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 Outlook			Stable

Analysts

Nicolas Painvin, Paris
+33 1 44 29 91 28
nicolas.painvin@fitchratings.com

Fernando Mayorga, Barcelona
+34 93 323 84 07
fernando.mayorga@fitchratings.com

Summary Data

	31 Mar 05	31 Mar 04
Operating Rev. (GBPm)	4,713.8	4,938.2
Debt (GBPm)	1,285.8	577.1
Operating Bal./ Operating Revenue (%)	24.2	24.9
Debt Service/ Current Revenue (%)	0.1	0.0
Debt/Cur. Balance (Yrs)	1.1	0.5
Operating Balance/ Interest Paid (x)	277.7	n.a.
Capital Expenditure/ Total Expenditure (%)	24.4	18.6
Surplus (Deficit) Before Debt Variation/Total Rev. (exc. New Debt) (%)	5.7	11.3
Current Balance/ Capital Expenditure	102.8	146.9

Profile

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 over all responsibilities for buses and other transport functions in London from the government (roads and bridges, buses, river services and taxis etc.) in July 2000. London Underground Limited was passed to TfL only in July 2003 after lengthy political and judicial disputes, once the public private partnerships ("PPPs") were established in late 2002 and in early 2003.
TfL's 437 km of subway and 580 km of bus routes serve an urban area that is home to 7.4 million people; it employs 19,400 staff.

■ Rating Action and Outlook

The ratings primarily reflect TfL's position in the British political and institutional set-up, giving it good access to governmental funding, which is secured by a five-year agreement. The ratings also consider TfL's sound budgetary performance. However, they take into account TfL's ambitious capital spending plan, which will be partially debt-financed.

The Stable Outlook reflects the political and financial visibility of TfL in the next two years of operations. Fitch will monitor TfL's financial planning and ensure that borrowing is in line with projections and hence remains compatible with the 'AA' rating.

■ Key Rating Factors and Performance

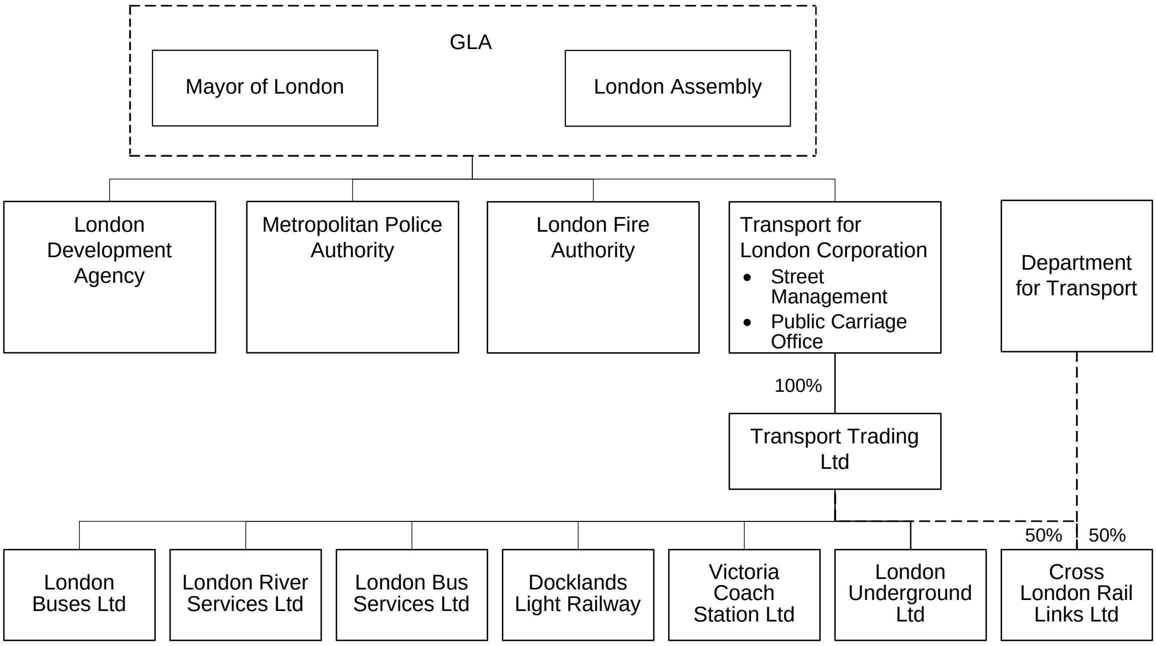
Positive rating factors include:

