Research Update:

High Speed Rail Finance (1) PLC 'BBB+' Rating Affirmed; Outlook Remains Negative On Delayed Traffic Recovery

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Rating Action Overview

- Travel restrictions on both sides of the Channel Tunnel are persisting amid concerns over delays in the rollout of vaccines on the continent. We have therefore deferred our forecast start of recovery of international traffic served by Eurostar International Ltd. to the second half of 2021.
- The exposure of High Speed (1) PLC (HS1), the sister company of the issuer, High Speed Rail Finance (1) PLC (HSRF1), to domestic traffic is protected by the commitment from the Department for Transport (DfT) to purchase a minimum level of trains paths corresponding to 95.8% of the pre-pandemic domestic train paths.
- Despite HS1 implementing a number of debt-cost-saving initiatives, fewer trains running will lead to the annual debt service coverage ratios (ADSCRs) remaining lower than we previously expected in 2021-2023, with the minimum under our base case occurring in March 2022 at 1.25x.
- We have affirmed our 'BBB+' issue rating on HSRF1's senior secured debt.
- The negative outlook reflects continued risks to our forecasts due to uncertainty around the timing of the opening of the border between France and the U.K., and the pace of traffic recovery.

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 (£292.3 million outstanding on Aug. 31, 2020) 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 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 March 31, 2021, and due March 2024 (not rated) issued by HS1, and a total of £859.5 million private placements by High Speed Rail Finance PLC (not rated) due between March 2028 and December 2039. All the senior secured debt (£1,778 million) ranks at the same seniority.

Strengths

- A supportive and transparent regulatory framework under which revenue generated from track access charges--which represents 90% of the project's total revenue--is regulated and subject to annual increases in line with the retail price index (RPI).
- Domestic train path bookings, corresponding to approximately two-thirds of the regulated revenue, are largely protected by the U.K. Secretary of State's commitment to pay for 52,806 train paths on average per year, which largely mitigates the project's exposure to domestic volume risk.
- 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 Eurotunnel).

Risks

- The project bears full volume risk of Eurostar's international train path bookings. These have been reduced to skeleton operations due to COVID-19-related travel restrictions. Their upturn will depend on recovery of demand for international travel and Eurostar's ability to operate the services.
- 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

We expect international traffic served by Eurostar to start recovering at some point in the second half of 2021. This will depend on both the U.K. and France opening their borders, and travelers' confidence being restored in both the safety of travel in confined spaces and the cessation of unexpected travel restrictions. Given the holdups in the rollout of vaccinations on the continent, the resumption of international travel could be further delayed. There is also a risk that traffic resurgence may be too late to take advantage of school summer holidays when the demand for travel is usually highest. We do not expect the volumes of train paths reserved to return to pre-pandemic levels before 2023-2024, or Eurostar to revert to future bookings before the end of the current regulatory period (CP3) in March 2025. This is because we understand that over the next few years, there is no tariff incentive to reserve train paths quarterly in advance, and absent the entrance of any competitor, the network has enough capacity to satisfy Eurostar's demand for services.

Although not our base case, any disruption to Eurostar's operations could weigh on HS1's path to recovery. Eurostar, whose services generated about 30% of HS1's revenue before the outbreak of COVID-19, is currently operating two return services a day, one to Paris and one to Amsterdam. This compares with about 24 return services previously. We understand such a low level of operations has strained HS1's liquidity position. Although not our base-case expectation, if Eurostar were unable to continue operations, this could further disrupt HS1's revenue generation, although in our opinion any period of disruption would be limited. We expect that in this situation another operator would step in to provide services. That said, despite currently operating only about 3% of pre-pandemic services, Eurostar has committed to pay HSRF1 for 2,444 train paths per year until at least December 2021. This corresponds to about 14% of train paths run in the year to March 2019.

