

United Kingdom
Credit Analysis

Transport for London (TfL)

Ratings

Foreign Currency

Long-Term..... AA
Short-Term.....F1+

Local Currency

Long-Term..... AA

Rating Outlook

Stable

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Summary Data

	31 Mar 2003*	31 Mar 2002*
Current Revenue (GBPm)	3,448	2,617
Total Debt (GBPm)	0	
Operating Balance/ Current Revenue (%)	7.5	6.5
Total Debt Service/Current Revenue (%)	0	0.0
Total Debt/Current Rev.(%)	0.0	0.0
Total Debt/Current Balance (Years)	0.0	0.0
Current Balance/Capital Expenditure (%)	35.7	26.6

* Actual

Rating Rationale

The ratings primarily reflect Transport for London's (TfL) position in the British political and institutional set-up, giving it a close link, though not totally secured, to governmental funding.

TfL, which reports to London's Mayor, is a functional body of the Greater London Authority ("GLA"). It took on all of London Regional Transport's (a central government agency) previous responsibilities (roads and bridges, buses, surface rail, river services, taxis etc) on July 2000, apart from London Underground (LUL). The latter was passed to TfL only in July 2003 after lengthy political and judicial disputes, once the Public Private Partnerships contracts (PPPs) were established, in late 2002 and in early 2003. PPP is the option that was chosen by central government for upgrading the "Tube's" infrastructure. TfL's board has appointed experienced top management, who have implemented ambitious measures of internal reorganisation and business improvements. The current institutional and financial framework makes TfL's rating independent from that of the GLA.

TfL must, by statute, present a balanced budget, and to date it has done so. Its budget structure is relatively rigid: it is primarily funded by the Department for Transport ("DfT") through the GLA Transport Grant (50% of TfL's resources in the 2003/04 budget), which is paid to the GLA and ring-fenced for TfL. Fares (38% of revenue) are set by the Mayor although there is limited room for raising them further in view of their already relatively high level. Local taxation (GLA council tax precept) is only 1% of revenues and provides only limited leeway, as is the case for the other revenue sources (including capital receipts and congestion charge), totalling 11% of revenue. Expenditure is also relatively inflexible, with staff costs (16%) and contract payments (52%) making up the bulk. TfL's obligations related to the PPP project (a possible early redemption of up to GBP4.5 billion of the constructors' debt) are backed by a letter of comfort provided by the DfT to investors. The TfL group (corporation and subsidiaries) is currently debt-free and has a satisfactory level of liquidity. Additionally, the government may access particular departmental and/or treasury facilities to support TfL's obligations related to the PPP.

Outlook

The outlook reflects the political visibility of TfL in the next two years of operations. Fitch Ratings acknowledges that there is a risk, in the long run, that the Mayor's ambitious upgrading plan for transport in London may not be fully covered by central government funding. Fitch will monitor the possible recourse of financial debt by TfL, made possible under the new prudential borrowing regime for UK local authorities.

Strengths

- Institutional and financial security derived from the public status of TfL as the authority for transport in London
- Current debt-free situation, though future capital funding needs to be possibly covered by borrowing

Concerns

- Funding gap between long-term infrastructure upgrading costs and the level of grants committed by central government in the medium term
- Operational and contractual risks related to PPP, including moral hazard in the implementation of the UK government's letter of comfort

■ Institutional Set-Up and Responsibilities

Transport for London (TfL) is a statutory corporation, a functional body in the field of urban transport of the Greater London Authority (GLA). TfL is chaired by the Mayor of London, the executive head of the GLA, and is subject to the financial framework of a UK local authority. TfL's position as authority and integrated provider for urban transport services in the UK's capital city, as well as its statutory basis are credit strengths. TfL was created by the central government in the GLA Act of 1999, and took over London Transport's responsibilities (the central government agency previously in charge of transport in the capital city), apart from the underground, which was due to be transferred only after the conclusion of the PPP arrangements. This was achieved in July 2003, and TfL took over London Underground Ltd (LUL) from London Transport, which was dissolved.

TfL's Responsibilities Encompass all Modes of Transport Apart from Overground Rail

Since July 2000 TfL has been responsible for most transport in London, including buses, major roads, river transport, cycling, taxis and private hire (the Public Carriage Office) and trams. Since July 2003, it has also been responsible for the "Tube" (the London underground, see below). However, TfL has only an advisory role as far as overground rail

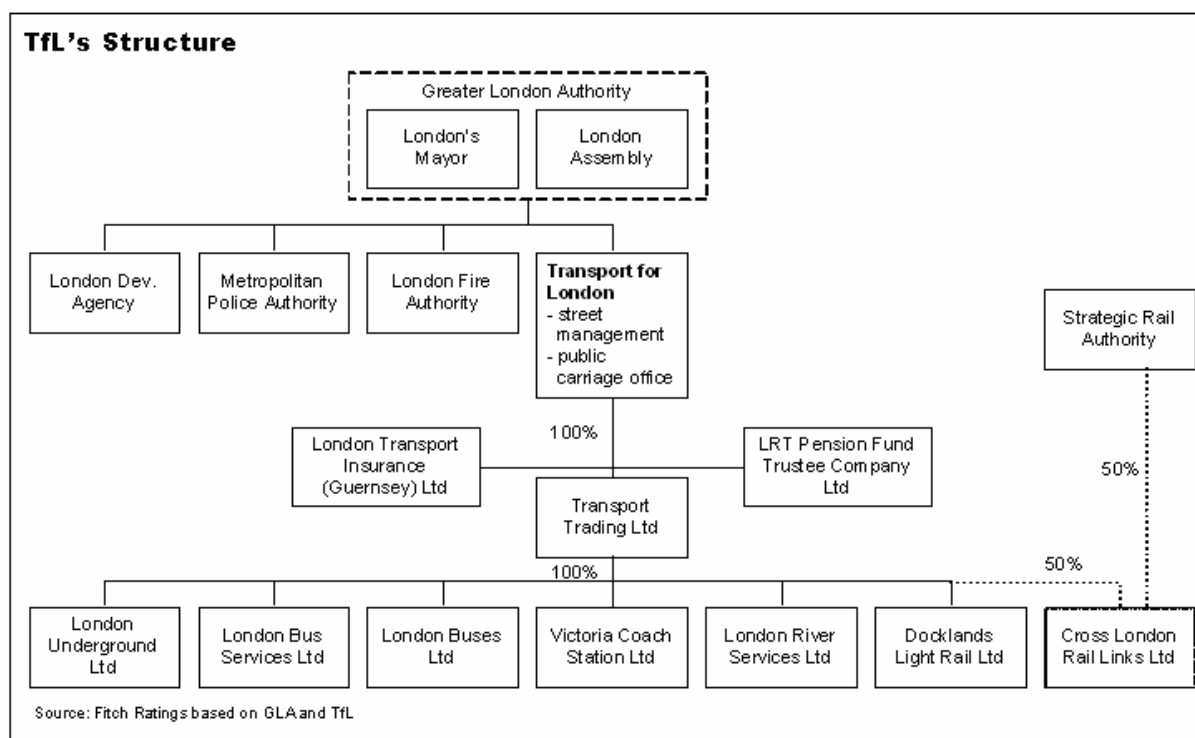
services are concerned. The latter remain under the aegis of National Rail Networks and are regulated by the Strategic Rail Authority (SRA, Fitch Long-term rating "AAA"). Unlike Paris or Berlin, the London urban area is not fully-integrated into one single metropolitan transport authority (MTA).

