

United Kingdom
Credit Analysis

Transport for London

Ratings

	Current Rating	Previous Rating	Rating Action
Foreign Currency			
Long-Term	AA	-	Mar 2004
Short-Term	F1+	-	Mar 2004
Local Currency			
Long-Term	AA	-	Mar 2004
Rating Outlook			Stable

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Summary Data

	31 Mar 06	31 Mar 05
Operating Rev. (GBPm)	4,748.1	4,713.8
Debt (GBPm)	2,558.4	1,285.8
Operating Bal./	22.5	24.2
Operating Revenue (%)		
Debt Service/	0.2	0.1
Current Revenue (%)		
Debt/Cur. Balance (Yrs)	2.3	1.1
Operating Balance/	104.6	277.7
Interest Paid (x)		
Capital Expenditure/	32.6	24.4
Total Expenditure (%)		
Surplus (Deficit) Before Debt	-5.5	5.7
Variation/Total Rev. (exc. New Debt) (%)		
Current Balance/	62.5	102.8
Capital Expenditure (%)		

Profile

Transport for London (TfL), which reports to London's mayor, is a functional body of the Greater London Authority (GLA). TfL was created in 2000 and, for most financial purposes, is treated as a local authority. In July 2000 it took over all responsibilities for buses and other transport functions in London from the government, including roads and bridges, buses, Docklands Light Railway (DLR), river services and taxis. London Underground Limited (LUL) was passed to TfL only in July 2003 after lengthy political and judicial disputes, once the public-private partnerships (PPPs) were established in late 2002 and in early 2003.

TfL's 408km of tube network and 700 bus routes serve an urban area that is home to 7.4 million people. It employs around 20,400 staff.

Rating Action and Outlook

The affirmation mirrors the fact that recent developments and updated forecasts are in line with plans taken into account so far. The ratings continue to primarily reflect TfL's position in the British political and institutional set-up, giving it good access to government funding, which is secured by a five-year agreement. The ratings also consider TfL's sound operating and budgetary performance. However, the ratings take into account TfL's ambitious capital spending plan, which will be partially debt-financed; limited and shrinking budgetary flexibility; as well as operational and contractual risks attached to the PPP scheme. The Stable Outlook reflects the political and financial visibility of TfL in the next two years of operations. Fitch Ratings will monitor TfL's financial planning and ensure that borrowing is in line with projections and hence remains compatible with the 'AA' rating.

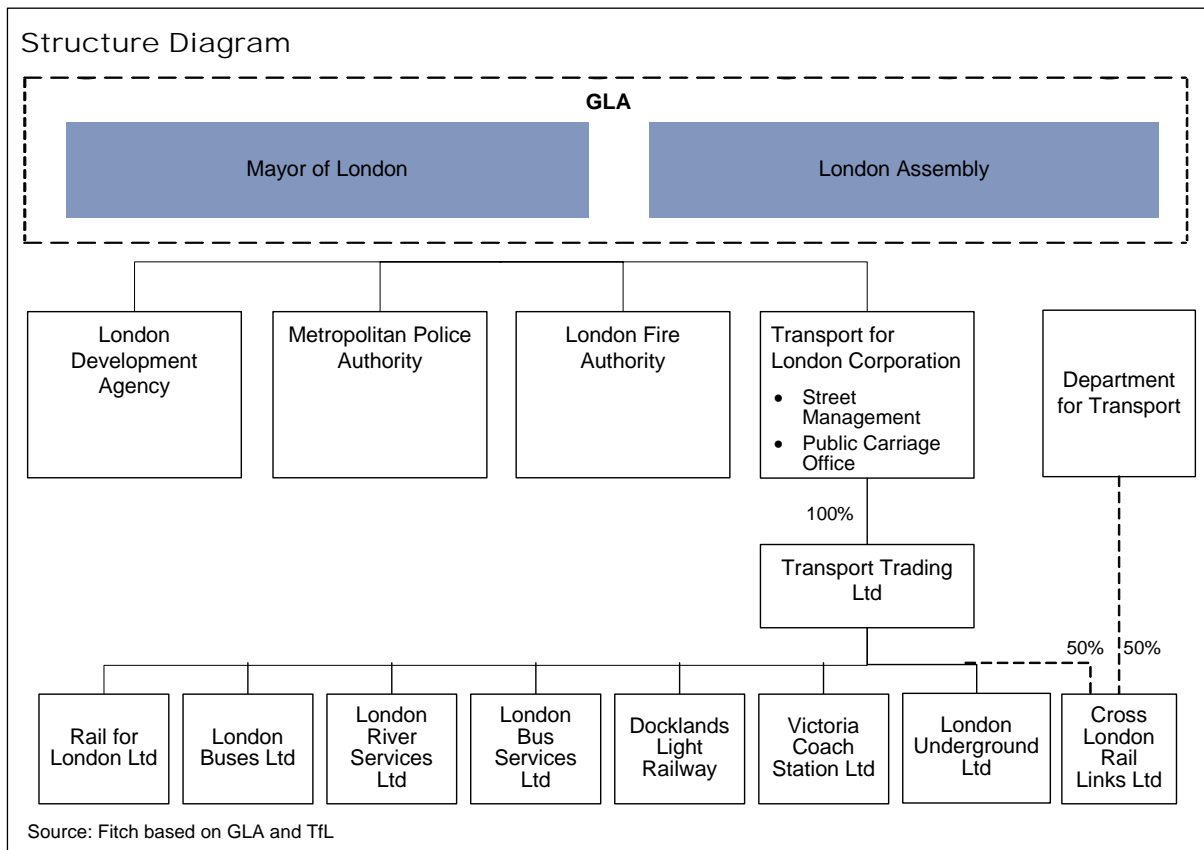
Key Rating Factors and Performance

Positive key rating factors include:

- As Fitch expected, TfL has reached the operational and financial targets set for the first half of the business plan that it introduced in 2003. Though relatively rigid, its budget structure gives good predictability: it is funded by the Department for Transport (DfT) through the transport grant – 41% of TfL's total resources in the financial year to end-March 2006 (FY06) and secured by a five-year settlement – and by fares set by the mayor – 42% of revenue.
- The TfL group (corporation and subsidiaries) has moderate debt outstanding (GBP2.6bn, including finance leases) and a high level of liquidity, with liquid assets representing 65% of financial liabilities at 31 March 2006 (FYE06).
- Despite revisions, the projections of the business plan remain in line with initial plans, and the amount of debt to be raised until 2010 remains unchanged at GBP3.3bn.

Negative key rating factors include:

- The ambitious capital spending plan for FY05-FY10 totals GBP13.5bn, including GBP200m for the successful Olympic bid for 2012. Within this amount, GBP1.5bn is to be funded mainly through an increase in TfL's own resources, driven by the sustained growth in patronage.
- Although TfL has demonstrated its capacity to increase fares if necessary and will use this flexibility to support its development, it has only limited leeway given the already relatively high fares. Other revenue sources (including the congestion charge) provide limited scope for material increases. Expenditure is also relatively inflexible, with staff costs (18%) and contract payments (48%) making up the bulk.
- PPPs have not proven as efficient as expected in terms of service improvement and still represent a potential source of operational and contractual risks.



■ Institutional Framework

Legal structure

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

Accounting regime is primarily based on the local authorities' framework¹

Under the Greater London Authority Act 1999, TfL is treated as a local authority for accounting purposes. Accordingly, it is required to deliver a balanced budget. The statement of accounts has two parts:

- corporation and group revenue accounts (income and expenditure on the provision of transport services), showing the sources of revenue; and

- 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.

TfL accounts are audited by external auditors (KPMG).

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

TfL's responsibilities encompass all modes of transport, now including overground rail. Since July 2000 TfL has been responsible for most transport in London, including buses, DLR, 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). TfL has been vested with a new role as far as overground rail services are concerned: from autumn 2007, the North London Railway will be operated by TfL under the brand London Overground, along with the East London line, when this line will be reopened in 2010.

¹ Source: Statement of accounts 2002, p.3.

Transport Provision (2005-2006)

Transport Modes	Passenger Journeys a Year (m)	Operation Mode	Maintenance of Infrastructure
Buses	1,816	Franchise	Contractors
Underground	971	Direct (LUL)	PPP (infracos)
DLR*	53	PFI	Concessionaire

* DLR serves a 27km automatic metro track from the City to East London's renovated dockland area. It is run under a seven-year PFI contract by Serco Docklands Ltd.
Source: Fitch based on TfL

The bulk of overland rail within London remains under the aegis of Network Rail and is regulated by the DfT. 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 Greater London Authority Act 1999, the mayor of London (Ken Livingstone, re-elected in June 2004 for a second four-year term), is the key figure in urban transport for the UK's capital city.

The mayor sets the budget, appoints the board and can direct the actions of TfL. Having made transport a priority, he has chosen to become the chair of the TfL board.

He also sets the fares for the Tube, buses, London Overground, DLR, Croydon Tramlink and taxis.

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 PPP for the underground was in place. The PPP aims to provide a GBP16bn upgrade and maintenance programme for the Tube for the first 15 years. The government decided on and organised the PPP, leading to a political and legal dispute with the mayor and TfL.

Control functions vested in chief finance officer

According to the finance framework of the local authorities, the chief finance officer is required to produce a report if the 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 check were not carried out faithfully. TfL is not subject to any specific supervision from the central administration. However, it has a good working relationship with the DfT, the Government Office for London, the Department of Communities and Local Government and Her Majesty's Treasury.

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 for transport 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.

■ Administration

Transport in London is a national political issue

The Greater London area is home to 7.4 million people, representing more than 12% of the UK's population. More notably, the capital city provides 18% of national gross value added. 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 dramatically improve the comfort and reliability of the capital's transport system. It is widely recognised that London suffers from many handicaps in this respect compared with other large capital cities (New York, Paris and Tokyo). The success of London's Olympic bid in July 2005 underlined the commitment of central government to supporting the upgrade of the capital city's transport network. Fitch shares the view that the organisation of the games will ease the implementation of the mayor's transport strategy, although the agency will monitor the actual financial support delivered to TfL from the central administration. Transport projects related to the Olympics are integrated in the business plan discussed in this report.

In the particular context of London, Fitch examines the relationship between London's mayor and the central administration in view of both the major role of the DfT in the ongoing funding of TfL (see *Revenue* section) and the letter of comfort provided

by the Secretary of State in respect of TfL's guarantee on LUL's commitment to its PPP counterparties (see *Contingent Liabilities* section).

