

United Kingdom Credit Analysis

Transport for London (TfL)

Ratings

	Current Rating	Previous Rating	Rating Action
Foreign Currency			
Long-Term	AA		Mar 2004
Short-Term	F1+		Mar 2004
Local Currency			
Long-Term	AA		Mar 2004
Rating Watch	None		
Rating Outlook	Stable		

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Summary Data

	31 Mar 2004*	31 Mar 2003*
Current Revenue (GBPm)	4,938	3,780
Total Debt (GBPm)	0	0
Operating Balance/Current Revenue (%)	15.3	17.3
Total Debt Service/Current Revenue (%)	0	0
Total Debt/Current Rev.(%)	0.0	0.0
Total Debt/Current Balance (Years)	0.0	0.0
Current Balance/Capital Expenditure (%)	206.5	81.2

* Actual

Strengths

- Institutional and financial security derived from the public status of TfL as the authority for transport in London
- Improved certainty about future government funding
- Projected borrowing will remain manageable in view of budgetary performance

Weaknesses

- Significant recourse to external financing needed to fund capital spending plan
- Limited budgetary flexibility
- Operational and contractual risks related to PPP

Rating Rationale

The ratings primarily reflect TfL's position in the British political and institutional set-up, giving it good access to governmental funding, which was recently strengthened by a five-year agreement. However, they also take into account TfL's ambitious capital spending plan, which will be partially debt-financed. The current institutional and financial framework makes TfL's rating independent from that of the GLA.

TfL must, by statute, present a balanced budget, and to date it has done so, with strong budgetary performance in 2003/04. Its budget structure is relatively rigid: it is primarily funded by the Department for Transport ("DfT") through the GLA transport grant (50% of TfL's resources in 2003/04), which is paid to the GLA and ring-fenced for TfL. Fares (38% of revenue) are set by the Mayor. Although TfL has demonstrated its capacity to increase fares if necessary and will use this possibility to support its development, there is only limited room for raising them further as they are already relatively high. Local taxation (GLA council tax precept) is only 1% of revenue and provides only limited scope, as do other revenue sources (including capital receipts and the congestion charge), all of which total 11% of revenue. Expenditure is also relatively inflexible, with staff costs (17%) and contract payments (55%) making up the bulk.

TfL's contingent liabilities related to the Public Private Partnership contracts (PPP) (a possible early redemption of up to GBP4.5 billion of the constructors' debt) are backed by a letter of comfort provided by the DfT to investors. The TfL group (corporation and subsidiaries) is currently debt-free and has a satisfactory level of liquidity.

Recent Performance

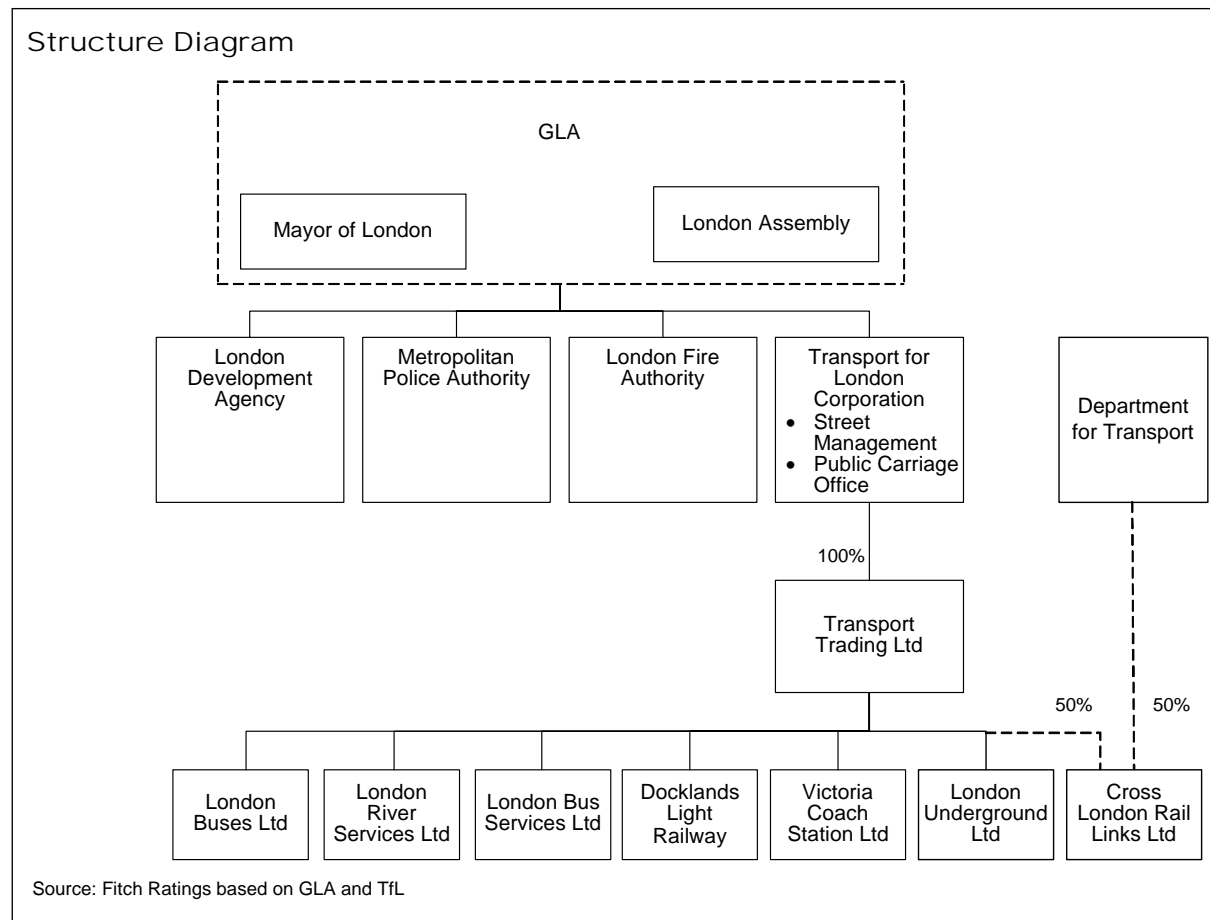
Budgetary performance was better than budgeted in 2003/04, with revenue in line with projections and expenditure below the budget. In July 2004 London's Mayor obtained more certainty over long-term funding through a five-year funding settlement signed with the government. This increased certainty is offset by the expectation that TfL will be required to increase its liabilities in the future to fund its ambitious capital spending plan. As a result, TfL has established a GBP3.3bn MTN programme, which is likely to be fully utilised by 2010.