TfL and the Mayor's Powers over Transport in London

Since the devolution of power to the local level, enacted by the GLA Act in 1999, the Mayor of London (Ken Livingstone, elected in 2000 for a four-year term), is the key figure in urban transport for the UK capital city.

The Mayor:

- Sets the budget, appoints the board and can direct the actions of TfL. Having made transport a priority, the Mayor has chosen to become the chair of the TfL board;
- Is legally required to produce a transport strategy for London, which guides the policies of TfL and the London borough councils. The Mayor's transport strategy was published in July 2001; it complements the government's 10-Year Transport Plan enacted in April 2001;
- Sets the fares for the "Tube", buses, Docklands Light Railway, Croydon Tramlink and taxis;
- Can issue guidance to the SRA on overground rail services in London.



Transfer of Responsibility for London Underground to the Mayor

On 15 July 2003 responsibility for the London underground passed from the government to the Mayor and TfL - three years after the other transport responsibilities were transferred. Indeed, the "Tube" was only transferred once the Public Private Partnership (PPP) for the underground was in place. The PPP, aimed at providing a GBP16bn upgrade and maintenance programme for the "Tube", was decided upon and organised by the government, leading to a political and judicial dispute with the Mayor and TfL.

Transport Provision

Transport Modes	Passenger Journeys a Year (m)	Operation Mode	Maintenance of Infrastructure
Buses	1,500	Concession	Contractors
Underground	950	Direct (LUL)	PPP (infracos)
Light Rail (Tram* + DLR)	61	PFI	Concessionaire

* DLR serves a 16 miles automatic metro track from the City to East London's renovated docks area. It is run under a PFI 7-year contract by Serco Docklands Ltd. Tramlink is a tram service on the south bank of the Thames River, operated under a 99-year concession. Source: Fitch Ratings based on TfL

Legal Structure

The legal structure comprises:

- The Corporation – which contains Street Management, the Public Carriage Office and the corporate centre and constitutes, for legal and accounting purposes, the local authority;
- The Group – which is made up of the Corporation and its subsidiaries (all wholly-owned except for Crossrail, 50% TfL and 50% SRA), grouped under Transport Trading Ltd.

■ Governance, Management and Control

TfL is the administrative instrument to discharge a highly political responsibility: the successful running of public transport is critical to urban and economic development in the UK's capital city. Moreover, it is a test case for the devolution of powers from the central government to the local level, a sensitive issue in the case of London. TfL is completely in the hands of London's Mayor. The corporation is governed by a board of directors headed by the chairman. All directors are nominated by the Mayor, who also chose to be the chairman. The Chief Finance Officer, subject to statutory duties, embodies the functions of a financial controller over TfL activity. Although crucial in the funding, central administration has few supervisory powers.

Transport in London is a National Political Issue

The Greater London area is home to 7.2 million people, representing more than 12% of the UK's population. More notably, the capital city provides 18% of national Gross Value Added (GVA). Capital cities play a central role in international competitiveness, and in this context, urban transport is crucial for the economic development of the megalopolis (mobility of the workforce, efficiency of the communications network, quality of life for residents etc). The Mayor of London has made public his ambition to improve dramatically the comfort and reliability of the capital's transport system. It is widely-recognised, that the UK metropolis suffers from many handicaps in this respect in comparison with other large capital cities (New York, Paris and Tokyo).

In the particular context of London, Fitch examines the relationship between London's Mayor and the central administration in view of: (i) the major role of the DfT in the ongoing funding of TfL (see section 'Revenue') and (ii) the letter of comfort provided by the Secretary of State in respect of TfL's guarantee on LUL's commitment towards its PPP counterparties (see section Contingent Liabilities).

The Mayor is Key in TfL's Organisation

TfL is completely in the hands of London's Mayor. The corporation is governed by a board of directors headed by the chairman. All directors are nominated by the Mayor, who also chose to be the chairman. The board has four committees (remuneration, audit, safety and finance). TfL is managed by a commissioner; assisted by three advisory panels (underground, rail, surface transport), who heads a total of 18,000 people. In the course of its recent history TfL recruited some high-profile senior managers. Specifically, the position of Chief Programme Officer was created to lead dedicated teams that manage the PPP contracts and the existing PFI contracts. The effective integration of LUL into TfL represents a major challenge for the institution and management has put in place strategies and has requested organisational efforts to achieve important cost savings.

Advanced Corporate Governance

TfL has endeavoured strongly to apply established corporate governance principles. In view of the importance of the political factor, these are critical to the rating. Beyond the development of efficient processes and organisation, which cannot be judged yet, transparency and publicity are ensured:

- The Mayor has published his transport strategy;

- TfL regularly publishes reports on its performance;
- The public has access to TfL board papers and meetings;
- TfL has developed and implemented consultation processes with all interested parties (users, companies etc.) in the decision-taking process.

Chief Finance Officer Embodies the Control Functions

According to the finance framework of the local authorities, the Chief Finance Officer is required to produce a report if expenditure, to be incurred in the financial year, is likely to exceed the resources available to meet that expenditure. He would be personally liable if this control were not carried out faithfully. TfL is not subject to any specific supervision from the central administration. However, it has good working relationship with the Government Office for London, the Office of the Deputy Prime Minister and Her Majesty's Treasury. The National Audit Office (NAO) does not exercise continuous controls over TfL.

