S&P Global
Ratings

RatingsDirect®

High Speed Rail Finance (1) PLC

Primary Credit Analyst:
Luisina Berberian, Madrid +(34) 91-788-7200; luisina.berberian@spglobal.com

Secondary Contact:
Beata Sperling-Tyler, London (44) 20-7176-3687; beata.sperling-tyler@spglobal.com

Table Of Contents

High Speed Rail Finance (1) PLC

Credit Rating(s)	
Senior Secured	
£246.5 mil 1.566% index-linked bnds due 11/01/2038	
Local Currency	A-/Stable
£610 mil 4.375% bnds due 11/01/2038	
Local Currency	A-/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country.

Project Description

U.K.-based special-purpose entity High Speed Rail Finance (1) PLC (HSRF1) is a finance vehicle for HS1 Ltd. (HS1, the project operating company; not rated), the operator of the U.K.'s sole high-speed rail line. HS1 operates under a 30-year concession agreement with the U.K. Secretary of State through December 2040 and is regulated by the Office of Rail and Road (ORR), an independent U.K. regulator. 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, which it subcontracts to Network Rail High Speed (NRHS) under a fixed price agreement through 2047. The rail line, which connects St. Pancras International station in London with the Channel Tunnel boundary in south-east Kent, provides track access to domestic and international high-speed traffic, plus a small quantity of freight traffic. HS1 has been in operation since 2007.

HSRF1's debt facilities comprise £610 million rated senior secured fixed-rate bonds and £246.5 million rated senior secured index-linked bonds (£285 million outstanding on March 31, 2019), both due Nov. 1, 2038. The other senior project debt in the secured ring-fenced operating group comprises a £98 million seven-year bank facility due March 31, 2022 (£78 million outstanding on March 31, 2019), issued by HS1, and a total of £879 million private placement notes due between March 2028 and December 2039 issued by High Speed Rail Finance PLC (HSRF; not rated). All senior secured debt ranks pari passu.

Credit Highlights

Overview	
Key strengths	**Key risks**
Transparent and supportive regulatory framework	Exposure to international train paths
Strong competitive position	Back-ended amortization profile

The project has a clear and transparent regulatory framework, including a fixed-for-life retail price index (RPI)-linked revenue payment, underpinned by the U.K. government via the Secretary of State and signed in 2010. This feature, in our view, helps mitigate the project's exposure to domestic market and volume risk.

As the sole high-speed rail connection between London and Continental Europe via the Dover-Calais crossing (known as the Fixed Link), the project has a strong competitive position. The Dover–Calais corridor is the shortest and most widely used of all cross–channel routes. The tunnel is directly linked to the British and French motorway and railway networks.

The project is exposed to international train paths' revenue, which has shown some volatility owing to larger train sizes, terrorist attacks in France and Belgium, and the potential impact of the Brexit vote. However, the project's market exposure to international routes is mitigated by the obligation for train paths to be booked up to 12 months in advance, and paid for quarterly in advance, irrespective of whether the service is run.

The amortization of the debt is relatively back-ended for a project reliant on growth assumptions. The majority of the facilities do not start amortizing until at least 2027. In addition, the December 2016 debt issuance shortened the concession tail to one year from two years, and includes a bullet repayment of £130 million in December 2039. We reflect this weakness by applying a one-notch negative debt structure adjustment.

Outlook

The stable outlook on HSRF1's debt reflects our view that the project will continue to deliver strong operational performance and benefit from a supportive and stable regulatory regime. The outlook also factors in the project's strong competitive position as operator of the sole high-speed train route connecting the U.K. to Continental Europe, as well as our view that the minimum annual debt service coverage ratio (ADSCR) of at least 1.4x under our base case is sustainable.

Downside scenario

We could lower the rating on HSRF1's debt if the project's financial profile weakened, causing the minimum ADSCR to fall below 1.4x or a weakening of performance under our downside scenario. This could occur because of operational underperformance or long-term reduced demand for international train paths, resulting, for example, from the impact of Brexit or terrorist events. A prolonged period of materially high inflation could also lead to deterioration in the project's financial performance under our ADSCR calculation, which treats the net revenue RPI swap payments as scheduled debt service, although we view such a scenario as unlikely.