- TfL has, remarkably, reached the first operational and financial targets set in the business plan that it introduced in 2003. Though relatively rigid, its budget structure gives good predictability: it is primarily funded by the Department for Transport ("DfT") through the Transport grant (45% of TfL's total resources in 2004/05), which is secured by a five-year settlement. Fares (41% of revenue) are set by the Mayor.
- Low debt. The TfL group (corporation and subsidiaries) currently has a low debt outstanding (GBP1.3 billion including financial leases) and a high level of liquidity, with liquid assets exceeding financial liabilities as at 31 March 2005.
- Despite revisions, the projections of the business plan remain balanced, and the amount of debt to be raised until 2010 remains unchanged at GBP3.3 billion.

Negative rating factors include:

- The ambitious capital spending plan for 2005-10 has been increased by GBP2.7bn, GBP1.75bn of which will be financed by third parties, while GBP950m will correspond to new projects and cost increases, including approximately GBP200m for the Olympic bid for 2012. These GBP950m are expected to be funded mainly through an increase in TfL's own resources, which makes its ability to meet its targets for fare and patronage growth even more critical.
- Limited and shrinking budgetary flexibility. Although TfL has demonstrated its capacity to increase fares if necessary and will use this flexibility to support its development, it has only limited leeway given the already relatively high fares. Other revenue sources (including the congestion charge) provide little scope for material increase and, in any case, account for only 9% of total revenue in aggregate. Expenditure is also relatively inflexible, with staff costs (19%) and contract payments (52%) making up the bulk.
- PPPs have not proven as efficient as expected in terms of service improvement and still represent a potential source of operational and contractual risks.

Structure Diagram



Source: Fitch Ratings based on GLA and TfL

■ Institutional Framework

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.

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, it 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).

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

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, although from autumn 2007, the London rail services, collectively known as the North London Railway, will be managed by TfL.

The bulk of overland rail within London remains under the aegis of National Rail Networks and is regulated by the Department for Transport. 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;
- sets the fares for the Tube, buses, Docklands Light Railway, Croydon Tramlink and taxis;

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 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.

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 the 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 check 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, the 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.

■ Administration

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 dramatically improve 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). The success of London's Olympic bid in July 2005 has underlined the commitment of central government to supporting the upgrade of the capital city's transport network. Fitch shares the view that the organisation of the games will ease the implementation of the Mayor's transport strategy, although the agency will monitor the actual financial support delivered to TfL from the central administration. Transport projects related to the Olympics are integrated in the business plan discussed in this report.

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 *Revenue* section); and (ii) the letter of comfort provided by the Secretary of State in respect of TfL's guarantee on LUL's commitment to its PPP counterparties (see *Contingent Liabilities* section).

Transport Provision

Transport Modes	Passenger Journeys a Year (m)	Operation Mode	Maintenance of Infrastructure
Buses	1,793	Concession	Contractors
Underground	976	Direct (LUL)	PPP (Infracos)
Light Rail (Tram* + DLR)	72	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 based on TfL

TfL is Ultimately Answerable to 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 leads a total of 19,400 people.

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 (TfL, the London Development Agency, the Metropolitan Police Authority and the London Fire and Emergency Planning Authority).

A six-year business plan (currently 2005-10) is prepared every year and approved by the board, consisting of 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.

TfL's financial debt is contracted by the Corporation. To service the debt, it relies on the Transport Grant that it receives directly from the DfT, as well as on internal flows from trading subsidiaries.

Advanced Corporate Governance

TfL has strongly endeavoured 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 by the following factors:

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

■ Finances and Performance

Business Plan Increases Investment; Unchanged 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 current 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 GBP12.5bn in grants for the period. TfL and the DfT have also agreed to lower cost increases and substantially higher fare revenue, which includes increases in bus fares that are substantially higher than inflation. Together, these actions have eliminated the funding gaps identified in previous years.

Through the update of December 2005, the ambitious capital spending plan for 2005-10 has been increased by GBP2.7bn, of which GBP1.75bn will be financed by third parties[1], while GBP950m will correspond to new projects and cost increases, including approximately GBP200m for the Olympic bid for 2012. These GBP950m will be funded mainly through an increase in TfL's own resources (primarily fares and fees). Overall, the projections of the plan remain balanced, and the amount of debt to be raised until 2010 remains unchanged at GBP3.3bn.

