



Research: Transport for London

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ISSUER CREDIT RATING

Transport for London

Issuer Credit Rating	AA/Stable/--
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Issuer credit rating history:

June 5, 2000	AA
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Major Rating Factors

Strengths:

- Strong links with the U.K. government;
- Recent five-year funding agreement with the government that gives greater certainty over future revenues;
- Dominant transport provider in London, which has strategic importance for the U.K. economy;
- Strong and experienced management team;
- Flexibility to increase fares or reduce service levels, if required; and
- Stability and oversight provided by the U.K. local authority framework.

Weaknesses:

- Proposed increase of direct debt by up to £3.3 billion over a five-year planning period;
- Above-inflation fare increases, particularly on buses, which may create political difficulties and reduce ridership levels;
- Challenging new program of investment that may stretch project-management capacity; and
- Ongoing risks associated with managing major London Underground investment programs undertaken by PPP contractors.

■ Rationale

The rating on Transport for London (TfL) reflects its significant fare-generating capacity and its strong links with the U.K. government, both through the provision of funding via transport grants and central oversight by the U.K. local authority framework. TfL, an executive body of the Greater London Authority (GLA; AA+/Stable/--), is responsible for certain public transport functions in London, including the London Underground system and London bus services.

The strong relationship with government was reflected in the recent five-year funding agreement, which sets out increased grant levels and the flexibility to raise new debt over a five-year period of up to about £3.3 billion (\$6.4 billion). The five-year agreement is unprecedented in U.K. local authority funding arrangements and is a good indicator of the government's strong support for TfL. The agreement, however, does not constitute a guarantee by the U.K. government for the proposed levels of grant, nor for any debt issued by TfL. The new debt will be used to fund important improvements to London's transport infrastructure, both for the Underground and for the bus network.

TfL's relationship with the government is further reinforced by its importance as the major transport provider in London. London contributes a disproportionately high percentage to the U.K. GDP, and is a growing city. A major impediment to future growth is its transport infrastructure, which the government is keen to see improved.

In addition, TfL has a strong and experienced management team that has successfully delivered a number of important projects to date, including the first congestion-charging scheme in central London, together with significant improvements to the bus network, which has seen increased numbers of passengers. This has helped the government move toward its wider transport and environmental objectives.

TfL enjoys an extremely strong business position, and has a near monopoly over public transport, with control over the London Underground system and the bus system. Furthermore, TfL is able to capture additional revenues from private transport through its congestion charge. Due to its dominant market position, TfL has significant flexibility to raise fares without adversely affecting ridership levels.

A key new development is TfL's plans to borrow up to £3.3 billion from a variety of sources, including a medium-term note (MTN) program sized to this amount. The level of borrowing is planned to build up over a five-year period. The borrowing has been agreed with the government and is allowed under the prudential borrowing flexibilities for local authorities, which came into effect in April 2004. The initial stage of the program will be to borrow up to £400 million in the financial year ending March 31, 2005. Although this represents a material change from TfL's previous debt-free status, the level is set with reference to the prudential code, which ensures debt is kept at manageable levels.

The business plan underpinning the growth in debt assumes increases in fares and in ridership levels on both bus and Underground services. Although demand for public transport services in London has, historically, not been much affected by price increases, a decline in London's economy could potentially reduce projected ridership levels.

The planned fare increases for the London Underground are at just above inflation, which is within recent fare-increase levels. The planned changes to bus fares, although representing significant increases over inflation, project average fares that remain within recent historical ranges. The main increases will be staged over three years. The magnitude of these increases causes some uncertainty regarding their effect on ridership levels, particularly following the third proposed bus fare increase. Bus demand and revenues have, however, continued to rise in the current financial year, despite the fare increase in January 2004.

Although the plans for debt accumulation are a major new development for TfL, the growth in debt will take place on an incremental basis and will be subject to adjustments if needed to restore the balance of revenues and operating expenses. Furthermore, TfL has a legal obligation to set a balanced budget every year, and therefore its policy regarding debt accumulation and associated debt service costs must reflect this obligation.