TfL is ultimately answerable to London's mayor

TfL is governed by a board, the members of which are nominated by the mayor, who also chose to be the chair. The board has four committees (remuneration, audit, safety and finance). TfL is managed by a commissioner, who leads 20,400 staff, assisted by five advisory panels (rail transport, underground, surface, corporate and strategic policy).

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, the mayor sets, in advance, a balanced budget for the GLA and each of the four functional bodies (TfL, the London Development Agency, the Metropolitan Police Authority and the London Fire and Emergency Planning Authority).

A five-year business plan (currently FY06-FY10, in line with the timeframe of the funding agreement negotiated with the government) is updated every year and approved by the board, consisting of a costed programme of action. The planning process is updated throughout the fiscal year. Fitch believes that planning is a key factor for MTAs, in view of their capital-intensive activity and relatively high cost rigidity.

TfL's financial debt is contracted by the corporation. To service the debt, it relies on all sources of income, stemming from the transport grant that it receives directly from the DfT, as well as on internal flows from trading subsidiaries (including fares).

Advanced corporate governance

TfL has strived to apply established corporate governance principles. In view of TfL's political importance, these are critical to the rating. Beyond the development of efficient processes and organisation, transparency and publicity are ensured by the following factors.

- The mayor has published his transport strategy.
- TfL has published a long-term planning manifesto, called Transport 2025, contemplating several investment scenarios.
- TfL regularly publishes reports on its performance, including quarterly financial updates.
- 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-making process.

■ Finances and Performance

Unchanged GBP3.3bn of debt for capital requirements

In July 2004 TfL and the government agreed to a unique five-year settlement, which provides stability and assures GBP12.8bn in grants for 2005-2010. TfL and the DfT have also agreed to lower cost increases and substantially higher fare revenue, which includes increases in bus fares that are substantially higher than inflation. Together, these actions have eliminated the funding gaps identified in previous years.

More demanding projections have been met so far

An update in December 2005 raised the ambitious capital spending plan for FY05-FY10 by GBP2.6bn, of which GBP1.6bn to be financed by third parties², while approximately GBP1bn correspond to new projects and cost increases, including approximately GBP200m for the Olympic bid for 2012. This GBP1bn must be funded mainly through an increase in TfL's own resources (primarily with a growing patronage that will increase fares income). The November 2006 update of the plan did not involve a material deviation from these targets. Overall, the amount of debt to be raised by FYE10 remains unchanged at GBP3.3bn.

As per March 2007, the targets in terms of growth in patronage and revenue generation are met. Fitch will closely monitor TfL's ability to continue to meet the demanding projections set out in the revised FY05-FY10 business plan, notably its ability to raise the required own resources.

Revenue

Fares are critical but offer little flexibility

Fares are an important source of income for the TfL budget. They are increasing as a proportion of total revenue and represent a much higher proportion than in many European transport systems (42% of revenue in FY06 compared with 28% in Greater Paris). Annual Tube travelcards for zones 1 to 4 cost

² The bulk of the increase relates to the capital expenditure of PPP projects, whose valuation was updated in the most recent annual asset management plans provided by the infracos. This results in a change of breakdown between operating and capital expenditure within the infrastructure service charge paid by TfL, which remains unchanged.

Budgetary Projections (business plan presentation)

(GBPm)	FY06 Actual	FY07 Forecast	FY08 Plan	FY09 Plan	FY10 Plan
Local tax	20.0	12.0	12.0	12.0	12.0
Transfers received (transport grant)	2,196.0	2,389.0	2,598.0	2,781.0	2,826.0
Fares, charges and other revenue	2,825.0	3,037.0	3,332.0	3,557.0	3,756.0
Current revenue	5,041.0	5,438.0	5,942.0	6,350.0	6,594.0
Operating expenditure	-3,579.0	-3,847.0	-4,133.0	-4,332.0	-4,456.0
Operating balance	1,462.0	1,591.0	1,809.0	2,018.0	2,138.0
Financial revenue	55.0	59.0	65.0	40.0	23.0
Interest paid	-10.0	-59.0	-70.0	-106.0	-151.0
Current balance	1,507.0	1,592.0	1,804.0	1,952.0	2,010.0
Capital revenue	175.0	185.0	186.0	220.0	165.0
Capital expenditure	-714.0	-736.0	-1,240.0	-1,579.0	-1,257.0
Capital projects (PFI/PPP)	-1,416.0	-1,513.0	-1,572.0	-1,672.0	-1,862.0
Capital balance	-1,955.0	-2,064.0	-2,626.0	-3,031.0	-2,954.0
Balance before debt variation	-448.0	-472.0	-822.0	-1,079.0	-944.0
Debt repayment	0.0	0.0	0.0	0.0	0.0
New borrowing	550.0	604.0	600.0	750.0	600.0
Net debt increase (decrease)	550.0	604.0	600.0	750.0	600.0
Net surplus/(deficit)	102.0	132.0	-222.0	-329.0	-344.0
Contingencies	0.0	-26.0	-27.0	-28.0	-28.0
Adjust for working capital, reserves	-102.0	-106.0	249.0	358.0	372.0
Surplus/deficit	0.0	0.0	0.0	0.0	0.0
Debt stock (consolidated)					
Short-term (excl. leases)	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term financial debt (excl. leases)	746.0	1,324.4	1,887.5	2,587.0	3,124.3
Direct debt (excl. leases)	746.0	1,324.4	1,887.5	2,587.0	3,124.3