We could also lower the rating if the project becomes exposed to additional counterparty risk. Revenue counterparty risk could increase, for example, through the weakening of the credit quality of existing or new train operators. Financial counterparty risk could heighten as a result of a downgrade of swap counterparties or working capital facility providers to below the project debt rating level, or if the project incurs additional exchange-rate risk due to the issuance of a further tranche of foreign currency-denominated debt with a lower-rated swap counterparty.

Upside scenario

A positive rating action is unlikely, in our view, without further significant improvement in our base-case projection of the minimum ADSCR, assuming no counterparty rating constraint. For us to consider an upgrade, we would need to observe a minimum ADSCR of about 1.80x, or a restructuring of the debt repayment profile to make it less back-ended.

Performance Update

International paths: Flat expectation in the short term and increasing in later years

In the fiscal year (FY) ending March 31, 2019, international train paths--operated by Eurostar International Ltd. (EIL)--showed a strong growth of 4% versus FY2018, rising to 18,070. This was above our forecast of 17,780, and a result of the 7% increase in passenger numbers to 11 million in 2018.

Traffic numbers were boosted by the opening of the Netherlands route, which transported 250,000 passengers between April 2018 and December 2018. This is a positive development after 2018's 8% reduction versus 2017, reflecting EIL's tough operating environment following the terrorist attacks in France and Belgium. The EIL rollout of new E320 larger capacity trains (which have a 20% greater passenger capacity) also contributed to the train-path reduction on the main Paris route.

For FY2020, HS1 expects EIL train paths to remain almost flat, owing to larger trains and the Amsterdam services being extensions of the Brussels service, rather than additional train paths. HS1 has an expectation of 18,215 EIL train paths, comprising 17,523 First Working Timetable (FWT) and 692 spot train paths. EIL is increasing the use of spot train paths as a means of managing station capacity constraints and providing scheduling flexibility. This limits EIL's exposure to train cancellations. HS1 receives quarterly in-advance revenue receipts from EIL, based on the pre-agreed annual timetable (the FWT), which helps to protect HS1 from short-term passenger fluctuations. The quarterly payments are a material feature, which has supported HS1's traffic visibility and operational resilience ahead of Brexit in the past two years.

We continue to forecast flat international train paths of 18,000 through FY2024, and a subsequent buildup to 22,000 train paths through to FY2040, to reflect an increase in services to new or existing destinations by either EIL or another international train operator. This compares prudently with HS1's forecasts, which anticipate over 30,000 train paths by the end of the concession.

Domestic market: Further delays in the rail-franchise program

Key domestic train operator, London & South Eastern Railway Ltd.'s (LSER's) franchise award was originally due to end on June 24, 2018, with an extension up to Jan. 6, 2019, followed by a refranchising bid. However, the U.K Department for Transport (DfT) cancelled the refranchising bid in August this year, and extended LSER's directly awarded contract to April 1, 2020.

This will ensure service continuity beyond the expected publication by the government of the Rail Review, which will look into the structure of the U.K. rail industry. It is expected to include train fares, refranchise processes, and performance-related targets, among other areas. We do not expect the HS1 concession to be materially adversely affected by a change in the framework resulting from the review.

Domestic train paths remain relatively stable, although HS1 has included in its forecasts a minor domestic train-path increase in the Ebbsfleet services, once the new franchisee contract is awarded. We do not anticipate any material interruption from the new franchisee award, and maintain our base flat demand of 55,575 train paths in our forecasts throughout the concession.

CP3 regulatory review

The regulator, the Office of Rail and Road (ORR), is required to carry out a periodic (every five years) review of the Operation, Maintenance, and Renewals Charge (OMRC). The ORR determines the level of costs that an efficient operator would incur, and so pass on to the train operating companies (TOCs). The recalibration has the scope to respond to any change in efficiently incurred costs and volumes, in effect minimizing HS1's exposure to fluctuation in operating costs. Track OMRC costs are split into two components: one at cost accounting for 15% (and passed through as incurred); and one at risk for the remaining 85% (reset every five years). Interim reviews (within a control period) may occur following a significant event, and ORR approval is required.

