Research Update:

High Speed Rail Finance (1) Outlook To Stable On Expected Traffic Recovery And Supportive Regulation; Rating Affirmed

May 6, 2022

Rating Action Overview

- High Speed Rail Finance (1) PLC (HSRF) has started to benefit from a rebound in subdued traffic levels. For the financial year ending March 2023, we expect a recovery in international traffic to close to 70% of pre-pandemic levels following the timetable submitted by international operator Eurostar and assuming no escalation in COVID-19 related restrictions. For domestic traffic, which is inherently stable, we still forecast volumes at the underpin level, which represents 95% of pre-pandemic levels.
- Despite the risks from the weaker macroeconomic backdrop and geopolitical conflict in Europe, we also expect HSRF1's recovery to hold up thanks to its supportive regulatory framework. The framework requires semi-annual adjustments to train charges in line with retail price index (RPI) inflation as well as pass-through of increasing operational costs, either directly or via the regulatory charging framework. It also has limited exposure to capital expenditure (capex) because it is paid by train operators and funded through an escrow account.
- We have revised our outlook on HSRF1's senior secured debt to stable from negative and affirmed the rating on the debt at 'BBB+'.
- The stable outlook reflects the continued support from U.K.'s rail regulatory regime and our expectations of improving operating and financial performance amid a recovery in traffic despite the uncertainty in the sector.

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Project Description And Key Credit Factors

U.K.-based special-purpose entity HSRF1 issued £610 million senior secured fixed-rate bonds and £246.5 million senior secured index-linked bonds (£305.8 million outstanding on Sept. 30, 2021) due Nov. 1, 2038, to partially refinance the existing acquisition debt facilities of its sister company HS1, the ProjectCo. The original facilities were used to fund the acquisition from the U.K. government of HS1 by Borealis Infrastructure and Ontario Teachers' Pension Plan in November 2010. In September 2017, HS1 was acquired by a consortium of funds managed by Equitix

Investment Management Ltd. (35%) and third-party funds managed by Infrared Capital Partners Ltd. (65%).

HS1 Ltd. (HS1), the sister company of the issuer HSRF1, operates the high-speed railway network connecting St. Pancras International station in London with the Channel Tunnel boundary in southeast Kent under a concession with the U.K. Secretary of State expiring 2040. HS1 has been operating since 2007 and primarily relies on track access charges paid by train operating companies (TOCs) to service its debt. Under the concession, HS1 is responsible for the operations, maintenance, and renewal of the track and associated infrastructure, along with the four railway stations served by the route. In addition to domestic and international high-speed traffic, the rail line also serves a small portion of freight traffic.

In addition to the rated notes, the secured ring-fenced operating group comprises a £13.0 million bank facility outstanding on Sept. 31, 2021, and due March 2024 (not rated) issued by HS1, and a total of £853.9 million private placements by High Speed Rail Finance PLC (not rated) due between March 2028 and December 2039. All the senior secured debt (£1,783 million) ranks at the same seniority.

Strengths

- A proven supportive and transparent regulatory framework under which revenue generated from track access charges--which represents 90% of the project's total revenue pre-COVID-19--is regulated and subject to annual or semi-annual increases (depending on the charge component) in line with the retail price index (RPI).
- Domestic train path bookings, corresponding to approximately two-thirds of the regulated revenue, are protected by the U.K. Secretary of State's commitment to pay for 52,806 train paths per year, which largely mitigates the project's exposure to domestic volume risk.
- Under the "volume re-opener," HS1 has largely mitigated the effect of lower volumes on its operations and maintenance recovery charge (OMRC) costs. We expect this mechanism to remain in place until March 2025 by the time we expect Eurostar and SE's train path bookings to return to pre-pandemic levels.
- The project's strong competitive position results from operating a sole high-speed rail connection between London and continental Europe via the Dover-Calais crossing (known as the Eurotunnel).