Fitch will closely monitor TfL's ability to meet the more demanding projections set out in the revised 2005-10 business plan, and notably its ability to raise the required own resources.

Revenue

Fares are Critical but Offer Little Flexibility

Fares are an important source of income for the TfL budget (41% of revenue in 2005), and represent a growing and much higher proportion than in many European transport systems (28% in Greater Paris). Annual Tube travelcards for zones 1 to 4 cost approximately 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 among the most expensive in the world: GBP1.5[2] (approx. EUR2.2) for a single trip in zone 1. The fare structure is, however, highly sophisticated, with pricing innovation (off-peak prices, family discounts etc), and is much more market-orientated than in other cities.

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[1] The bulk of the increase relates to the capital expenditure of PPP projects, whose valuation was updated in the most recent Annual Asset Management Plans provided by the infracos. This results in a change of breakdown between operating and capital expenditure within the Infrastructure Service Charge paid by TfL, which remains unchanged.

[2] When paid via the new Oyster fare system; GBP3 (approx EUR4.4) when paid with cash (i.e. more than three times the price paid in Paris)

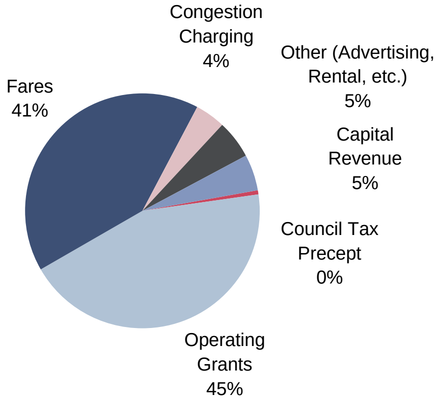
Budgetary Projections

(GBPm)	Forecast 2005/06	Budget 2006/07	Plan 2007/08	Plan 2008/09	Plan 2009/10
Local Tax	20.0	12.0	22.0	23.0	25.0
Transfers Received (Transport Grant)	2,168.0	2,383.0	2,549.0	2,665.0	2,709.0
Fares, Charges and Other Revenue	2,727.0	2,956.0	3,194.0	3,361.0	3,506.0
Current Revenue	**4,915.0**	**5,351.0**	**5,765.0**	**6,049.0**	**6,240.0**
Operating Expenditure	-3,488.0	-3,821.0	-4,054.0	-4,248.0	-4,504.0
Operating Balance	**1,427.0**	**1,530.0**	**1,711.0**	**1,801.0**	**1,736.0**
Financial Revenue	52.0	53.0	47.0	44.0	38.0
Interest Paid	-2.0	-59.4	-95.1	-136.5	-176.3
Current Balance	**1,477.0**	**1,523.6**	**1,662.9**	**1,708.5**	**1,597.7**
Capital Revenue	185.0	236.0	194.0	132.0	123.0
Capital Expenditure	-772.0	-766.0	-1,149.0	-1,332.0	-1,034.0
Capital Projects (PFI-PPP)	-1,420.0	-1,609.0	-1,332.0	-1,294.0	-1,368.0
Capital Balance	-2,007.0	-2,139.0	-2,287.0	-2,494.0	-2,279.0
Balance Before Debt Variation	**-530.0**	**-615.4**	**-624.1**	**-785.5**	**-681.3**
Debt Repayment	-8.0	-25.6	-36.9	-50.5	-62.7
New Borrowing	550.0	604.0	600.0	750.0	600.0
Net Debt Increase (Decrease)	542.0	578.4	563.1	699.5	537.3
Net Surplus/(Deficit)	**12.0**	**-37.0**	**-61.0**	**-86.0**	**-144.0**
Contingencies	**0.0**	**-26.0**	**-27.0**	**-28.0**	**-28.0**
Adjust for Working Capital, Reserves	**-11.0**	**63.0**	**89.0**	**114.0**	**172.0**
Surplus/Deficit	**1.0**	**0.0**	**1.0**	**0.0**	**0.0**
DEBT STOCK (Consolidated)					
Short-Term	n.a.	n.a.	n.a.	n.a.	n.a.
Long-Term Financial Debt (excl. Leases)	738.0	1,316.4	1,879.5	2,579.0	3,116.3
Direct Debt	**738.0**	**1,316.4**	**1,879.5**	**2,579.0**	**3,116.3**