The DfT is topping up revenues for domestic path bookings to the underpin level. London & South Eastern Railway Limited (LSER) submitted a timetable of train paths for mid-May to mid-December 2021 at approximately 16% below the minimum level guaranteed by the DfT. The effect of this lower booking level is mitigated by the DfT topping up the revenues for the domestic train path bookings to the underpin level of 52,806 train paths on average per year. The underpin level corresponds to about 95.8% 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 the CP3, as hybrid working arrangements by many employers could deal a lasting blow to the demand for domestic travel, in particular commuting travel. In the longer term, we expect these could be partially compensated by a shift from car, coach, and air travel to rail on environmental grounds. As demand reaches pre-pandemic levels, we expect that future timetable bookings could be complemented by additional spot bookings.

Under the "volume re-opener," HS1 can recover its operations and maintenance recovery charge (OMRC) costs despite fewer train paths, although this incurs negative working capital in the near term. In February 2021, HS1 was granted a "volume re-opener" by the Office of Rail Regulation to allow it to recover its fixed OMRC costs over the fewer train paths than were forecast at the start of CP3 (April 2020-March 2025), and allocate those costs between the TOCs. The re-opener has largely mitigated the effect of lower volumes on the OMRC. However, given that from December 2020, Eurostar has not been paying track access charges quarterly in advance, but only monthly in arrears, based on actual services run, cash flow available for debt service for the purpose of the ADSCR calculation in March 2020 and September 2020 will not include the revenues of the following three months. The negative working capital impact will continue in 2021 and 2022. As we expect Eurostar's path bookings will increase toward the second half of CP3, we anticipate positive working capital in 2023, thus allowing full cost recovery over the whole period.

HS1 implemented cash-management initiatives to increase headroom over the ADSCR of 1.20x under the lockup covenant. The initiatives included:

- Prepaying, in December 2020, £28 million of a £41 million outstanding bank facility A due in March 2022.
- Extending, in March 2021, the maturity of the remaining £13 million of bank facility A to March 2024 from the original date of March 2022. We consider this transaction as opportunistic as it involved two lenders upsizing their participation to £6.5 million each from £2.2 million before, while four other lenders exited the facility. There was no change to the structure or covenants of the facility, although a small increase in the interest margin coincided with converting the base rate of Libor to Sonia.
- Upsizing the working capital facility to £84 million from £65 million.
- Bringing forward some operating expenditure invoices to before March 31, 2020.
- Deferring non-urgent expenditure and reducing discretionary capital investments. This has led to an overall 18% reduction of the capital expenditure program until 2039.

We forecast that the headroom under the ADSCR as of September 2021 has increased, but expect a minimum ADSCR of 1.25x as of March 2022. Given the above initiatives, we now estimate the historical ADSCR as of September 2021 to be around 1.28x, rather than the 1.23x we previously expected. Therefore, we no longer exclude this period from our analysis. However, due to the delayed traffic recovery, we now anticipate the ADSCR was at its lowest in March 2022, at 1.25x. While the now-expected minimum ratio is lower than the 1.33x we previously forecast (after excluding 1.23x expected in September 2021), in our view, it still corresponds with the project's stand-alone credit profile (SACP) of 'bbb'. For the period ending Sept. 30, 2020, HS1 reported a 12-month historical ADSCR of 1.49x, and a forward-looking ADSCR of 1.22x for the following 12 months. HS1 has not yet reported the corresponding ratios for the period ending March 31, 2021.

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects.

Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Outlook

The negative outlook reflects the uncertainties related to when the border between the U.K. and France will reopen and the journey to recovery for international train paths used by Eurostar, which accounted for about 20% of HS1's total pre-pandemic revenues. A slower recovery in travel could reduce HS1's cash flows more than we anticipate in the next 12-24 months, in turn reducing dividend distributions to the parent company, Betjeman Holdings Ltd. We expect LSER to continue operating at the underpin level of train paths until the end of the current regulatory period in March 2025. However, we anticipate Eurostar traffic, and the unregulated retail revenue, to start recovering gradually from the summer months of 2021, and reach pre-pandemic levels by March 2025. While we envisage a rapid traffic recovery driven by pent-up demand for visiting family and leisure travel, rating downside could arise from a lesser ability or propensity to travel, in particular by commuters and business travelers; from further health-related restrictions; or harsher macroeconomic conditions.

