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Research Update:

Transport for London 'AA+/A-1+' Ratings Affirmed Despite Declining Budgetary Performance; Outlook Stable

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Table Of Contents

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Overview

- Transport for London (TfL) continues to perform in line with our expectations.
- Operating balances and balances after capital accounts continue to weaken as a consequence of lower grants; however, fare revenue is proving buoyant.
- We are therefore affirming our 'AA+/A-1+' issuer credit ratings on TfL.
- The stable outlook reflects our expectation that TfL's flexibility, financial management, liquidity, and supportive institutional framework will continue to be credit strengths, despite the deteriorating financial profile.

Rating Action

On April 15, 2016, Standard & Poor's Ratings Services affirmed its 'AA+' long-term and 'A-1+' short-term issuer credit ratings on U.K. transport provider Transport for London (TfL). The outlook is stable.

We also affirmed our 'A-1+' short-term rating on TfL's £2 billion commercial paper program and our 'AA+' long-term rating on its senior unsecured debt.

Rationale

The ratings on TfL reflect the extremely predictable and supportive institutional framework within which it operates as a U.K. local authority; its exceptional liquidity position in international terms; and London's strategic importance to the U.K. economy, and growing population, which underpin demand for TfL's services.

Although TfL has a major capital program, the U.K. government (via the Department for Transport) effectively underwrites much of the exposure to cost overruns on TfL's largest capital project, Crossrail 1. Therefore, we believe TfL has very low contingent liabilities. Positively, TfL has strong budgetary flexibility owing to its large capital investment program and a high and rising share of self-generated modifiable operating revenues (mostly fares). Although its ability to increase fares can be subject to political constraints, we view TfL's overall commitment to fiscal discipline and the quality of its financial management as being very strong.

The ratings are constrained by the weakening budgetary performance driven by the reduction in government grants and substantial capital expenditure (capex). Furthermore, TfL has a high level of tax-supported debt, which we expect to reach about 167% of consolidated operating revenues by 2019. The long-term rating on TfL is equivalent to our 'aa+' assessment of its stand-alone credit profile.

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TfL is a functional body of the Greater London Authority (GLA) and is responsible for implementing the mayor's transport strategy in London. TfL has many subsidiaries that together comprise the TfL Group. In our analysis, we focus on this consolidated group.

We continue to view the U.K. institutional framework, within which TfL operates as a local authority, as extremely stable and predictable. Although many local authorities will face continued spending pressures over the coming years, as the U.K. seeks to reduce its fiscal deficit, we anticipate that this will not be detrimental to the general functioning of the authorities or a threat to the mandatory services they provide.

Reflecting the austerity in the U.K. public sector, TfL is also experiencing reductions in its grant income, particularly operating grant received from the central government, which we understand will be phased out by 2018. However, unlike other local authorities, TfL has been allocated a substantial multiyear capital grant. Following the Chancellor’s Budget announcement on March 16, 2016, the capital grant is expected to be replaced by an equivalent increase in the business rates TfL receives from the GLA, from 2017. This reflects the ongoing government commitment to support investment in London's transport network.

The strength of London's economy, the growth in its population, and the consequent demand for public transport, are key to TfL's creditworthiness. These factors support both its ability to generate fare revenues, and the rationale for continued central government funding. We estimate that London's gross value added (GVA) per capita was £42,690 in 2015, and we forecast growth in GVA will remain steady at about 3% on average over the next three years, supported by rising employment levels. We expect London will grow faster than the U.K. average, reflecting the more flexible and service-oriented nature of London's economy, in which financial services play a key role.

London is both pivotal to the U.K.'s economic growth and a major net contributor to the U.K.'s fiscal position. In our view, TfL will continue to play an essential role in delivering the transport infrastructure needs of London.

Benefiting from London's resilient economy, growth in TfL's fare revenues has also proved buoyant. Despite this, declining government grants and substantial investment in capital infrastructure result in weakening budgetary performance. In our base case, we expect TfL to post deficits after capital accounts averaging 15% of total revenues, over the next three years, and average operating surpluses of about 1.6% of Standard & Poor's-adjusted operating revenues.