Source: Fitch, based on TFL business plan (updated in March 2006)

Although fares are relatively high, further increases appeared necessary to achieve the targets of the revised business plan. Fares are the sole responsibility of the Mayor. 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. The first two years of RPI+10[3] fare increases on buses and RPI+1 increases for the Underground have been put into effect, and a third round of increases has been publicly announced for January 2007. However, these increases predominantly apply to single tickets purchased for cash, whereas a growing number of travellers are using prepaid media (Oyster Card).

Breakdown of Revenue
As of 2004/05 Accounts



Source: TfL

A Monopoly Position and Low Risk of Swings in Demand

As an MTA, TfL has a monopoly position in the organisation of urban transport in London. TfL is not exposed to competition in its role of integrated transport provider (no outsider private or public

[3] Retail Price Index + 10%

transport provider can arise). Indeed, the risk of Londoners strongly reducing their use of urban transport facilities is unlikely.

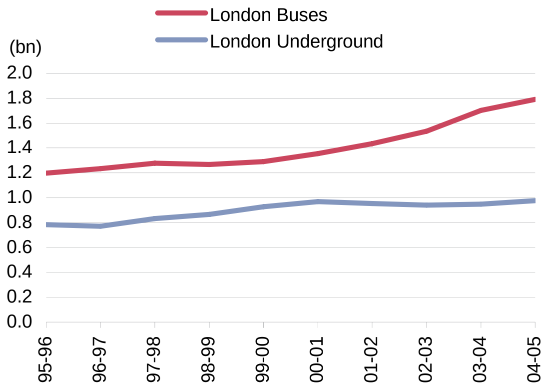
Bus Patronage is Growing Strongly while Tube Use Is Contingent on a Reduction in Capacity Gaps

As highlighted by the Audit Commission report issued in late 2005, the growth of bus use in London has been well above targets and is a combination of increased investment and the introduction of measures that support public transport. Except for extraordinary events (terrorist attacks, major floods, fires, derailments), and for a limited period, users may have no other option but to take buses and the Tube. This was illustrated in summer 2005, after terrorist attacks hit the UK capital city (7 and 21 July); patronage recovered from the service interruption caused by the attacks just months afterwards.

On a longer term view, however, the significant changes in the fare system may have adverse effects on paid patronage and Fitch will therefore monitor the price-elasticity of the demand. As far as the Tube is concerned, the actual improvement in service and the development of capacity, which is still below expectations (see comments on PPP below), will be key to the recovery of a growth trend.

Despite the risk of lower economic growth, Fitch believes the patronage trend is supported by strong structural elements: the development of population in the urban area is fuelling the customer base, while the enhanced service and network quality – as well as the extension of the congestion charge area – are also contributing to a greater use of public transport. In addition, the cyclical increase in oil prices makes the use of private vehicle more expensive and favours TfL's offer.

Passenger Journeys per Annum



Source: TfL

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 reduces this risk; and (ii) this would not have a sudden impact even were it to happen. This is a very strong credit factor.

Central Government Grants Remain Crucial...

Grants are the major item in TfL's revenue statement, representing 45% 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 its 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.

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, i.e. 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 ability to tap into 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 (GBP20m in the 2005/6 budget, i.e. 0.5% of budgeted revenue). The Mayor's has made a policy decision to earmark this portion of the council tax to transport policing. It is not supposed to fund the service itself.

Congestion Charging: Strategic Success

On 17 February 2003, TfL launched the congestion charge, which 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 congestion charge was raised from GBP5 to GBP8 as of 4 July 2005. In September 2005 the Mayor approved the extension of the congestion charging zone to include the western portion of central London as of 19 February 2007. However, the revenues yielded by the extension are expected to be largely offset by the costs of administering this area.

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 is Secondary

Most of the fixed assets are self-financed, thanks to the GLA Transport Grant (see above), which is now made without restriction to either operating or capital requirements (LUL used to receive a central government grant hypothecated for capital expenditure). TfL receives capital receipts from third parties.