n.a. = not available

Source: Fitch, based on TfL business plan (updated in November 2006)

approximately 6% of the average wage of a London worker, which is much higher than the equivalents for Paris and Berlin (2% of the average wage). Single Tube tickets are among the most expensive in the world: GBP1.50³ (approx. EUR2.20) for a single trip in zone 1. The fare structure is, however, highly sophisticated, with pricing innovation (off-peak prices, family discounts etc), and is much more market-orientated than in other cities.

Although fares are relatively high, further increases appear necessary to achieve the targets of the revised business plan. Fares are the sole responsibility of the mayor. Following the announcement of the five-year agreement in July 2004, the mayor unveiled additional changes in the fare structure for FY06 and the remaining years of the plan. These changes include a small but regular increase in the course of the plan for the underground (RPI+1) and substantial

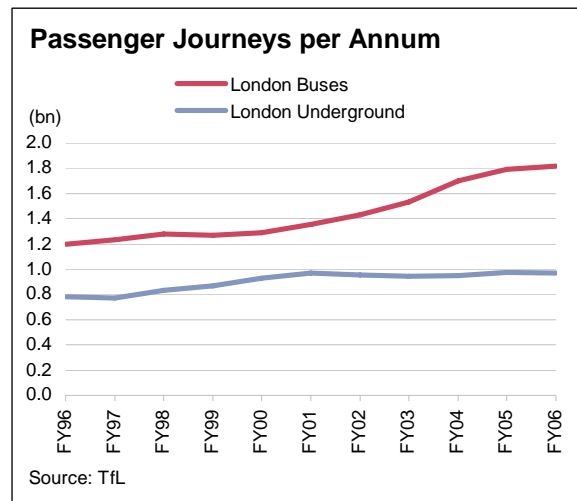
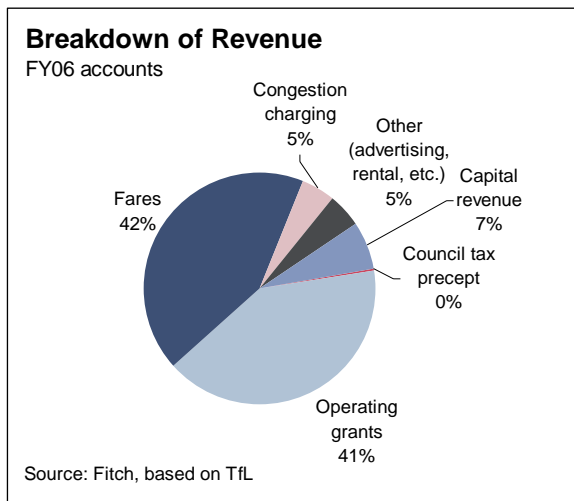
increases for the bus network (RPI+10)⁴. However, these increases predominantly apply to single tickets purchased for cash, whereas a growing number of travellers are using prepaid media (Oyster Card): more than 70% of journeys were paid through Oyster Card in 2006.

Monopoly position and low risk of swings in demand

As an MTA, TfL has a monopoly position in the organisation of urban transport in London. TfL is not exposed to competition 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. Both a cause and a consequence of this is the low rate of car ownership in London: 40% of Greater London's inhabitants do

³ When paid via the Oystercard fare system; GBP4 (approx EUR5.60) when paid with cash (i.e. four times the price paid in Paris).

⁴ These RPI+10 were applied only during two years; the increased patronage and the efficiencies achieved in 2006 allowed TfL to raise fares less afterwards.



not own any car, while the proportion is only 23% in the rest of Great Britain.

Bus patronage is growing strongly while Tube use is contingent on a reduction in capacity gaps

As highlighted by the Audit Commission report issued in late 2005, the growth of bus use in London has been well above targets and is a combination of increased investment and the introduction of measures that support public transport. Except for extraordinary events (terrorist attacks, major floods, fires, derailments), and for a limited period, users may have no other option but to take buses and the Tube. This was illustrated after terrorist attacks in the city on 7 and 21 July 2005: patronage recovered from the service interruption caused by the attacks just months afterwards.

On a longer-term view, however, the significant changes in the fare system may have adverse effects on paid patronage and Fitch will therefore monitor the price elasticity of the demand. As far as the Tube is concerned, the actual improvement in service and the development of capacity, which is still below expectations (see comments on PPP below), will be key to the recovery of a growth trend.

Despite the risk of lower economic growth, Fitch believes the patronage trend is supported by strong structural elements: the rising population in the urban area is fuelling the customer base, while the enhanced service and network quality – as well as the extension of the congestion charge area – are also contributing to a greater use of public transport. In addition, the cyclical increase in oil prices makes the use of private vehicles more expensive and favours TfL's offering. As a matter of fact, in 2006 LU carried more than one billion passengers in a calendar year for the first time, and reached a record

4 million passenger journeys in a day shortly before Christmas 2006.

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 reduce this risk; and (ii) this would not have a sudden impact even were it to happen. This is a very strong credit factor.