Risks

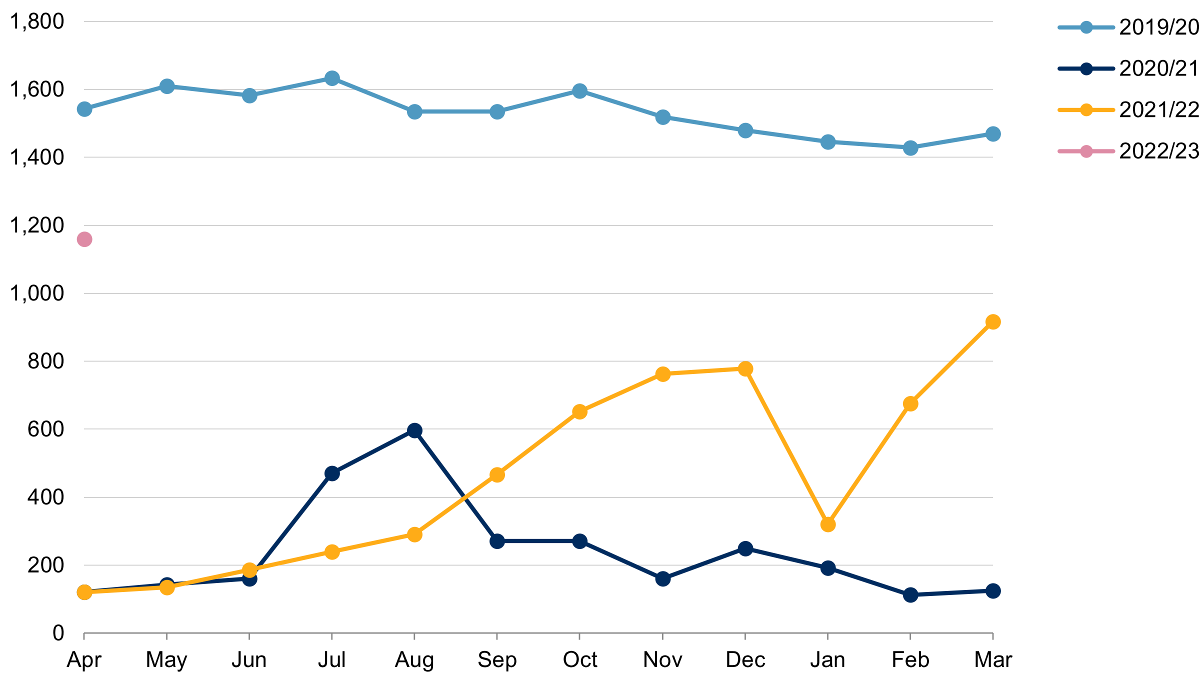
- One-third of the regulated revenue bears full volume risk of Eurostar's international train path bookings. Their upturn will depend on consumer's ability and willingness to travel under a context of inflationary pressures and geopolitical instability.
- The debt repayment profile is relatively back-ended because most of the facilities do not start amortizing until 2027 or 2028. The last private placement issued in December 2016 shortened the concession tail to one year from two and included a £130 million bullet repayment in December 2039.

Rating Action Rationale

Traffic volumes on the Eurotunnel are recovering and should further improve in the summer. The removal of pandemic-related travel restrictions on both the U.K. and France borders will support a material resurgence of international traffic through the Eurotunnel, as trains paths have responded to harsh border restrictions above all else. Our revised base-case scenario reflects Eurostar's pre-booked train paths of about 7,500 for 2022 complemented by additional spot bookings amounting to 5,600 train paths based on the more than 20 returned services Eurostar currently offers. It also considers the potential impact that rising inflationary pressures and geopolitical instability in Europe could have on consumers' ability and willingness to travel, although we expect most of the impact to be largely on passenger volumes rather than number of services. We have revised our forecast for 2022 and we now expect international traffic to reach about 65%-70% of pre-pandemic levels compared to our previous forecast of 80%. We do not expect the volumes of train paths to return to pre-pandemic levels before 2024 and Eurostar to fully revert to future bookings before the end of the current regulatory period (CP3) in March 2025. This is because, in our view, there is no tariff incentive over this volatile period to reserve most of the train paths quarterly in advance, and absent the entrance of any competitor the network has enough capacity to satisfy Eurostar's demand for services.