Expenditure

Staff Costs and Energy Prices Put Upward Pressure on Expenditure

The TfL group employed around 20,000 people at mid-March 2006 and staff costs make up some 19% of total expenditure (including contract staff). As expected, this amount has risen significantly after agreements were reached with the Tube drivers' trade unions in 2004. A reduction in the working week – 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. The safety measures taken after the July 2005 terrorist attacks have entailed new hires in British Transport Police, which added pressure to staff costs.

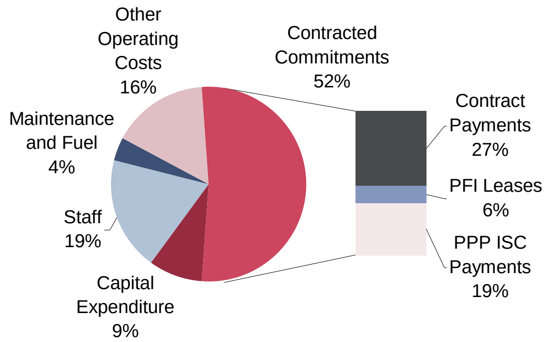
The increase in energy prices also have weighed on TfL's costs. The electricity bill alone has increased by GBP58m in 2004-05.

Contracts make up a Large Proportion of Expenditure

TfL has outsourced many of its responsibilities, including bus services, all of which 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). Over the long term, this contract structure offers some flexibility. 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.

Breakdown of Expenditure

As of 2004/05 Accounts



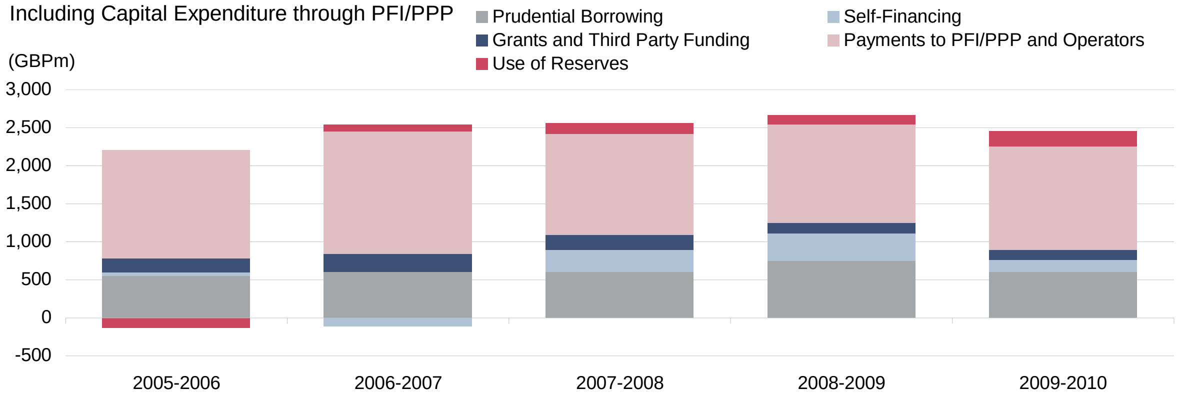
Source: TfL

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 Alstom[4]). They total

[4] 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.

Sources of Funding for Investment

Including Capital Expenditure through PFI/PPP



Source: Fitch, based on TfL's 5-Year Investment Programme (Dec 2005), updated March 2006

approximately GBP310m p.a. and represent a growing share of LUL's operating expenditure.

PPP Charges are Balanced by Equivalent Central Government Grants

One major expenditure item will be connected with the PPP contracts, i.e. the Infrastructure Service Charge ("ISC"). These are amounts paid every four weeks to the infrastructure companies ("infracos"), corresponding to the maintenance and renewal works that they provide on the underground network and rolling stock (see below *Contingent Liabilities*). Under a commitment made by the DfT in February 2003, this expenditure will be taken into account in the level of the Transport Grant. However, any necessary uplifts and adjustments in the grant will form part of the global negotiation with the central government.

TfL is Committed to Realising 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 GBP161m in 2004/05, significantly higher than the revised GBP42m of the previous year. However, TfL's objective of saving a total of GBP1,137m by 2010 remains a challenge, and Fitch will monitor progress in this area.