Institutional Framework

TfL, which reports to London's Mayor, is a functional body of the Greater London Authority ("GLA"). TfL was created in 1999, and for most regulatory purposes is treated as a local authority. It took on all of London Regional Transport's (a central government agency) previous responsibilities for buses, and other transport functions in London from the government (roads and bridges, buses, river services and taxis etc.) on July 2000. London Underground Limited was passed to TfL only in July 2003 after lengthy political and judicial disputes, once the PPPs were established in late 2002 and in early 2003.

Outlook

The Stable Outlook reflects the political and financial visibility of TfL in the next two years of operations. Fitch Ratings will monitor the accuracy of the financial planning, and check that actual recourse of financial debt, made possible under the new prudential borrowing regime for UK local authorities, is in line with projections and hence remains compatible with the 'AA' rating range.



■ Government and Political Context

TfL's Responsibilities Encompass all Modes of Transport Apart from Overground Rail

Since July 2000 TfL has been responsible for most transport in London, including buses, major roads, river transport, cycling, taxis and private hire (the Public Carriage Office) and trams. Since July 2003, it has also been responsible for the "Tube" (the London underground, see below). However, TfL has to date only an advisory role as far as overground rail services are concerned.

The latter remain under the aegis of National Rail Networks and are regulated by the Strategic Rail Authority (SRA, Fitch Long-term rating 'AAA'). Unlike Paris or Berlin, the London urban area is not fully-integrated into one single metropolitan transport authority (MTA).

TfL and the Mayor's Powers over Transport in London

Since the devolution of power to the local level, enacted by the GLA Act in 1999, the Mayor of London (Ken Livingstone, re-elected in June 2004 for a four-year term), is the key figure in urban transport for the UK's capital city. The Mayor:

- Sets the budget, appoints the board and can direct the actions of TfL. Having made transport a priority, the Mayor has chosen to become the chair of the TfL board;
- Is legally required to produce a transport strategy for London, which guides the policies of TfL and the London borough councils. The Mayor's transport strategy was published in July 2001; it complements the government's 10-Year Transport Plan enacted in April 2001 and updated in August 2004;
- Sets the fares for the "Tube", buses, Docklands Light Railway, Croydon Tramlink and taxis;
- Can issue guidance to the SRA on overground rail services in London.

Transport Provision

Transport Modes	Passenger Journeys a Year (m)	Operation Mode	Maintenance of Infrastructure
Buses	1,702	Concession	Contractors
Underground	948	Direct (LUL)	PPP (infracos)
Light Rail (Tram* + DLR)	69	PFI	Concessionaire

* DLR serves a 16 mile automatic metro track from the City to East London's renovated dockland area. It is run under a PFI seven-year contract by Serco Docklands Ltd. Tramlink is a tram service on the south bank of the Thames River, operated under a 99-year concession.

Source: Fitch Ratings based on TfL

Transfer of Responsibility for London Underground to the Mayor

On 15 July 2003 responsibility for the London underground passed from the government to the Mayor and TfL – three years after the other transport responsibilities were transferred. Indeed, the Tube was only transferred once the Public Private Partnership (PPP) for the underground was in place. The PPP, aimed at providing a GBP16bn upgrade and maintenance programme for the Tube, was decided upon and organised by the government, leading to a political and judicial dispute with the Mayor and TfL.

Legal Structure

The legal structure comprises:

- The Corporation – which contains Street Management, the Public Carriage Office and the corporate centre and constitutes, for legal and accounting purposes, the local authority;
 - The Group – which is made up of the Corporation and its subsidiaries (all wholly-owned except for Crossrail, which is 50% owned by TfL and 50% by the Department for Transport), grouped under Transport Trading Ltd.
- Governance, Management and Control

Transport in London is a National Political Issue

The Greater London area is home to 7.4 million people, representing more than 12% of the UK's population. More notably, the capital city provides 18% of national Gross Value Added (GVA). Capital cities play a central role in international competitiveness, and in this context, urban transport is crucial for the economic development of the megalopolis (mobility of the workforce, efficiency of the communications network, quality of life for residents etc). The Mayor of London has made public his ambition to improve dramatically the comfort and reliability of the capital's transport system. It is widely-recognised, that the UK metropolis suffers from many handicaps in this

respect in comparison with other large capital cities (New York, Paris and Tokyo).

In the particular context of London, Fitch examines the relationship between London's Mayor and the central administration in view of: (i) the major role of the DfT in the ongoing funding of TfL (see section 'Revenue') and (ii) the letter of comfort provided by the Secretary of State in respect of TfL's guarantee on LUL's commitment towards its PPP counterparties (see section Contingent Liabilities).

TfL is Ultimately Responsible to London's Mayor

TfL is completely in the hands of London's Mayor. The corporation is governed by a board headed by the chair. All board members are nominated by the Mayor, who also chose to be the chair. The board has four committees (remuneration, audit, safety and finance). TfL is managed by a commissioner; assisted by three advisory panels (underground, rail, surface transport), who heads a total of 18,674 people. In the course of its recent history TfL recruited some high-profile senior managers. Specifically, the position of Chief Programme Officer was created to lead dedicated teams that manage the PPP contracts and the existing PFI contracts. The effective integration of LUL into TfL represents a major challenge for the institution and management has put in place strategies and has requested organisational efforts to achieve important cost savings.

