MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Transport for London's ratings to A3 from A1; outlook negative

15 Jun 2021

London, 15 June 2021 -- Moody's Public Sector Europe ("Moody's") has today downgraded Transport for London's (TfL) long-term senior unsecured debt ratings to A3 from A1 and its long-term EMTN programme rating to (P)A3 from (P)A1. The outlook remains negative. Moody's has also downgraded TfL's short-term issuer rating and short-term commercial paper rating to Prime-2 (P-2) from Prime-1 (P-1).

The downgrade reflects Moody's conclusion that TfL's intrinsic financial strength has been durably and materially weakened by the pandemic, and that the limited level of financial support provided by the Government of the United Kingdom (Aa3 stable), and the absence of clarity on ongoing financial support arrangements, at a time when TfL faces a long-lasting shortfall in ridership post pandemic, signals that this erosion in its financial strength is unlikely to be reversed. TfL's adjustment to a weaker, less supportive operating environment will be challenging and may involve significant cuts to operating and capital expenditures that undermine the value of its service and hence its revenue base and that raise costs in the longer term. In most scenarios, TfL's financial strength will be diminished.

The rating downgrade also takes into account a lower likelihood of extraordinary support than previously assumed, reflecting the limited nature of the UK government's financial commitment to TfL during the crisis and its revealed preference for TfL to address its financing shortfall through internal budgetary changes.

The negative outlook reflects Moody's view that risks remain skewed to the downside. Heightened uncertainty remains about whether TfL will secure a long-term funding agreement, which it needs to plan its operations and capex; and, if an agreement is reached, what conditions will be attached to it, how extensive further operating cuts would need to be, and how it will fund its large capital programme, which remains important to protect the attractiveness and reliability of services.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADE TO A3

The rating downgrade reflects Moody's assessment that both TfL's intrinsic financial strength and the probability of extraordinary support from the UK government are lower than previously estimated.

The negative pressure on TfL's intrinsic financial strength is reflected in the downgrade of the Baseline Credit Assessment (BCA) to baa2 from a3.

Moody's considers that the operating environment for TfL has become considerably less predictable and supportive. Since the beginning of the pandemic, support has been delivered through three six-month funding agreements and three very short extensions, which failed to provide funding visibility. In addition, the amounts provided through these funding agreements fell short of the large pandemic-related funding gaps that TfL faced in FY2021 and faces in FY2022, leading TfL to draw from its cash buffer and implement further cost cutting or cost deferrals. However TfL has maintained cash balances of at least GBP1.2bn throughout, in line with its liquidity policy.

Moody's expects that ongoing funding will be delivered similarly under conditions that undermine TfL's capacity to run its operations and plan for and execute its capital expenditure needs.

The UK government has set TfL the objective to be self-sufficient by April 2023 (FY2024) with no grants apart from business rates, and covering some capital renewals and minor enhancements. Moody's expects a funding shortfall of around GBP500 to GBP600 million on its operating budget -- for which TfL would be required to find additional revenues or expenditure cuts - and GBP1.6 billion on its capital programme from FY2024, although the UK government has stated TfL would not be expected to fund major capital enhancements and major renewals from its operating income.

Achieving this objective will necessitate large cost cuts and/or increases in revenue, if TfL is to preserve its liquidity buffers and avoid a sharp increase in debt. However, such a significant adjustment is not consistent with TfL's limited budget flexibility and a long-lasting shortfall in fares as ridership fails to return to pre-pandemic trends. The conditions in the funding agreement published on 1st June 2021, which covers the next six months, mean that TfL will need to find a further GBP900 million of savings or additional income in fiscal 2022, after GBP1 billion of recurring cost savings already delivered in the past four years and a further GBP400 million planned to be delivered by fiscal 2025. Even if TfL finds the means to achieve these savings, a large proportion is likely to correspond to one-off rather than recurring cuts, which will only defer this year's funding challenge to future years.

There is no clarity on TfL's ongoing funding support after 11th December 2021 but extending the approach to funding of the past 18 months would leave TfL's financial strength weakened.

The UK government's management of TfL's funding needs during the pandemic described above, consisting of a series of short-term agreements, often delivered late up to the day of expiry of the previous agreement, denotes a lower likelihood of extraordinary support than Moody's had previously assessed. Moreover, the UK government's policy priorities to foster a 'levelling up' of economic activity across the country is also consistent with lower extraordinary support. Based on this, Moody's has lowered its Extraordinary Support assumption for TfL to "strong" from "very high."

The final ratings of A3 incorporate a two-notch uplift based on Moody's assessment of a strong likelihood of support from the UK government, as per the application of Moody's Joint Default Analysis (JDA).

RATIONALE FOR NEGATIVE OUTLOOK

The negative outlook reflects the significant uncertainty that remains about TfL's funding sufficiency over the medium term, and about the credit implications of the measures that the organisation may take to achieve it, which puts downward pressure on the rating.

There is no clarity on how TfL will raise an additional GBP500-600 million from its existing revenue sources from FY2024 or make further cuts to its inflexible operating cost base, or how its large capital programme will be funded.

Not achieving these adjustments risks leading TfL to either drawdown its cash buffers further or raise significant amounts of debt which would further increase an already large interest bill. Achieving these adjustments risks forcing cuts to operating and capital expenditures that compromise service quality and lead to further increases in costs later.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Environmental considerations are material to TfL's credit profile. TfL is central to the Mayor of London's ambition to achieve a zero carbon London and improve air quality which will entail significant capital expenditure.

Social considerations are also material to TfL's credit profile including socially-driven policy, which can influence passenger fares, and the coronavirus pandemic. The pandemic and associated economic recession has reduced TfL's ridership materially, given its strong correlation with the strength of London's economy and population growth.

Governance considerations are also material to TfL's credit profile. TfL has high standards of financial management and governance.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

WHAT COULD LEAD TO A STABLE OUTLOOK

Moody's would likely consider changing the outlook to stable if it became increasingly likely that a funding plan was implemented that ensured TfL's long-term financial sustainability, through a clear and plausible strategy for raising the additional revenues and/or cutting the expenditure required to balance its operating budget in the medium term, and supporting its capital programme at levels that maintained service quality, without burdening the company with significant additional debt.

WHAT COULD LEAD TO A DOWNGRADE

Further material downward pressure on the ratings would result were Moody's to conclude, for example following further negotiations between TfL and the government later this year, that a solution was unlikely to emerge which would offer a transparent and sustainable solution to TfL's long-term financial challenges and which would clearly signal the government's willingness to continue to support TfL through unforeseen shocks. In that event, the increased likelihood of funding arrangements that ultimately lead TfL to bridge its large post-pandemic funding gaps through unsustainable cost cutting, significant drawdowns on cash buffers and/or increases in debt would be strongly credit negative.

The methodologies used in these ratings were Government-Related Issuers Methodology published in February 2020 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1186207, and Mass Transit Enterprises Methodology published in December 2017 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_1105431 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1263068 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on www.moodys.com.

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