S&P Global
Ratings

Research

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

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OVERVIEW

- London's solid economic fundamentals, exceptional access to liquidity, and high demand for Transport to London's (TfL) services are major credit strengths for the rating.
- On the other hand, reduced financial flexibility owing to grant cuts and a fare freeze, high debt, and declining cash balances are credit challenges.
- We are affirming our 'AA/A-1+' long- and short-term ratings on TfL.
- The negative outlook indicates that we would lower the rating on TfL if we lowered our long-term rating on the U.K. or if we observed significant risks emanating from Brexit that could erode TfL's business fundamentals.

RATING ACTION

On March 31, 2017, S&P Global Ratings affirmed its 'AA' long-term and 'A-1+' short-term issuer credit ratings on London-based transport operator Transport for London (TfL). The outlook is negative.

At the same time, we affirmed our 'AA' issue rating on TfL's senior unsecured debt.

RATIONALE

We updated our approach and now rate TfL according to our criteria for public transport providers (see "Mass Transit Enterprise Ratings: Methodology And Assumptions", published on Dec. 18, 2013). In our view, mass transit criteria more accurately capture the credit drivers of TfL's operating model. As part of this approach, we also consider TfL as a government-related entity (GRE) (see "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015), related to both the Greater London Authority (GLA) and the U.K. central government.

TfL plays a very important role as a near monopoly providing essential transportation services in the U.K.'s capital region. We also believe there is a very strong link between TfL, the GLA, and the U.K. government. 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 an increasing part of TfL's revenues. The central government, via the Department for Transport, sets the incremental borrowing limits for TfL, and provides ready access to reliable liquidity sources via the Public Works Loan Board (PWLB). We believe that if TfL faced acute financial stress, the U.K. government--through the GLA--would likely extend the necessary support to TfL's operations and debt service. As a result, we believe there is a very high likelihood of government support, which we factor in our rating with a one-notch uplift to the standalone credit profile (SACP).

As per our mass transit criteria, we have revised down TfL's SACP to 'aa-' from 'aa', reflecting our view of the extremely strong enterprise risk profile and its strong financial risk profile. Our assessment of the enterprise risk profile is underpinned by very low risk for the mass transit industry, globally. The sector is characterized by low cyclicality risk and high barriers to entry due to the scale of investment required for transport infrastructure.

In our view, TfL benefits from London's extremely strong and diversified economic fundamentals; the population is growing rapidly, and local income (gross value added) per capita is significantly higher than the national average. Nearly 5.5 million people work in the capital, having risen from 4.9 million in 2011--a five-year historical growth rate of about 14.2%. A large proportion of the population utilizes public transport services provided by TfL and we expect both the population and employment trends to continue, supporting resilient demand for TfL's services to also continue.

We expect ridership will continue to increase, albeit at a slightly slower pace, reaching 4.16 billion journeys by 2017/2018. TfL has benefited from very high ridership levels historically, having increased in each of the last five years, with over 4 billion journeys completed in 2015/2016 on London Underground, bus, and TfL Rail (including the DLR, London Overground, and London Trams). The growth in ridership will be supported by Elizabeth Line (Crossrail), which will add about 10% to the rail capacity carrying over 200 million passengers a year from 2019. In addition, TfL began a 24-hour weekend service (London Night Tube) on five lines. The uptake on this service has exceeded management's expectations with nearly 2.5 million journeys recorded since opening.

Bus services account for the largest passenger volume--exceeding 2.3 billion journeys in 2015/2016. However, since 2015, bus ridership has endured a challenging operating environment due to traffic delays and road congestion (exacerbated by construction projects and roadworks). Ridership declined by 2.6% in 2015/2016 and although we expect a further decline this financial year (ending March 2017), we believe it will gradually return toward growth over its business plan period to 2021/2022.

The pre-eminent risk to the economic fundamentals and demand for TfL's services is related to the U.K.'s exit from the EU. We believe the long-term implications from Brexit are not yet clear, and will depend on the openness and attractiveness of London to international business, as well as its ability to attract migrants.

We consider TfL's financial planning as credible. We also positively note TfL's capability to deliver large-scale capital projects--such as Elizabeth Line (Crossrail), which remains on schedule and within the £14.8 billion funding envelope. At the same time, we see certain challenges ahead for management stemming from changes in the revenue structure (more volatile business rates replacing government grants), management of a significant cost reduction program, and wider economic uncertainty. We will continue to monitor management's ability to adapt and respond to the new environment.