Advanced Corporate Governance

TfL has endeavoured strongly to apply established corporate governance principles. In view of the importance of the political factor, these are critical to the rating. Beyond the development of efficient processes and organisation, which cannot be judged yet, transparency and publicity are ensured:

- The Mayor has published his transport strategy;
- TfL regularly publishes reports on its performance;
- The public has access to TfL board papers and meetings;
- TfL has developed and implemented consultation processes with all interested parties

Budgetary Projections

(GBPm)	2004/05 Budget	2005/06 Plan	2006/07 Plan	2007/08 Plan	2008/09 Plan	2009/10 Plan
Local Tax	26.0	26.0	27.0	28.0	28.0	29.0
Transfers Received (Transport Grant)	2,231.0	2,161.0	2,383.0	2,544.0	2,528.0	2,651.0
Fares, Charges and Other Revenue	2,585.0	2,827.0	2,969.0	3,131.0	3,299.0	3,468.0
Current Revenue	4,842.0	5,014.0	5,379.0	5,703.0	5,855.0	6,148.0
Operating Expenditure	-3636.0	-3,865.0	-4,146.0	-4,291.0	-4,565.0	-4,765.0
Operating Balance	1,206.0	1,149.0	1,233.0	1,412.0	1,290.0	1,383.0
Net Financial Charges	-7.9	-56.9	-89.0	-120.4	-160.2	-190.2
Current Balance	1,198.1	1,092.1	1,144.0	1,291.6	1,129.8	1,192.8
Capital Revenue	189.0	140.0	113.0	95.0	94.0	68.0
Capital Expenditure	-587.0	-768.0	-776.0	-1,002.0	-1,018.0	-740.0
Capital Projects (PFI-PPP)	-919.0	-1,025.0	-1,009.0	-1,047.0	-979.0	-1,084.0
Capital Balance	-1,317.0	-1,653.0	-1,672.0	-1,954.0	-1,903.0	-1,756.0
Balance Before Debt Variation	-118.9	-560.9	-528.0	-662.4	-773.2	-563.2
Debt Repayment	2.0	15.3	25.6	36.9	50.5	62.7
New Borrowing	400.0	550.0	550.0	550.0	700.0	550.0
Net Debt Increase (Decrease)	398.0	534.7	524.4	513.1	649.5	487.3
Net Surplus/(Deficit)	279.1	-26.2	-3.6	-149.3	-123.8	-75.9
Contingencies	-25.0	-26.0	-26.0	-27.0	-28.0	-28.0
Adjust for Working Capital, Reserves	-255.0	50.0	29.0	177.0	151.0	103.0
Surplus/Deficit	-0.9	-2.2	-0.6	0.7	-0.8	-0.9

DEBT STOCK (Consolidated)

Short-Term						
Long-Term	398.0	932.7	1,457.1	1,970.2	2,619.6	3,106.9
Direct Debt	398.0	932.7	1,457.1	1,970.2	2,619.6	3,106.9

Source: Fitch Ratings, based on TFL business plan0

(users, companies etc.) in the decision-taking process.

Chief Finance Officer Embodies the Control Functions

According to the finance framework of the local authorities, the Chief Finance Officer is required to produce a report if expenditure, to be incurred in the financial year, is likely to exceed the resources available to meet that expenditure. He would be personally liable if this control were not carried out faithfully. TfL is not subject to any specific supervision from the central administration. However, it has good working relationship with the Department for Transport, Government Office for London, the Office of the Deputy Prime Minister and Her Majesty's Treasury. The National Audit Office (NAO) does not exercise continuous controls over TfL.

Duty of Best Value: Supervision and Intervention Power by Central Government
As with all UK local authorities, TfL must make arrangements to ensure that it operates in a way that balances economy, efficiency and effectiveness. The

Secretary of State (DfT) may direct the Audit Commission to carry out an examination of the authority in this respect.

Moreover, the DfT is accountable to parliament for its expenditure. As a result it monitors the use of the GLA Transport Grant, through regular financial information sharing.

■ Budgetary Framework

The Accounting Regime is Primarily Based on the Local Authorities' Framework

Under the GLA Act, TfL is treated as a local authority for accounting purposes. Accordingly, TfL is required to deliver a balanced budget. The statement of accounts comprises two particular pieces:

- Corporation and Group revenue accounts (income and expenditure on the provision of transport services), showing the sources of revenue;

- balance sheets which show the overall financial position of the Corporation and the Group as a whole.

The subsidiaries are subject to the accounting requirements of the Companies Act and are consolidated into the statement of accounts.

TfL accounts are audited by external auditors (KPMG).

The Budgetary Process is Clearly Under the Mayor's Control

Unless the London Assembly can achieve a two-thirds majority in favour of alternative budget proposals it is the Mayor who sets, in advance, a balanced budget for the GLA and each of the four functional bodies (Transport for London, the London Development Agency, the Metropolitan Police Authority and the London Fire and Emergency Planning Authority).

These budgets together form the consolidated budget. Although the Mayor plays a major role in this process, he does not have total discretionary powers: 2003/04's budget was amended by the London Assembly and the GLA precept was set at GBP57.8m, which is GBP28m less than the amount sought by the Mayor.

A six-year business plan (currently 2005–2010) is prepared every year and approved by the board, constituting a costed programme of action. The planning process is ongoing. Fitch believes that planning is a key factor for MTAs, in view of their capital-intensive activity and relatively high cost rigidity.

■ Budgetary Performance

Business Plan Eliminates Funding Gap, but uses GBP3.3bn of Debt for Capital Requirements

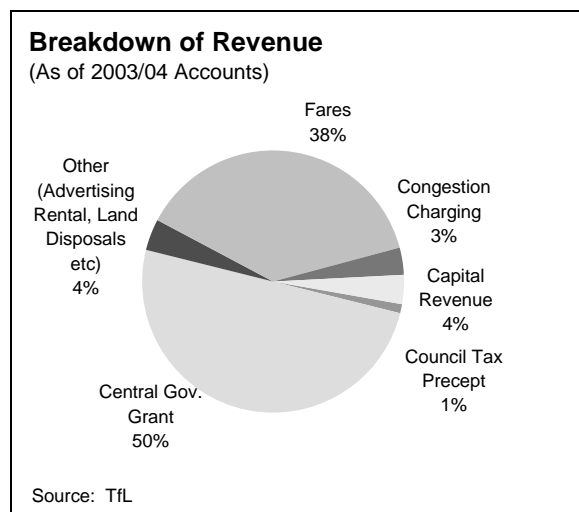
According to TfL's business plan for the period 2003-10 (issued in 2003), the group projected a funding gap of up to GBP4.9bn (in 2004 prices). TfL has since identified GBP3.3bn (in cash prices, or GBP3.1bn in 2004 prices) of debt for capital purposes until the end of 2010, which would be consistent with the prudential code. To make this financing package viable, TfL and the government agreed to a unique five-year settlement, which provides stability and assures GBP14.5bn in grants for the period. TfL and the DfT have also agreed to lower cost increases and substantially higher fare revenue, which include increases in bus fares that are substantially higher than inflation. Together, these

actions have eliminated the funding gaps identified in previous years.