TfL continues to face the ongoing challenges of managing cost pressures, particularly associated with London Underground Ltd. (LUL) and the public-private partnership (PPP) contracts. TfL is liable for

95% of the £5 billion debt of the Underground PPPs if a put option is exercised in the event of project default, and this risk is reflected in the rating on TfL. The Department for Transport has strong incentives to step in to pay this obligation, which is treated as a contingent liability of the U.K. government and is supported by a letter of comfort. This support, however, is not legally binding and may not be timely.

■ Outlook

The outlook is stable, reflecting TfL's prudent approach to debt growth, and its strengthening relationship with government. Although TfL is gaining greater levels of financial flexibility, its use of debt is expected to be gradual, and consistent with its balance of operating revenues and expenses, and the level of government funding support. TfL still remains dependent on government for nearly one-half of its revenues. Under its ambitious development program to make improvements to London's transport infrastructure network, TfL has the flexibility to reduce its investment program and associated debt requirements in the event of unforeseen changes to its business-planning assumptions.

Standard & Poor's will continue to assess the progress of TfL's project management and debt utilization against its stated business plans.

■ Issuer

TfL is an executive body of the GLA, responsible for providing an integrated transport service in London covering the London Underground system, buses, taxis, and strategic trunk roads. Although TfL is an executive arm of the GLA, it is constituted as a separate local authority body. In addition, TfL has a different credit risk profile from the GLA. The strategic goals of TfL and GLA, however, should be closely aligned because the Mayor of London, Ken Livingstone, is also Chairman of TfL. The Mayor also appoints the Transport Commissioner for London, who heads the executive management team. The Mayor and TfL work very closely together, but TfL's interests may not always necessarily coincide with those of the Mayor or the GLA.

TfL is subject to the support and constraints of the U.K. local government financing system, which translates into a variety of financial and regulatory controls that are significant credit strengths. These include the requirement to provide a balanced budget every year, restrictions on the amount of debt that can be raised, and the requirement for external audits. TfL has a five-year funding agreement with government, and funds are provided to TfL on an annual basis.

■ MTN Program

Bonds under the MTN program will be issued by TfL and will rank *pari passu* with subsequent debt issues. Further notes are expected to be issued under the MTN program, with substantially the same terms and conditions to the debut issuance. No debt is expected to be issued at the subsidiary level. The notes will be a corporate obligation for TfL and will be rated in accordance with TfL's ratings. Any change to the ratings of TfL will be reflected in a change to the ratings on the bonds.

The proposed growth and pace of debt accumulation is not set in stone, and TfL has considerable flexibility to reduce its capital investment program and cut back its plans for increases in debt levels on a year-by-year basis, if required.

■ Legal Structure

TfL is one of the four functional bodies of the GLA established by the GLA Act. TfL's role is to discharge the GLA's transport-related duties, and it can only carry out activities that are within its statutory powers. TfL is a statutory corporation that may be the subject of insolvency proceedings and be placed under administration.

TfL has eight wholly owned subsidiaries: Transport Trading Ltd. (TTL), London Bus Services Ltd., London Buses Ltd., London Underground Ltd., Docklands Light Railway Ltd., Victoria Coach Station Ltd., London River Services Ltd., and London Regional Transport Pension Fund Trustee Co. Ltd. TfL also holds the majority shares in London Transport Insurance (Guernsey) Ltd. TTL is the holding company for all the operating transport companies owned by TfL. Under the GLA Act, TfL must ensure that its subsidiary companies do not do anything that TfL itself does not have power to do.

The main operating companies generate their own revenues (principally fares), but do not break even with just their own revenues. The operating companies therefore rely on grant funding provided by the U.K. government to TfL via the GLA. The GLA has some powers to contribute additional transport funds via the council tax precept on Londoners. The level of funding that could be provided by the GLA, however, will amount to only a relatively small amount of additional income. Government transport grants given to GLA are passed straight through to TfL. In the event that these transport grants are removed in their entirety from TfL, and TfL is downgraded to below investment grade, bondholders have the right to redeem the bonds. Standard & Poor's is of the opinion that the government, or a successor organization to TfL, would provide support to repay the bonds in the event that they were redeemed. There is, however, no letter of comfort provided by government to this effect. Furthermore, government support may not be timely.

