delay or cancel these projects once they are committed. While incremental borrowing limits are settled with the central government and the GLA during spending reviews, the use of short-term commercial paper and planned sale and leaseback of Elizabeth line trains could add volatility to its otherwise predictable debt profile.

We see continued pressure on TfL's financial flexibility to raise farebox revenues, resulting from the commitment to keep TfL-controlled fares frozen until December 2020. Nevertheless, TfL over-delivered on savings in fiscal 2017 and fiscal 2018, and is £250 million ahead of its deficit target for fiscal 2019. So far, TfL's saving program has focused on vertical, divisional organization changes. Over the coming years, it will focus on end-to-end process and structural integration across the organization, a more horizontal view to find synergies. In addition, we believe TfL has the flexibility to raise capital income from its substantial estate, including commercial and retail real estate in central London. Taken together, TfL continues to demonstrate strong financial flexibility, resulting in a farebox recovery ratio among the highest of the mass transit systems we rate globally, although this is based more on its ability to cut costs rather than to increase revenues.

Liquidity

TfL's liquidity remains strong, with free cash of 108 days of operating expenditure in fiscal 2018. We anticipate a similar figure for fiscal 2019.

This is largely the result of an anticipated receipt from the sale and leaseback of Elizabeth line trains, while operating balances (after capital renewals and financing costs) are expected to remain in deficit. In our view, cash balances may decline to about 80 days by fiscal 2020 as a result of weak internal cash generation. Cash to debt service remains well below 2x over our forecast horizon through fiscal 2020.

Nevertheless, TfL's exceptional access to external liquidity via the PWLB mitigates some of these risks, in our view. As a statutory body within the Debt Management Office, the PWLB lends to local authorities (and TfL) at short notice. In addition, TfL has a very strong track record of issuing own-name bonds on the capital markets. Hence, we do not view refinancing risk on TfL's commercial paper borrowings to be particularly high, and we have affirmed our short-term rating of 'A-1+'.

Outlook

The negative outlook reflects our view that TfL's financial profile is stretched, leading to declining cash balances, at a time of heightened risk as a result of economic uncertainty and delivery of large capital projects.

We could lower the rating if we anticipated a considerable weakening in TfL's growth prospects, potentially as a result of a more pronounced economic slowdown than we currently expect or changes in consumer patterns, or if ridership growth from capacity increases was below our base case. Additional cost overruns and debt on the Crossrail project or failure to achieve the savings already planned could have an adverse impact on TfL's liquidity, and add to the downward pressure on ratings over the next two years.

We could revise the outlook to stable over the next two years if TfL performed in line with our base-case expectations.

Table 1

Transport for London - Operating Performance

	--Year ended March 31--			
	2015	2016	2017	2018
Total revenues (mil. £)	9,548.6	9,124.0	8,045.0	7,869.0
Passengers (mil.)	3,970.8	4,031.2	4,028.5	3,988.1
Staff	N.A.	31,213	29,190	28,456

N.A.--Not available.

Table 2

Transport for London - Financial Summary

	--Fiscal year ended Dec. 31--			
(Mil. €)	2015	2016	2017	2018
Operating revenues	7,675.6	6,697.0	6,763.0	6,559.0
Farebox revenues	4,281.0	4,587.0	4,694.0	4,643.0

Table 2

Transport for London - Financial Summary (cont.)				
	--Fiscal year ended Dec. 31--			
(Mil. €)	2015	2016	2017	2018
Operating expenses before D&A	6,059.3	6,179.3	6,067.9	6,143.7
EBITDA	1,616.3	517.7	695.1	415.3
Cash and short-term investments	4,696.0	3,203.4	1,961.5	1,931.3
Financial debt (including leases)*	10,013.6	10,591.5	11,350.3	12,010.8
Adjusted ratios				
EBITDA (DSC) coverage	2.7	0.8	1.0	1.4
Debt service carrying charge (%)	18	19	19	22
Farebox recovery ratio (%)	71	74	77	76
Financial debt to revenues (x)	1.0	1.2	1.4	1.5
Financial debt to net revenues (x)	6.2	20.5	16.3	28.9

*Including financial leases and capitalized operating leases.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Governments - General: Mass Transit Enterprise Ratings: Methodology And Assumptions, Dec. 18, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- GLA Has Capacity To Absorb Additional Debt For Crossrail; TfL Still On CreditWatch Negative, Dec. 13, 2018
- Sovereign Risk Indicators, Dec. 13, 2018
- Bulletin: United Kingdom 'AA/A-1+' Ratings And Negative Outlook Not Immediately Affected By Agreement With EU, Nov. 15, 2018
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, Oct. 26, 2018
- Transport For London 'AA-/A-1+' Ratings On CreditWatch Negative On Delayed Opening Of The Elizabeth Line, Sept. 5, 2018
- Greater London Authority Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, March 23, 2018

Ratings List

Ratings Affirmed

	To	From
Transport for London		
Issuer Credit Rating	AA-/Negative/A-1+	AA-/Watch Neg/A-1+
Senior Unsecured	AA-	AA-/Watch Neg
Commercial Paper	A-1+	A-1+/Watch Neg

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