

## ISSUER COMMENT

6 November 2020

 Rate this Research

### RATINGS

#### Transport for London

Domicile	United Kingdom
Long Term Rating	A1
Type	Senior Unsecured - Dom Curr
Outlook	Negative

Source: Moody's Investors Service

### Contacts

**Zoe Jankel** +44.20.7772.1031  
VP-Senior Analyst  
zoe.jankel@moodys.com

**Maylis Chapellier** +44.20.7772.1429  
Associate Analyst  
maylis.chapellier@moodys.com

**Sebastien Hay** +34.91.768.8222  
Senior Vice President/Manager  
sebastien.hay@moodys.com

### CLIENT SERVICES

Americas 1-212-553-1653

Asia Pacific 852-3551-3077

Japan 81-3-5408-4100

EMEA 44-20-7772-5454

## Transport for London (United Kingdom)

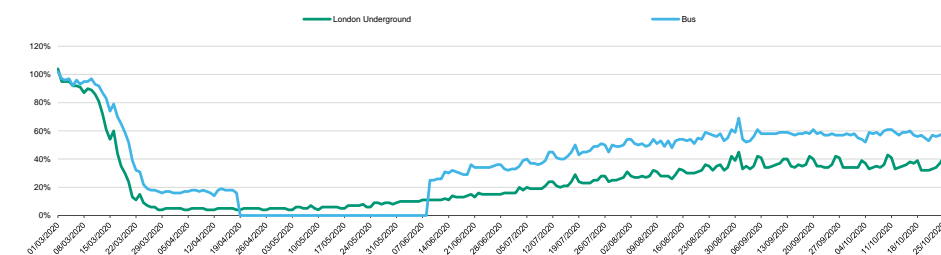
Funding agreement supports credit profile but environment remains credit negative

On 31 October, the [United Kingdom](#) (Aa3 stable) Secretary of State for Transport, Grant Shapps, announced the Extraordinary Funding and Financing Agreement for the second half of FY2021. The agreement supports [Transport for London's](#) (TfL, A1 negative) credit profile by providing it with the funding it requires to run transport services in London for the remainder of FY2021 (up to 31 March 2021). Although the agreement predominantly focuses on this fiscal year, it also acknowledges the importance of TfL's longer-term financial sustainability.<sup>1</sup> We expect further government grant to be required in FY2022 and FY2023 to compensate for the continued impact of the pandemic on TfL's finances.

- » **Funding agreement supports TfL's credit profile.** We expect £3.5 billion in revenue losses in FY2021, but for government funding in H1 and H2, in addition to measures implemented by TfL, to be sufficient for TfL to meet its financial commitments in FY2021. The H2 funding agreement also notes the importance of TfL's long-term financial sustainability, which will be critical in supporting its credit profile post-FY2021.
- » **Credit pressures remain to the downside.** TfL continues to face significant negative credit risks, including the economic effects of the coronavirus shock, alongside pre-pandemic challenges such as completion of the Crossrail project. Although government support compensates downside risks in FY2021, we expect the effects of the pandemic to be protracted, and could transform demand for TfL's services, requiring an overhaul of its funding framework.

Exhibit 1

**Passenger numbers on London Underground and bus services remain 60% and 40% below year-on-year levels, respectively**  
(Passenger journeys as a % of previous year, on a daily basis)



Bus data was not available from mid-April to mid-June due a change in boarding policy.

Source: UK Department for Transport, transport use by mode: Great Britain since 1 March 2020

## Agreement supports TfL's credit profile through sufficient funding for FY2021 and acknowledgment of need for a long-term deal

The coronavirus pandemic has had a very material impact on TfL's finances – we estimate a £3.5 billion loss in passenger and other income for FY2021. Given that the vast majority of TfL's revenues rely on fares – 65% of total operating revenues in FY2020 – and it has a large and inflexible cost base, it has limited ability to offset the impact of the pandemic through raising additional own-source revenues or cost-cutting measures.

TfL is therefore reliant on government support in FY2021, and we expect it to continue to rely on further support in FY2022 and FY2023 given the ongoing impacts of the pandemic. In H1 of FY2021, TfL received £1.05 billion in grant funding from the UK government, and the H2 funding agreement provides another £905 million in grant support at a base level - we expect this to be scaled up to £1.705 billion based on our assumption of a £2 billion shortfall in passenger revenues in H2.

We expect the remaining gap between the full year impact and grant funding (of around £745 million) to be met by the drawdown of around £600 million of TfL's cash reserves and cost control measures. The funding will be sufficient to meet TfL's financial commitments in FY2021, in our view.