We forecast that TfL will post a small operating surplus of less than 1% in 2015/2016. This marked decline from last year is due to a change in the way that some government grant is classified from 2015/2016; although going forward there will also be funding pressures from a fall in overall government grants.

As a consequence of its capital program, we forecast that TfL's debt burden will remain high. The steep increase in the ratio of tax-supported debt to operating revenues to about 167% in 2019 from 124% in March 2015 is largely due to the decrease in the operating-revenue denominator from the reclassification of capital grants, as well as reduced operating grants, as we noted in our previous research update (see "Research Update: Transport for London 'AA+/A-1+' Ratings Affirmed Despite Heavy Capital Program; Outlook Stable," published on May 1, 2015).

In our view, TfL exhibits robust expenditure flexibility as it has the willingness and the ability to delay or cancel many elements of its capital program, if required. Although in theory TfL has significant flexibility to raise its transport fares, given its near-monopolistic position over public transport in London, we believe that in reality the raising of fares depends on political will, which remains limited, particularly in light of the upcoming mayoral elections. Therefore, in our base-case scenario, we forecast that TfL will increase fares by less than its business plan assumes.

We view TfL's overall commitment to fiscal discipline, and the quality of its financial management, as very strong. This reflects our view, in particular, of TfL's detailed long-term planning, clear budgetary procedures, and high level of transparency. Furthermore, management’s success in managing large-scale projects such as Crossrail 1 and the Northern Line Extension highlight sophisticated execution and delivery process.

Liquidity

We view TfL's liquidity position as exceptional. It has very positive debt service coverage of 2.5x, supported by strong and predictable cash flows. TfL has ready access to external liquidity, based on its ability to borrow from the U.K. government's Public Works Loan Board (PWLB). TfL also has an established track record of issuing on the capital markets and borrowing from the European Investment Bank.

We estimate that, on average, TfL will have cash and short-term investments that cover the next 12 months' debt service by 2.5x, after allowing for some loss of value in a stress scenario. We calculate debt service to include repaying commercial paper. (TfL also has access to undrawn committed facilities of £500 million, which we do not include in our base-case calculation.)

Beyond the next 12 months, we see TfL's levels of free cash and equivalents continuing to diminish in order to fund its planned capital program. TfL has effectively been prefunding its capital program by raising debt in advance of the associated capex.

We view TfL as having exceptional access, in international terms, to external liquidity. This is primarily due to the U.K. government's PWLB, which can provide funding to TfL within 48 hours of an application, as long as TfL is operating according to the Prudential Code. In addition, TfL has an established track record of issuing commercial paper and medium-term notes on the capital markets.

Outlook

The stable outlook reflects our expectation that TfL's flexibility, financial management, and liquidity will continue to be credit strengths, even though its financial profile is set to weaken as grant reduces and capital investment continues, resulting in deficits after capital accounts.

We may consider raising the long-term rating within the next two years if TfL's total revenues rise such that deficits after capital accounts shrink substantially below our base-case expectations. In this scenario, TfL would likely receive extra support from the government to fund its investment program, such that it reduces borrowings and its debt position improves.

Conversely, we could consider lowering the rating in the next two years if TfL is unable to raise fares in line with inflation, combined with increasing operating expenses in the absence of other sustainable revenue sources. We could also lower the rating if TfL substantially increases its capex, either as a result of cost overruns or a shift in financial strategy. This would result in deficits after capex substantially exceeding our base-case expectations on a recurrent basis and its debt burden increasing more rapidly than we currently forecast. In such a scenario, we might consequently revise downward our view of TfL's financial management, and its willingness to use its expenditure flexibility.

Key Statistics

Table 1

Transport for London Economic Statistics

	--Fiscal year end Dec. 31--						
	2012	**2013**	**2014**	**2015bc**	**2016bc**	**2017bc**	**2018bc**
Population	8,308,362	8,416,636	8,528,813	8,639,691	8,757,268	8,868,846	8,980,224
Population growth (%)	1.3	1.3	1.3	1.3	1.4	1.3	1.3
GDP per capita (local currency) (single units)	39,191	40,215	41,912	42,690	43,755	45,132	46,622
Real GDP growth (%)	1.5	3.3	4.1	3.1	2.8	2.8	2.8
Unemployment rate (%)	8.4	8.2	6.4	6.3	6.2	6.1	6.0

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. Sources typically include national statistical offices, Eurostat, and Experian Ltd.