The control period 3 will commence on April 1, 2020, for the subsequent five years. The periodic review 2019 is currently taking place for the route and stations, and the regulatory authorities will publish a final determination in October for stations, and on Jan. 7, 2020 for route.

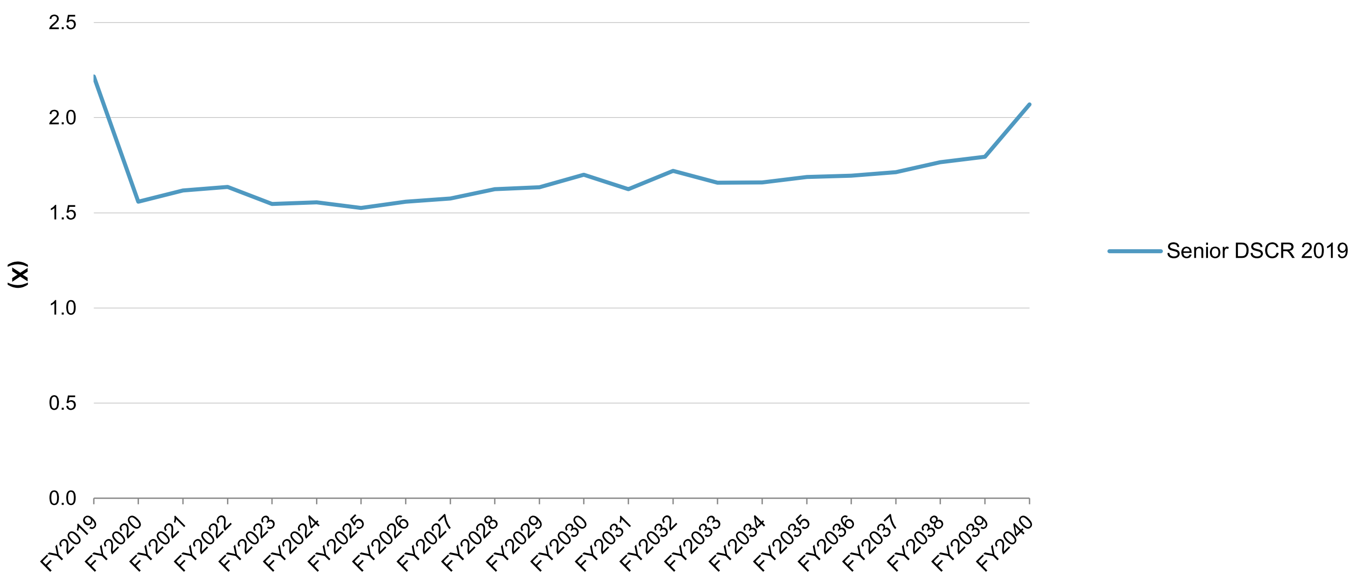
HS1 is assuming breakeven until the outcome is known. It is worth noting that, as per the fixed price operator agreement, until March 2025 the operator, Network Rail (High Speed) Ltd., takes regulatory risk associated with OMRC revisions for control periods 2 and 3, hence HS1 should be protected.

International Financial Reporting Standards (IFRS) conversion of the group

The whole group is now aligned to IFRS service concession accounting. The adoption of IFRS will not change the underlying contracts of the business. We understand this has been pursued to gain group simplicity and ease of comparability, together with minor changes to the tax profile over the concession. We do not expect this change to have an impact on the debt service coverage ratios. In addition, our forecast this year is already incorporating the expected tax payments under IFRS, starting from this financial year.

Chart 1

High Speed Rail Finance (1) PLC--S&P Global Ratings' Base-Case Debt Service Coverage Ratio



DSCR--Debt Service Coverage Ratio.

Table 1

High Speed Rail Finance (1) PLC--Preliminary Operations-Phase Stand-Alone Credit Profile

	aa	a	bbb	bb	b
Operations-phase business assessment			**--Minimum DSCR ranges*--**		
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.

