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Transport for London

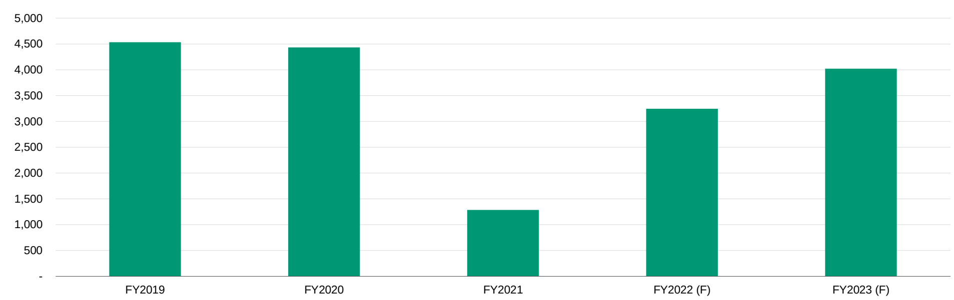
Absence of a longer-term funding arrangement elevates credit risks

On 25 February, the UK (Aa3 stable) Department for Transport (DfT) announced[1] that it would provide Transport for London (TfL, A3 negative) with £200 million in emergency funding and guarantee £1.6 billion in passenger income until June this year. It also confirmed its intention to provide further support until 2023. Whilst the government's commitment to TfL's viability is positive, it will be difficult for TfL to meet the government's unchanged timeline of being self sustainable[2] by 2023 given the structural reduction in ridership post pandemic and its limited spending flexibility.

TfL will generate an additional £178 million per year (7.5% of income (excluding grants) in fiscal 2021) following a recent 4.8% fare increase. We also expect passenger income will more than double to £3.2 billion this year and rise further to £4.0 billion in 2023 as numbers recover (see Exhibit 1). However, as a condition of the funding agreement, TfL needs to identify £400 million of savings or new income for fiscal 2023.

It is unclear at this stage where the savings could come from, but TfL could reduce service levels, scale back its capital plans or reduce staff costs (including pensions). However, further operating efficiencies will be difficult to achieve after the £1 billion in cuts over the last five years and given the strength of the National Union of Rail, Maritime and Transport Workers (RMT), whose members' recent strike action led to most Tube lines being suspended. Further disruption to services is likely if plans to reduce jobs or pension benefits progress.

Exhibit 1
Passenger income is expected to recover in 2022 and 2023
F: Forecast. Figures are in £ million



Source: TfL, Moody's forecasts

The London Assembly has approved increasing Londoners' council tax by about £32 per property per year for the next three years, with £20 of the increase[3] specifically to fund TfL, which will generate around £170 million in additional revenue for TfL. Revenue diversification would be credit positive for TfL given that it is much more highly reliant on farebox income than its global peers (see Exhibit 2).[4] However, tax revenue can be hard to predict and budget for. Income projections from the recently expanded Ultra Low Emission Zone tax have already been lowered by £600 million for 2023-25.

At the same time, negotiations over TfL's funding arrangements with the UK government remain challenging with no credible plan to date on how to address TfL's long-term capital funding needs. This is significant because growth in passenger income, a crucial source of income for TfL, is highly uncertain. We expect slowing population growth, changes to working patterns,[5] inflation and still weak tourist arrivals will contribute to a permanent reduction of 10%-20% in ridership compared to pre-pandemic numbers (see Exhibit 3). Moreover, forecasted income from higher fares may not materialise as expected if price elasticity increases post pandemic and people opt to work from home more days to avoid higher travel costs. There is also little in terms of upside because TfL would have to repay the difference to the DfT if passenger numbers and income were to exceed expectations under the terms of its agreement until June. Moreover, as highlighted above, it will be difficult for TfL to deliver on further cost savings if required.

TfL's strong liquidity position and policy will continue to mitigate the short-term risk of reduced operating cash flows. Although the most recent agreement requires TfL to maintain £1.2 billion of liquidity, this has been changed to a target rather than a minimum, which will result in TfL holding less cash than in the last year. That said, TfL has very strong access to liquidity through its Commercial Paper programme and the Public Works Loan Board (PWLB).

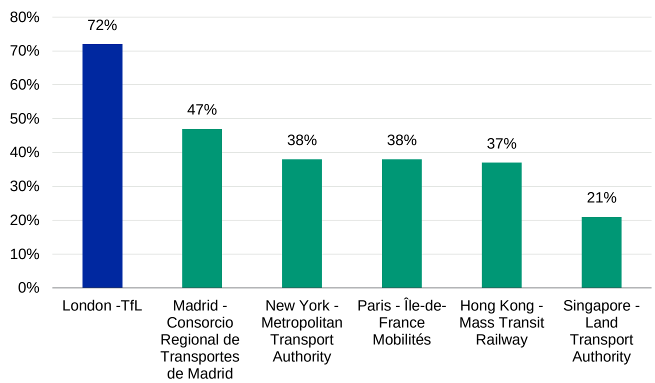
A working group with representatives from TfL, HM Treasury, Greater London Authority and DfT aim to reach a long-term agreement on a capital funding agreement by the end of March. However, given the track record of funding extensions and last minute settlements, a long-term solution to the significant capital funding gap of between £1.5 to £2 billion is unlikely to be reached in the next few months.

An agreement that secures long-term funding stability is crucial for TfL given the near-term implications for service quality and the importance of long-term capital projects for a major transit provider. TfL has flagged that projects like fleet replacements on the Central and Bakerloo lines are at risk unless a multi-year funding agreement is reached. Short-term settlements have also limited TfL's contribution to government's strategic objectives, including the decarbonisation agenda.

Exhibit 2

TfL is much more reliant on passenger revenue than its international peers

Fares as % of operating income

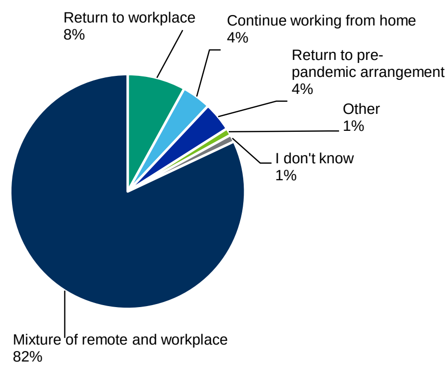


Sources: TfL, Financial Sustainability Plan 11 January 2021

Exhibit 3

A permanent shift towards flexible work will weaken passenger demand

Survey results on expected future working arrangements among Londoners



Source: TfL City Planning

Moody's related publications

» **Credit Opinion**: Transport for London (United Kingdom) : Update following downgrade to A3/Prime-2, 18 June 2021

» **Rating action:** Moody's downgrades Transport for London's ratings to A3 from A1; outlook negative, 15 June 2021

» **Sector In-Depth**: Global - Transportation: Structural fall in ridership post pandemic opens substantial funding shortfall, 29 March 2021

» **Methodology**: Government-Related Issuers Methodology, 21 February 2020

Endnotes

1 https://www.gov.uk/government/news/government-agrees-200-million-deal-to-keep-vital-transport-for-london-services-running

2 Government defines financially sustainable as TfL's ability to cover operating expenditure, capital renewals, servicing and repaying debt and capital enhancements without government grant. It acknowledges government support will be required for major capital enhancements and renewals.

3 Increase is for a Band D property

4 According to TfL, 72% of its income came from fare revenue compared to 38% for both the New York MTA and 38% for Ile-de-France Mobilites, the funding body for Paris's RATP.

5 TfL's survey data finds 82% of London's workers expect hybrid working to be the norm going forward

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