Duty of Best Value: Supervision and Intervention Power by Central Government

As with all UK local authorities, TfL must make arrangements to ensure that it operates in a way that balances economy, efficiency and effectiveness. The Secretary of State (DfT) may direct the Audit Commission to carry out an examination of the authority in this respect.

Moreover, the DfT is accountable to parliament for its expenditure. As a result it monitors the use of the GLA Transport Grant, through regular financial information sharing.

The Scrutiny Power of the GLA

TfL manages its own affairs and is governed directly by the Mayor. Nonetheless, it is subject to scrutiny by the GLA (Transport Committee and Budget Committee of the London Assembly).

■ Finances: Budgetary Framework

The nature of TfL means that it is subject to the local authorities' accounting and budgetary framework, in which the Mayor's role is prominent. TfL is required by law to deliver a balanced budget.

The Accounting Regime is Primarily Based on the Local Authorities' Framework

Under the GLA Act, TfL is treated as a local authority for accounting purposes. Accordingly, TfL is required to deliver a balanced budget. The

statement of accounts comprises two particular pieces:

- Corporation and Group revenue accounts (income and expenditure on the provision of transport services), showing the sources of revenue;
- balance sheets which show the overall financial position of the Corporation and the Group as a whole.

The subsidiaries are subject to the accounting requirements of the Companies Act and are consolidated into the statement of accounts.

At the time of writing, no official consolidated statement including LUL was available.

TfL accounts are audited by external auditors (KPMG).

The Budgetary Process is Clearly under the Mayor's Control

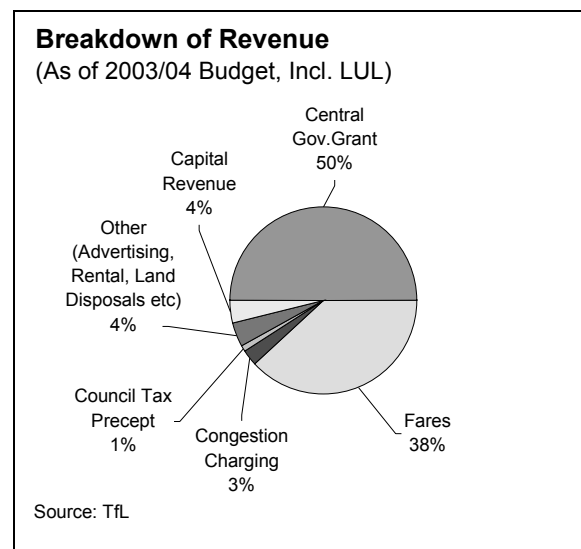
Unless the London Assembly can achieve a two-thirds majority in favour of alternative budget proposals it is the Mayor who sets, in advance, a balanced budget for the GLA and each of the four functional bodies (Transport for London, the London Development Agency, the Metropolitan Police Authority and the London Fire and Emergency Planning Authority). These budgets together form the consolidated budget. Although the Mayor plays a major role in this process, he does not have total discretionary powers: 2003/04's budget was amended by the London Assembly and the GLA precept was set at GBP57.8m, which is GBP28m less than the amount sought by the Mayor.

A six-year business plan (currently 2003–2009) is prepared every year and approved by the board, constituting a costed programme of action. The planning process is ongoing. Fitch believes that planning is a key factor for MTAs, in view of their capital-intensive activity and relatively high cost rigidity.

■ Finances: Revenue

TfL is primarily funded by central government, through the "Transport Grant" (50% of resources in 2003/04's budget), set annually by the DfT within the three-year term of the Spending Review. Paid to the GLA, it is ring-fenced for TfL. Fares make up 38% of revenue, and although the Mayor has discretionary powers their currently high level limits any increases. Nonetheless, TfL's monopoly position and inelastic demand limit any large swings in revenue. Local taxation (the GLA council tax precept) is only

1% and does not represent any alternative source of revenue.



Fares are Critical but Offer Little Flexibility

Fares are an important source of income for the TfL budget (38% of revenue in 2003), and represents a much higher proportion than in many European transport systems (28% in Greater Paris). Annual “Tube” travelcards for zones 1 to 4 cost GBP1,136, ie 6% of the average wage of a London worker, which is much higher than the equivalent for Paris and Berlin (2% of average wage), indicating that it can only be raised marginally in the future. Single “Tube” tickets are one of the most expensive in the world: GBP2 (approx. EUR3) for a single trip in zone 1 (ie more than twice the price paid in Paris). The fare structure is, however, highly sophisticated, with pricing innovation (off-peak prices, family discounts etc), and is much more market-oriented than in other cities.

This year, the Mayor has decided on a fare package applicable from 2004 onwards, to raise additional funding. Fare changes are expected to bring TfL an additional GBP81m in revenue – GBP42m from “Tube” increases and GBP39m from the buses. Any further annual increases will be pegged at the rate of inflation.

A Monopoly Position and Low Risk of Swings in Demand

As an MTA, TfL has a monopoly position in the organising of urban transport in London. Although competition exists (through the contracts with bus, light rail, PFI and PPP operators), TfL is not exposed to it in its role of integrated transport provider (no outsider private or public transport provider can arise). Indeed, the risk of Londoners strongly reducing their use of urban transport facilities is

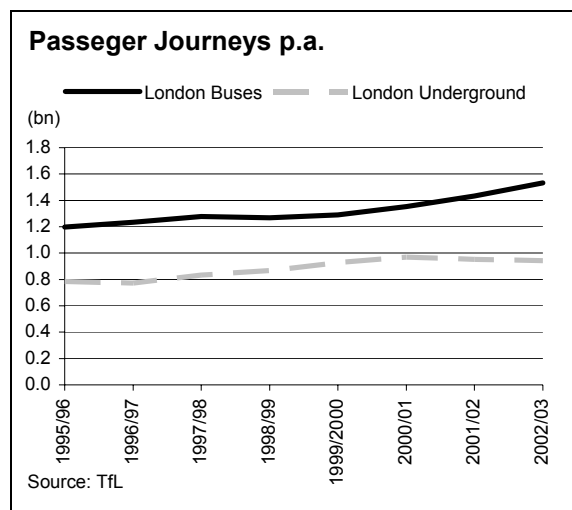
unlikely. Except for extraordinary events (terrorist attacks, major floods, fires, derailments), and for a limited period, users may not have other possibilities but take buses and the “Tube”. For example the closure of the Central Line for three months, following the Chancery Lane derailment, incurred a loss of GBP65m (GBP35m in lost revenue and GBP30m of additional costs).