Under the terms of the Local Government Act 2003, the Mayor (alongside TfL) can set prudent borrowing limits for TfL. These limits have also been set with regard to wider negotiations with the government regarding future grant levels. The government has reserve powers to cap the level of borrowing of any local authority, if it is deemed to be borrowing more than it can afford.

The U.K. government has established the Prudential Code, which helps set a level of prudent borrowing and an approach to monitoring. Prudential borrowing must be used for capital investment purposes and cannot be used to fund revenue shortfalls. The level of borrowing is set on an annual basis. The borrowing levels agreed with government and set out in the five-year business plan are based on TfL's projections of affordable borrowing, and therefore may be adjusted year-on-year to reflect changing conditions and underlying business assumptions.

■ Demand

The business plan and borrowing strategy is set against a background of very strong demand, with TfL enjoying a near-monopolistic position in its specific transport markets in London.

London's population is estimated at 7.4 million, and the catchment area for commuting into the city covers a significantly larger population base. The city's population is forecast to grow by about 800,000 to 1 million by 2016. London has a major financial and business services industry and is a major administrative and tourism center. The vast majority of London commuters working in central London travel by public transport. Since the potential for increased road use is severely limited, significant increases in transport capacity, both bus and Underground, are therefore required to deal with the forecast growth.

London buses carry about 5.4 million passengers every weekday, and bus ridership levels have risen by 31% in the period from financial 2001 to financial 2004. This in part reflects the low fares policy, but also reflects the improvements in bus service quality and reliability, and the effect of the growing London economy. TfL has plans to increase bus capacity and is investing in further service improvements. Bus services are tendered out to private operators and TfL has a monopolistic position regarding the allocation of contracts.

LUL carries about 3 million passengers each weekday and accounts for more than one-third of all journeys to work in central London. Each day, as many passengers use the Underground as use the entire U.K. rail network. Underground ridership declined by about 2.3% from financial year ending March 31, 2001 through to financial 2004, which in part reflects the effect of the economic slowdown early in the period, and the decline of tourism due to Sept. 11, 2001. Further causes were the transfer of ridership to improved and lower-priced bus services and--in the last year of the period--the line closure and service disruption on the Central and Northern Lines. Ridership levels to date, however, have increased by 3% and revenues to 6%, compared with financial 2004.

TfL is in a strong position regarding the delivery of public transport services in London within most of its markets, particularly since the transfer of LUL. Only in parts of south London, where privatized national rail companies provide significant local commuter services, is there alternative public transport provision not under TfL's direct control. There are limited Underground services in these areas, and the private rail services are not a significant competitive threat.

The only possible alternative transport competition is from private motor vehicles. Private car use has reached saturation levels, with declines in recent years during peak travel periods because London

suffers from serious peak-hour congestion. Furthermore, as the congestion charge has proved to be successful in reducing private-vehicle trips to central London, demand for public transport is likely to increase further.

The congestion charging system has been successfully introduced in the central London business district area, and TfL has plans to extend the zone westward to the retail and leisure center of London. In addition, the Mayor is proposing increasing the charge. The proposal will be subject to a consultation process, and any increase will not be implemented before July 2005.

■ Operating Activities and PPPs

TfL's main operating activities include bus and Underground-train service provision. All bus services are provided under a rolling program of contracts, the majority of services being provided by private sector operators on rolling five-year contracts. Service patterns can be altered and contracts are subject to variations. In addition, private bus operators take on the risk of managing cost, including wage pressures, and negotiate directly with unions.

Underground services, meanwhile, are provided by LUL, which is responsible for operating the Underground train network and managing the stations. LUL has entered into separate contracts for infrastructure improvement programs with PPP contractors. In this respect, LUL has essentially a contract-management role. Tim O'Toole was appointed as managing director of LUL in February 2003. Mr. O'Toole has extensive experience of contract management in the U.S. Overall, the relationships with the PPP contractors are businesslike. There are a limited number of disputed areas, and the PPP arbiter has not been engaged over disputes to date.