Central government grants remain crucial...

Grants are a prominent item in TfL's revenue statement, representing 41% 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 Greater London Authority Act 1999. 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, within the five-year settlement agreed in 2004, which took into account TfL's income and expenditure forecasts, including all its 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.

... with the unique funding settlement providing more certainty for FY05-FY10...

Government funding is regulated by the spending review process, which sets a global funding package for a three-year term.

In July 2004, London's mayor obtained more certainty over TfL's long-term funding through a five-year funding settlement signed with the government. Although it is not a contractual and binding commitment from the government, the

agreement, which has been made public, shows the high-profile commitment and supports the credibility of the FY05-FY10 business plan.

...and 2007 being a milestone for the near future

The central government's budget process, the three-year Comprehensive Spending Review, will probably be settled in autumn 2007. TfL expects it to confirm the intentions in the 2004 funding settlement. It could also provide the basis for TfL planning its financial development up to eight years beyond the FY05-FY10 business plan.

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 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, i.e. it cannot be made while the Commons is in recess, unless approval has 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 ability to tap into these cash sources is a positive factor, it does not amount to unlimited and immediate access to the Treasury.

Congestion charging: strategic success

On 17 February 2003, TfL launched the congestion charge, which aims to reduce the number of private cars entering the most congested central area. The congestion charge system is operated by a private contractor. Although it has been extremely successful as far as the restriction of car traffic (-13%) and the increase in bus patronage are concerned, the congestion charge is generating less revenue than expected. The congestion charge was raised from GBP5 to GBP8 as of 4 July 2005. In February 2007 the congestion charging zone was extended to include the western portion of central London. However, the revenue yielded by the extension is expected to be largely offset by the costs of administering this area.

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.

Surplus income used for capital funding

Most of the fixed assets directly managed by TfL are self-financed. In FY06, GBP205m of net operating revenue was allocated to capital expenditure, on a purely voluntary basis, with no restriction to either operating or capital requirements. TfL also receives capital receipts from third parties (mainly government and land developers).

Expenditure

Staff costs and energy prices put upward pressure on expenditure

The TfL group employed around 20,400 people at mid-March 2007 and staff costs make up some 18% of total expenditure (including contract staff). As expected, this amount rose significantly after agreements were reached with the Tube drivers' trade unions in 2004, and renewed in 2007. The pay agreement concluded in February 2007 envisages the payroll increasing 4% in FY07 and RPI+0.5 thereafter (or 3%, whichever is greater). This growth will have to be met by an equivalent pace on the revenue side.

The increase in energy prices also have weighed on TfL's costs. The electricity bill alone rose GBP58m in FY05.

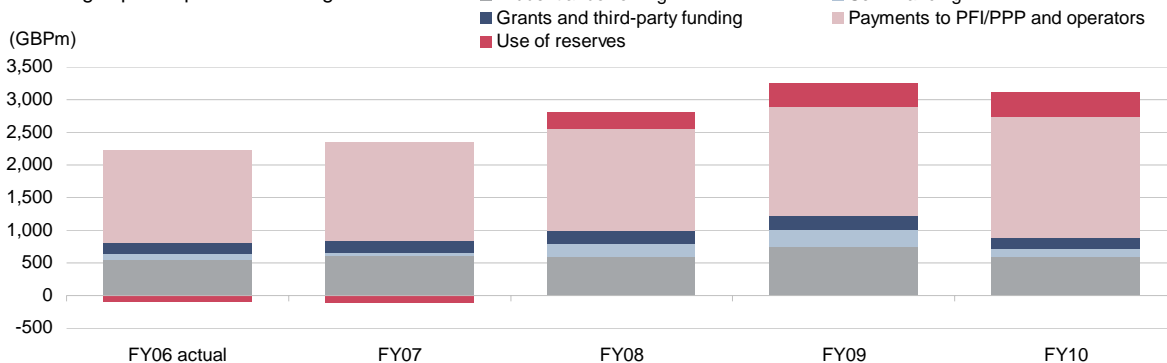
Contracts make up a large proportion of expenditure

TfL has outsourced many of its responsibilities, including bus services, all of which 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). Over the long term, this contract structure offers some flexibility. DLR 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, communications and ticketing), which total approximately GBP210m p.a.

Modes of Funding for Investment

Including capital expenditure through PFI/PPP

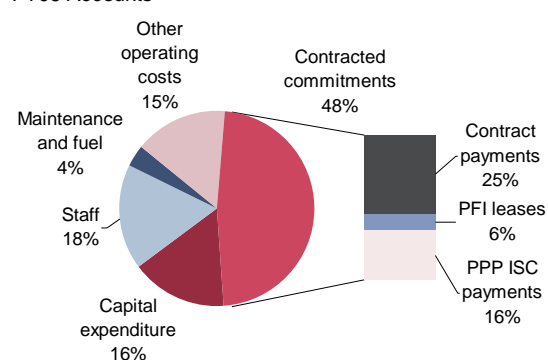


* net of debt repayment and payments to PFI/PPP

Source: Fitch, based on TfL's fine-year investment programme (Nov 2006)

Breakdown of Expenditure

FY06 Accounts



Source: Fitch based on TfL

TfL is committed to realising efficiency gains

In addition to the savings made following the integration of LUL into TfL, TfL management has initiated a business improvement plan. Recurrent savings reached GBP222m in FY06, significantly higher than the revised GBP119m of the previous year. However, TfL's objective of saving a total of GBP1,262m by 2010 remains a challenge, and Fitch will monitor progress in this area.