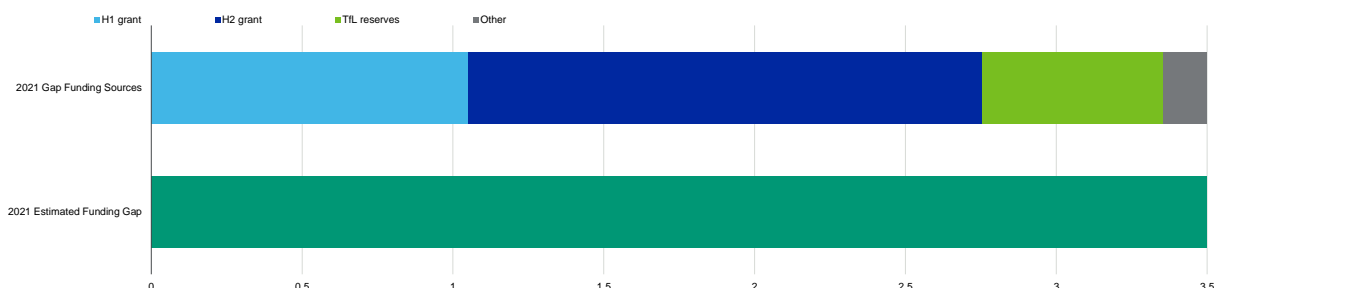
Importantly, the new funding agreement also notes the need for a longer-term solution to TfL's financial sustainability, which will be critical in supporting its credit profile after FY2021. Despite the considerable grant provided, we note that the drawdown of TfL's cash reserves is credit negative as it is a one-off measure which weakens TfL's ongoing liquidity buffer.

TfL will also increase its debt by £600 million this year, in line with its existing borrowing limits detailed in its 2017 funding settlement, in addition to the previously agreed incremental borrowing of £750 million to fund Crossrail capital expenditure. However, debt cannot be used to offset operational losses and we therefore do not consider it to be part of the funding support package.

Exhibit 2

**We expect TfL's funding gap in FY2021 to predominantly be met by a combination of government grants and the use of some of its cash reserves.**

£ billion



Source: TfL, Moody's analysis

The H2 funding agreement also contains a number of conditions in addition to the funding support. Some of the conditions could support TfL's long term revenue raising capacity, while some could be credit negative, in our view.

The stipulation that a review of TfL's commercial development activities and its surplus non-operational assets (including land and property) is conducted could generate more revenues for the organisation. However, we note that commercial activities – which include rents from its commercial estate and advertising revenues – are a relatively immaterial component of TfL's operating revenues and that materially increasing these revenues in the current economic climate would be challenging. In addition, selling TfL's surplus assets would be one-off receipts that would not mitigate the ongoing challenges for TfL's budgetary performance. Commercial activities accounted for £252 million of gross income in FY2020 or 3.6% of TfL's total operating revenues of £6.8 billion.

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In terms of the credit negative conditions, the funding agreement notes that the prioritisation of TfL's long-term capital plan should be focused on safety and quality of existing services with options for varying degrees of investment with regard to other services. If investment in revenue-generating projects – such as line extensions or signalling upgrades, which enable additional capacity – is reduced, this could have long-term negative impacts on TfL's revenue capacity.

### Credit pressures remain to the downside

TfL remains vulnerable to the economic slowdown as a result of the coronavirus shock as well as restrictions implemented to manage virus transmission. As a result, fare revenues and other income over the medium term will continue to remain low. In TfL's revised budget, published in July 2020, it estimates a shortfall of £2.9 billion in FY2022. Although we assume some efficiencies will be implemented in this year, the majority of this shortfall would need to be funded through grant, in the absence of material additional funding sources.

Over the longer term, we expect passenger revenues to continue to be depressed due to a slow economic recovery in the UK and a potentially permanent loss of passenger demand due to changes in lifestyle and working patterns, which have been accelerated by the pandemic. The negative impact on TfL's budget has reversed the organization's progress towards operational self-sufficiency, which it had expected by FY2023 in its 2019 Business Plan. TfL is now reliant on continued support from the UK government in the absence of fundamental changes to its funding framework.

In addition to the effects of the pandemic, TfL also has idiosyncratic pressures – the most notable is the successful completion of the Crossrail project. The opening of the central section of the Elizabeth line (the operational name for the project) has been delayed from an original date of December 2018 to as soon as practically possible in the first half of 2022. The project is expected to add an additional 10% capacity to London's rail network and, in TfL's 2019 Business Plan, was expected to deliver total operating income of £894 million in FY2023 and £1.3 billion in FY2024, with net operating surpluses of £344 million and £443 million, respectively. Any further delays would be significantly negative for TfL as these operating surpluses will be critical in supporting its financial sustainability.

### Moody's related publications

#### Issuer research

- » [Transport for London \(United Kingdom\): Update following downgrade to A1 negative](#), October 2020
- » [Transport for London \(United Kingdom\): Coronavirus impact will be credit negative](#), March 2020

### Endnotes

- 1 The Extraordinary Funding and Financing Agreement defines financial sustainability as TfL's ability to cover operating expenditure, capital renewals, servicing and repaying debt and capital enhancements from sources available to it, excluding government grant. However, for major capital enhancements and major renewals, TfL would not be expected to solely finance these from operating incomes.

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