S&P Global Ratings

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Research Update:

Transport for London Outlook Revised To Stable From Negative; 'A+/A-1' Ratings Affirmed

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PRIMARY CREDIT ANALYST

Celia Franch Lopez
London
+ 44 20 7176 0100
celia.franch_lopez@spglobal.com

SECONDARY CONTACTS

Luke Linnell
London
luke.linnell@spglobal.com

Felix Ejgel
London
+ 44 20 7176 6780
felix.ejgel@spglobal.com

Overview

- Transport for London (TfL, the authority) benefits from its position as a well-integrated mass transit authority operating in the large and congested London urban area.
- COVID-19 pandemic-related travel restrictions and stay-at-home directives are exacerbating a long-term weakening trend in demand for TfL's services.
- However, we assume the U.K.'s Department for Transport (DfT) will continue to provide adequate extraordinary support to TfL until ridership rebounds to sustainable levels post-pandemic, which would lead to a gradual recovery of TfL's financial indicators.
- We revised the outlook on TfL back to stable from negative and affirmed our 'A+/A-1' long- and short-term issuer credit ratings on the authority.

Rating Action

On May 20, 2021, S&P Global Ratings revised its outlook on TfL to stable. We also affirmed the 'A+/A-1' long- and short-term issuer credit ratings on the authority.

At the same time, we affirmed our 'A+' rating on TfL's senior unsecured debt.

Outlook

The stable outlook reflects our expectation that TfL will continue to receive adequate temporary extraordinary grant support from the U.K. central government until its financials recover to sustainable levels. In the meantime, we also assume TfL will retain uninterrupted access to capital markets and PWLB to refinance upcoming debt service.

Downside scenario

We could lower the rating should slower-than-expected recovery post-pandemic lead to a large and more sustained deterioration in financial metrics and liquidity. We could also lower the rating if we observed signs of weakening in the willingness and ability of the U.K. government to provide extraordinary support to TfL.

Upside scenario

We could raise the rating if ridership recovery materialized faster than we expect, with demand improving above historical levels, especially as a result of the opening of the Elizabeth line.

Rationale

The outlook revision reflects our expectation that TfL will continue to receive substantial temporary grants from the U.K. to bridge the period of subdued ridership resulting from pandemic-related social distancing measures. The central government provided extraordinary support to TfL via the DfT during the fiscal year ending March 31, 2021 (FY2021). This support totaled £3.1 billion, comprising a £2.5 billion extraordinary support grant and £600 million of borrowings from the Public Works Loan Board (PWLB). We expect extraordinary government support will continue in FY2022 and FY2023.

Moreover, TfL benefits from its monopoly position in operating an essential mass transit system in the very large and affluent London metropolitan area. That said, long-term declining demand for its service has weakened its market position. We expect ridership will not recover to historical levels of 4 billion passengers per year over the next two years. Moreover, pandemic-related travel restrictions and stay-at-home directives triggered unprecedented declines in ridership across the TfL network. In FY2021, passenger income stood at £1.6 billion, about 30% of pre-pandemic levels, and tube ridership stood at just 22% of 2019 levels over this period.

Structurally weaker ridership combined with high debt service needs have led to weakening debt service coverage ratio (DSCR; S&P Global Ratings-calculated) despite significant support from the DfT. However, we now expect TfL will not borrow incrementally over the next two years, which will put less pressure on debt metrics than we had previously forecasted.

There remains uncertainty regarding TfL's long-term business and funding model because future large capital projects such as Crossrail would be unsustainable under TfL's current financial metrics. The future flow of funds to TfL from both Greater London Authority (GLA) and DfT remains unclear. Until the key risks to financial performance abate and we gain stronger visibility on the long-term capital needs and related financing, we expect to maintain the one-notch downward adjustment that we currently incorporate in our 'A+' long-term issuer credit rating on the authority.

Due to strong extraordinary support from the U.K. government, the rating on TfL is two notches higher than its stand-alone credit profile. In our opinion, there is a very high likelihood that the U.K. government would provide timely and sufficient extraordinary support to TfL, via the DfT, in the event of financial distress. We base our opinion on:

- TfL's very important role as a near monopoly providing essential transportation services in the U.K.'s capital region; and
- The very strong link between TfL and the U.K. government. Representatives of the DfT now attend TfL's board meetings, with oversight of its financials and business plan. The central government also sets incremental borrowing limits for TfL via the DfT and provides ready access to reliable liquidity sources via the PWLB. In our view, a default of TfL would affect the U.K. government's reputation and impair U.K. local authorities' and other public sector entities' access to the market.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

We analyzed TfL's risks related to environmental, social, and governance factors and acknowledge elevated governance and social risks. We think the regulatory framework under which the authority operates will evolve, leading to a new distribution of responsibility for financing between the central government, GLA, and TfL. We also think TfL is exposed to temporary health and safety social risks related to the pandemic that have resulted in significant ridership and revenue declines, leading to operating and financial pressures.

Enterprise Risk Profile

Our strong assessment of the enterprise risk profile reflects our view of the authority's:

- Strong market position, reflecting its monopolistic business position because of its status as a critical service provider to the London metropolitan area. This is offset by a long-term weakening trend of demand for TfL's service, exacerbated by the ongoing pandemic, which is outside management's control;
- Extremely strong service area economic fundamentals, including favorable levels of economic activity as measured by GDP per capita and a populous service area;
- Low industry risk relative to that of other industries; and
- Adequate management and governance, reflective of an experienced management team with a strong track record of achieving recurring savings, albeit facing challenges in implementing its unique capital projects and uncertainty around the future long-term financial framework.