In the long run, the risk of reduced patronage exists, as has happened in the past. However, Fitch is confident that: (i) the current strategy and priority given to transport would make this unlikely and (ii) this would not have a sudden impact even were it to happen. This is a very strong credit factor.

Central Government Grants are Crucial but in the Long Term are Uncertain

Grants are the major item in TfL’s revenue statement, representing 50% of the total. TfL’s transport grant is part of DfT’s settlement and is passed to TfL through the GLA, according to the provisions laid down in the GLA Act. This grant is earmarked for TfL and the GLA cannot use it for other purposes.

The GLA’s transport grant is set annually by the DfT, taking into account forecast levels of TfL’s income and expenditure, including all their contractual commitments. However this does not equate to an automatic balancing subsidy, as the government may not agree to fund investment not agreed in advance or expenditure slippage. The GLA’s transport grant is a block grant, covering both operating and capital expenditure.



Government funding is regulated by the spending review process, which sets a global funding package for a three-year term. In December 2002, TfL was advised of the GLA’s transport grant for 2003/4 to

2005/6 inclusive. Estimates for subsequent years are derived from the government's 10-Year Plan. The next spending review will take place in 2004. Although this system provides some basis for planning a number of years in advance, it does not guarantee funding for the subsequent years, and is not a contractual commitment from the government.

Additional Funding Arrangements

Following the Integration of LUL

Following the integration of LUL, the GLA's transport grant will be accordingly increased. In February 2003 the DfT announced that it will adjust GLA's transport grant so that LUL's funding is adequately included (covering PPP and existing PFI obligations as well as a portion dedicated to the establishment of a reserve). The average amount of LUL's grant reaches approximately GBP1bn p.a. up to 2009/10. In addition, the DfT has agreed to take into account (in its assessment of the GLA's transport grant) between government spending reviews, major expenditure that falls to LUL outside of its business plan (and therefore unforeseen), including shortfalls contained in the 2003 valuation of LUL's pension scheme (see below Contingent Liabilities).

However DfT's calculations are much lower than TfL's 2003–2010 business plan estimates, resulting in an accumulated funding gap related to LUL for GBP1.4bn (see table below).

Extraordinary Grants and Contingencies

Fund

Were TfL to need extraordinary funding and the Government to agree, UK budgetary law allows for two possibilities, subject to top-level political consent:

- Central government can decide to make the GLA (with earmarking to TfL) a one-off grant known as a Special Grant. A Special Grant is subject to the Treasury's agreement and can only be paid after prior approval by the House of Commons, ie it could not be made while the Commons is in recess, unless approval had been granted in advance.
- The DfT could provide funds from the contingencies fund, managed by the Treasury and available for expenditure that cannot await a vote in parliament. This can be made within 48 hours. Advances from the Fund must be repaid by the DfT, indicating that the DfT would either have to reallocate funds within its budget or gain parliamentary approval for additional funding.

Although the possibility of accession to these cash sources is a positive factor, it does not amount to unlimited and immediate access to the Treasury.

Local Taxation Makes a Small Contribution

TfL receives part of the GLA council tax precept (GBP57.8m in 2003/4 budget, ie 1.1% of budgeted revenue). The Mayor's policy intends to affect the Council tax precept to transport policing. It is not supposed to fund the service itself.

TfL is currently looking at additional means of raising funding within the tax system (eg business rates) but this is controlled by central government and would require new legislation.

Prospects: New Revenue Sources are Contemplated

Like almost all European and Northern American MTAs, TfL is trying to address its funding constraints, through investigating two sources of non-debt revenue:

- voluntary contributions for infrastructure improvements from land developers (as an example, Heron Quays DLR station was co-financed by the Canary Wharf developer); and
- Tax Increment Financing (a process well known in the US, which aims at capturing a share of the increases in land and property values from public investment in infrastructure). This could be used for the Crossrail project, but requires changes in legislation.

Congestion Charging: Strategic Success or Budgetary Failure?

On 17 February 2003, TfL launched the congestion charge. The charge aims to reduce the number of private cars entering the most congested central area. The congestion charge system is operated by a private company under a PFI contract. Although it has been extremely successful as far as the restriction of car traffic (-20%) and the increase in bus patronage are concerned, the congestion charge is generating far less revenue than expected in the budget (the current forecast is GBP164m while budget was GBP220m). The cost of the facility is around GBP100m p.a. TfL is contemplating the extension of the congestion charge to a wider area of the city.

TfL also envisages the use of tolls for new projects, in particular the Thames Gateway Bridge. Other income sources (advertising, property management etc.) are marginal.

Capital Revenue are Secondary

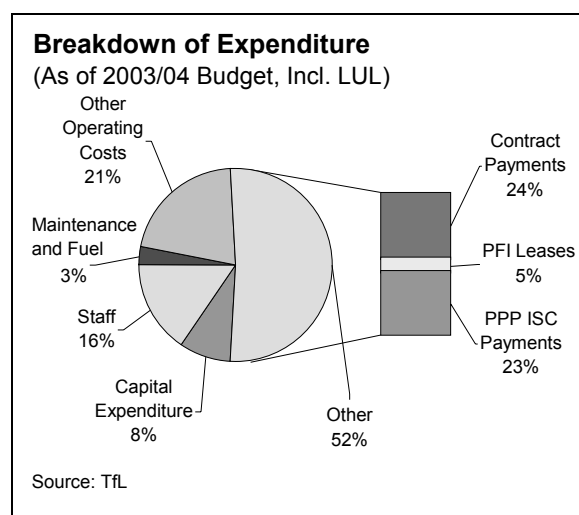
Most of the fixed assets are self-financed, thanks to the GLA Transport Grant (see above), which now covers both operating and capital requirements (LUL used to receive a central government grant hypothecated for capital expenditure). TfL receives capital receipts from third parties.

■ Finances: Expenditure

Expenditure is relatively inflexible, with staff costs (16%) and bus franchises, PFI and PPP contracts (52%) making up the bulk. Although service charges related to LUL's PPP for the next 7.5 years are matched by equivalent DfT funding commitments, the latter is not earmarked and thus cannot be treated separately. Capital expenditure only accounts for 8% of total expenditure, as upgrading works for LUL are counted as operating expenditure (ISC). Fitch has assured itself that TfL would reduce non-essential expenditure if necessary (see Overall Balance).