Chart 1

Monthly International Rail Traffic By Train Paths



Domestic services revenue continues to be underpinned by the Department for Transport (DfT), which limits HSRF1's exposure to still-recovering domestic traffic. Similar to last year, Southeastern Trains Ltd. (SET) submitted a timetable of train paths for mid-May to mid-December 2022 at approximately 12% below the minimum level guaranteed by the DfT. This means DfT will continue topping up the revenue for domestic train path bookings to the underpin level of 52,806 train paths per year. This level corresponds to about 95% of the pre-pandemic domestic timetable of 55,575 train paths. We assume domestic services will continue generating revenue based on the underpin amount until the end of CP3. Although we see a clear intention from the government to encourage citizens to return to previous modes of living, outstanding hybrid working arrangements by many employers continue to influence commuting, which is the main purpose of rail journeys in London. In the short to medium term, we expect these to be partially compensated by a shift toward rail away from car and coach use as a result of rising petrol prices. On a longer horizon, we do expect rail to play greater role as a primary modes of transport given its crucial role in the decarbonization strategy of countries because of rail's low emissions.

The supportive regulatory framework will mitigate weaker macroeconomic backdrop, although it could result in income timing differences. About 90% of total cash flow generation comes from regulated revenue. Under the framework, train operators running on HS1 have to pay a regulated charge that is designed to enable the company to recover in full the cost of construction, maintenance, and operation of the tracks and stations. Track charges are adjusted in line with RPI twice a year, which mitigates the rise of operational costs in a context of inflationary pressures in the U.K. In terms of capex, the budget is defined by the regulator and subject to a five-year regulatory cycle review, which permits HS1 to adjust charges to mirror any revision on construction and raw materials costs. Until the next control period review starting in April 2025, all variation costs would rest on the subcontractor Network Rail High Speed (NRHS) under the outstanding Operator Agreement.

At the same time, we expect high electricity prices to remain insulated from the company's operating expenses as regulatory framework pass-through power consumption to train operators. However, since traction electricity is billed monthly in arrears based on actual consumption rates instead of paid in advance, this should generate higher cash flow needs in the short term. We expect the impact to be limited and alleviated by the working capital facility of £84 million available in the structure.

The macroeconomic situation in Europe remains highly uncertain and volatile, and any disruption on revenue counterparties could potentially affect the project's recovery. Although we acknowledge that supportive regulation will allow the project to pass through most of the risks emerging from growing inflation, energy prices, and raw materials to train operators through train charges, HSRF1's cash inflows will rely on SET's and Eurostar's financial capacity. In our view, Eurostar introduces greater uncertainty as international travel is the most sensitive to increasing costs of living and geopolitical instability, which could affect its recovery in the short term. Meanwhile, we don't foresee any challenges arising from the domestic operator after London & Southeastern Railway (LSER) services were successfully handed over to the government-owned SET in 2021.

HS1's expected stability on cash flows compares favorably to the closest rated peer, Channel Link Enterprises Finance PLC (CLEF). HS1 benefits from a fixed-for-life RPI-linked revenue payment for 90% of the cash flow it generates. Track charges allow for cost pass-through, and the U.K. government guarantees most of the domestic traffic through the underpinned revenue, which mitigates the project's exposure to domestic market and volume risk. On the contrary, CLEF retains volume and price risk, and we would expect operational and financial pace of recovery to remain sensitive to more favorable market conditions. Although shuttlepricing is flexible, CLEF's exposure to car shuttle and Eurostar passenger volumes limits the direct pass-through of rising inflation, given that these segments are more exposed to consumers' discretionary spending, which could be affected in the short-term following the overall increase in the cost of living. Lastly, CLEF has an extensive capex program ahead and we deem the works as highly complex compared to HS1, given the Channel Tunnel's nature as an underwater large-span tunnel.

Outlook

The stable outlook indicates that we expect HSR1's operating and financial performance to improve gradually in the next 12-24 months amid an expected traffic recovery in 2022-2023 to about 80% of 2019's total volumes. It also reflects continued support from the U.K. rail regulatory regime that would allow the project to withstand challenging macroeconomic conditions.

Downside scenario

We could lower the rating if the pace of traffic recovery is severely disrupted by harsher macroeconomic conditions and geopolitical conflict or if we see an increasing risk of nonpayment coming from train operators that would affect the stability of cash flows. We could lower the rating if we expected HS1's annual debt service coverage ratio (ADSCR) to trend toward 1.20x in the next 12-24 months, or if we forecast the average ADSCR throughout the life of the project to be lower than 1.40x.