In our view, TfL benefits from its dominant monopoly position as an operator of trains and buses in the central London urban area, which is characterized by a very high GDP per capita of £51,457 as of 2020. We expect London's strong and diverse economy, with a population of almost 9 million, to lead the U.K.'s economic recovery. In 2020, London's economy shrank by 7%, which is less than the 9.9% decline observed on a national level. We forecast growth in GDP per capita of 4.3% in 2021 and 6.8% in 2022.

That said, we expect ridership will not recover to the historical record of 4 billion passenger journeys per year over the next two years. In our view, behavioral changes regarding the use of public transit, such as increasing working and studying from home and online shopping, will lead to a long-term declining trend for TfL services. Following the steep drop in FY2021, we forecast that tube ridership will average about 60%-65% of pre-pandemic levels in FY2022 and 85% in FY2023. Any further delays to the opening of the central section of the Elizabeth line beyond 2022 would further hinder TfL's ridership and farebox recovery prospects.

We think TfL will restore its revenue flexibility following negotiations between GLA and DfT. The Mayor of London froze fares from 2016-2021, but this policy has since been lifted; therefore, in 2021, TfL raised fares by inflation plus 1% in 2021 as a prerequisite for DfT support. In addition, TfL collects congestion charge and ultra low emission zone payments, which are set to increase because TfL has significantly expanded the congestion charge zone. Moreover, TfL has shown its ability to cut costs by over-delivering on its savings program since 2016.

Our view of TfL's management stems from a positive track record of achieving cost savings and arranging funding for operations and unique infrastructure projects, balanced by the uncertainty around its long-term financial framework. With declining ridership, TfL faces uncertainty around the long-term financial framework to be agreed with GLA and DfT, which will regulate future sources of revenue and quality of services. In addition, the Crossrail project continues to constrain TfL's execution plans, since significant uncertainty remains regarding the opening date of the central section, and funding has yet to be identified for a portion of the latest announced cost overruns. We view positively that TfL took over governance of Crossrail in late 2020.

Financial Risk Profile

The strong assessment of the financial risk profile reflects our view of TfL's:

- Adequate financial performance, reflecting our expectation that TfL's net revenue DSCR will be about 1.2x in the short term because of pandemic-related effects and rising debt service;
- Very strong debt and liabilities capacity, reflecting TfL's forecasted debt staying well below 10x net revenue; and
- Strong liquidity and financial flexibility, reflecting our expectation that TfL will be able to maintain about 90 days' cash on hand and exceptional market access.

We expect pressure on TfL's financial profile will primarily stem from a deterioration in its DSCR. TfL's significant incremental borrowings and use of cash reserves undertaken during FY2021 have also weakened its financials. Our new base case assumes that TfL will require significant extraordinary grant support--in excess of £3.5 billion--from the DfT over FY2022 and FY2023 to shore up its funding gap.

We now forecast that TfL will not borrow incrementally over the next two years, but we expect debt will remain elevated at above £15 billion--on average, 9x net revenue--over the next two years as TfL refinances upcoming maturities. TfL undertook incremental borrowings totaling £1.3 billion in FY2020.

We continue to expect higher debt service obligations will constrain TfL's DSCR, despite extraordinary support from the DfT that will counterbalance lower operating income generation. We forecast that the DSCR will stand at about 1.2x in FY2022 and FY2023, down from 1.5x on average FY2018-FY2020. Higher debt service obligations are a result of sizable upcoming repayments, some of which related to additional borrowing contracted to fund Crossrail cost overruns.

We view TfL's liquidity and financial flexibility as strong, primarily based on its cash reserves and £200 million of credit facilities, and supported by TfL's exceptional access to PWLB. A decline in liquidity compared to historical levels stems from TfL's drawing of about £900 million from its cash reserves at the onset of the pandemic, which the authority has only partly replenished. We forecast that unrestricted cash on hand, including credit facilities, will dip to represent about 90 days of operating expenditure, or 11% of total debt, over the next two years. This compares with liquidity of more than 120 days in FY2019 and FY2020. In any case, we expect TfL to maintain a cash position above its golden rule of £1.2 billion.

TfL's exceptional access to liquidity via the PWLB and capital markets mitigates some of these risks, in our view. As a statutory body within the Debt Management Office, the PWLB lends to local authorities--including TfL--at short notice. In addition, TfL has a very strong track record of issuing own-name bonds on the capital markets. Hence, we do not view refinancing risk on TfL's commercial paper borrowings to be particularly high.

Related Criteria

- Criteria | Governments | General: Global Not-For-Profit Transportation Infrastructure Enterprises: Methodologies And Assumptions, Nov. 2, 2020
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Governments | U.S. Public Finance: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Why The U.K.'s Worse Recession Should Turn Into A Stronger Recovery, May 12, 2021
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 23, 2021
- Industry Top Trends 2021: Global Transportation Infrastructure: Uneven And Protracted Recovery From Unprecedented Shock, Dec. 10, 2020
- Research Update: Greater London Authority Ratings Affirmed At 'AA/A-1+'; Outlook Negative, Sept. 18, 2020

Ratings List

Ratings Affirmed		
Transport for London		
Senior Unsecured	A+	
Commercial Paper	A-1	
Ratings Affirmed / Outlook Action		
	To	**From**
Transport for London		
Issuer Credit Rating	A+/Stable/A-1	A+/Negative/A-1