PPP charges are balanced by equivalent central government grants until 2010

One major expenditure item will be connected with the PPP contracts: an infrastructure service charge (ISC) is paid every four weeks to the infrastructure companies (infracos), corresponding to the maintenance and renewal works that they provide on the underground network and rolling stock (see below, *Contingent Liabilities*). Under a commitment made by the DfT in February 2003, this expenditure will be taken into account in the level of the transport grant. However, any necessary uplifts and

adjustments in the grant will form part of the global negotiation with the central government.

Capital expenditure plan mainly relies on PFI/PPP

TfL has published an ambitious capital expenditure plan that totals GBP13.6bn for FY05-FY10 (more than half being dedicated to works on the Tube). The investments over this period are projected to be fully funded and many of these projects are supposed to be financed through PFI/PPP schemes and payments to operators (a total of GBP8.0bn). The most relevant projects in TfL's investment programme are the Underground renewal works, carried out through the set of PPP contracts. For instance, a GBP3.1bn project within Metronet's PPP contract consists in upgrading the sub-surface lines: the Circle, District, Hammersmith & City and Metropolitan lines will get new trains, together with a new signalling system and upgraded track layouts. The new 190-strong train fleet will be delivered between 2009 and 2015. The balance of capital expenditure (GBP5.5bn) will be debt-financed (GBP3.3bn) or self-financed (GBP2.2bn, including third-party grants and the use of reserves). Within these on-balance-sheet financings, the East London line extension (under the newly created brand Overground) is estimated to cost GBP0.94bn. These and certain other projects related to the successful bid for the 2012 Olympic Games have increased the importance of TfL's capacity to manage its investment programme to ensure that it is on time and on budget.

Beyond this period, and in addition to the abovementioned investment plan, the most important project is Crossrail (estimated at a cost of GBP10.3bn), a regional train line similar to the Parisian RER. It is jointly sponsored by TfL and the DfT, and will probably not require any funding out of TfL's existing resources.

The table below details the major infrastructure projects currently envisaged, a large proportion of them focusing on the East London development.

Major Infrastructure Projects

Project	Amount (GBPbn)	Funding Mode	Time Frame
Projects under construction			
Overground (East London line)	0.94	TfL	2011
DLR extensions			
Woolwich Arsenal	0.20	PFI	2009
Stratford International	0.19	TfL	2010
Projects under discussion			
Crossrail	10.3	DfT	2009-18
Thames Gateway Bridge	0.46	PFI/Toll	2013

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

Prospects: Increased service levels may lead to funding pressure

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, TfL is initiating a clear catch-up process 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 corresponding resources. Yet, since TfL is legally required to run balanced budgets, the board has to keep development plans within budgetary feasibility.

■ Debt and Liquidity

Low though growing debt position

As discussed in the *Institutional Framework* section, the local authorities' finance framework applies to the TfL corporation and is used to regulate its ability to borrow. Until 2004, the entity had no long-term financial debt and reported a low GBP746m financial debt at FYE06 (excluding financial leases). TfL has also sizeable long-term commitments in the form of finance leases (GBP1,250m at 31 March 2006).

Overall the debt total as per the appendices amounted to GBP2,558m at FYE06. Even before the high cash position is taken into consideration (GBP1,687m), this debt level appears very modest and the debt/current balance ratio is low: 2.3 years of self-financing capacity would be sufficient to pay off all the debt and finance leases.

PPPs represent some quasi-debt

This low debt must be placed in the context of an important feature of TfL: PPP contracts to a greater

extent provide external funding sources (rather than just the outsourcing of operating services), as the PPPs 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. Consequently ISC payments (see below, *Contingent Liabilities*) can be partly incorporated into debt servicing⁵.

GBP3.3bn borrowing programme

According to the prudential borrowing regime adopted for local authorities by parliament in September 2003, TfL established a GBP3.3bn borrowing programme, which will be used to raise external funding over the next five years (notably but not solely through a medium-term note programme with a ceiling of GBP3.3bn). The programme is designed to fully match the requirement identified in the business plan, though TfL will consider other means of accessing external funding. The issues will be denominated in pounds sterling only. The yearly amounts to be raised will depend on the annual authorisations granted by TfL's board.

For FY06, the TfL board had approved a cap of GBP550m on additional borrowing, which was raised in full. For FY07, the TfL board has approved a cap of GBP604m. The group raised the full amount approved, broken down as follows: GBP64m from the European Investment Bank (against a total line of agreed credit of GBP450m to be drawn until 2010); GBP200m from two bond issues; and the balance (GBP340m) from the Public Works Loan Board (PWLb), a specialist lender to local governments. This brings the financial debt outstanding to GBP1,350m at FYE07. For FY08, borrowing of GBP600m has been approved by the board.

Strong liquidity position

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. The limited amount of these facilities is mitigated by the fact that TfL has a very strong cash position (GBP1,687m at FYE06), which is prudently managed. This cash and liquid assets represented 29 times the debt service (interest + capital) for the subsequent year. At end-December 2006, the cash was higher than financial debt outstanding.

