MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Transport for London's ratings to Baa1 from A3; outlook stable

09 May 2022

London, May 09, 2022 -- Moody's Investors Service ("Moody's") has today downgraded Transport for London's (TfL) long-term senior unsecured debt ratings to Baa1 from A3 and its long-term EMTN programme rating to (P)Baa1 from (P)A3. The outlook has been changed to stable from negative. Moody's has affirmed TfL's short-term issuer rating and short-term commercial paper rating at Prime-2 (P-2) and downgraded the baseline credit assessment to baa3 from baa2.

RATINGS RATIONALE

The downgrade reflects Moody's view that TfL's operating performance will be weaker than expected due to new hurdles, namely weaker economic growth and higher inflation, hindering the recovery of passenger growth. The downgrade also reflects the ongoing uncertainty around TfL's long-term funding framework, especially for capital funding. While Moody's expects additional government support to be forthcoming, it is unlikely to fully cover TfL's capital funding needs and likely to be accompanied with onerous conditions.

TfL will remain highly reliant on passenger income compared to global peers and we expect growth to slow over the next two years in the face of multiple demand risks including hybrid working and fewer leisure passengers as discretionary spending is hit. Passenger numbers have grown significantly since pandemic lows with the most recent data reporting ridership across TfL of 72% of pre-pandemic numbers. However, we expect ridership growth to slow, reaching 80% by fiscal 2024. Moody's estimate for passenger income for fiscal 2023 is £4.3 billion, down £400 million from last year's forecast of £4.7 billion. High inflation also poses downside risks to this forecast if it increases the sensitivity of passenger demand to TfL's prices.

Given the nature of its services, TfL has limited expenditure flexibility it can deploy to mitigate anemic growth in passenger income. Under the terms of its current funding agreement with government, TfL must identify £400 million of cost savings or additional revenue in fiscal 2023. The organisation has a strong track record of cost savings, however, we view further efficiencies as challenging especially in a high inflation environment. TfL has already reduced services on buses and the Tube and delayed some capital projects to bolster its financial position.

Under the terms of the current funding agreement, TfL has identified new funding sources which will diversify and increase its income including designated council tax, fare increases, and the expanded Ultra Low Emission Zone (ULEZ), a road user charge. In addition, TfL has announced the opening of the Elizabeth Line in May 2022 which will drive higher passenger income. Together, we expect these new sources to provide between £500 - £750 million per year from fiscal 2023. Even with these new revenue sources, the estimated government operating subsidy required for fiscal 2023 is around £1 billion. TfL may require additional operating subsidy to balance its budget for fiscal 2024 given the more challenging operating environment.

Ongoing uncertainty on TfL's long-term funding framework will continue to weigh on its credit strength. Government has stated its willingness to support TfL's capital programme through a multi-year funding agreement but to date no agreement has been reached. Agreements continue to be last-minute and short-term; the current agreement covers only four months to June 2022. While Moody's expects government to continue to provide financial support to TfL, the level of funding is unlikely to be sufficient to fully cover TfL's capital spending needs. The estimated capital funding gap is between £500 million and £1 billion per year. If funding under the multi-year agreement doesn't fully cover its capital requirements, TfL will have to either borrow to fund its capital plan or make cuts to key projects such as line upgrades leading to a gradual erosion of service quality.

Additional government funding is likely to be accompanied with cumbersome conditions requiring significant resource. Conditions required under the current funding agreement such as changes to staff pay and benefits will be challenging to implement given the strength of TfL's unionized workforce. Others such as service level reductions on the Tube and bus network may prove detrimental to TfL's long-term financial sustainability. The government has also imposed a target (rather than a minimum) for TfL's liquidity of £1.2 billion which has led to a reduction in liquidity from £1.6 billion a year earlier. Overall, the low level of funding and numerous conditions are hindering TfL's ability to plan long term and are likely to result in further delays to capital projects.

TfL's Baseline Credit Assessment (BCA) has been downgraded to baa3 from baa2. The final ratings of Baa1 incorporate a two-notch uplift based on Moody's assessment of a strong likelihood of support from the UK government, as per the application of Moody's Joint Default Analysis (JDA).

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook balances the challenges of weaker operating performance and funding framework uncertainty with TfL's strengths including the essentiality of its services to London's and the national economy, an expectation that passenger numbers will continue to rise, strong assess to liquidity and limited additional borrowing over the medium term. TfL also benefits from strong governance and management including high quality and transparent reporting in addition to a strong track record of cost control.

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

TfL's credit profile would improve with prospects of sustained outperformance on passenger and other income driving a return to sustainable operating surpluses without actions which could be detrimental in the long term including delays or cancellation of capital enhancements. A multi-year agreement to fully fund its capital programme with minimal conditions would also be supportive to the rating.

Downward pressure would arise from weaker than expected operating performance with multi-year deficits or evidence that reduced quality of services was adversely impacting demand. A deterioration in government support including significant underfunding of TfL's capital funding gap or an agreement which places unattainable conditions on TfL resulting in further erosion of quality of services would also be negative. Lastly, a material increase in debt or further reduction in liquidity would also exert negative pressure on the rating.

ESG CONSIDERATIONS

Environmental considerations are material to TfL's credit profile. TfL is central to the London Mayor's ambition to achieve a zero carbon London and improve air quality. This involves significant expenditure on the TfL bus fleet such as introducing low-emission buses, increasing energy efficiency on the London Underground and Rail services, introducing the Ultra Low Emission Zone (ULEZ), upgrading London's cycling and walking infrastructure alongside many other capital projects and programmes. TfL's services can also be affected by flooding and other weather-related events but these do not have a material impact on the issuer's finances.

Social considerations are material to TfL's credit profile. The pandemic has impacted demand for TfL's services and we anticipate a permanent reduction in ridership of 10%-20% relative to pre-pandemic numbers due to changes in working patterns. Socially driven policy can also have a material impact on TfL's credit profile, especially fares which are highly political. We also note the highly unionised workforce, which gives rise to potential strike action and constrains its ability to adapt its cost base to lower ridership. In addition, demand for TfL's services, particularly for the London Underground, is correlated to income levels, which may cause a reduction in the demand given the impact of higher inflation on households and a reduction in real wages.

Governance considerations are material to TfL's credit profile. TfL has high standards of financial management and governance, and has a number of internal committees that review investment and spending decisions. There is also an external body providing independent assurance and expert advice to the Mayor, the Independent Investment Programme Advisory Group (IIPAG). TfL has high standards of transparency and all material documentation including its annual five-year business plan, budget, financial statements, board meeting notes and material spending decisions are published on its website.

PRINCIPAL METHODOLOGY

The methodologies used in these ratings were Government-Related Issuers Methodology published in February 2020 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1186207, and Mass Transit Enterprises Methodology published in December 2017 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_1105431 . Alternatively, please see the Rating Methodologies page on www.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 at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288235 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on www.moodys.com.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Jeanne Harrison
VP - Senior Credit Officer
Financial Institutions Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Mauro Crisafulli
Managing Director

Financial Institutions Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization (“NRSRO”). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any credit rating, agreed to pay to MJKK or MSFJ (as applicable) for credit ratings opinions and services rendered by it fees ranging from JPY100,000 to approximately JPY550,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.