Upside scenario

We could take a positive rating action if we observe a material traffic recovery close to pre-pandemic levels, and some visibility on post-pandemic traffic patterns. We would also need to be confident that TOCs' passenger demand is robust enough to enable them to restore their operational and financial strength. This should allow HS1 to present DSCRs comfortably above 1.35x on a consistent basis.

Base Case

Assumptions

- International train paths: A combination of forward and spot bookings until March 2025. Total train paths in 2022 (12 months to March 2023): 7,462 as per Eurostar's submitted commitment and additional 5,600 booked on the spot; 2023: 16,123; 2024: 16,566; 2025: 18,461; 2026: 18,665; resumption of spot bookings of 130 train paths per year and around 300 on forward bookings from 2027 onwards.
- Domestic train paths: Until March 2025 (Q4 2025): an underpin amount of 52,806 paths per year. From April 2025: a flat rate of 55,575 train paths per year, which was the number run pre-Covid.
- Freight train paths: about 450-500 train paths per year.

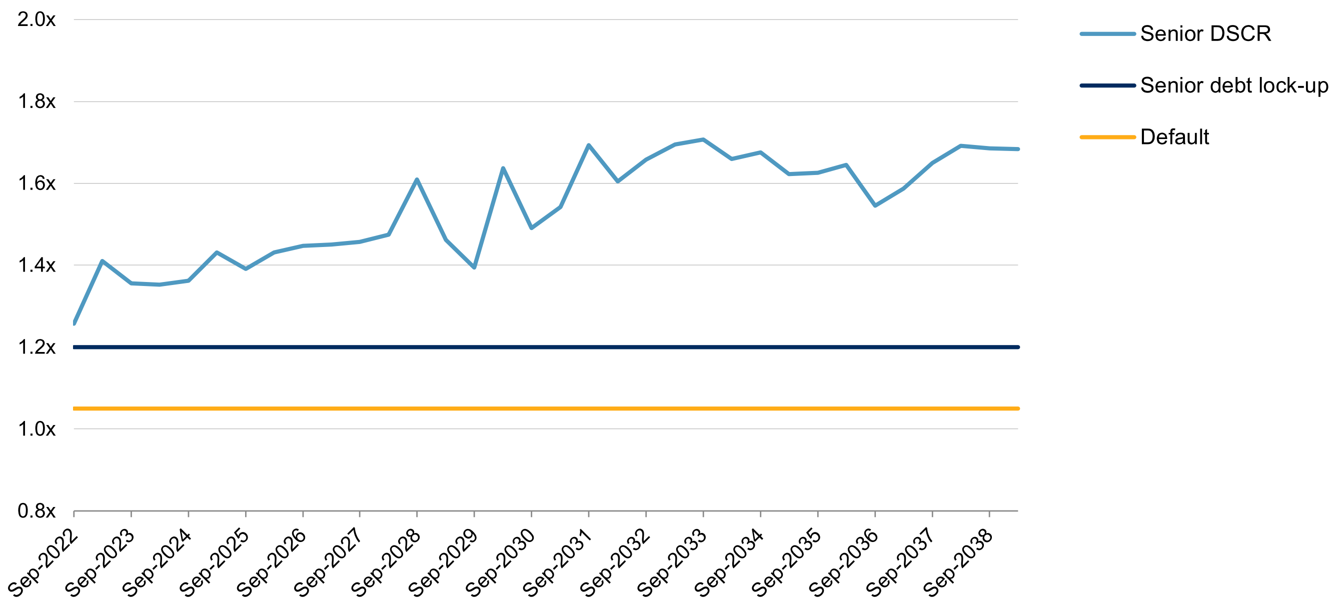
- Unregulated revenue from retail and carparks for March 2021-March 2024: We applied the following stresses to 2019 actual footfall:
- --Until March 2023: -20%;
- --Until March 2024: -10%;
- --Until March 2025: -5%; and
- --April 2025 onward: as per actual footfall in 2019.
- Operating costs: In line with management's forecast, with cost pass-through of the OMRC, power, and station costs.
- A recessionary period between 2035 and 2038, in line with our assumptions in the peer project, Channel Link Enterprise Finance PLC, which is designed to replicate the stress on the underlying volumes in 2008-2009.
- Cost of letter of credit (LoC): To ensure comparability in our cash flow analysis, we assume that the liquidity facility is drawn on an amount equal to the next six months of debt service. We also consider £51 million of the working capital facility as drawn, in line with project's actual balance.
- Tax rate: 2020-March 2023: 19%; from April 2023: 25%, as per the 2021 U.K. budget announcement.
- RPI: 8.5% for 2022; 4% in 2023; 2.2% for 2024; 2% for 2025; 2.9% for 2026-2030; and 2.00% growth thereafter, in line with S&P Global Ratings' macroeconomic forecasts.