Operationally, LUL is divided into three units, and this division of the Underground network is also reflected in the three PPP contracts. The three private sector infrastructure companies (Metronet Rail SSL Ltd., Metronet Rail BCV Ltd., and Tube Lines Ltd.) are responsible for network renewal and maintenance, which over time will lead to operational and capacity improvements. The PPP contracts are for 30 years and are subject to a review every 7.5 years by an independent statutory arbiter. These periodic reviews allow for changes to service needs and unexpected cost pressures. Under the service contract, the infrastructure companies are protected against higher costs that are deemed economic and efficient. As a consequence, the level of PPP payment by LUL to the PPP contractors could be subject to change. In the event of any material change, Standard & Poor's expects the U.K. government will provide additional assistance to ensure TfL meets any change to its obligations.

To date, Metronet Rail SSL and Metronet Rail BCV appear to be behind on track renewal and station upgrade programs, and this seems to have been caused by problems with the Metronet consortium's supply chain, which it is now addressing. The problems have led to some difficulties in receiving full and timely information from Metronet.

Tube Lines JNP appears to be ahead of schedule on its Jubilee and Northern line upgrades. In 2004, Tube Lines (Finance) PLC successfully refinanced its debt issue with new bonds (the main tranche of which looked through to the TfL guarantee underpinning the PPPs). TfL received 40% of the refinancing gain.

LUL also has private finance initiative (PFI) operators to fund specific projects, related to communications and power supply. The communications PFI is behind time and over budget, and TfL is subject to a claim by the PFI contractor for additional works. If the claim is successful, the payment would be covered by TfL's reserves. TfL guarantees LUL's obligations under these arrangements. TfL itself also has a PFI for fare collection across the Underground and bus systems.

■ Business Plan

TfL has produced a balanced five-year business plan reflecting its program of investment, the levels of grant funding, increases in fares revenues, and its borrowing plans. The balanced plan marks a departure from previous plans, which consistently showed funding gaps reflecting the uncertainty over future revenues to meet plans for transport infrastructure improvements.

The business plan incorporates operating savings of about 2%–4% a year. Much of the forecast savings comes from back-office efficiencies from the integration of the London Underground with TfL. This includes savings in procurement, marketing, and internal business services. Additional operational

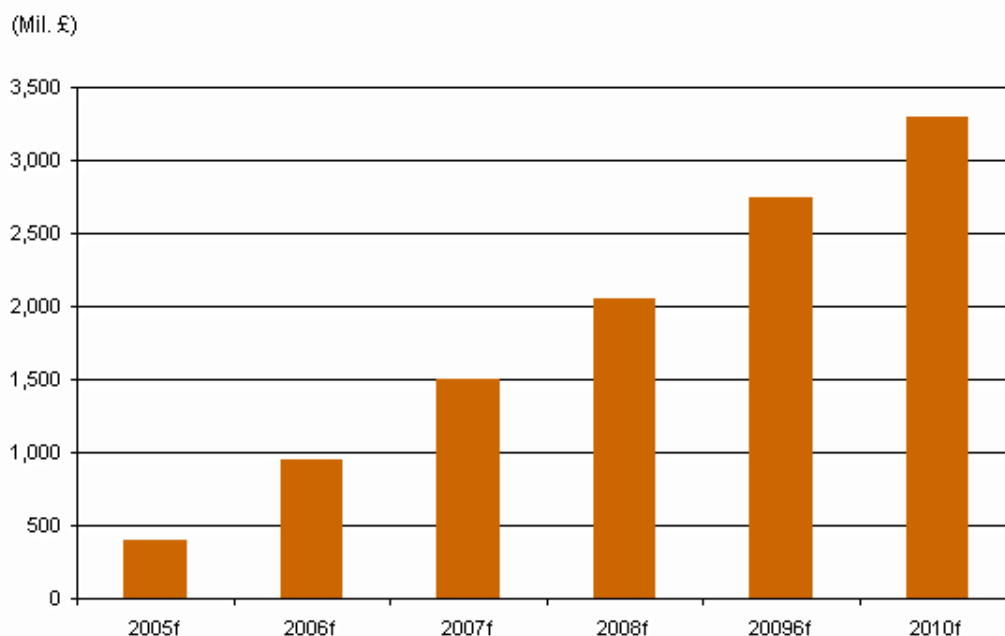
savings have been identified from the introduction of cashless buses, leveraging benefits from the already established Oystercard (prepaid ticket card), and from communications efficiencies.

Achieving projected year-on-year savings will be challenging, particular as savings from technological improvements could be offset from cost pressures elsewhere in the future, for example from union demands for high wage settlements.