Moreover, TfL could have access to the contingencies fund (see *Revenue*) from the Treasury in case of extraordinary need.

⁵ 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.

■ Contingent Liabilities

Pensions

Most TfL employees are members of the LRT Pension Fund, a defined-benefit scheme managed by a wholly owned subsidiary of TfL. The fund's actuary makes valuations every three years and recommends the level of contributions to be made by the participating employers to ensure the long-term solvency of the fund. TfL's actuarial valuation of the fund was carried out on 31 March 2003 and showed a deficit of GBP450m. In the latest accounts (31 March 2006), the fund showed a deficit of GBP752m under FRS17 standards⁶. Provisions to keep the fund balanced include annual payments of GBP170m. 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. An update of the actuarial valuation is underway.

Guarantees

With the exception of the guarantees related to the PPP contracts (GBP4,453m see below), TfL has not issued any guarantees of significant importance. However, some PFI contracts contain commitments for TfL that may result in the payment of break costs in the event of early termination of the contracts. The maximum amount of debt that was projected to be drawn by the counterparties (and that may be subject to guarantee) is GBP1,031m.

TfL has provided performance guarantees to the International Olympic Committee as part of its successful bid for the 2012 games. However, these guarantees only apply to projects to be delivered. There are no fixed or implied amounts of capital expenditure.

LUL's PPP obligations are backed by the government

The PPP is a suite of 30-year service contracts between LUL and three privately owned infracos for the maintenance and upgrade of the Tube's infrastructure (see details in Appendix C of Fitch's Credit Analysis of TfL, dated 29 November 2004 and available on www.fitchresearch.com). 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, signalling and other infrastructure. A total of GBP16bn is to be invested in the underground infrastructure during the first 15 years. 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.

The risks and obligations for LUL (and thus for TfL) in relation to the infracos are twofold.

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, need to substitute itself with one or all of the infracos and repay between 95% and 100% of the debt (called the underpinned amount), i.e. 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 and the additional work to be undertaken under those contracts.

Back-up from central government

The DfT has issued a letter of comfort to the infracos' providers of finance. The letter ensures that ISCs are taken into account when setting the GLA transport grant. It also states that "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 make any payment of grant;
- he would stand by and do nothing in those circumstances."

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

Credit implications of commitments given and received related to PPP

It is Fitch's view that, given the complexity of the service contracts, there is a risk that circumstances could arise in which TfL's guarantee would be

⁶ These standards require the discounting of projected pension liabilities by the 'AA' high-quality corporate bond rate, and measure them against the market valuation of assets. This FRS17 deficit is relatively unchanged since 31 March 2003 (GBP920m), because the increase in pension liabilities has occurred in the context of lower interest rates, offsetting the increases in employee contributions, and strong returns on investments.

triggered. In such a worst case, 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.

Fitch recognises that 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; and
- the potential effect of a default⁷ (of TfL on the PPP) for the financial community and the future of the whole PFI/PPP programme, which is the backbone of the UK's public infrastructure upgrading effort.

PPPs: An Update

In recent months, infracos have been under pressure, as TfL and the mayor have publicly voiced their concerns about the value for money provided: according to TfL, works are being carried out, but the progress is too slow and insufficient, given the sums of money involved. Several corrective action notices were issued to Metronet in the past few years and TfL noted: "Much of the work that has been achieved appears to be costing more than anticipated in the bids, particularly for Metronet, and there is evidence that some payments to contractors are running ahead of performance. This may reduce leverage for both infracos and LU".

Both infracos have critical challenges:

Tube Lines must restore the performance of the Northern line, the worst-performing line, to at least the standard seen on the Jubilee and Piccadilly lines.

Metronet must prove that its corporate structure is sufficiently robust to make up for delays in its renewal programmes and deliver the balance of them as per the original schedule. The PPP arbiter had published his report on Metronet's performance during the first three years of the PPP, which found that neither of the Metronet companies had performed its activities efficiently or economically or in line with good industry practice.

⁷ Such a default, if it were to happen, would not be considered an event of default for issues made under the medium-term note programme.

■ Appendix A

Transport for London (Group)