Recourse to debt, while substantial, is consistent with European local government practice of meeting capital funding requirements that are not met by income, government grants or third-party funding.

Fitch will closely monitor TfL's ability to meet the projections set out in the 2005-10 business plan, which the agency considers to be the first planning document to reflect shared objectives and available resources with the government.

■ Revenue



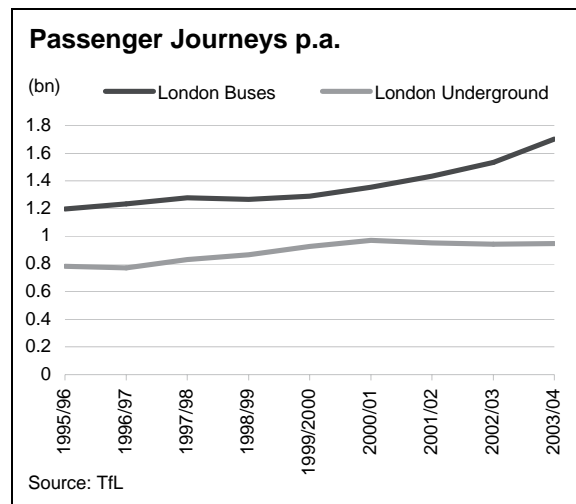
Fares are Critical but Offer Little Flexibility
Fares are an important source of income for the TfL budget (38% of revenue in 2004), and represents a much higher proportion than in many European transport systems (28% in Greater Paris). Annual "Tube" travelcards for zones 1 to 4 cost GBP1,136, i.e. 6% of the average wage of a London worker, which is much higher than the equivalent for Paris and Berlin (2% of the average wage). Single "Tube" tickets are one of the most expensive in the world: GBP2 (approx. EUR3) for a single trip in zone 1 (ie more than twice the price paid in Paris). The fare structure is, however, highly sophisticated, with pricing innovation (off-peak prices, family discounts etc), and is much more market-oriented than in other cities.

Although fares are relatively high, a further increase cannot be ruled out. Fares are the sole responsibility of the Mayor, who decided on a fare package applicable from 2004 onwards, to raise additional funding, which is expected to bring TfL a further GBP81m in revenue. Following the announcement of the five-year agreement in July 2004, the Mayor unveiled additional changes in the fare structure for

2005/06 and the remaining years of the plan. These changes include a small but regular increase in the course of the plan as far as the underground is concerned and substantial increases as far as the bus network is concerned.

A Monopoly Position and Low Risk of Swings in Demand

As an MTA, TfL has a monopoly position in the organising of urban transport in London. TfL is not exposed to competition in its role of integrated transport provider (no outsider private or public transport provider can arise). Indeed, the risk of Londoners strongly reducing their use of urban transport facilities is unlikely. Except for extraordinary events (terrorist attacks, major floods, fires, derailments), and for a limited period, users may not have other possibilities but take buses and the Tube.



In the long run, the risk of reduced patronage exists, as has happened in the past. However, Fitch is confident that: (i) the current strategy and priority given to transport would make this unlikely and (ii) this would not have a sudden impact even were it to happen. This is a very strong credit factor.

Central Government Grants are Crucial ...

Grants are the major item in TfL's revenue statement, representing 50% of the total. TfL's transport grant is part of DfT's settlement and is passed to TfL through the GLA, according to the provisions laid down in the GLA Act. This grant is earmarked for TfL and the GLA cannot use it for other purposes.

The GLA's transport grant is set annually by the DfT, taking into account forecast levels of TfL's income and expenditure, including all their contractual commitments. However this does not equate to an automatic balancing subsidy, as the government may not agree to fund investment not agreed in advance

or expenditure slippage. The GLA's transport grant is a block grant, covering both operating and capital expenditure.

...and the Unique Funding Settlement

Provides more Certainty for 2005-10

Government funding is regulated by the spending review process, which sets a global funding package for a three-year term.

In July 2004, London's Mayor obtained more certainty over TfL's long-term funding through a five-year funding settlement signed with the government. Although it is not a contractual and binding commitment from the government, the agreement, which has been made public, shows the high-profile commitment and supports the credibility of the 2005-10 business plan.

Funding Arrangements Owing to the Integration of LUL Remain Unchanged

As part of the integration of LUL, the GLA's transport grant has been increased. In February 2003 the DfT announced that it will adjust GLA's transport grant so that LUL's funding is adequately included (covering PPP and existing PFI obligations as well as a portion dedicated to the establishment of a reserve). The average amount of LUL's grant reaches approximately GBP1bn p.a. (in constant prices) up to 2009/10. In addition, the DfT has agreed to take into account (in its assessment of the GLA's transport grant) between government spending reviews, major expenditure that falls to LUL outside of its business plan (and therefore unforeseen), including shortfalls contained in the 2003 valuation of LUL's pension scheme (see below Contingent Liabilities).

Extraordinary Grants and Contingencies Fund

Were TfL to need extraordinary funding and the Government to agree, UK budgetary law allows for two possibilities, subject to top-level political consent:

- Central government can decide to make the GLA (with earmarking to TfL) a one-off grant known as a Special Grant. A Special Grant is subject to the Treasury's agreement and can only be paid after prior approval by the House of Commons, ie it could not be made while the Commons is in recess, unless approval had been granted in advance.
- The DfT could provide funds from the contingencies fund, managed by the Treasury and available for expenditure that cannot await a vote in parliament. This can be made within 48

hours. Advances from the Fund must be repaid by the DfT, indicating that the DfT would either have to reallocate funds within its budget or gain parliamentary approval for additional funding.