■ Borrowing Strategy and Projections

Total borrowing at the end of the business plan period in 2010 is forecast to be about £3.3 billion, which will represent about 60% of total revenues less PPP-associated revenues (see Charts 1 and 2). The proposed new debt issues will not be earmarked for specific projects; instead, the new debt will be used to finance a range of projects set out by TfL that reflect the Mayor's transport priorities.

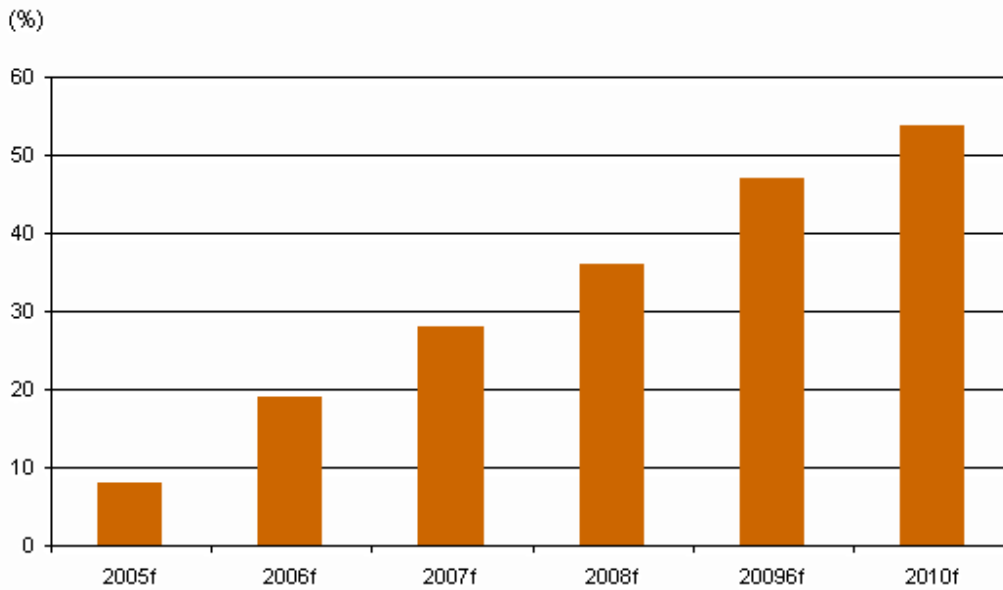
Chart 1
**Transport for London
Debt Forecasts**



f--Forecast. Source: Standard & Poor's calculations from Transport for London business plan.

Chart 2

Transport for London Debt-to-Revenue Forecasts



f--Forecast. Source: Standard & Poor's calculations from Transport for London business plan.

The variety and range of projects will give a good deal of flexibility to adjust the investment program in response to unforeseen events. Standard & Poor's has received the details of the scale and timing of the borrowing, which have been finalized, and there is now greater clarity regarding the use of proceeds on the planned investment program.

Future borrowing is likely to be a mix of funding types and maturities. The overall objective of the strategy is to match maturities with the asset lives of the investments in the program.

TfL's cash balances provide a buffer against unforeseen variances and should provide further comfort to investors. The reserve provision for LUL is £170 million, which will be replenished by the government if drawn. There is also a £100 million general reserve for TfL. Grants are received at the start of the financial year, which contributes to good liquidity levels through the year. Furthermore, in the event of program slippage, TfL carries cash forward into the next financial year. TfL is also forecasting creditor balances of about £250 million a year throughout the five-year plan.