Table 2

Transport for London Financial Statistics

	--Fiscal year beginning April 1--						
(Mil. £)	**2012**	**2013**	**2014**	**2015bc**	**2016bc**	**2017bc**	**2018bc**
Operating revenues	7,954	7,874	7,704	6,691	6,842	7,008	7,314

Table 2

Transport for London Financial Statistics (cont.)

	--Fiscal year beginning April 1--						
(Mil. £)	**2012**	**2013**	**2014**	**2015bc**	**2016bc**	**2017bc**	**2018bc**
Operating expenditures	5,873	6,119	6,407	6,644	6,670	6,990	7,164
Operating balance	2,081	1,755	1,297	47	172	18	150
Operating balance (% of operating revenues)	26.2	22.3	16.8	0.7	2.5	0.3	2.1
Capital revenues	2,046	2,141	1,484	1,885	1,599	1,594	1,519
Capital expenditures	3,237	3,146	3,429	4,027	3,504	3,009	2,489
Balance after capital accounts	890	750	(648)	(2,096)	(1,733)	(1,398)	(820)
Balance after capital accounts (% of total revenues)	8.9	7.5	(7.1)	(24.4)	(20.5)	(16.2)	(9.3)
Debt repaid	1,255	1,274	858	879	926	1,159	867
Balance after debt repayment and onlending	(365)	(524)	(1,506)	(2,974)	(2,660)	(2,557)	(1,687)
Balance after debt repayment and onlending (% of total revenues)	(3.6)	(5.2)	(16.4)	(34.7)	(31.5)	(29.7)	(19.1)
Gross borrowings	1,533	1,538	1,432	1,447	1,563	1,983	1,297
Balance after borrowings	1,168	1,014	(74)	(1,527)	(1,096)	(573)	(390)
Operating revenue growth (%)	5.7	(1.0)	(2.2)	(13.1)	2.2	2.4	4.4
Operating expenditure growth (%)	4.8	4.2	4.7	3.7	0.4	4.8	2.5
Modifiable revenues (% of operating revenues)	51.9	56.2	59.6	73.1	74.8	77.0	79.9
Capital expenditures (% of total expenditures)	35.5	34.0	34.9	37.7	34.4	30.1	25.8
Direct debt (outstanding at year-end)	7,564	7,898	8,548	9,148	9,878	10,778	11,278
Direct debt (% of operating revenues)	95.1	100.3	111.0	136.7	144.4	153.8	154.2
Tax-supported debt (% of consolidated operating revenues)	109.4	114.2	124.2	154.9	160.7	168.5	167.2
Interest (% of operating revenues)	4.6	5.0	5.3	6.2	6.3	8.0	8.3
Debt service (% of operating revenues)	20.4	21.1	16.5	19.4	19.8	24.6	20.2

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. Base case reflects Standard & Poor's expectations of the most likely scenario. Downside case represents some but not all aspects of Standard & Poor's scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of Standard & Poor's scenarios that could be consistent with an upgrade.

Ratings Score Snapshot

Table 3

Transport for London Ratings Score Snapshot

Key Rating Factors	
Institutional Framework	Extremely predictable and supportive
Economy	Very strong
Financial Management	Very strong
Budgetary Flexibility	Strong
Budgetary Performance	Very weak
Liquidity	Exceptional
Debt Burden	High
Contingent Liabilities	Very low

*Standard & Poor's ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the rating.

Key Sovereign Statistics

For sovereign statistics, please click here: http://www.spratings.com/sri

Related Criteria And Research

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments - June 30, 2014
- 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

Related Research

- Sovereign Risk Indicators - April 12, 2016. An interactive version is also available at http://www.spratings.com/sri
- Default, Transition, and Recovery: 2014 Annual International Public Finance Default Study And Rating Transitions - June 8, 2015
- Report Card: U.K. Local Authorities Absorb Major Cuts, But What Flexibility Remains? - March 31, 2015
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - February 5, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Transport for London		
Issuer Credit Rating		
Foreign and Local Currency	AA+/Stable/A-1+	AA+/Stable/A-1+
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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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.