S&P Global Ratings

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Research Update:

Transport for London 'A+/A-1' Ratings Affirmed; Outlook Stable

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Overview

- Transport for London (TfL, the authority) benefits from its position as a well-integrated mass transit authority operating in the large and wealthy London area.
- We think the COVID-19 pandemic has exacerbated 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 support to TfL until performance rebounds to sustainable levels.
- We therefore affirmed our 'A+/A-1' long- and short-term issuer credit ratings on the authority. The outlook is stable.

Rating Action

On May 26, 2022, S&P Global Ratings affirmed the 'A+/A-1' long- and short-term issuer credit ratings on TfL. The outlook is stable.

At the same time, we affirmed our 'A+' rating on TfL's senior unsecured debt and 'A-1' short term rating on TfL's commercial paper program.

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 if we observed signs of weakening in the willingness and ability of the U.K. government to provide extraordinary support to TfL. We could also lower the rating should slower-than-expected recovery post-pandemic or inability to deliver costs savings and additional revenue sources will lead to a significant and more sustained deterioration in financial metrics and liquidity.

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 affirmation of the rating on TfL reflects our expectation that the authority will continue to receive substantial temporary funding from the U.K. until it can bridge the pandemic-induced gap in income. We expect that total central government extraordinary support to TfL, provided via the DfT, in the three years through the current fiscal year ending March 31, 2023 (fiscal 2023) will exceed £5 billion, which includes funding to still be secured in the current fiscal year.

Like similar entities globally, TfL has experienced an unprecedented drop in ridership and income since the beginning of the pandemic. While most COVID-related restrictions have been lifted by now in the U.K., ridership is still around 70% of pre-pandemic levels on average across TfL's various services. While we expect ridership to gradually recover, the pandemic exacerbated an already weakening trend in demand for TfL's services in our view, reflecting behavioral changes and work from home practices.

This creates 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 under negotiations. This lack of visibility on the long-term financial model for TfL hampers our assessment of its stand-alone credit profile (SACP).

Due to strong extraordinary support from the U.K. government, the rating on TfL is two notches higher than its SACP. 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, especially the services sector; 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 Public Works Loan Board (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.

TfL benefits from strong market position, given its near monopoly business position operating an essential mass transit system in the very large and affluent London metropolitan area, and operations that we consider carrying low industry risk relative to that of other industries. Its area of operations is characterized by a very high GDP per capita, which we estimated to be about £55,900 as of fiscal 2022, compared with a national average of £34,400 in the same year. We expect London's strong and diverse economy, with a population of almost nine million, to continue leading the U.K.'s economy.

That said, long-term declining demand for TfL's service has weakened its market position. We think it is unlikely that ridership will recover to historical peak of four billion passengers per year over the next two years. This trend had been exacerbated by pandemic-related travel restrictions and stay-at-home directives in the past two years, which triggered unprecedented declines in ridership across the TfL network. In fiscal 2022, we estimate that passenger income stood at £3.2 billion, which while twice that of the year before is still around 70% of pre-pandemic levels. 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 shift in demand pattern for TfL's services. We expect that ridership will continue to gradually recover, supported by the opening of the central line of the Elizabeth line this month, and even more in the following year, when the line should be fully open and operational.

Our view of TfL's adequate management and governance 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.

We expect TfL's performance to be strong, supported by gradually recovering ridership and stable debt service. This should lead to slightly improved debt service coverage ratio (DSCR; S&P Global Ratings-calculated) compared with our previous expectations, of just above 1.25x in the coming two years. Supporting this is our expectation that government support will continue in the current fiscal year, and that TfL will be able to balance its budgets in fiscal 2024, when government support will diminish. We further note that the current year's debt service includes a large bullet payment due this summer, which squeezes the ratio this year, while the next one is only due in fiscal 2025, supporting lower debt service going forward.

We think that TfL will maintain its revenue flexibility, which was restored following negotiations between GLA and DfT. Fares have been frozen since 2016, but this has been lifted and in March 2022 TfL raised fares by an average of 4.8%. While this is below current inflation, we believe there will be additional increases going forward, to allow for sustainable performance considering the increasing cost base. In addition, TfL had to identify additional revenue sources in the coming years, which include continued congestion charge and ultralow emission zone payments and increased transfers from GLA through council tax and others. Moreover, TfL has shown its ability to cut costs by over-delivering on its savings program since 2016.

We expect that TfL's capital program will remain contained until it can finance more of it through its operating cash flow or capital grants. We further expect that TfL, GLA, and the DfT will continue to work towards a medium-term capital funding arrangement, as announced earlier this year. We currently do not expect TfL to pursue additional large-scale capital projects, like Crossrail 2 and the extension of the Bakerloo line.

This supports our forecast that TfL's debt stock will remain fairly stable, albeit elevated, over the next two years. TfL's debt stock including leases will remain above £15 billion, which is slightly over 10x of net revenue, over the next two years, with TfL refinancing upcoming maturities.

We view TfL's liquidity and financial flexibility as strong, primarily based on its cash reserves and exceptional access to external liquidity through PWLB. We expect that the extraordinary government support will continue in FY2023 and FY2024, to an extent allowing TfL to maintain its target of £1.2 billion in cash. We forecast that TfL's unrestricted cash on hand, including its £200 million of credit facilities, will represent about 80 days of operating expenditure (opex), or 11% of total debt, over the next two years. This is also similar to the level of liquidity held throughout the pandemic, but represents a decline compared with pre-pandemic levels, when TfL held liquidity equating more than 120 days of opex, and around 15% of total debt.

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.

Environmental, social, and governance factors

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's social role is impaired currently by its exposure to health and safety social risks related to the pandemic, which have resulted in significant ridership and revenue declines, leading to operating and financial pressures.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 22, 2022
- Greater London Authority Ratings Affirmed At 'AA/A-1+'; Outlook Negative, March 18, 2022
- Industry Top Trends 2022 Global Transportation Infrastructure Navigating A New Virus Variant While Recovery Paces Vary, Jan. 26, 2022
- How U.K. Public Finance Sectors Fare Under Latest Spending Review, Nov. 11 2021

Ratings List

Ratings Affirmed	
Transport for London	
Issuer Credit Rating	A+/Stable/A-1

Ratings Affirmed

Transport for London	
Senior Unsecured	A+
Commercial Paper	A-1