Base Case

Assumptions	Key Metrics
• International train paths: 17,780 total services in FY2019, and flat at 18,000 through to FY2024. Linear total growth of 4,000 train paths thereafter, through the end of the concession. This profile reflects the tough operating conditions facing international traffic demand in the short term in light of larger train sizes and the potential impact of the Brexit vote. Our medium-term growth forecast models the introduction of new services by EIL or a new operator to existing or new destinations, such as Amsterdam or Frankfurt. • Domestic train paths: Flat demand of 55,575 train paths per year. • Freight train paths: Flat at 800 train paths per year. • Spot train paths: Flat at 130 train paths per year for both domestic and international operators. • Unregulated revenue from retail and carparks: about £38 million in March 2020; zero real growth thereafter. • Operating costs: In line with management's forecast, with cost pass-through of the operations and maintenance renewals charge (OM&RC), power, and station costs. • RPI: 2.5% for 2019, 2.7% for 2020, and 3.5% for 2021. We assume inflation of 3.1% in 2022, 3.3% for 2023-2027, 3.1% in 2028-2032, and 3.0% growth thereafter. • A recessionary period between 2035 and 2039, designed to replicate the stress experienced in 2008-2009 and in line with the assumptions in the peer project, Channel Link Enterprise Finance PLC. • Interest income: None, in line with our ADSCR calculation. • To ensure comparability in our cash flow analysis, we assume that the liquidity facility is fully drawn and the reserve account is cash funded.	• Minimum ADSCR: 1.53x in 2025. • Average ADSCR: 1.66x. • The minimum forecast ADSCR remains above 1.40x, which supports a preliminary stand-alone credit profile (SACP) of 'a-' given the project's operations-phase business assessment (OPBA) of '4'. • Chart 1 shows the profile of our forecast base-case debt service coverage ratios (DSCR).

Downside Case

Assumptions	Key Metrics
• International train paths: Flat at 18,000 total train paths, plus two three-year shocks starting in 2021 and 2035. The shocks reflect the impact of an incident, such as a tunnel fire, resulting in partial temporary tunnel closures with 20% capacity constraint in two consecutive semesters. Steady traffic recovery to pre-stress 18,000 train paths levels in the fourth year. • Domestic train paths: Train paths at the underpin level (53,000 train paths per year). • Freight train paths: No change from our base case, plus three-year train path shocks in 2021 and 2035 (as per international train paths). • Spot train paths: None. • Unregulated revenue: 20% below our base case. • Unregulated costs: 20% above our base case. • RPI: 1 percentage point below our base case for the five years (2018-2022). Thereafter, in line with the base case (including the recessionary period between 2035 and 2039).	• 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 1.2x at all times, supporting a downside assessment of 'aa'. • We incorporate a one-notch positive adjustment to the preliminary SACP to reflect the project's strong financial performance under the downside-case scenario. This is a reflection of the contractual agreement that supports domestic revenues and protection afforded to HS1 by the revenue payment mechanism, along with our expectations that international demand will not decline materially from current levels.

Peer Comparison

Table 2

Ratings Score Snapshot And Peer Comparison

	High Speed Rail Finance (1) PLC	Channel Link Enterprises Finance PLC	Verdun Participation 2 S.A.	Autopista del Sol, Concesionaria Española S.A.
Operations-phase SACP (senior debt)				
Asset class operations stability	3	3	3	2
Performance risk and market risk	1	1	1	2
Operations-phase business assessment	4	4	4	5
Minimum DSCR	1.53x	1.56x	1.19x	1.43x
Average DSCR	1.66x	1.87x	1.57x	2.35x

Table 2

Ratings Score Snapshot And Peer Comparison (cont.)				
Preliminary SACP	a-	a-	bb+	bbb-
Downside assessment	+1 notch ('aa' downside)	Neutral	+1 notch ('bbb' downside)	Neutral
Capital structure and avg. DSCR	-1 notch	--	-	+1 notch
Liquidity	Neutral	Neutral	Neutral	Neutral
Operations-phase SACP	a-	bbb+	bbb-	bbb
Modifiers (senior debt)				
Parent linkage	Delinked	Delinked	Delinked	Capped at BBB
Structural protection	Neutral	Neutral	Neutral	Neutral
Full credit guarantee	N/A	aa (G3 and G6 only)	N/A	N/A
Senior debt issue rating	A-	BBB+	BBB-	BBB

DSCR--Debt service coverage ratio. SACP--Stand-alone credit profile. N/A--Not applicable.

