FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Transport for London to 'AA-'; Outlook Negative

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Fitch Ratings - London - 26 Jan 2023: Fitch Ratings has upgraded Transport for London's (TfL) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) to 'AA-' from 'A+' and affirmed its Short-Term Foreign-Currency IDR at 'F1+'. The Outlooks are Negative, reflecting that on the UK sovereign (AA-/Negative).

The upgrade reflects an improvement in our assessment of TfL's financial profile and our strong assessment of the linkage between TfL and its sponsor, the UK and the incentives to prevent default based on Fitch's Government-Related Entities (GRE) criteria. The Negative Outlook reflects that on the sovereign as the ratings are now equalised, reflecting that TfL's Standalone Credit Profile (SCP) is three notches away from the sovereign IDR.

KEY RATING DRIVERS

Status, Ownership and Control: 'Strong'

TfL's legal status is that of a statutory corporation subject to local government finance rules, and as such it must produce a balanced budget each year. TfL is a functional body of the Greater London Authority (GLA) and reports to the mayor of London, who is the chair of the board. The mayor appoints the board members and develops and publishes a transport strategy reflecting national and local priorities. Since 2004, a prudential scheme for local authorities has been in place, allowing TfL to borrow up to authorised limits.

Support Track Record: 'Strong'

The UK government has always expressed its support for TfL's long-term commitments, although it has not subsidised TfL's investment plan since April 2017. Since then, the investment plan has included the Elizabeth Line, the extensive modernisation of tube services and stations and the transformation of the road network. From April 2017, the investment grant from the UK government was replaced with business rates grant from the GLA

The majority of the grant TfL receives is from business rates collected and distributed by the GLA. During the Covid-19 pandemic, TfL received further extraordinary grants from the UK government to maintain operations and financial stability. Under the latest funding settlement in August 2022, this will continue until at least March 2024. The support provided by the government during the pandemic was not immediate, and led to some financial deterioration. It was also initially provided partially as a loan. This is reflected in the 'Strong' assessment. .

Socio-Political Implications of Default: 'Strong'

TfL is strategically important for London and the UK economy. Prior to the pandemic, around 4 billion journeys were undertaken on TfL's services annually. TfL would be difficult to substitute in the short to medium term, with the transition process likely to lead to severe service disruption. Financial default would temporarily endanger the continued provision of essential public services and hamper TfL's investment programme. Disruption would lead to significant political or economic repercussions.

Financial Implications of Default: 'Very Strong'

If TfL defaulted, it would impair the availability and cost of borrowing for other GREs in the UK. The shock waves would result in a fundamental rethink of exposure to the public sector and inevitably lead to a restriction on lending. We believe the capital markets (17% of TfL's borrowing following bond repayment and buyback during FY23) and the European Investment Bank (25% of borrowing) would restrict funding.

Standalone Credit Profile

Revenue Defensibility 'Stronger'

TfL's revenue defensibility is driven by a strong demand assessment. Despite the pandemic, we expect passenger demand to return to high levels through the cycle. TfL has limited pricing power, but we consider the overall assessment to be strong, given its position as the key provider of public transport in the capital.

TfL has historically had strong demand. Passenger revenues declined by 95% during the pandemic, but it was expected demand would return and figures have shown this, even if they may not return to pre-pandemic levels for some time. We consider the pandemic to be an exceptional situation where demand was artificially constrained by government measures, but has rebounded given the lack of transport alternatives in London.

Fitch considers the pricing characteristic 'Midrange', because TfL does not have the independent ability and full flexibility to collect revenues sufficient to cover all costs through increases in fares. TfL's primary source of gross income is passenger income on London Underground, rail and bus networks, representing over 70% of all revenue generated by TfL (excluding grant income).

Operating Risk 'Midrange'

We assess operating risk based on a 'Midrange' assessment of operating costs and 'Stronger' assessment of resource management, with a neutral influence from the capital planning and management factor.

TfL is one of the largest employers in London, with an average 26,994 staff (including agency and fixed-term contracts) in the financial year ending 31 March 2022 (FY22), an increase from 26,867 in FY21. In FY22, staff costs accounted for 36% of cash operating costs. There are no supply constraints for labour or resources in terms of amount, cost or timing.

Financial Profile 'Stronger'

We have revised this assessment to 'Stronger' due to increased certainty in Fitch's projections and low levels of net debt/EBITDA. Fitch expects leverage ratios will be maintained at around 10-11x across its five-year rating case, as a result of the financial settlement agreed with the UK government in August 2022.