Staff Costs may add Pressure on Expenditure

The TfL group employs around 18,000 people. Staff costs make up some 16% of total expenditure. This amount may rise as the "Tube" drivers are calling for material wage increases. The Mayor is prepared to negotiate and has offered a 3.7% pay rise for 2003. A possible reduction in the workweek (35 hour week) will also inflate staff costs in the next few years.



Contracts Makes up a Large Proportion of Expenditure

TfL has outsourced many of its responsibilities, including bus services (all are operated by private companies, with which TfL has five-year contracts; six companies control 90% of the bus routes). Expenditure related to bus operators' contracts has

increased as a result of: (i) the "TfL bonus" (an increase in wages with a view to reducing labour shortages) and (ii) bonuses paid to operators for providing a more reliable service following the implementation of the congestion charge (these incentives are capped and currently do not exceed 6% of the contract's value). Docklands Light Railways is also run under a concessionary system, in which the private contractor provides infrastructure and rolling stock, while TfL makes availability payments.

Some PFI contracts are also binding obligations for TfL: LUL has PFI contracts in three major procurement areas (power, ticketing and communications), but also for train services (the Northern Line with Alstom¹). They approximately total GBP250m p.a. and represent around 10% of LUL's operating expenditure.

The TfL corporation has only one PFI contract, congestion charge management that is worth GBP100m p.a.

PPP Charges are Balanced by Equivalent Central Government Grants

A major expenditure item will be connected with the PPP contracts, ie the Infrastructure Service Charge (ISC). These are amounts paid every four weeks to the infracos, corresponding to the maintenance and renewal works provided by the latter on the underground network and rolling stock (see below Contingent liabilities and Appendix C). Under a commitment made by the DfT in February 2003, this expenditure will be taken into account in the level of the GLA Transport Grant. However, necessary uplifts and adjustments of the latter will be part of the global negotiation with the Central Government.

TfL is Committed to Realise Efficiency Gains

In addition to the savings made following the integration of LUL into TfL, TfL management has initiated a BIP (Business Improvement Plan). Both should progressively increase cost savings, up to GBP69m p.a. in 2009. This remains a challenge and Fitch will monitor progress in this area.

The Capital Expenditure Plan Will Rely on Additional PFI Solutions

In addition to the underground upgrading programme decided by central government and undertaken by TfL – which will be financed and operated through the PPP contracts (see below) – the

¹ This contract will be passed from LUL to JPN. It contains a clause of step in by LUL in the event of an infraco failure.

GLA has published an ambitious capital expenditure plan for TfL that totals GBP2bn for the period 2003 to 2008.

The Capital Spending Plan

(GBPm)	2003/04	2004/05	2005/06	2006/07	2007/08
Surface	63.0	53.7	63.4	64.8	64.9
Transport					
Street Management	221.0	210.2	221.4	211.5	187.3
Rail Services	34.6	40.2	73.6	82.9	40.1
Central Directorates*	43.5	69.4	112.1	60.1	44.3
Total Capital Expenditure	362.1	373.5	470.5	419.3	336.6

* Includes costs involved in the projects mentioned in "major infrastructure projects"
Source: GLA

The table below represents the major infrastructure projects currently envisaged, a large proportion of them focusing on East-London development. Many of these projects are supposed to be financed through PFI/PPP schemes. The most important project is Crossrail (GBP7bn to GBP10bn), a regional train line (similar to the Parisian RER). It is jointly sponsored by TfL and central government (SRA), and will probably not require any funding out of TfL's existing resources.

Major Infrastructure Projects

Project	Amount (GBPbn)	Funding Mode	Time Frame
Crossrail	7 to 10		2006/14
Light Transit Schemes (4 Tramway Projects)	1.43	PFI	2008/11
DLR Extensions	0.30	PFI	2007
Thames Gateway Bridge	0.45	PFI / Toll	2010

Source: Fitch Ratings based on TfL, GLA, Crossrail, Thames-Gateway

Prospects: Increased Service Levels Lead to Higher Funding Gaps

Fitch views urban transport as a structurally loss-making sector (losses are compensated by positive externalities, which in turn must justify the public grants that balance the budgets). According to the ambitious transport strategy unveiled by the authorities (which may be even extended if London were to host the Olympics in 2012, with an around-the-clock-service), TfL is initiating a clear catching-up in terms of infrastructure and quality of service. And yet, despite efficiency and productivity gains, it appears to be difficult to develop and improve the level of service without increasing the funding gap.

Finances: Overall Balance

In accordance with its statutory duties, TfL has maintained balanced budgets, with modest surpluses in the past three years. So did LUL before it got transferred to the group. As a result the group has self-financed its capital expenditure, and it has not taken on debt. However, it may need to borrow as its business plan shows a funding gap for the period 2005-10. However this gap must be understood as the level of additional support from central government required to achieve a satisfactory improvement in London's transport facilities. Fitch has assured itself that TfL could reasonably adjust its expenditure, were the funding not available.

Funding Gap: An Issue to be Qualified

According to TfL's business plan for the period 2003-2010 (see table overleaf), the group should be able to balance its accounts during the first two financial years. In contrast, a large deficit is expected thereafter (up to GBP4.9bn for the total period, of which GBP1.4bn for LUL and GBP3.5bn for the remaining businesses), under its current revenue assumptions. Fitch recognises that the projected deficit corresponds to an additional level of funding expected from central government to comply with the Mayor's transport strategy. As visible in the table above, TfL has identified its necessary spending (capital and operating, grouped in the "baseline" items) and its discretionary. The "baseline" expenditure represents on average 84% of the total planned expenditure, leaving only a 16% share for the discretionary expenditure. Consequently, Fitch will closely monitor TfL's ability to adjust the expenditure to the secured income generation (fares and grants).

Building a Reserve Provision

It was the Secretary of State (DfT)'s intention to allow LUL for progressively establishing a reserve provision (up to GBP170m in 2007). This was supposed to be made possible through additional amounts that the DfT was to grant to TfL. However, the funding gap identified by TfL shows that its ability to establish such a reserve will depend on it being able to reduce the deficit.