Although the possibility of accession to these cash sources is a positive factor, it does not amount to unlimited and immediate access to the Treasury.

Local Taxation Makes a Small Contribution
TfL receives part of the GLA council tax precept (GBP26m in 2004/5 budget, ie 0.5% of budgeted revenue). The Mayor's policy intends to affect the Council tax precept to transport policing. It is not supposed to fund the service itself.

Prospects: New Revenue Sources are Contemplated

Like almost all European and Northern American MTAs, TfL is trying to address its funding constraints, through investigating two sources of non-debt revenue:

- voluntary contributions for infrastructure improvements from land developers (as an example, Heron Quays DLR station was co-financed by the Canary Wharf developer); and
- Tax Increment Financing (a process well known in the US, which aims at capturing a share of the increases in land and property values from public investment in infrastructure). This could be used for the Crossrail project, but requires changes in legislation.

Congestion Charging: Strategic Success

On 17 February 2003, TfL launched the congestion charge. The charge aims to reduce the number of private cars entering the most congested central area. The congestion charge system is operated by a private contractor. Although it has been extremely successful as far as the restriction of car traffic (-30%) and the increase in bus patronage are concerned, the congestion charge is generating less revenue than initially expected: the actual income for 2003-04 was GBP169m, while the cost of the facility is around GBP91m p.a., generating a net surplus of GBP78m. TfL is contemplating the extension of the congestion charge to a wider area of the city.

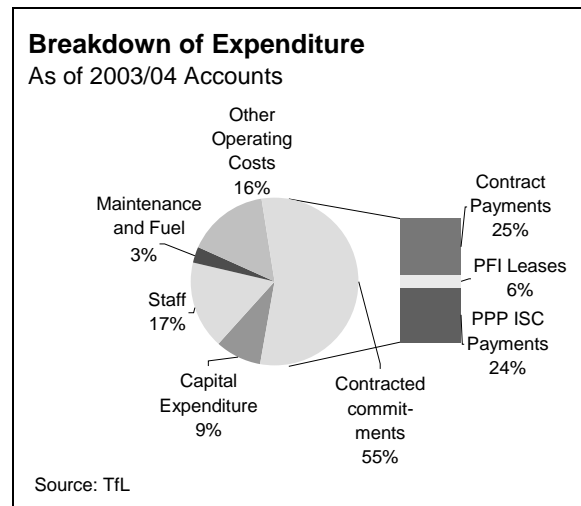
TfL also envisages the use of tolls for new projects, in particular the Thames Gateway Bridge. Other income sources (advertising, property management etc.) are marginal.

Capital Revenue are Secondary

Most of the fixed assets are self-financed, thanks to the GLA Transport Grant (see above), which now covers both operating and capital requirements (LUL

used to receive a central government grant hypothecated for capital expenditure). TfL receives capital receipts from third parties.

■ Expenditure



Staff Costs may Put Upward Pressure on Expenditure

The TfL group employed 18,674 people (full-time equivalent) at 31 March 2004. Staff costs make up some 17% of total expenditure. This amount is to rise following discussions with the Tube drivers' trade unions, which have agreed on significant wage increases. TfL has offered a 3.5% pay rise from July 2004 (paid in October 2004) and another pay increase (0.5% above the rate of increase in the retail prices index, with a guaranteed 3% floor) for 2005. A reduction in the workweek – to 36 hours for people currently working 37.5 hours per week, and from 36 hours to 35 hours for others – from July 2005 will also have an impact on staff costs in the next two years.

Contracts Make up a Large Proportion of Expenditure

TfL has outsourced many of its responsibilities, including bus services (all are operated by private companies, with which TfL has five-year contracts; six companies control 90% of the bus routes). Expenditure related to bus operators' contracts has increased as a result of: (i) the "TfL bonus" (an increase in wages with a view to reducing labour shortages) and (ii) bonuses paid to operators for providing a more reliable service following the implementation of the congestion charge (these incentives are capped and currently do not exceed 6% of the contract's value). Docklands Light Railways is also run under a concessionary system, in which the private contractor provides

infrastructure and rolling stock, while TfL makes availability payments.

Some PFI contracts are also binding obligations for TfL: LUL has PFI contracts in two major procurement areas (power and communications), but also for train services (the Northern Line with Alstom¹). They approximately total GBP250m p.a. and represent around 10% of LUL's operating expenditure.

The TfL corporation has only one PFI contract, congestion charge management that is worth GBP91m p.a.

PPP Charges are Balanced by Equivalent Central Government Grants

A major expenditure item will be connected with the PPP contracts, ie the Infrastructure Service Charge (ISC). These are amounts paid every four weeks to the infracos, corresponding to the maintenance and renewal works provided by the latter on the underground network and rolling stock (see below Contingent liabilities and Appendix C). Under a commitment made by the DfT in February 2003, this expenditure will be taken into account in the level of the GLA Transport Grant. However, necessary uplifts and adjustments of the latter will be part of the global negotiation with the Central Government.

TfL is Committed to Realise Efficiency Gains

In addition to the savings made following the integration of LUL into TfL, TfL management has initiated a BIP (Business Improvement Plan). Recurrent savings reached GBP36.5m in 2003/04, significantly higher than the GBP24m target. However, TfL's objective of saving GBP69m *per annum* by 2009 remains a challenge, and Fitch will monitor progress in this area.

The Capital Expenditure Plan Will Rely on Additional PFI Solutions

The GLA has published an ambitious capital expenditure plan for TfL that totals GBP6.6bn for the period 2004 to 2009 (including some works on the Tube). The table below represents the major infrastructure projects currently envisaged, a large proportion of them focusing on East-London development. Many of these projects are supposed to be financed through PFI/PPP schemes. Within TfL's plan, the most relevant project is the East London Line Extension, which is estimated to cost GBP0.9bn. Outside TfL's budget, the most important project is

Crossrail (now estimated at a cost of GBP12bn), a regional train line (similar to the Parisian RER). It is jointly sponsored by TfL and central government (SRA and then the DfT), and will probably not require any funding out of TfL's existing resources.