TfL suffered some deterioration in its financial metrics at the beginning of the pandemic, and through FY21. However, prudent management and extraordinary support from Government have returned it to a strong financial position. Net debt/EBITDA deteriorated to around 14x in FY21 as a result of reduction in passenger revenue and maintained service levels. Support was provided by the UK government in various settlement agreements, the first of which included both borrowing and grants. All subsequent agreements were solely grant funded, but required certain concessions from TfL, including increasing fare levels, reviewing certain areas of policy and reducing costs.

Fitch expects TfL to improve pre-pandemic EBITDA levels (FY20: GBP1.4 billion, FY23-27: GBP1.5 billion average) as the increased revenue from the Elizabeth line is collected. Overall Fitch sees increased near-term certainty in its projections for TfL after the latest funding agreement, which covers the period to March 2024. This protects TfL from revenue risk in the near-term. Fitch expects strong performance to continue through the rating case.

Under Fitch's rating case, net Debt/EBITDA will slightly deteriorate but remain reasonably stable from FY22, at 7.8x to 9.8x in FY27, with a peak in FY24 at around 12.0x. The recovery from FY21 will be led by increased passenger levels, capital projects providing additional capacity (Elizabeth line, extension of the Northern line), additional areas of revenue generation (including expansion of the ultra-low emission zone) and strong control over costs. This should mean EBITDA is maintained at around GBP1.7billion without significant increases in expected net debt (FY22: GBP14.2 billion, FY27:GBP16. 2billion).

The improvement in leverage ratios, partially as a result of the latest funding settlement, have led us to revise the SCP to 'a-' from 'bbb+'.

Additional Risk Factors Assessment

We assess all asymmetric risk factors as neutral to the rating, TfL has high levels of fixed-rate, sterling borrowing across various liquidity sources. Governance is acceptable, with oversight from a democratically elected mayor and board of non-executives. Fitch has a neutral assessment of the legal environment in the UK as well as for the quality of information provided, as TfL publishes annual audited accounts and regular business plans. There is no country ceiling in place in the UK, and TfL maintains reasonable levels of liquidity.

Derivation Summary

Fitch views TfL as a GRE of the UK. This reflects a score of 40 under our GRE criteria. As the 'a-' SCP is three notches below the sovereign's rating, the IDR is equalised with that of the sponsor.

Short-Term Ratings

The short-term rating has been affirmed at 'F1+', in line with the sovereign's.

Debt Ratings

TfL's 'AA-' debt ratings are aligned with its IDR as the notes of each series constitute direct, unconditional, unsubordinated, unsecured obligations of TfL and rank pari passu among themselves.

Liquidity and Debt Structure

TfL had cash and liquid deposits of GBP1.4 billion at end-FY22, none of which is ring-fenced. It has a policy of maintaining cash and liquid assets of at least 60 days of operating expenditure.

TfL generally has ample access to external liquidity. Along with other local authorities, it can borrow from the Public Works Loan Board (PWLB, a statutory body operating within the UK Debt Management Office), which provides easy and direct access to funding at short notice. PWLB will lend any amount to TfL within authorised borrowing limits set by the mayor, at a rate of Gilts + 80bp. Funds would be credited to TfL within five days.

Issuer Profile

TfL is a statutory body established under the GLA Act 1999. Its main activity is the provision of integrated transport facilities and services in Greater London, including buses, London Underground, Docklands Light Railway, London Overground, TfL Rail/Elizabeth line, trams, the management of certain roads in London and the Congestion Charge scheme, cycling, river services, the licensing of taxi and private hire.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A change in the assessment of the factors under the GRE Criteria, or a sustained weakening in the financial profile, with net debt/EBITDA sustainably above 12x. Negative rating action on the sovereign would also directly impact TfL's rating.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Improvement in the financial profile through the cycle, specifically a sustained improvement in the net adjusted debt/EBITDA ratio to below 10x under Fitch's rating case, alongside an upgrade of the sovereign.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Linked to the UK sovereign rating.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Transport for London	LT IDR	AA- Rating Outlook Negative	Upgrade	A+ Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AA- Rating Outlook Negative	Upgrade	A+ Rating Outlook Stable
senior unsecured	LT	AA-	Upgrade	A+
senior unsecured	ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Transport for London	UK Issued, EU Endorsed

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