

## CREDIT OPINION

13 May 2022



### RATINGS

#### Transport for London

Domicile	United Kingdom
Long Term Rating	Baa1
Type	Senior Unsecured - Dom Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## Transport for London (UK)

Update following downgrade to Baa1 stable

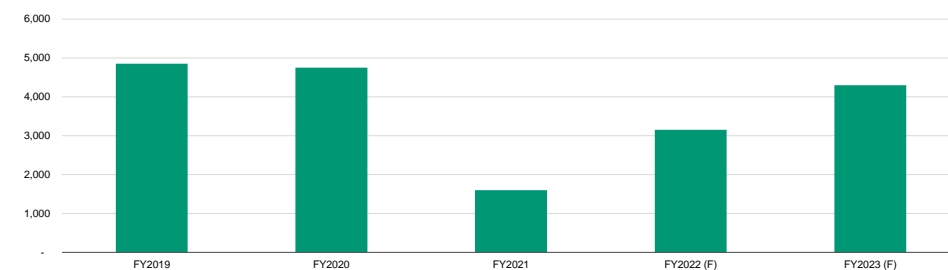
### Summary

[Transport for London's](#) (TfL, Baa1/Prime-2 Stable) credit profile reflects its rising passenger income, weak operating environment reflected in unpredictable and very short-term funding support from the [UK government](#) (UK, Aa3 stable) and a relatively inflexible cost and revenue base. It also reflects TfL's strategic importance as the main public transport provider in London and its strong management and governance. Its credit profile also reflects the strong likelihood of extraordinary support expected to be provided by UK government in the event that the issuer faced extreme liquidity stress.

Exhibit 1

### Passenger income will continue to grow

F: Forecast. Figures are in £ million



Source: TfL

### Credit Strengths

- » Strategic importance for the local and national economy
- » Strong access to liquidity
- » Strong management and governance

### Credit Challenges

- » Weak operating environment, ongoing uncertainty over long-term funding framework
- » Slowing recovery in passenger numbers
- » Large capital programme with limited visibility on how it will be funded
- » High debt but limited additional borrowing will support stable debt metrics

## Rating Outlook

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

## Factors that could lead to an upgrade

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

## Factors that could lead to a downgrade

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

## Key Indicators

### Transport for London Year-ended 31 March

	2016/17	2017/18	2018/19	2019/20	2020/2021
Own Source Revenues / Total Revenues (%)	66.9	68.4	65.1	63.7	33.6
Grants / Total Revenues (%)	33.0	31.5	34.7	36.1	66.3
Operating Surplus (Deficit) / Operating Revenues (%)	6.8	14.8	15.8	18.6	12.0
Interest Payables / Total Revenues (%)	5.3	5.6	5.4	5.6	7.2
Net direct and indirect debt / Operating Revenues (%)	157.0	145.1	149.8	178.7	221.5
Short-term debt / Total Debt (%)	11.4	8.4	7.1	6.8	7.9
Current Assets / Current Liabilities (%)	110.1	73.2	83.6	80.5	63.9

Source: Moody's

## Detailed credit considerations

On 9 May 2022, Moody's downgraded Tfl's BCA to baa3 from baa2 and its long-term ratings to Baa1 from A3, affirmed its short-term ratings at Prime-2 and changed its outlook to stable from negative. The rating action reflects our view that passenger income growth will slow due to weaker economic growth and higher inflation. The current government funding agreement to June 2022 guarantees passenger income at an agreed level, but government have not committed to supporting income beyond fiscal 2023. In addition, the downgrade reflects ongoing uncertainty around Tfl's long-term funding framework, especially for capital funding.

The credit profile of Transport for London, as expressed in a Baa1 rating, combines (1) a baseline credit assessment (BCA) for the entity of baa3 and (2) a strong likelihood of extraordinary support coming from the [UK](#) (Aa3 stable) in the event that the entity faced acute liquidity stress.

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## Baseline Credit Assessment

### Strategic importance for the local and national economy

TfL's credit profile benefits from its scale and very strong market position. It is the largest urban transit system in the UK, and one of the largest in the world. It serves a large population of more than 9 million in London with little competition. London accounts for around 25% of national GDP and its future economic growth and the capacity of its public transportation system are closely linked and are significant policy concerns to citizens, businesses and the local and national levels of government.