Major Infrastructure Projects

Project	Amount (GBPbn)	Funding Mode	Time Frame
Crossrail	12	DfT	2013
West London Tram & Cross River Tramway	0.95	PFI	2008/11
DLR Extensions	0.34	PFI	2010
Thames Gateway Bridge	0.38	PFI/Toll	2012
East London Line	0.90		2010

Source: Fitch Ratings based on TfL, GLA, Crossrail, Thames-Gateway

Prospects: Increased Service Levels may Lead to Funding Pressure

Fitch views urban transport as a structurally loss-making sector (losses are compensated by positive externalities, which in turn must justify the public grants that balance the budgets). According to the ambitious transport strategy unveiled by the authorities (which may be even extended if London were to host the Olympics in 2012), TfL is initiating a clear catching-up in terms of infrastructure and quality of service. And yet, despite efficiency and productivity gains, it appears to be difficult to develop and improve the level of service without increasing the funding gap.

■ Debt and Liquidity

TfL Plans to Take on GBP3.3bn in Debt

As mentioned in the section Budgetary Framework, the local authorities' finance framework applies to the TfL corporation and used to restrict its ability to borrow. As a result, as of November 2004, the entity has no debt.

This debt-free situation must be seen in the context of an important feature of TfL: the PPP contracts to a greater extent provide external funding sources (and not only the outsourcing of operating services), as they intend to upgrade infrastructure (capital expenditure will account for around 50% of total expenditure for the first 15 years of the contract and around 30% thereafter); thus ISC payments (see below Contingent Liabilities) can partly be incorporated into debt servicing²;

¹ This contract will be passed from LUL to Tube Lines. It contains a clause of step in by LUL in the event of an infraco failure.

² In the Public Sector Comparator simulations, which are supposed to provide alternative funding solutions to the PPP scheme, three separate bond drawdowns were assumed,

The New Prudential Borrowing Regime

In September 2003, parliament passed a new Local Government Act, introducing from April 2004 onwards a prudential borrowing regime for local authorities (of which the GLA and its functional bodies), which allows TfL to borrow without prior approval from the DfT. The new system will be based largely on self-regulation by local authorities. Conditions and limits are set as follows:

- The decision to borrow has been made by London's Mayor after consultation with the London Assembly and TfL's board.
- Debt can be incurred only for capital expenditure.
- The amount and maturity of debt are to be set by the Mayor according to three criteria which he defines as follows³:
 1. affordability (capacity to service debt)
 2. sustainability (the consequences of investment in terms of running costs and income)
 3. prudence.
- The Mayor and TfL would exert self-control authority; however, HM Government keeps the possibility by regulations to make provisions about the above-mentioned duties and rights.

A GBP3.3bn MTN Programme

TfL established a GBP3.3bn MTN programme, which will be used to raise external funding over the next five years. The programme is designed to match the requirement identified in the business plan fully, though TfL will consider other possibilities for accessing external funding. The issues will be denominated in pounds Sterling only. The yearly amounts to be raised will depend on the annual authorisations granted by TfL's board. For 2004/05, the Board approved a prudential borrowing maximum of GBP400m.

Liquidity

TfL and its subsidiaries have access to traditional liquidity facilities (bank overdrafts). Limits collectively total GBP50m and the three banks involved are rated 'F1+' by Fitch.

Moreover, TfL could have access to the Contingencies Fund (see Revenue) from the Treasury in the event of extraordinary necessity.

GBP477m in 2002, GBP2,904m in 2007 and GBP2,658m in 2012.

³ In determining these criteria and the borrowing terms, the Mayor shall consult TfL's board. It shall rely on the CIPFA prudential code.

■ Contingent Liabilities

Pensions

A majority of TfL's employees are members of the LRT Pension Fund, managed by a wholly-owned subsidiary of Transport for London. The fund's actuary makes valuations every three years and recommends the level of contributions to be made by the participating employers to ensure long-term solvency of the Fund. The latest valuation of the fund was carried out on 31 March 2003 and shown deficit of GBP450m. Provisions to keep the fund balanced include annual payments of GBP65m. The pensions related to LUL (accounting for the bulk of TfL's pension obligations) are subject to the agreement signed in February 2003 by the DfT, which undertakes any possible shortfall contained in the scheme at the date of transfer.

Olympic Bid

TfL has provided performance guarantees to the International Olympic Committee. However, these guarantees only apply to projects to be delivered. There is no fixed or implied amounts of capital expenditure.

Guarantees

With the exception of the guarantees related to the PPP contracts (GBP4,450m see below), TfL has not issued guarantees of significant importance. However, some PFI contracts contain commitments for TfL that may result in the payment of break costs in the case of early termination of the contracts. The maximum amount of debt that was projected to be drawn by the counterparties (and may be subject to guarantee) is GBP1,033m.

LUL's PPP Obligations are Backed by the Government

The PPP is a suite of 30-year service contracts between London Underground and three privately-owned infrastructure companies (infracos) for the maintenance and upgrade of the "Tube's" infrastructure (see details in Appendix C). LUL remains the operating company, responsible for running the trains and stations and determining the service pattern. Three infracos are responsible for maintaining and upgrading the trains, stations, tracks, signalling and other infrastructure. A total of GBP16bn is expected to be invested in the underground infrastructure. The infrastructure assets are on lease to the infrastructure companies, while the freehold of the assets remains with LUL. At the end of the 30 years, all of the assets are to return to London Underground.

The Tube Lines consortium started modernising and maintaining the Jubilee, Northern and Piccadilly

lines on 31 December 2002. The Metronet consortium started work on the remaining lines on 4 April 2003.

Risks and obligations for LUL (and thus for TfL) in relation to the infracos are two-fold:

Contractual

- LUL is committed to paying the ISC every four weeks. The ISC may be increased/reduced if the infracos' performance is above/below target.
- LUL may, under certain circumstances (see details in Appendix C), need to substitute itself with one or all of the infracos and repay between 95% and 100% of the debt (called the Underpinned Amount), ie up to GBP4.5bn.

Operational

- Volume or fare revenue risks remain in LUL's hands;
- The interface between the PPP contracts, the existing PFI contracts (eg the Northern Line PFI with Alstom) and the additional work to be undertaken under those contracts.