Downside scenario

We could lower the rating by one notch if we expected HS1's ADSCR to trend toward 1.20x in the next 12-24 months, or if the average ADSCR throughout the life of the project were lower than 1.40x. The former could occur, for example, because of further travel restrictions and delays in traffic recovery due to further new variants of COVID-19 emerging, or because of a traffic disruption due to Eurostar's inability to provide services. The latter could be triggered by lower-than-expected unregulated revenue, for example.

Upside scenario

We would revise the outlook to stable if COVID-19-related traffic disruption were contained, a risk of further traffic restrictions due to health concerns diminished, we observed strong traffic recovery for Eurostar, and the economic situation stabilized.

Base Case

Assumptions

- International train paths: As per spot bids until March 2025. Until Sept. 31, 2021 (first and second quarter [Q1 and Q2] 2022) 2,444 paths per year, as per Eurostar's commitment under the volume re-opener. In Q2 and Q3, 3,588 additional spots due to traffic recovery. Total train paths in 2022 (12 months to March 2022): 7,919; 2023: 14,772; 2024: 16,071; 2025: 16,536; resumption of spot bookings of 130 train paths per year from 2026.
- Domestic train paths: December 2020 to 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: Flat at 800 train paths per year.
- Unregulated revenue from retail and carparks for March 2021-March 2024: We applied the following stresses to 2019 actual footfall:
- --April 2021-June 2021: -97% to reflect the very low load on the trains;
- --July-September: -95%;
- --October 2021-December 2021: -35%, reflecting recovery and Christmas traffic;
- --January 2022-June 2022: -40%;
- --July 2022-September 2023: -10%;
- --October 2023-March 2025: -5%; and
- --April 2025 onward: as per actual footfall in 2019.

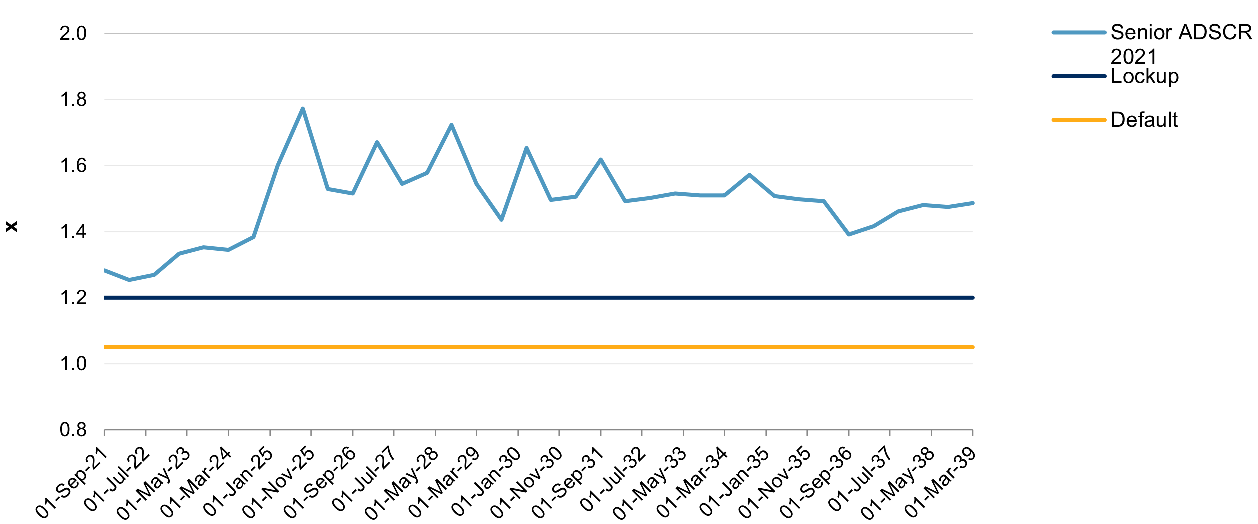
- Minimum annual guaranteed revenue: In line with management's forecast, minus 5% to reflect a potential loss of tenants.
- Operating costs: In line with management's forecast, with cost pass-through of the OMRC, power, and station costs.
- A recessionary period between 2035 and 2038, in line with our assumptions in the peer project, Channel Link Enterprise Finance PLC, which is designed to replicate the stress on the underlying volumes in 2008-2009.
- To ensure comparability in our cash flow analysis, we assume that the liquidity facility (£125 million as of September 2020, fully undrawn) is fully drawn and the reserve account is cash-funded.
- Tax rate: 2020-March 2023: 19%; from April 2023: 25%, as per the 2021 U.K. budget announcement.
- RPI: 2.22% for 2021. We assume inflation of 2.68% in 2022; 3.05% in 2023; 3.26% for 2024; 3.21% for 2025-2029; 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 1.25x in March 2022, reflected in a 'bbb' preliminary operations phase SACP.
- The average ADSCR is significantly higher, at 1.49x, which we reflect through a one-notch positive adjustment to the preliminary operations phase SACP.