Prior to the pandemic, TfL's underground, bus and rail network provided around 4 billion passenger journeys per year. TfL's very strong utilization ratio of 426 (annual ridership relative to the service area population) in 2020 was the highest of any system we rate under the Mass Transit Enterprises Methodology, reflecting the pervasiveness of public transport. Passenger numbers fell significantly during the pandemic, but we expect an increase over the next couple years and a recovery in the utilisation ratio to levels above 200 by fiscal 2023.

Transport for London is a key functional body of the Greater London Authority (GLA). Its Board is chaired by the Mayor of London, who is also in control of Board appointments.

### Strong access to liquidity

TfL benefits from a diverse investor base and may borrow from the Public Works Loan Board (PWLb, statutory body operating within the UK Debt Management Office, an executive agency of the UK Government's Treasury Department), which could also act as a lender of last resort for the entity and hence mitigate the threat of liquidity shocks. For short-term liquidity needs, its European Commercial Paper programme of £2 billion allows for rapid and flexible access to liquidity.

TfL has a policy of maintaining a minimum level of cash of 60 days of operating cost on average (representing approximately £1.2 billion on average for fiscal 2022). Its funding agreements with the Department for Transport include provisions for maintaining this level of liquidity. However, in the funding agreement to June 2022, the £1.2 billion has been changed to a target from a minimum, which will result in TfL holding less liquidity than it has in the past couple years. As of March 2022, TfL had £1.3 billion of cash and short term investments.

### Strong management and governance

TfL's governance and management is strong, evidenced by delivery of significant cost savings, the accuracy of its budgeting, quality of data analysis and transparency of information. TfL implemented a major transformation programme over the past six years to reduce recurring costs, adapt to its lower grant environment and improve its long-term financial sustainability. It has made around £1 billion of recurring cost savings sourced from numerous initiatives included reducing layers in the organisation, merging functions and contract negotiations.

One condition of the funding agreement to June 2022 is that TfL generate £400 million either through additional savings or increased revenue. Considering the extensive transformation and cost reductions implemented by TfL to date, we consider that additional cost cuts would be challenging for TfL.

Alongside the strong track record of cost reduction, management display a high degree of transparency. Material documentation including its budget, financial statements, business plans and board meeting notes are publicly available. Detail on rationale and quantification of key policy changes which impact TfL such as new road user charges are also available from the GLA. In addition, TfL does extensive data analysis such as its annual Travel in London report, which details passenger trends and key developments.

### Weak operating environment, ongoing uncertainty over long-term funding framework

We consider that the stability and predictability of TfL's funding subsidies and policy support from the UK government has weakened fundamentally since the onset of the pandemic. This is evidenced by the challenges involved in agreeing funding support which has been delivered through multiple funding agreements or extensions, many agreed at or after the date of expiry of the previous agreement. Agreements have been relatively short-term; the current agreement covers four months to June 2022.

In addition, funding agreements continue to include onerous conditions necessitating significant resource, some of which will be difficult to adhere to or will result in an erosion of quality. For example, a reprioritisation of its capital programme and review of service levels resulted in some project delays and a reduction in Tube and bus services. Conditions reviewing staff pay and benefits, including

pension reform, will be challenging and may erode staff relations or lead to further strike action. The latest funding agreement to June 2022 has a condition to limit TfL's liquidity to £1.2 billion which has resulted in lower liquidity held compared to a year earlier, when liquidity was £1.6 billion. The low level of funding and numerous conditions are hindering TfL's ability to plan long term.

We expect TfL's fare increases to continue to be volatile reflecting their political sensitivity. Under the current funding agreement, TfL was required to increase rents by the Retail Prices Index (RPI) + 1% which it implemented in March 2022. Fares had been frozen for five years prior to the March increase. Given forecasted high inflation over the next year, inflation-linked fare increases will partially mitigate cost increases. However, there is uncertainty over future fare increases and potential for higher price sensitivity given the weakening economic outlook.