■ Investment Program

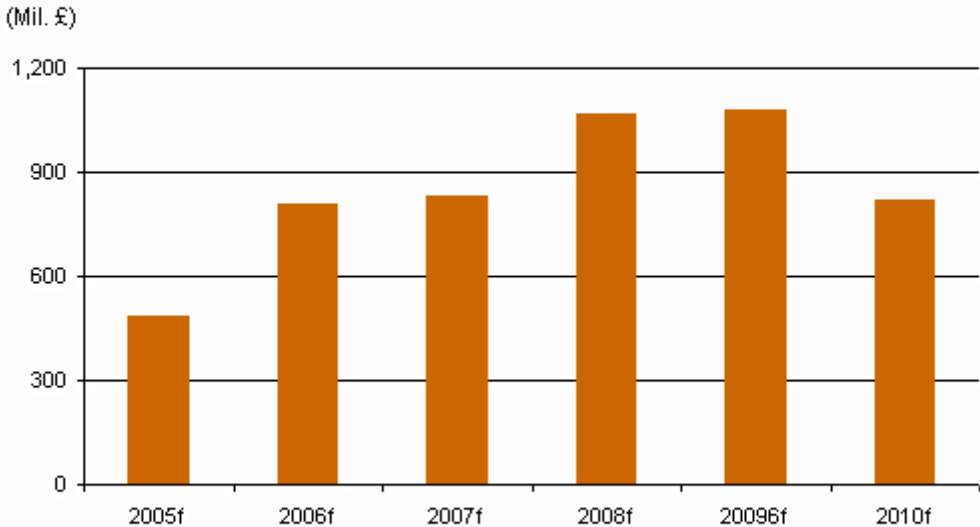
TfL's non-PFI/PPP investment program is characterized by a diverse number and type of projects. In addition, there are only a few larger projects that, once committed to, may expose TfL to certain project-management risks. The main project in the investment plan is the approximately £900 million East London Line extension (ELLX). This represents 15% of all the non-PFI/PPP capital investment work.

The construction risks associated with the ELLX are relatively low compared with other recent Underground extensions such as the Jubilee Line Extension (JLE). The ELLX does not involve any new tunneling work, and in part follows existing, or disused, overground railway lines. TfL has undertaken a full risk assessment and has included a significant risk allowance over the expected capital cost levels. This includes some additional flexibilities to allow for interim works to extend the railway even further, and an additional contingency allowance for unforeseen risks. The cost estimates have been based on best practice and full outturn prices from recent Underground projects, and have been rigorously tested by designers and quantity surveyors.

Other projects in the program are substantial, but significantly smaller than the ELLX. For example, the western extension of the congestion charge, various PPP enabling works, the Camden Town station upgrade, and the Tottenham Court Road station upgrade combine to approximately two-thirds of the cost of ELLX. Appropriate levels of contingencies have been factored into these and other projects in the program. The progress of these and other projects in terms of running to time and to budget will be key credit considerations, and will be continually monitored by Standard & Poor's.

The majority of the projects in the investment program, however, are much smaller in size and scope. For example, they include cycle paths, bus shelters, and cameras for bus lane enforcement. This means that TfL has considerable flexibility to quickly cut back its spending on its investment program, if required. Even the larger projects can be revised, if required, with appropriate lead times. The level of planned capital expenditure is shown in Chart 3.

Chart 3
**Transport for London
 Capital Spend Net of PPP/PFIs**



f--Forecast. PPP--Public-private partnership. PFI--Private finance initiative.
 Source: Transport for London.

■ **Government Grant Funding Agreement**

TfL has received a letter (dated July 20, 2004) from the Department for Transport setting out its grant funding levels from April 2005. The agreement sets out five years of certainty regarding funding. Although the agreement is not a legal commitment by government, the letter states that, "the Secretary of State will take all possible steps to avoid any deviation from this funding plan." It confirms that the additional income from planned fare increases will not be used to reduce the Secretary of State's commitments under the agreement. This letter has been put into the public domain on the Web sites of the Department for Transport and TfL.

The Mayor's transport plan for London is consistent with the U.K. government's transport objectives and strategic direction. Furthermore, improvements in London's transport have a key role to play in London's bid to host the 2012 Olympic Games, and the U.K. government is keen to promote this bid.

The relationship between the Mayor and U.K. government is more settled and stable than in the past, when the Mayor was opposing the PPP contracts. The Mayor has been accepted back into the Labour

Party, and stood as the Labour Party candidate in the Mayoral elections in 2004, when he was re-elected for a further four-year term. Mr. Livingston intends to stand again at the next election in 2008.

TfL has delivered some notable transport successes in its relatively short history. The funding agreement reflects the stable relationships and the delivery record of TfL, and the recognition by the government of TfL's importance in delivering both Mayoral and government policy objectives.