Key metrics

- The project's 12-month backward-looking minimum ADSCR, calculated in accordance with our criteria, is 1.26x in September 2022, reflected in a 'bbb' preliminary operations phase SACP. We exclude the positive impact of Stratford land sales from our cash flow calculation for September 2022.
- The average ADSCR is significantly higher, at 1.54x, which we reflect through a one-notch positive adjustment to the preliminary operations phase SACP.

Chart 2

S&P Global Ratings' Base -Case DSCR



DSCR--Debt service coverage ratio.

Table 1

Preliminary Operations Phase SACP

	--Preliminary operations phase SACP outcome in column headers-- --Minimum DSCR ranges shown in the cells below*--				
	aa	a	bbb	bb	b
OPBA					
1-2	=> 1.75	1.75–1.20	1.20–1.10	<1.10§	<1.10§
3-4	N/A	=> 1.40	1.40–1.20	1.20–1.10	< 1.10
5-6	N/A	=> 2.00	2.00–1.40	1.40–1.20	< 1.20
7–8	N/A	=> 2.50	2.50–1.75	1.75–1.40	< 1.40
9–10	N/A	=> 5.00	5.00–2.50	2.50–1.50	< 1.50
11-12	N/A	N/A	N/A	=> 3.00x	< 3.00

*DSCR ranges include values at the lower but not upper bound. For example, for a range of 1.20x-1.10x, a value of 1.20x is excluded while a value of 1.10x is included. §To determine the outcome in these cells, the key factors are typically the forecasted minimum DSCR (with at least 1.05x generally required for the 'BB' category), as well as relative break-even performance and liquidity levels. Please see "Project Finance: Project Finance Operations Methodology," published Sept. 16, 2014. SACP--Stand-alone credit profile. OPBA--Operations phase business assessment. DSCR--Debt service coverage ratio. N/A--Not applicable.

Downside Case

Assumptions

- International train paths: December 2020-March 2025: A combination of forward and spot bookings with heavier reliance on spot bids. We model a slower recovery path in international train paths than under our base case.
- 2022: 7,462 as per Eurostar's submitted commitment and spot bids;
- 2023: 14,609; 2024: 16,566; 2025: 18,461; 2026: 18,665; resumption of spot bookings of 130 train paths per year and around 300 on forward bookings from 2027 onwards.
- This is followed by a second shock from 2035 based on our base case:
- --January 2035–December 2035: -15%
- --January 2036–December 2036: -10%
- --January 2037–December 2037: -5%
- Domestic train paths: Train paths at the underpin level of 52,806 per year through the life of the project.
- Freight train paths: No change from our base case
- Unregulated revenue: 10% below our base case in 2022-2025, followed by a 20% decline below our base case after 2025.
- Regulated costs: As per the base case.
- Unregulated costs: 20% above our base case.
- RPI: One percentage point above our base case for 2022-2026. Thereafter, in line with the base case (including the recessionary period 2035-2039).
- Cost of LoC: we assumed LIBOR at 6% throughout the life of the project.

Key metrics

- The project performs strongly under our downside-case scenario, with a minimum base-case ADSCR that remains above 1.10x supporting a downside assessment of 'a'. On top of this, the project benefits from a fully available 12-month debt service reserve facility.