Funding Shortfall in Business Plan

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2004/10
(2004/05 Prices) (GBPm)	Plan	Plan	Plan	Plan	Plan	Plan	Total
Baseline*	298	-83	-55	-10	-40	-90	20
Income	4,907	4,732	4,755	4,786	4,791	4,877	28,848
Expenditure	-4,609	-4,815	-4,810	-4,795	-4,831	-4,967	-28,827
Restoration of Bus Service Levels	-18	-38	-49	-59	-68	-69	-301
Ensuring the System Runs Smoothly**	-60	-83	-88	-95	-86	-88	-500
Meeting Increased Demand for Existing Services	-69	-142	-255	-268	-245	-206	-1,185
Accommodating London's Growth	-52	-88	-124	-95	-123	-170	-652
Service Quality Enhancements	-215	-409	-404	-424	-405	-392	-2,249
Risk Reserve Provision	71	-101	-10	0	0	0	-40
Total Income of all Above	4,924	4,784	4,847	4,912	4,940	5,038	29,445
Total Expenditure of all Above	4,969	5,729	5,832	5,863	5,907	6,053	34,353
Funding Requirement	-45	-945	-985	-951	-967	-1,015	-4,908
of Which:							
LU	-45	-365	-308	-246	-235	-225	-1,424
Rest of TfL	0	-580	-677	-705	-732	-790	-3,484
of Which:							
Operating	-45	-382	-400	-392	-484	-563	-2,266
Capital	0	-563	-584	-559	-483	-451	-2,640

* Essential safety and committed expenditure (net of efficiencies)

** State of good repair and other safety expenditure

source: TfL Business Plan

■ Finances: Debt and Liquidity

Because of TfL's obligation to produce balanced budgets, it is debt free as per October 2003. However, the PPP contracts may be assimilated to debt obligations, as the Infrastructure Service Charge corresponds partly to the cost of capital needed to renew the tracks, signals and stations of the underground, which could have been debt-funded under another financial option. TfL may decide to fund its next capital improvements through the newly-designed prudential borrowing framework for local authorities.

A Current Debt-Free Position that Must be Commented

As mentioned in the section Budgetary Framework, the local authorities' finance framework applies to the TfL corporation and restricts its ability to borrow. As a result, as of February 2004, the entity has no debt. In contrast, the trading subsidiaries can borrow on a short-term basis from one year to another, although they have no long-term obligations.

This debt-free situation must be regarded in view of several elements:

- the PPP contracts to a greater extent provide external funding sources (and not only the outsourcing of operating services), as they intend to upgrade infrastructure (capital expenditure will account for around 50% of total expenditure for the first 15 years of the contract and around 30% thereafter); thus ISC payments

(see below Contingent Liabilities) can largely be incorporated into debt servicing²;

- non-debt funding was also attributable to a longstanding low investment policy and may be difficult to incorporate with the ambitious Mayor's transport strategy. TfL is thus contemplating the use of new prudential borrowing.

The New Prudential Borrowing Regime

In September 2003, parliament passed a new Local Government Act, introducing from April 2004 onwards a prudential borrowing regime for local authorities (of which the GLA and its functional bodies), which allows TfL to borrow without prior approval from the DfT. The new system will be based largely on self-regulation by local authorities. Conditions and limits are set as follows:

- The decision to borrow has been made by London's Mayor after consultation with the London Assembly and TfL's board.
- Debt can be incurred only for capital expenditure.
- The amount and maturity of debt are to be set by the Mayor according to three criteria which he defines as follows³:

² In the Public Sector Comparator simulations, which are supposed to provide alternative funding solutions to the PPP scheme, three separate bond drawdowns were assumed, GBP477m in 2002, GBP2,904m in 2007 and GBP2,658m in 2012.

1. affordability (capacity to service debt)
 2. sustainability (the consequences of investment in terms of running costs and income)
 3. prudence.
- The Mayor and TfL would exert self-control authority; however, HM Government keeps the possibility by regulations to make provisions about the above-mentioned duties and rights.

Liquidity

TfL and its subsidiaries have access to traditional liquidity facilities (bank overdrafts). Limits collectively total GBP50m and the three banks involved are rated 'F1+' by Fitch.

Moreover, TfL could have access to the Contingencies Fund (see Revenue) from the Treasury in the event of extraordinary necessity.

■ Contingent Liabilities

Pensions and PFI/PPP are the largest of TfL's contingent liabilities. Most of them are backed by an equivalent commitment from central government. The pension scheme is regularly valued and a large share of it is backed by the government's balancing agreement. The "Tube's" PPP commitments, for which a letter of comfort from the Secretary of State for Transport has been received, are also backed by the government's balancing agreement.

Pensions

A majority of TfL's employees are members of the LRT Pension Fund Trustee Company Limited, a wholly-owned subsidiary of Transport for London. The fund's actuary makes valuations every three years and recommends the level of contributions to be made by the participating employers to ensure long-term solvency of the Fund. The latest valuation of the fund was carried out on 31 March 2003 and shown deficit of GBP450m. Provisions to keep the fund balanced include annual payments of GBP65m. The pensions related to LUL (accounting for the bulk of TfL's pension obligations) are subject to the agreement signed in February 2003 by the DfT, which undertakes any possible shortfall contained in the scheme at the date of transfer.

Guarantees

Except the guarantee related to the PPP contracts (see below), TfL has not issued guarantees of material importance.

LUL's PPP Obligations are Backed by the Government

The PPP is a suite of 30-year service contracts between London Underground and three privately-owned infrastructure companies (infracos) for the maintenance and upgrade of the "Tube's" infrastructure (see details in Appendix C). LUL remains the operating company, responsible for running the trains and stations and determining the service pattern. Three infracos are responsible for maintaining and upgrading the trains, stations, tracks, signaling and other infrastructure. A total of GBP16bn is expected to be invested in the underground infrastructure. The infrastructure assets are on lease to the infrastructure companies, while the freehold of the assets remains with LUL. At the end of the 30 years, all of the assets are to return to London Underground.

The Tube Lines consortium started modernising and maintaining the Jubilee, Northern and Piccadilly lines on 31 December 2002. The Metronet consortium started work on the remaining lines on 4 April 2003.