Back-up by Central Government

The DfT issued a letter of comfort to the infracos' providers of finance to ensure that: (i) ISC are taken into account in setting the GLA Transport Grant and (ii) "in the event that LUL was unable to meet its financial obligations under any PPP contracts the Secretary of State regards it as untenable that:

- he would not consider whether it was appropriate [to provide financial support]; ...
- he would stand by and do nothing in these circumstances."

Fitch regards the letter of comfort as not legally binding, but an expression of strong political commitment.

Credit Implications of Given and Received Commitments Related to PPP

It is Fitch's view that given the complexity of the service contracts, the risk exists that circumstances in which TfL's guarantee would be triggered could arise. In such a worst case, TfL may find it difficult to raise sufficient funding on its own to meet the infracos' debt. The solidity of the letter of comfort would thus be tested.

Fitch recognises there is an element of moral hazard in the implementation of the letter of comfort: it is highly unlikely that the government would not bail out TfL, were it to face the huge financing requirements that could be triggered by PPP break-up clauses, because of:

- the objective importance and political visibility of the London underground for the city (and thus for the whole country);
- the publicity given to the government's responsibility for (and support of) the PPP, which was also welcomed by the opposition parties;
- the potential effect of a default⁴(of TfL on the PPP) for the financial community and the future of the whole programme of PFI/PPP, which is the axis of the UK's public infrastructure upgrading effort.

⁴ Such a default, if it were to happen, would not be considered an event of default for issues made under the MTN programme.

■ Appendix A

Transport for London

TfL + LUL pro forma GBPm	2000/2001 Actual	2001/2002 Actual	2002/2003 Actual	2003/2004 Budget	2003/2004 Actual	2004/2005 Budget
Local Tax	7.4	10.1	35.8	57.8	57.8	26.0
Transfers Received (Transport Grant)	573.3	1,177.1	1,771.4	2,562.6	2,559.6	2,231.0
Fares, Charges and Other Revenue	1,703.6	1,775.2	1,972.5	2,320.6	2,320.8	2,585.0
Current Revenue	2,284.3	2,962.4	3,779.7	4,941.0	4,938.2	4,842.0
Operating Expenditure	-1,832.2	-2,400.5	-3,124.9	-4,535.8	-4,183.6	-4,554.0
Operating Balance	452.1	561.9	654.8	405.2	754.6	288.0
Net Financial Charges	-0.2	-0.1	-1.9	-0.2	18.5	-10.0
Current Balance	451.9	561.8	652.9	405.0	773.1	278.0
Capital Revenue	154.5	100.1	159.3	196.0	180.5	189.0
Capital Expenditure	-606.4	-650.9	-804.3	-573.5	-374.3	-587.0
Capital Balance	-451.9	-550.8	-645.0	-377.5	-193.8	-398.0
Balance Before Debt Variation	0.0	11.0	7.9	27.5	579.3	-120.0
Debt Repayment of Which Prepayment	0.0	0.0	0.0	0.0	0.0	0.0
New Borrowing	0.0	0.0	0.0	0.0	0.0	400.0
Net Debt Increase (Decrease)	0.0	0.0	0.0	0.0	0.0	400.0
Net Surplus/(Deficit)	0.0	11.0	7.9	27.5	579.3	280.0
Debt Stock (Consolidated)						
Short-Term	22.1	39.9	55.3	n.a.	n.a.	
Long-Term	0.0	0.0	0.0	0.0	0.0	400.0
Direct Debt	22.1	39.9	55.3	n.a.	n.a.	400.0
Guarantees Issued*				5,488	5,488	5,488
Cash and Liquid Deposits	51.4	143.1	179.8	n.a.	874.8	n.a.

* of which (i) GBP4,450m of guarantees given to PPP contractors, backed by Central Government and (ii) GBP1,033m maximum amounts envisaged to be drawn by PFI counterparts, that could be payable by TfL under a guarantee or contractual commitment
n.m. : Not material, n.a. : Not available
Source: TFL

■ Appendix B

Transport for London

TfL + LUL Pro Forma	2000/2001 Actual	2001/2002 Actual	2002/2003 Actual	2003/2004 Actual
Fiscal Performance Ratios				
Operating Balance/Current Revenue (%)	19.8	19.0	17.3	15.3
Operating Balance/Operating Expenditure (%)	24.7	23.4	21.0	18.0
Current Balance/Current Revenue (%)	19.8	19.0	17.3	15.7
Balance Before Debt Variation/Total Revenue (%)	0.0	0.4	0.2	11.3
Current Revenue Growth (Annual % Change)		29.7	27.6	-0.1
Operating Expenditure Growth (Annual % Change)		31.0	30.2	-7.8
Debt Ratios (All Ratios Include METP Debt)				
Debt Annual % Change		80.5	38.6	
Interest Paid/Current Revenue (%)	0.0	0.0	0.1	-0.4
Debt Servicing*/Current Revenue (%)	0.0	0.0	0.1	0.0
Debt Servicing*/Operating Balance (%)	0.0	0.0	0.3	0.0
Debt/Current Revenue (%)	1.0	1.3	1.5	n.a.
Debt/Current Balance (yrs)	0.0	0.1	0.1	n.m.
Revenue Ratios				
Tax Revenue/Current Revenue (%)	0.3	0.3	0.9	1.2
Current Transfers Received/Current Revenue (%)	25.1	39.7	46.9	51.8
Current Revenue/Total Revenue** (%)	93.7	96.7	96.0	96.5
Expenditure Ratios				
Staff Expenditure/Operating Expenditure (%)			19.1	0.0
Capital Expenditure/Total Expenditure*** (%)	24.9	21.3	20.5	8.2
Current Balance/Net Capital Expenditure (%)	100.0	102.0	101.2	398.9
Capital Expenditure Financing				
Capital Revenue/Capital Expenditure (%)	25.5	15.4	19.8	48.2
Current Balance/Capital Expenditure (%)	74.5	86.3	81.2	206.5
Net Debt Variation****/Capital Expenditure (%)	0.0	-1.7	-1.0	-154.8

* Contractual debt service only, without debt prepayments

** Total revenue = current revenue + capital revenue (excl. new borrowings)

*** Total expenditure = operating exp. + interests+ capital exp. + contractual debt repayment

**** Net debt variation = debt variation + change in reserves

■ Appendix C: Detailed Issues re. PPP

PPP and Tube Lines deal diagrams: see overleaf.