Rating Score Snapshot

Operations phase SACP (senior debt)

- Operations phase business assessment: 4 (1=best to 12=worst)
- Preliminary SACP: 'bbb'
- Downside impact on preliminary SACP: 'a' (+1 notch)

- Debt structure: Negative (-1 notch)
- Forecast average ADSCR: Positive (+1 notch)
- Liquidity: Neutral (no impact)
- Comparative analysis assessment: None
- Operations phase SACP: 'bbb+'

Modifiers (senior debt)

- Parent linkage: Delinked (no impact)
- Structural protection: Neutral (no impact)
- Senior debt issue rating: 'BBB+'

Operations counterparties

- HS1's revenue comprises approximately 90% regulated revenue and 10% nonregulated revenue. The latter is generated by multiple station retail units and car park users, and, in our opinion, the rating does not depend on any individual nonregulated customer.
- Regulated revenue comprises the fixed investment recovery charge (IRC), the OMRC, and the qualified station expenditure charges (QX). HS1 passes the OMRC and QX charges through to the train operators, hence the IRC fuels HS1's profitability.
- Most of the IRC (approximately two-thirds of total cash flow) is provided by the domestic TOC and is directly underpinned by the U.K. government under the agreement effective since January 2015. Furthermore, the DfT maintains step-in arrangements that would enable it to take over a failing domestic TOC and directly operate its service. We therefore view the domestic TOC as a material and irreplaceable counterparty, with credit quality in line with our view of the U.K. government (unsolicited; AA/Stable/A-1+).
- HS1's regulated revenue is generated by two TOCs: SE and Eurostar. TOCs running on HS1 tracks have to enter into a track access agreement with HS1 and pay a regulated charge. We view the project's exposure to the IRC counterparties as material and our analysis to assess the dependency of HS1 to these counterparties adopts a rating to principles approach, using our criteria "General Criteria: Principles Of Credit Ratings," published Feb. 16, 2011, in conjunction with our "Project Finance Construction And Operations Counterparty Methodology," published Dec. 20, 2011. Under the rating to principles approach, we determine the overall revenue counterparty credit quality by calculating the weighted average creditworthiness of the two revenue counterparties in proportion to their regulated revenue contribution. The revenue counterparty credit quality under this approach does not constrain the debt rating.
- We consider the operations and maintenance counterparty, Network Rail High Speed (NRHS), to be irreplaceable, and we weak link the issue rating on the project's debt to the credit quality of NRHS, which is not a rating constraint. NRHS retains performance risk and the responsibility for safety under railway regulation, in line with the operator's role in transport projects. NRHS' payment and performance obligations benefit from a guarantee from its parent company, Network Rail Infrastructure Ltd. (Network Rail). Network Rail is funded by the debt program of Network Rail Infrastructure Finance PLC, which is a government-related entity, and which we rate in line with our rating on the U.K. government.

- U.K. Power Networks (UKPN) operates the electricity distribution infrastructure and supplies electricity under a finance lease agreement (through to 2057) with HS1. The electricity distribution market is wide in the U.K. and we believe that UKPN could be replaced if necessary, without material disruption. We therefore do not weak link the debt rating on the project to the credit quality of UKPN.
- The ratings on the project debt are weak linked to the ratings on the swap counterparties and working capital facility providers because the terms of the swap and liquidity facilities do not fulfil our criteria requirements for collateral and timely replacement. However, the rating on these counterparties does not constrain the rating on the project's debt.

Liquidity

- We assess the project's liquidity as neutral. The project maintains a 12-month liquidity facility agreement through March 2040 equal to the forthcoming 12 months of scheduled debt service, including swaps (£125 million liquidity facility as of March 31, 2022, fully undrawn). In addition, as of the same date, HSRF1 had £33 million undrawn out of a £84 million working capital facility.
- For the maintenance of the assets and replacement capital expenditure, the project maintains escrow accounts into which it places the renewals component of the regulated revenue.

Other modifiers

- We apply a one-notch negative debt adjustment due to amortization of the debt being relatively back-ended.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Key Credit Factors For Road, Bridge, And Tunnel Project Financings, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Operations Methodology, Sept. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Financial Institutions | Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria | Corporates | Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- High Speed Rail Finance (1) PLC 'BBB+' Rating Affirmed; Outlook Remains Negative On Delayed Traffic Recovery, May 13, 2021
- High Speed Rail Finance (1) PLC Debt Downgraded To 'BBB+' On Expected Eurostar Traffic Decline; Outlook Negative, Oct. 20, 2020

Ratings List

Ratings Affirmed; Outlook Action

	To	From
High Speed Rail Finance (1) PLC		
Senior Secured	BBB+/Stable	BBB+/Negative