The Capital Expenditure Plan Mainly Relies on PFI/PPP Solutions

TfL has published an ambitious capital expenditure plan that totals GBP12.4bn for the period 2005-10 (more than half being dedicated to works on the Tube). The investments over this period are projected to be fully funded and many of these projects are supposed to be financed through PFI/PPP schemes (a total of GBP6.8bn). The most relevant projects in TfL's Investment Programme are the Underground renewal works, carried out through the set of PPP contracts. The balance of capital expenditure (GBP5.6bn) will be debt-financed (GBP3.1bn) or self-financed (GBP2.1bn, including third-party grants and the use of reserves). Within these on-balance financings, the East London Line Extension is estimated to cost GBP0.94bn. These and certain other projects related to the successful bid for the 2012 Olympic Games have increased the importance of TfL's capacity to manage its investment programme to ensure that it is on time and on budget.

Beyond this period, and outside of the above-mentioned investment plan, the most important project is Crossrail (now estimated at a cost of GBP10.3bn), a regional train line similar to the Parisian RER. It is jointly sponsored by TfL and the Department for Transport, and will probably not require any funding out of TfL's existing resources.

The table below details the major infrastructure projects currently envisaged, a large proportion of them focusing on the East London development.

Major Infrastructure Projects

Project	Amount (GBPbn)	Funding Mode	Time Frame
Crossrail	10.3	DfT	2015
West London Tram & Cross River Tramway	1.22	PFI	2008/11
DLR Extensions	0.39		
Woolwich Arsenal	0.20	PFI	2009
Stratford International	0.19	TfL	2010
Thames Gateway Bridge	0.46	PFI/Toll	2012
East London Line	0.94	TfL	2010

Source: Fitch, 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, TfL is initiating a clear catch-up process 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 *Institutional Framework* section, the local authorities' finance framework applies to the TfL corporation and used to regulate its ability to borrow. Until 2004, the entity had no long-term financial debt and it is expected to report a relatively low GBP750m financial debt at end-March 2006 (excluding financial leases).

This low-debt situation must be placed in the context of an important feature of TfL: the PPP contracts to a greater extent provide external funding sources (rather than just the outsourcing of operating services), as the PPPs 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. Consequently ISC payments (see below *Contingent Liabilities*) can be partly incorporated into debt servicing[5].

A GBP3.3bn MTN Programme

According to the prudential borrowing regime adopted for local authorities by parliament in September 2003, 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 fully match the requirement identified in the business plan, though TfL will consider other means of 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, of which TfL issued GBP196m. TfL has agreed with the government that the remaining GBP204m will be spread evenly over the remaining years of the investment programme.

For 2005/06, the TfL Board approved a cap of GBP550m on additional borrowing, broken down as follows: GBP18m from the European Investment Bank (against a total line of agreed credit of GBP450m to be drawn over the next five years); and the balance from a bond issue and the Public Works Loan Board ("PWLB"), a specialist lender to local governments.

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 case of extraordinary need.

Contingent Liabilities

Pensions

A majority of TfL's employees are members of the LRT Pension Fund, a defined benefit scheme managed by a wholly owned subsidiary of TfL. The fund's actuary makes valuations every three years and recommends the level of contributions to be made by the participating employers to ensure the long-term solvency of the fund. TfL's actuarial valuation of the fund was carried out on 31 March 2003 and showed a deficit of GBP450m. Fitch notes that the latest valuation of the fund, carried out on 31 March 2005, showed a deficit of GBP946m under FRS-17 standards[6]. Provisions to keep the fund balanced include annual payments of GBP170m. 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.

Guarantees

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

TfL has provided performance guarantees to the International Olympic Committee as part of its successful bid for the 2012 games. However, these

[5] In the Public Sector Comparator simulations, which are supposed to provide alternative funding solutions to the PPP scheme, three separate bond drawdowns were assumed, GBP477m in 2002, GBP2,904m in 2007 and GBP2,658m in 2012.

[6] These standards require the discounting of projected pension liabilities by the 'AA' high-quality corporate bond rate, and measure them against the market valuation of assets. This FRS-17 deficit is relatively unchanged since 31 March 2003 (GBP920m), because the increase in pension liabilities has occurred in the context of lower interest rates, offsetting the increases in employee contributions, and strong returns on investments.

guarantees only apply to projects to be delivered. There are no fixed or implied amounts of capital expenditure.

LUL's PPP Obligations are Backed by the Government

The PPP is a suite of 30-year service contracts between LUL and three privately owned infracos for the maintenance and upgrade of the Tube's infrastructure (see details in Appendix C of Fitch's report dated November 2004). 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.