Risks and obligations for LUL (and thus for TfL) in relation to the infracos are two-fold:

Contractual

- LUL is committed to paying the ISC every four weeks. The ISC may be increased/reduced if the infracos' performance is above/below target.
- LUL may, under certain circumstances (see details in Appendix C), need to substitute itself with one or all of the infracos and repay between 95% and 100% of the debt (called the Underpinned Amount), ie up to GBP4.5bn.

Operational

- Volume or fare revenue risks remain in LUL's hands;
- The interface between the PPP contracts, the existing PFI contracts (eg the Northern Line PFI with Alstom) and the additional work to be undertaken under those contracts.

Back-up by Central Government

The DfT issued a letter of comfort to the infracos' providers of finance to ensure that: (i) ISC are taken into account in setting the GLA Transport Grant and (ii) "in the event that LUL was unable to meet its financial obligations under any PPP contracts the Secretary of State regards it as untenable that:

- he would not consider whether it was appropriate [to provide financial support]; ...

³ In determining these criteria and the borrowing terms, the Mayor shall consult TfL's board. It shall rely on the CIPFA prudential code.

- he would stand by and do nothing in these circumstances.”

Fitch regards the letter of comfort as not legally binding, but an expression of strong political commitment.

Credit Implications of Given and Received Commitments Related to PPP

It is Fitch’s view that given the complexity of the service contracts, the risk exists that circumstances in which TfL’s guarantee would be triggered could arise. In such a worst-case scenario, TfL may find it difficult to raise sufficient funding on its own to meet the infracos’ debt. The solidity of the letter of comfort would thus be tested out.

Fitch recognises there is an element of moral hazard in the implementation of the letter of comfort: it is

highly unlikely that the government would not bail out TfL, were it to face the huge financing requirements that could be triggered by PPP break-up clauses, because of:

- the objective importance and political visibility of the London underground for the city (and thus for the whole country);
- the publicity given to the government’s responsibility for (and support of) the PPP, which was also welcomed by the opposition parties;
- the potential effect of a default (of TfL on the PPP) for the financial community and the future of the whole programme of PFI/PPP, which is the axis of the UK’s public infrastructure upgrading effort.

Appendix A

Transport for London

TfL + LUL Pro Forma (GBPm)	2000/2001 Actual	2001/2002 Actual	2002/2003 Actual	2003/2004 Budget
Local Tax	7.4	10.1	35.8	57.8
Transfers Received (Transport Grant)	573.3	1,177.1	1,771.4	2,562.6
Fares, Charges and other Revenue	1,703.2	1,775.2	1,972.5	2,320.6
Current Revenue	2,284.3	2,962.4	3,779.7	4,941.0
Operating Expenditure	-1,832.2	-2,400.5	-3,124.9	-4,535.8
Operating Balance	452.1	561.9	654.8	405.2
Interest Paid*	-0.2	-0.1	-1.9	-0.2
Current Balance	451.9	561.8	652.9	405.0
Capital Revenue	154.5	100.1	159.3	196.0
Capital Expenditure	-606.4	-650.9	-804.3	-573.5
<i>Capital Balance</i>	<i>-451.9</i>	<i>-550.8</i>	<i>-645.0</i>	<i>-377.5</i>
Balance Before Debt Variation	0.0	11.0	7.9	27.5
Debt Repayment <i>of Which Prepayment</i>	0.0	0.0	0.0	0.0
New Borrowings	0.0	0.0	0.0	0.0
<i>Net Debt increase (Decrease)</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
Net Surplus/(Deficit)	0.0	11.0	7.9	27.5
DEBT STOCK (Consolidated)				
Short-Term	22.1	39.9	54.3	n.a.
Long-Term	0.0	0.0	0.0	0.0
Direct Debt	22.1	39.9	54.3	n.a.
Non-Debt Financial Obligations (Leases and ISC)	n.a.	n.a.	n.a.	n.a.
Guarantees Issued**				4,450
Cash and Liquid Deposits	51.4	143.1	179.8	n.a.

* Excluding finance lease charges, which are included in Operating Expenditure

** Including Guarantees given to PPP Contractors

n.m.: Not Material

n.a.: Not Available

Source: TfL

Appendix B

Transport for London

TfL + LUL Pro Forma	2000/2001 Actual	2001/2002 Actual	2002/2003 Actual	2003/2004 Budget
Fiscal Performance Ratios				
Operating Balance/Current Revenue (%)	19.8	18.9	17.3	8.2
Operating Balance/Operating Expenditure (%)	24.7	23.2	21.0	8.9
Current Balance/Current Revenue (%)	19.8	18.9	17.3	8.2
Balance Before Debt Variation/Total Revenue (%)	0.0	0.2	0.2	0.5
Current Revenue Growth (Annual % Change)	-	29.5	27.8	30.7
Operating Expenditure Growth (Annual % Change)	-	31.0	30.2	45.2
Debt Ratios				
Debt Annual % Change	-	80.5	36.1	n.a.
Interest Paid/Current Revenue (%)	0.0	0.0	0.1	0.0
Debt Servicing*/Current Revenue (%)	0.0	0.0	0.1	0.0
Debt Servicing*/Operating Balance (%)	0.0	0.0	0.3	0.0
Debt/Current Revenue (%)	1.0	1.3	1.4	n.a.
Debt/Current Balance (Yrs)	0.0	0.1	0.1	n.a.
Revenue Ratios				
Tax Revenue/Current Revenue (%)	0.3	0.3	0.9	1.2
Current Transfers Received/Current Revenue (%)	25.1	39.8	46.9	51.9
Current Revenue/Total Revenue** (%)	93.7	96.7	96.0	96.2
Expenditure Ratios				
Staff Expenditure/Operating Expenditure (%)	n.a.	n.a.	19.1	17.1
Capital Expenditure/Total Expenditure*** (%)	24.9	21.3	20.5	11.2
Current Balance/Net Capital Expenditure (%)	100.0	101.3	101.2	107.3
Capital Expenditure financing				
Capital Revenue/Capital Expenditure (%)	25.5	15.4	19.8	34.2
Current Balance/Capital Expenditure (%)	74.5	85.7	81.2	70.6
Net Debt Variation****/Capital Expenditure (%)	0.0	-1.1	-1.0	-4.8

* Contractual debt service only, without debt prepayments

** Total revenue = current revenue + capital revenue (excl. new borrowings)

*** Total expenditure = operating exp. + interest+ capital exp. + contractual debt repayment

**** Net debt variation = debt variation + change in reserves

Appendix C: Detailed Issues re. PPP

Historical Background

Date	Event
Mar 1998	British Deputy Prime Minister Announces the PPP.
Nov 1999	Greater London Authority Act LUL Restructured in Preparation of PPP
May 2000	Creation of the GLA Election of London's Mayor
Jul 2000	Transport Becomes GLA's Responsibility Through Newly-Created TfL
Jul 2001	First Judicial Review; Lost by Mayor.
Jul 2002	End of Judicial Review, Withdrawing of TfL's Claim
31 Dec 2002	Tube Lines Signs Contract for 1 Infraco
4 Apr 2003	Metronet Signs Contracts for 2 Infracos
15 Jul 2003	Transfer of LUL to TfL

Source: Fitch Ratings

PPP and Tube Lines deal diagrams: see overleaf.