Chart 1

S&P Global Ratings' Base-Case ADSCR



ADSCR--Annual 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: As per spot bids. We model a steeper decline in international train paths versus 2019 and a longer recovery than under our base case:
- --October 2021-September 2022: -84.7%
- --October 2022-September 2023: -98%
- --October 2023-March 2024: -50%
- --October 2023-March 2024: -50%
- --April 2024-September 2025: -40%
- --October 2025-March 2030: -10%
- --April 2030 -March 2032: -5%

This is followed by a second shock from 2035:

- January 2035–December 2035: -20%
- January 2036–December 2036: -13%
- January 2037–December 2037: -7%

- Domestic train paths: Train paths at the underpin level of 52,806 per year.
- Freight train paths: No change from our base case, plus three-year train path shocks in 2021 and 2035 (-20% / -13% / -7%) to reflect a prolonged pandemic impact in January

2021-December 2023, and a tunnel fire in January 2035-December 2037.

- Unregulated revenue: 10% below our base case in 2020-2023, which already reflects a traffic decline impact, followed by a 20% decline below our base case after 2023.
- Regulated costs: As per the base case.
- Unregulated costs: 20% above our base case.
- RPI: One percentage point below our base case for 2021-2025. Thereafter, in line with the base case (including the recessionary period 2035-2039).
- Libor: 1% in September 2021-March 2023, 2% until September 2023, followed by 3%.

Key metrics

- The project performs strongly under our downside-case scenario, supported by the 12-month debt service reserve facility. The minimum base-case ADSCR remains above 1.10x most of the time, supporting a downside assessment of 'a'.
- We incorporate a one-notch positive adjustment in the preliminary SACP to reflect the project's strong financial performance under the downside-case scenario. This reflects the contractual agreement that supports domestic revenue and protection afforded to HS1 by the revenue payment mechanism, along with our expectations that international demand will not decline materially from current levels.

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: 'bbb' (no impact)
- Debt structure: Negative (-1 notch)
- Forecast average ADSCR: Positive (+1 notch)
- Liquidity: Neutral (no impact)
- Comparative analysis assessment: Positive (+1 notch)
- 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 one-third of total revenues) 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: LSER 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 April 2021, fully undrawn). In addition, as of the same date, HS1 had £39 million undrawn out of a £84 million working capital facility that was extended to April 2024, and £3.5 million of available cash.

- 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.
- We apply a one-notch positive adjustment reflecting high--on average--ADSCR throughout the life of the project.
- We also apply a one-notch positive comparative adjustment to reflect that HS1 benefits from the additional protection--not available to its peers--against revenue volatility and traffic decline because the DfT underpins the domestic train paths. Revenue generated based on the underpin amount would cover--on average during the concession life--the project's debt service, although the ADSCR would not necessary be above 1.0x in all periods due to the working capital impact.

Related Criteria

- 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: Project Finance Operations 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
- 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

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

- High Speed Rail Finance (1) PLC 'A-' Rating Placed On CreditWatch Negative Amid Eurostar Train Paths Uncertainty, July 31, 2020

Ratings List

Ratings Affirmed	
High Speed Rail Finance (1) PLC	
Senior Secured	BBB+/Negative