The risks and obligations for LUL (and thus for TfL) in relation to the infracos are twofold:

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, need to substitute itself with one or all of the infracos and repay between 95% and 100% of the debt (called the Underpinned Amount), i.e. 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 (e.g. the Northern Line PFI with Alstom) and the additional work to be undertaken under those contracts.

Back-Up from Central Government

The DfT issued a letter of comfort to the infracos' providers of finance, which: (i) ensures that ISCs are taken into account when setting the GLA Transport Grant; and (ii) states that "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 Commitments Given and Received Related to PPP

It is Fitch's view that, given the complexity of the service contracts, there is a risk that circumstances could arise in which TfL's guarantee would be triggered. 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.

PPPs – An Update

In recent months, infracos have been under pressure, TfL and the Mayor having publicly voiced their concern about the value for money provided: according to TfL works are being carried out, but the progress is too slow and insufficient, given the sums of money involved. Two Corrective Action Notices were issued to Metronet in 2004/05. TfL noted: "Much of the work that has been achieved appears to be costing more than anticipated in the bids, particularly for Metronet, and there is evidence that some payments to contractors are running ahead of performance. This may reduce leverage for both infracos and LU". Both infracos have critical challenges:

Tube Lines must restore the performance of the Northern line, the worst-performing line, to at least the standard seen on the Jubilee and Piccadilly lines.

Metronet must prove that its corporate structure is sufficiently robust to make up for delays in its renewal programmes and deliver the balance of them as per the original schedule.

Fitch recognises that 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 default [7](of TfL on the PPP) for the financial community and the future of the whole PFI/PPP programme, which is the backbone of the UK's public infrastructure upgrading effort.

[7] 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 (Consolidated)

(GBPm) Adjusted[1]	Actual 2000/01	2001/02	2002/03	2003/04	2004/05	Forecast[2] 2005/06
Taxes	7.4	10.1	35.8	57.8	25.8	20.0
Transfers Received	573.5	1,177.1	1,771.4	2,559.6	2,133.5	2,168.0
Fees, Fines and Other Operating Revenue	1,703.6	1,181.1	1,963.5	2,320.8	2,554.5	2,727.0
Operating Revenue	**2,284.5**	**2,368.3**	**3,770.7**	**4,938.2**	**4,713.8**	**4,915.0**
Operating Expenditure[3]	-1,832.2	-2,400.5	-3,124.9	-3,708.0	-3,575.4	-3,488.0
Operating Balance	**452.3**	**-32.2**	**645.8**	**1,230.2**	**1,138.4**	**1,427.0**
Financial Revenue	0.0	0.0	7.1	18.5	55.4	52.0
Interest Paid[3]	0.0	0.0	0.0	0.0	-4.1	-2.0
Current Balance	**452.3**	**-32.2**	**652.9**	**1,248.7**	**1,189.7**	**1,477.0**
Capital Revenue	154.5	100.1	159.3	180.5	252.8	185.0
Capital Expenditure	-606.4	-650.9	-804.3	-849.9	-1,157.4	-2,192.0
Of which Estimated Capital Value of PFI/PPP's				-475.6	-712.1	1,420.0
Capital Balance	-451.9	-550.8	-645.0	-669.4	-904.6	-2,007.0
Surplus (Deficit) Before Debt Variation	**0.4**	**-583.0**	**7.9**	**579.3**	**285.1**	**-530.0**
Debt Repayment	0.0	0.0	0.0	0.0	0.0	-8.0
New Borrowing	0.0	0.0	0.0	0.0	196.0	550.0
Net Debt Movement	0.0	0.0	0.0	0.0	196.0	542.0
Overall Results	**0.4**	**-583.0**	**7.9**	**579.3**	**481.1**	**12.0**
Debt Stock						
Short-Term (Incl. Financial Leases)	22.1	39.9	55.3	173.5	453.7	n.a.
Long-Term (Incl. Financial Leases)	0.0	0.0	0.0	403.6	832.1	n.a.
Total Debt	**22.1**	**39.9**	**55.3**	**577.1**	**1,285.8**	
- Cash and Liquid Deposits	51.4	143.1	179.8	874.8	1,350.5	n.a.
Net Commitment	**-29.3**	**-103.2**	**-124.5**	**-297.7**	**-64.7**	
Guarantees[4]				5,488	5,484	n.a.
Net Debt of Public Sector Entities				0	0	n.a.