ISC (Infrastructure Service Charges)

The Service Contract is divided into four review periods of 7½ years each. The amounts of ISC for the first period are set out in the schedules to the contracts. Prior to the end of each review period, LUL will specify the work programme for the remaining life of the contract. The infracos will then have a period of time to calculate the amended ISC that it will require to cover the new programme. Any disagreements over estimates, which cannot be resolved between LUL and the borrower, will be referred to the Statutory Arbiter (being a PPP arbiter appointed under the GLA). The infracos will also receive bonus payments or suffer abatements based on their performance, which is measured against benchmarks set under the service contract that includes a performance measurement code.

Mandatory Sale Process

It is the procedure that must be followed in the event that, amongst other things, either LUL or the infracos breach their respective obligations under the service contract. This results in the transfer of the contract (and the attached assets and obligations) to a new counterpart (through a tender process). Conditions of this transfer vary depending on the circumstances that gave rise to servicing of the mandatory sale notice.

Put Option, Underpinned Amount and Standstill Agreement

If an insolvency event occurs in respect of the infracos or, a mandatory sale under the service contract is ineffective, the borrower security trustee (representing the interests of finance providers) will be able to “put” the debts due under the issuer/borrower facility agreement (the debt raised

by the securitisation) to LUL, which will trigger the guarantee it benefits from TfL, which in turn will very likely ask for central government support according to the letter of comfort.

The price (as defined in the put option agreement) LUL will pay will depend upon the particular circumstances giving rise to the exercise of the put option, however, the minimum amount payable by LUL (the underpinned amount) will be 95% of the amount due to the issuer under the senior tranche facilities (subject to certain adjustments) and the maximum amount payable by LUL will be [100% of the amounts due to the issuer under the issuer/borrower facility agreement] (subject to certain adjustments). The issuer will be obligated to transfer its debt to LUL on payment of the put option price.

Subject to certain exceptions, the stand still agreement will entitle LUL to require the issuer to delay acceleration of its debt for up to one year, provided that LUL makes all payments of principal, interest etc due to the issuer under the issuer/borrower facility agreement.

The Role of PPP Arbiter

The role of PPP arbiter was created in 1999 by the Greater London Authority Act (“GLAA”). The arbiter (independent of the UK government) is responsible for dealing with disputes about the financial terms of the three London underground PPP contracts. If the parties cannot agree an appropriate ISC for LUL’s restated requirements every 7½ years, the arbiter will determine the appropriate ISC via a periodic review. In setting an appropriate price, the arbiter will determine the economic and efficient price, for which a notional infraco should deliver the services required under the service contract for the next review period.

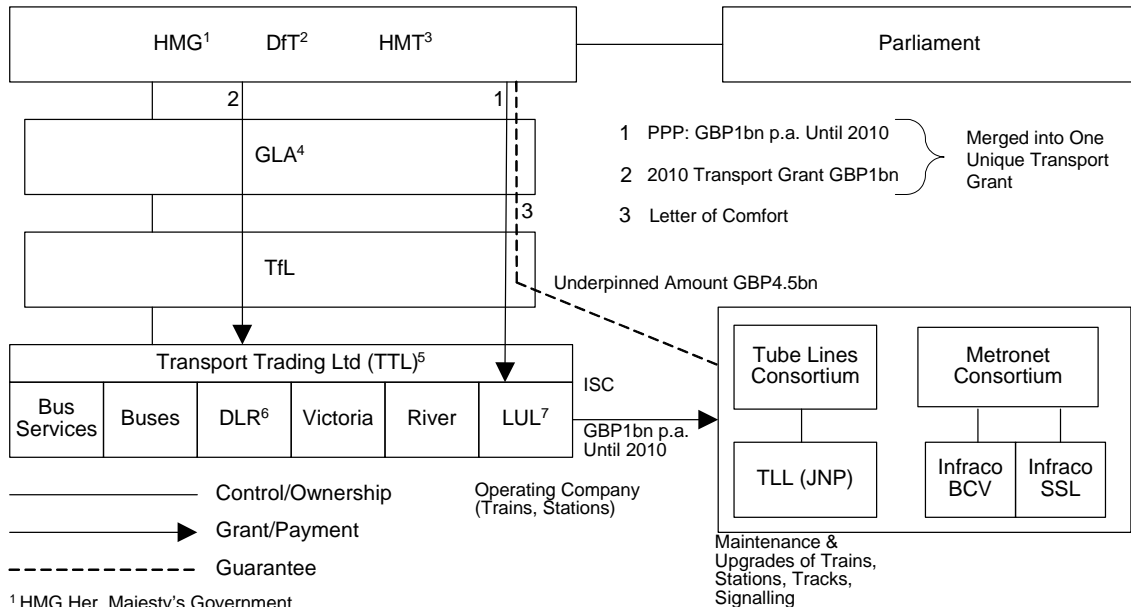
Historical Background

Date	Event
Mar 1998	British Deputy Prime Minister Announces the PPP.
Nov 1999	Greater London Authority Act LUL Restructured in Preparation of PPP
May 2000	Creation of the GLA Election of London’s Mayor
Jul 2000	Transport Becomes GLA’s Responsibility Through Newly-Created TfL
Jul 2001	First Judicial Review; Lost by Mayor.
Jul 2002	End of Judicial Review, Withdrawing of TfL’s Claim
31 Dec 2002	Tube Lines Signs Contract for 1 Infraco
4 Apr 2003	Metronet Signs Contracts for 2 Infracos
15 Jul 2003	Transfer of LUL to TfL

Source: Fitch Ratings

■ Appendix D

TfL/LUL/DfT Commitments in Respect of PPP



- ¹ HMG Her Majesty's Government
- ² DfT Department for Transport
- ³ HMT Her Majesty's Treasury
- ⁴ GLA Greater London Authority
- ⁵ TTL Transport Trading Limited
- ⁶ DLR Docklands Light Railway
- ⁷ LUL London Underground Limited
- ISC Infrastructure Service Charge
- LRT London Regional Transport
- DTLR Department of Transport London and Regions

Source: Fitch

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