■ **Fare Revenue Projections**

The key fare-increase assumptions underpinning TfL's five-year business plan include bus-fare increases of retail price index (RPI) plus 10% in 2005, 2006, and 2007, and thereafter increases of RPI plus 2%, and Underground fare increase of RPI plus 1% each year.

TfL recognizes that the planned increases in bus fares will take its standard price elasticities beyond their normal reliability; however, the projections of increased revenues should be seen as also benefiting from the continual improvement in service quality and reliability, and the fact that fares will remain affordable relative to earnings. Furthermore, the fare policy will seek to target peak travel, which is relatively inelastic, and to improve the yield from offpeak pricing, which is more elastic.

Demand for the Underground is more inelastic than for buses with regard to fare increases. Furthermore, planned fare increases are less than recent levels of increases that have had only limited effect on ridership. The Underground is more vulnerable to changes in the economic position of London, and to customers being turned away by service disruption. TfL has taken into account in its business plan projections its experience of disruption caused by the recent closure of part of the Central Line for health and safety reasons, and disruptions caused by the program of major refurbishment on the Underground.

TfL's planning assumptions on population growth, employment, tourism, and consumer spending reflect the forecasts for London set out by GLA's Economics Group. Standard & Poor's has applied a number of sensitivities to the assumptions underpinning the business plan and is satisfied with the level of conservatism in the plan.

As well as having flexibility to cut back its planned investment program and reduce the requirement to increase debt, TfL also has a high degree of flexibility to cut back services if required. For example, buses have low fixed costs; and service levels can be reduced within TfL's planning horizon in response to changes in business planning assumptions.

Financial Summaries

The following data shows TfL's financial performance (Table 1), together with its forecasts for the next six years (Table 2).

Table 1 Transport for London Financial Performance					
	--Year ended March 31--				
(000 £)	2002	2003	2004	2005f	2006f
Corporate revenue account					
Income	27	59	243	324	383
Grant	728	1,832	2,617	2,258	2,187
Revenue expenditure	(376)	(451)	(664)	(696)	(666)
Funding of subsidiaries	(274)	(1,230)	(1,396)	(1,274)	(1,648)
Capital expenditure	(96)	(204)	(261)	(87)	(328)
Transfer (to)/from reserves	(9)	9	(434)	(542)	62
Surplus/(deficit)	0	15	105	(17)	(10)
Transport Trading Ltd. Group profit and loss account*					
Sales revenue	494	1,891	2,090	2,292	2,421
Operating and other costs	(767)	(3,034)	(3,601)	(4,126)	(4,315)
Grant taken to P&L	273	1,147	1,501	1,834	1,894
Profit/(loss) for year	0	4	(10)	0	0
*Excludes London Underground Ltd. f--Forecast.					

Table 2 Transport for London Summary Business Plan						
	--Year ending March 31--					
Numbers in nominal terms (000 £)	2005f	2006f	2007f	2008f	2009f	2010f
Income	2,585	2,827	2,969	3,131	3,299	3
Operating costs (net of PFI/PPPs and support payments)	(3,636)	(3,865)	(4,146)	(4,291)	(4,565)	(4,765)
Net operating expenditure	(1,050)	(1,038)	(1,177)	(1,160)	(1,266)	(1,297)
Capital portion of PFI/PPPs and support payments	(919)	(1,025)	(1,009)	(1,047)	(979)	(1,084)
Capital projects	(587)	(768)	(776)	(1,002)	(1,018)	(740)
Third-party funding	189	140	113	95	94	68
Debt service (includes repayment of principal)	(10)	(72)	(115)	(157)	(211)	(253)
Contingency	(25)	(26)	(26)	(27)	(28)	(28)
Net expenditure	(2,402)	(2,789)	(2,990)	(3,299)	(3,408)	(3,334)
Adjust for working capital and reserve transfers	(255)	50	29	177	151	103
Funding required	(2,657)	(2,737)	(2,960)	(3,122)	(3,256)	(3,230)
Funded by:						
Total transport grant	2,231	2,161	2,383	2,544	2,528	2,651
Precept	26	26	27	28	28	29
Prudential borrowing	400	550	550	550	700	550
Total funding	2,657	2,737	2,960	3,122	3,256	3,230
Surplus/deficit	0	0	0	0	0	0
f--Forecast. PFI--Private finance initiative. PPP--Public-private partnership.						

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