[1] Adjustments include the reclassification from operating expenditure to capital expenditure of the capital value of PFI/PPP payments, in order to allow comparisons with international peers
[2] Classification may not be exactly comparable between "actual" and "forecast" presentations.
[3] Financial leases and interest on pensions are included in operating expenditure
[4] of which: (i) GBP4,453m of guarantees was given to PPP contractors, backed by central government; and (ii) GBP1,031m is the maximum amount envisaged to be drawn by PFI counterparts, which could be payable by TfL under a guarantee or a contractual commitment
n.m. : Not material, n.a. : Not available

Appendix B

Transport for London

Actual (%)	2000/01	2001/02	2002/03	2003/04	2004/05
Fiscal Performance Ratios					
Operating Balance/Operating Revenue	19.8	-1.4	17.1	24.9	24.2
Current Balance/Current Revenue[1]	19.8	-1.4	17.3	25.2	24.9
Surplus (Deficit) Before Debt Variation/Total Revenue[2]	0.0	-23.6	0.2	11.3	5.7
Overall Results/Total Revenue	0.0	-23.6	0.2	11.3	9.6
Operating Revenue Growth (Annual % Change)	n.a.	3.7	59.2	31.0	-4.5
Operating Expenditure Growth (Annual % Change)	n.a.	31.0	30.2	18.7	-3.6
Current Balance Growth (Annual % Change)	n.a.	-107.1	-2127.6	91.3	-4.7
Debt Ratios					
Debt (Annual % Change)	n.a.	n.a.	n.a.	n.a.	122.8
Interest Paid/Operating Revenue	0.0	0.0	0.0	0.0	0.1
Operating Balance/Interest Paid (x)	n.a.	n.a.	n.a.	n.a.	277.7
Debt Servicing/Current Revenue	0.0	0.0	0.0	0.0	0.1
Debt Servicing/Operating Balance	0.0	0.0	0.0	0.0	0.4
Debt/Current Revenue	0.0	0.0	0.0	11.6	27.0
Debt and Guarantees Issued/Current Revenue	0.0	0.0	0.0	122.4	141.9
Debt/Current Balance (Yrs)	0.0	0.0	0.0	0.5	1.1
Debt/GDP	n.a.	n.a.	n.a.	n.a.	n.a.!
Liquid Assets Brought Forward/Debt Servicing	n.a.	n.a.	n.a.	n.a.	1099.0
Debt Per Capita (GBP)	n.a.	n.a.	n.a.	n.a.	n.a.
Revenue Ratios					
Operating Revenue/Budget Operating Revenue	n.a.	n.a.	n.a.	100.6	100.7
Tax Revenue/Operating Revenue	0.3	0.4	0.9	1.2	0.5
Current Transfers Received/Operating Revenue	25.1	49.7	47.0	51.8	45.3
Operating Revenue/Total Revenue	93.7	95.9	95.8	96.1	93.9
Total Revenue Per Capita (GBP)	n.a.	n.a.	n.a.	n.a.	n.a.
Expenditure Ratios					
Operating Expenditure/Budget Operating Expenditure	n.a.	n.a.	n.a.	n.a.	n.a.
Staff Expenditure/Operating Expenditure	n.a.	n.a.	n.a.	n.a.	26.1
Current Transfer Made/Operating Expenditure	n.a.	n.a.	n.a.	n.a.	n.a.
Capital Expenditure/Budget Capital Expenditure	n.a.	n.a.	n.a.	n.a.	n.a.
Capital Expenditure/Total Expenditure[3]	24.9	21.3	20.5	18.6	24.4
Total Expenditure[3] Per Capita (GBP)	n.a.	n.a.	n.a.	n.a.	n.a.
Capital Expenditure Financing					
Current Balance/Capital Expenditure	74.6	-4.9	81.2	146.9	102.8
Capital Revenue/Capital Expenditure	25.5	15.4	19.8	21.2	21.8
Net Debt Movement/Capital Expenditure	0.0	0.0	0.0	0.0	16.9
Change in Reserves/Capital Expenditure	-0.1	89.6	-1.0	-68.2	-41.6

[1] Includes financial revenue
[2] Excluding new borrowing
[3] Including debt repayments