(GBPm) Adjusted ¹	Actual					Forecast ²
	FY02	FY03	FY04	FY05	FY06	FY07
Taxes	10.1	35.8	57.8	25.8	20.0	12.0
Transfers received	1,177.1	1,771.4	2,559.6	2,133.5	1,990.5	2,389.0
Fees, fines and other operating revenue	1,181.1	1,963.5	2,320.8	2,554.5	2,737.6	3,037.0
Operating revenue	2,368.3	3,770.7	4,938.2	4,713.8	4,748.1	5,438.0
Operating expenditure ³	-2,400.5	-3,124.9	-3,708.0	-3,575.4	-3,681.0	-3,847.0
Operating balance	-32.2	645.8	1,230.2	1,138.4	1,067.1	1,591.0
Financial revenue	0.0	7.1	18.5	55.4	58.2	59.0
Interest paid ³	0.0	0.0	0.0	-4.1	-10.2	-58.0
Current balance	-32.2	652.9	1,248.7	1,189.7	1,115.1	1,592.0
Capital revenue	100.1	159.3	180.5	252.8	385.1	185.0
Capital expenditure	-650.9	-804.3	-849.9	-1,157.4	-1,784.9	-2,249.0
Of which estimated capital value of PFI/PPPs	n.a.	n.a.	-475.6	-712.1	-887.6	-1,513.0
Capital balance	-550.8	-645.0	-669.4	-904.6	-1,399.8	-2,064.0
Surplus (deficit) before debt variation	-583.0	7.9	579.3	285.1	-284.7	-472.0
Debt repayment	0.0	0.0	0.0	0.0	0.0	0.0
New borrowing	0.0	0.0	0.0	196.0	550.0	604.0
Net debt movement	0.0	0.0	0.0	196.0	550.0	604.0
Overall results	-583.0	7.9	579.3	481.1	265.3	132.0
DEBT STOCK						
Short-term (incl. financial leases)	39.9	55.3	173.5	453.7	544.7	n.a.
Long-term (incl. financial leases)	0.0	0.0	403.6	832.1	2,013.7	n.a.
Total debt	39.9	55.3	577.1	1,285.8	2,558.4	n.a.
- Cash and liquid deposits	143.1	179.8	874.8	1,350.5	1,687.4	n.a.
Net commitment	-103.2	-124.5	-297.7	-64.7	871.0	n.a.
Guarantees ⁴	n.a.	n.a.	5,488	5,484	5,488	n.a.
Net debt of public-sector entities	0	0	0	0	0	0

¹ Adjustments include the reclassification from operating expenditure to capital expenditure of the capital value of PFI/PPP payments, in order to allow comparisons with international peers

² Classification may not be exactly comparable between "actual" and "forecast" presentations.

³ Financial leases and interest on pensions are included in operating expenditure

⁴ of which: (i) GBP4,453m of guarantees was given to PPP contractors, backed by central government; and (ii) GBP1,031m is the maximum amount envisaged to be drawn by PFI counterparts, which could be payable by TfL under a guarantee or a contractual commitment
n.m.: Not material, n.a.: Not available

■ Appendix B

Transport for London

(%)	Actual				
	FY02	FY03	FY04	FY05	FY06
Fiscal Performance Ratios					
Operating balance/operating revenue	-1.4	17.1	24.9	24.2	22.5
Current balance/current revenue ¹	-1.4	17.3	25.2	24.9	23.2
Surplus (deficit) before debt variation/total revenue ²	-23.6	0.2	11.3	5.7	-5.5
Overall results/total revenue	-23.6	0.2	11.3	9.6	5.1
Operating revenue growth (annual % change)	3.7	59.2	31.0	-4.5	0.7
Operating expenditure growth (annual % change)	31.0	30.2	18.7	-3.6	3.0
Current balance growth (annual % change)	-107.1	-2,127.6	91.3	-4.7	-6.3
Debt Ratios					
Debt (annual % change)	n.a.	n.a.	n.a.	122.8	97.6
Interest paid/operating revenue	0.0	0.0	0.0	0.1	0.2
Operating balance/interest paid (x)	n.a.	n.a.	n.a.	277.7	104.6
Debt servicing/current revenue	0.0	0.0	0.0	0.1	0.2
Debt servicing/operating balance	0.0	0.0	0.0	0.4	1.0
Debt/current revenue	0.0	0.0	11.6	27.0	52.9
Debt and guarantees issued/current revenue	0.0	0.0	122.4	141.9	167.0
Debt/current balance (yrs)	0.0	0.0	0.5	1.1	2.3
Debt/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Liquid assets brought forward/debt servicing	n.a.	n.a.	n.a.	1,099.0	132.4
Debt per capita (GBP)	n.a.	n.a.	n.a.	n.a.	n.a.
Revenue Ratios					
Operating revenue/budget operating revenue	n.a.	n.a.	100.6	100.7	96.3
Tax revenue/operating revenue	0.4	0.9	1.2	0.5	0.4
Current transfers received/operating revenue	49.7	47.0	51.8	45.3	41.9
Operating revenue/total revenue	95.9	95.8	96.1	93.9	91.5
Total revenue per capita (GBP)	n.a.	n.a.	n.a.	n.a.	n.a.
Expenditure Ratios					
Operating expenditure/budget operating expenditure	n.a.	n.a.	n.a.	n.a.	74.1
Staff expenditure/operating expenditure	n.a.	n.a.	n.a.	26.1	27.3
Current transfer made/operating expenditure	n.a.	n.a.	n.a.	n.a.	0.6
Capital expenditure/budget capital expenditure	n.a.	n.a.	n.a.	n.a.	n.a.
Capital expenditure/total expenditure ³	21.3	20.5	18.6	24.4	32.6
Total expenditure ³ per capita (GBP)	n.a.	n.a.	n.a.	n.a.	n.a.
Capital Expenditure Financing					
Current balance/capital expenditure	-4.9	81.2	146.9	102.8	62.5
Capital revenue/capital expenditure	15.4	19.8	21.2	21.8	21.6
Net debt movement/capital expenditure	0.0	0.0	0.0	16.9	30.8
Change in reserves/capital expenditure	89.6	-1.0	-68.2	-41.6	-14.9

¹ Includes financial revenue

² Excluding new borrowing

³ Including debt repayments

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