TfL's strong financial risk profile is underpinned by its robust financial policies that involve multiyear planning and transparent reporting. However, funding pressure from ongoing grant cuts, high debt, and falling cash balances represent credit weaknesses for TfL.

In our opinion, TfL's debt remains high and likely to increase as it invests in its large capital program including Elizabeth Line (Crossrail), tube modernization, and capacity upgrades to support growing demand. Therefore, we expect total debt to reach £9.8 billion by 2016/2017; increasing further to about £12.9 billion by 2021/2022. A larger 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. Even though the debt burden is very high, we see the predictable nature of its borrowing profile as a mitigating factor since its incremental borrowing limits are settled with the central government in its spending review.

Although TfL's debt service coverage (DSC) has deteriorated significantly since 2014/2015, we anticipate this ratio will likely improve in the future, as TfL will receive a higher portion of retained business rates that, if required, can be used for debt service replacing investment grants. TfL's DSC came under pressure historically, falling from above 4x in 2014/2015 to only marginally adequate, at just above 1x in 2016/2017. This was as a result of ongoing grant cuts and the reclassification of the general purpose grant to a capital investment grant by the government. Based on our criteria, we assume an interest rate of 3.5% and a repayment profile of 30 years in our debt service measure for TfL's commercial paper program.

TfL's farebox recovery ratio (fare revenue relative to operating expenditure) is one of the highest among the mass transit systems we rate globally. We view the high farebox recovery ratio as an indication of greater financial flexibility to raise revenues or cut costs. That said, we acknowledge TfL's ability to raise fares will be particularly challenged, at least until 2020/2021, due to the commitment to keep TfL-controlled fares frozen. Debt service (we include the entire amount of commercial paper outstanding) accounted for about 16% of total expenditure in 2015/2016 (including debt service and operating expenditure) and therefore remains high compared with rated peers. Taken together, TfL demonstrates strong financial flexibility, although this is based more on its ability to cut costs rather than increase farebox revenues.

Liquidty

The short-term rating on TfL is 'A-1+'.

We assess TfL's liquidity as strong despite our projections that its cash balances will decline as it uses more cash for capital spending.

TfL has held a healthy cash position historically--as of March 31, 2016, cash and equivalents were about £1.6 billion (excluding Crossrail cash)--although we expect these to decline toward a steady level of about £600 million in the coming years.

Days of available cash (unrestricted cash and committed lines as a proportion of total operating expenditure) is expected to show a corresponding drop from cash held for 108 days of operating expenditure in 2015/2016 to 77 days in 2017/2018.

Although TfL extensively utilizes commercial paper borrowings to fund its short-term liquidity needs, we do not consider the refinancing risk as particularly high thanks to the exceptional access to external liquidity via PWLB. As a statutory body within the Debt Management Office, PWLB lends funds 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.

OUTLOOK

The negative outlook reflects that on the U.K. and indicates that we would lower the rating on TfL if we lowered our long-term rating on the U.K. government.

We could also lower the rating if we anticipated a considerable weakening in TfL's growth prospects, potentially if protracted Brexit negotiations resulted in adverse economic conditions in London. Cost overruns on large capital projects such as Elizabeth Line (Crossrail) and the Northern line extension, or failure to realize savings from the cost reduction program, could add to the downward pressure on ratings over the next 18-24 months.

We could revise the outlook to stable over the next 18-24 months if the outlook on the U.K. was revised to stable and, at the same time, if TfL performs in line with our base-case expectations.

The ratings could also be affected if we changed our view of TfL's importance or its link with the U.K. government.

RELATED CRITERIA AND RESEARCH

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Governments - General: Mass Transit Enterprise Ratings: Methodology And Assumptions - December 18, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Governments - International Public Finance: 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 - October 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative On Brexit Uncertainties, October 28, 2016
- Greater London Authority Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative; October 21, 2016
- Local And Regional Government Debt 2017: China's Refinancing Will Lift Global Borrowing To A Massive $1.6 Trillion, March 23, 2017
- 2015 Annual International Public Finance Default Study And Rating Transitions, June 30, 2016
- Sovereign Risk Indicators - December 14, 2016. An interactive version is also available at http://www.spratings.com/sri.
- Institutional Framework Assessment For Non-U.S. Local And Regional Governments - April 21, 2016

RATINGS LIST

	Rating	
	To	From
Transport for London		
Issuer Credit Rating		
Foreign and Local Currency	AA/Negative/A-1+	AA/Negative/A-1+

Ratings List Continued...

Senior Unsecured		
Local Currency	AA	AA
Commercial Paper		
Foreign and Local Currency	A-1+	A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. 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 S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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.

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