Conditions have also required TfL to generate new sources of income which will boost and diversify its revenue base. Designated council tax, income from the expanded Ultra Low Emission Zone (ULEZ) road user charge and fare increases will provide between £500 - £750 million of new income for TfL by fiscal 2025. For fiscal 2023, TfL estimates it will require government subsidy for operations of around £1 billion.

#### **Slowing recovery in passenger numbers**

TfL's passenger numbers are recovering but we expect growth to slow. As of March 2022, total passenger journeys were 72% of pre-pandemic levels and passenger income was of £180 million below the year to date budget of £2.3 billion. This shortfall will be met by central government under the terms of the current funding agreement, however, there is no guarantee government will continue to plug the gap beyond June 2022 or after the target date for financial sustainability of April 2023.

We expect passenger numbers to rise slowly over the next two years reaching 80% by fiscal 2024. We forecast a permanent reduction of 10%-20% in passenger numbers compared to pre-pandemic numbers. However, there are downside risks to the forecast including higher price sensitivity which may affect commuters and leisure passengers. Higher inflation and lower discretionary spending may lead to fewer leisure trips and tourists. Similarly, higher inflation lead commuters to elect to work from home more often to save on costs.

Lastly, we note due to the existing funding framework, TfL is more reliant on farebox income than international peers. Pre-pandemic, TfL's farebox recovery ratio was 61% compared to between 40% - 55% for its closest peers.

#### **Large capital programme with limited visibility on how it will be funded**

Significant capital expenditure is required to maintain and improve TfL's services and there is uncertainty as to how its capital requirements will be prioritised and funded going forward amid reduced passenger income. As of February 2022, capital expenditure for fiscal 2022 was £1 billion, 25% lower than the £1.4 billion year to date budget due to project slippage, deferrals and increased spending controls amid ongoing funding uncertainty.

As of May 2022, TfL are working with the government to agree a multi-year plan to fund its estimated annual capital funding gap of £500 million to £1 billion. We expect government to provide capital funding to TfL, but view it unlikely that government will fully fund TfL's capital funding gap which could lead to either project cuts or delays, or increased borrowing to fund capex. TfL will continue to benefit from Business Rates Retention (BRR) income, which provides around £1 billion of capital funding per year.

Minimum capital requirements to maintain safety and address critical renewals cost approximately £750 million per year. Additional funding need is driven by major projects and TfL's role in delivering on both mayoral and national policy objectives.

TfL is the joint sponsor of the Crossrail project (operational name: Elizabeth line) - a new 118 kilometre railway line for London and the South East - with DfT. TfL announced that the Elizabeth line's central section (which runs from Paddington to Abbey Wood) will be brought into passenger service in May 2022, four years later than originally planned. The new line will boost passenger income for TfL. Other major ongoing capital projects include signalling, modernisation and rolling stock upgrades to London Underground lines aiming to improve service and capacity across the existing network, station upgrades and its "Healthy Streets" projects which include investment in walking and cycling infrastructure.

#### **High debt but limited additional borrowing will support stable debt metrics**

TfL's debt will remain high, however, limited forecasted borrowing combined with growing revenue will support stable debt metrics. At year end fiscal 2021, TfL's debt (inclusive of finance leases) stood at £15.3 billion. Debt to revenues was 2.2x for fiscal 2021, up

from 1.5x two years earlier driven by higher debt and lower income. We expect debt to revenues to remain stable in fiscal 2022 before improving in fiscal 2023 to 1.8x driven by rising income.

TfL's three-year average debt service coverage ratio was 10.5% in fiscal 2021, up from 5.5% two years earlier. The ratio will remain stable over the next two years near 11%.

Under the Prudential Code, TfL may borrow for capital purposes up to a level approved by the Mayor, subject to reserve powers retained by the government. TfL will remain below the limit; forecasted borrowing over the next three years is limited to c£150 million in TfL Properties Limited, its subsidiary for commercial property activity, and will be non-recourse to TfL. However, if the multi-year capital funding agreement with government does not fully fund its capital requirements, TfL may need to increase borrowing.