ISC (Infrastructure Service Charges)

The Service Contract is divided into four review periods of 7½ years each. The amounts of ISC for the first period are set out in the schedules to the contracts. Prior to the end of each review period, LUL will specify the work programme for the remaining life of the contract. The infracos will then have a period of time to calculate the amended ISC that it will require to cover the new programme. Any disagreements over estimates, which cannot be resolved between LUL and the borrower, will be referred to the Statutory Arbiter (being a PPP arbiter appointed under the GLA). The infracos will also receive bonus payments or suffer abatements based on their performance, which is measured against benchmarks set under the service contract that includes a performance measurement code.

Mandatory Sale Process

It is the procedure that must be followed in the event that, amongst other things, either LUL or the infracos breach their respective obligations under the service contract. This results in the transfer of the contract (and the attached assets and obligations) to a new counterpart (through a tender process). Conditions of this transfer vary depending on the circumstances that gave rise to servicing of the mandatory sale notice.

Put Option, Underpinned Amount and Standstill Agreement

If an insolvency event occurs in respect of the infracos or, a mandatory sale under the service contract is ineffective, the borrower security trustee (representing the interests of finance providers) will be able to “put” the debts due under the issuer/borrower facility agreement (the debt raised by the securitisation) to LUL, which will trigger the guarantee it benefits from TfL, which in turn will very likely ask for central government support according to the letter of comfort.

The price (as defined in the put option agreement) LUL will pay will depend upon the particular circumstances giving rise to the exercise of the put option, however, the minimum amount payable by LUL (the underpinned amount) will be 95% of the amount due to the issuer under the senior tranche facilities (subject to certain adjustments) and the maximum amount payable by LUL will be [100% of the amounts due to the issuer under the issuer/borrower facility agreement] (subject to certain adjustments). The issuer will be obligated to transfer its debt to LUL on payment of the put option price.

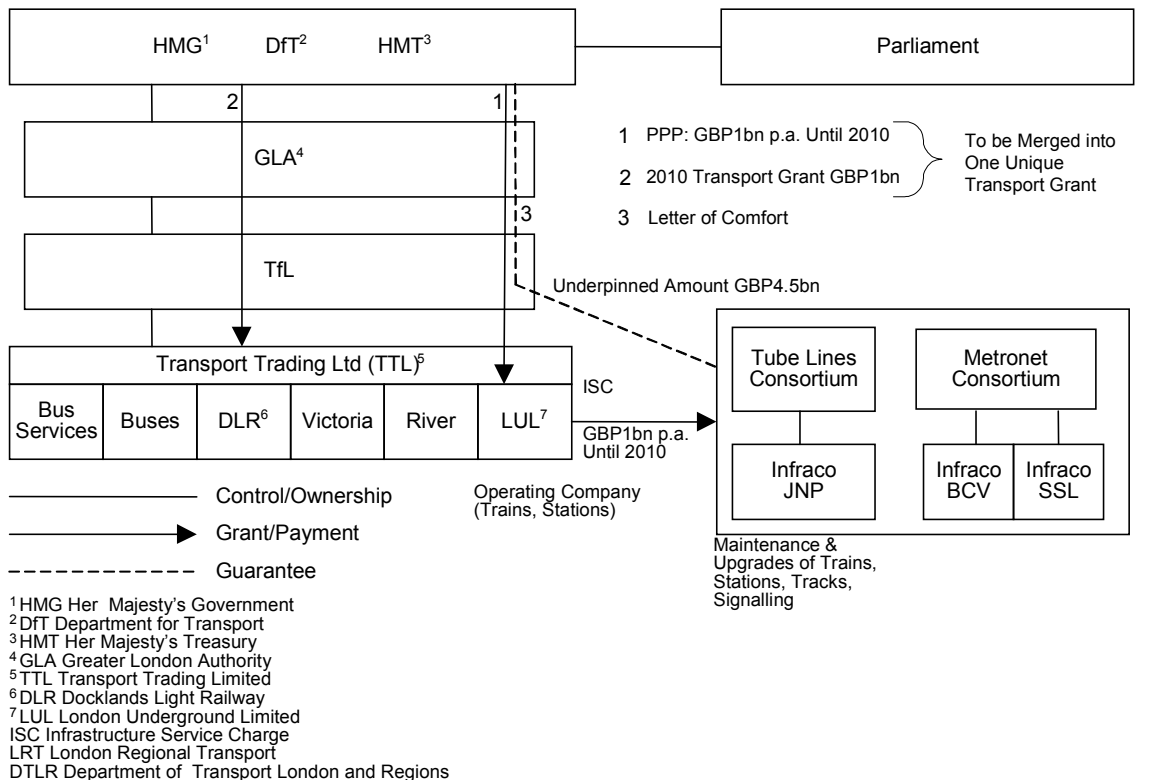
Subject to certain exceptions, the stand still agreement will entitle LUL to require the issuer to delay acceleration of its debt for up to one year, provided that LUL makes all payments of principal, interest etc due to the issuer under the issuer/borrower facility agreement.

The Role of PPP Arbiter

The role of PPP arbiter was created in 1999 by the Greater London Authority Act (“GLAA”). The arbiter (independent of the UK government) is responsible for dealing with disputes about the financial terms of the three London underground PPP contracts. If the parties cannot agree an appropriate ISC for LUL’s restated requirements every 7½ years, the arbiter will determine the appropriate ISC via a periodic review. In setting an appropriate price, the arbiter will determine the economic and efficient price, for which a notional infraco should deliver the services required under the service contract for the next review period.

Appendix D

TfL/LUL/DfT Commitments in Respect



Source: Fitch

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