TfL's total deficit of all funded and unfunded pension agreements, which currently are not included in TfL's debt, stood at £5.6 billion at fiscal 2021, up from £4.1 billion in fiscal 2020. The latest valuation of the TfL Pension Fund technical provisions was carried out as at 31 March 2021, and showed an improved position from three years earlier. The 2021 valuation has a surplus of £179 million (101% funded) compared with a deficit of £603 million (95% funded) at the time of the 2018 valuation.

### Extraordinary Support Considerations

The strong support assessment for TfL reflects the importance of the transport system and infrastructure improvement in London for the [UK](#) (Aa3 stable) as reflected in the funding agreements since the onset of the pandemic, despite their short-term focus.

## ESG considerations

### How environmental, social and governance risks inform our credit analysis of Transport for London

We take into account the impact of environmental, social and governance factors when assessing sub-sovereign issuers' economic and financial strength. In the case of TfL, the materiality of environmental, social and governance considerations to its credit profile are as follows:

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

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

Governance considerations are material to TfL's credit profile. TfL has high standards of financial management and governance, and has a number of internal committees that review investment and spending decisions. There is also an external body providing independent assurance and expert advice to the Mayor, the Independent Investment Programme Advisory Group (IIPAG). TfL has high standards of transparency and all material documentation including its annual five-year business plan, budget, financial statements, board meeting notes and material spending decisions are published on its website. Governance changes have also been implemented through the funding agreements with UK government. There is an Oversight Group which has been established by DfT and is chaired by DfT, with equal representation from TfL and DfT which will monitor progress on the conditions noted in the funding agreement. DfT will also closely monitor TfL's cash flow and management accounts on a monthly basis.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology [General Principles for Assessing ESG Risks](#).

### Rating methodology and scorecard factors

The assigned BCA of baa3 is the same as the scorecard-indicated BCA of baa3.

TfL's rating reflects our assessment of the company's business profile and financial performance in line with our [Mass Transit Enterprises Methodology](#), published on December 2017 and our [Government-Related Issuers Methodology](#), published in February 2020.

#### Transport for London, 2021 scorecard

Global Mass Transit Enterprises Methodology	FYE 31 March 2021	
Factor 1: Size (15%)	Measure	Score
a) Issuer Size - Annual Ridership (Million)	1293	Aaa
b) Market Size - Service Area Population (Million)	9	Aaa
Factor 2: Market Position (35%)		
a) Operating Environment	Baa	Baa
b) Service Area Characteristics	Aaa	Aaa
c) Market Share - Utilization (%)	142	Aa
Factor 3: Financial Flexibility (20%)		
a) Level of Self-Support - Farebox Recovery Ratio (%)	22%	Baa
b) Budget Flexibility (3 Year Avg Fixed Costs as % of Oper. Exp.)	19.6%	A
Factor 4: Debt & Financial Metrics (30%)		
a) Leverage - Debt/Revenues	2.2x	Baa
b) Budget Balance -Interest as a % of Operating Revenues (3 Year Avg)	10.5%	Baa
c) Budget Balance - Net Margin (3 Year Avg)	15.5%	Aaa
d) Liquidity - Days Cash on Hand	85	A
Adjustments / Notching Factors		
Factor 1: Size		
1) Particularly strong or weak ridership/population trends that are not currently reflected in data set	-0.5	
Factor 2: Market Position		
1) Challenges adopting adequate fare increases	-0.5	
Factor 3: Budget Flexibility		
3) Collective bargaining or high labor costs that decrease financial or operational flexibility	-1	
5) Other analyst adjustment to Budget Flexibility	-0.5	
Factor 4: Debt and Financial Metrics		
2) Large capital program and/or future borrowing plans	-0.5	
5) Other analyst adjustment to Debt & Financial Metrics (Specify)	-0.5	
Rating:		
a) Indicated Rating from Grid After Notching Adjustment	baa3	
b) BCA assigned	baa3	
c) Actual Rating Assigned	Baa1	

Source: Moody's

## Ratings

Exhibit 4

<u>Category</u>	<u>Moody's Rating</u>
<b>TRANSPORT FOR LONDON</b>	
Outlook	Stable
Baseline Credit Assessment	baa3
Senior Unsecured -Dom Curr	Baa1
Commercial Paper -Dom Curr	P-2

Source: Moody's Investors Service

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