The closest peer for HSRF1 is Channel Link Enterprise Finance PLC (CLEF), which we rate one notch lower at 'BBB+'. CLEF has a minimum DSCR (1.56x) in line with HS1 and a stronger average DSCR of around 1.87x. Unlike HSRF1, CLEF does not have the protection of U.K. government-guaranteed revenues, nor does it receive advanced payments from any of its revenue counterparties. The latter is a material feature, which has supported HS1's traffic and operational resilience ahead of Brexit in the past two years. We assign an operations-phase business assessment (OPBA) of '4' to CLEF, in line with our OPBA assessment of HS1's OPBA, although the complexity of maintaining a large-span tunnel such as the Channel Tunnel is higher than the track and associated infrastructure of HS1.

Rating Score Snapshot

Operations-Phase SACP (Senior Debt)

- Operations-phase business assessment: 4 (1=best to 12=worst)
- Preliminary SACP: 'a-'
- Downside impact on preliminary SACP: 'aa' (+1 notch)
- Debt structure: Negative (-1 notch)
- Liquidity: Neutral (no impact)
- Comparative analysis assessment: None
- Operations-phase SACP: 'a-'

Modifiers (Senior Debt)

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

Operations-Phase SACP

- We assess the project to have moderate operating risk and assign an OPBA of '4'. The project's transparent and supportive regulatory framework helps to mitigate operational risk and, combined with a strong competitive position and very low market risk, leads to a strong operational performance.
- Based on the OPBA of '4', the minimum DSCR of 1.5x results in a preliminary operations phase SACP of 'a-'.

Operations Counterparties

- HS1's revenue comprises approximately 90% regulated revenue and 10% nonregulated revenue. The nonregulated revenue is generated by multiple station retail units and car park users and there is not, in our opinion, a rating dependency on any individual nonregulated customer.
- The regulated revenue comprises the fixed investment recovery charge (IRC), the OM&RC, and the qualified station expenditure charges (QX). HS1 passes the OM&RC and QX charges through to the train operators and therefore it is the IRC, which represents about 55% of total revenues under our base case, that fuels HS1's profitability and cash flow performance.
- The majority of the IRC (approximately 70%) is provided by the domestic TOCs and is directly guaranteed by the U.K. government under the agreement put in place in 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/Negative/A-1+).
- HS1 regulated revenues are generated by two TOC: London & South Eastern Railway Ltd. (LSER, trading as Southeastern) and EIL. TOCs running on HS1 tracks have to enter into a Track Access Agreement (TAA) 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 of their regulated revenue contribution. The revenue counterparty credit quality under this approach does not constrain the debt rating.
- We consider the operations and maintenance (O&M) counterparty, NRHS, to be irreplaceable, and we weak link the project's debt rating 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's payment and performance obligations benefit from a guarantee granted 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 rated 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 project's debt rating to the credit quality of UKPN.
- The ratings on the project debt are weak-linked to the ratings on the swap counterparties, as the terms of the swap do not fulfil our criteria requirements for collateral and timely replacement. The project's hedging policy states that HS1 may enter into swaps with counterparties rated 'A-' or above and that the swap counterparty is committed to taking corrective action when its rating falls below investment grade. The agreement does not, however, require the

counterparty to post collateral or provide a timely replacement. The project maintains interest rate and cross-currency swaps with a number of rated counterparties: National Australia Bank, BNP Paribas, Bank of Nova Scotia, Royal Bank of Canada, and Lloyds Bank. We rate all of these entities at least one notch higher than HSRF's debt and therefore they do not constrain the project's debt rating. Should the rating on any of the entities fall below the issue rating, we would assess the fallout from this counterparty failing to fulfil its obligations under the swap.

- The 12-month forward-looking liquidity facility is provided by three financial counterparties: National Australia Bank, Bank of Nova Scotia London Branch, and BNP Paribas. The terms of the liquidity facility require that we rate the counterparties at least 'BBB' and that, should the rating of any counterparty fall below this level, HS1 must replace it within 60 days. The replacement period is in line with the required remedy period stipulated in our criteria to support transactions rated at 'A-'.
- Similarly, the terms of the account bank agreement with The Royal Bank of Scotland PLC require the account bank to be rated at least 'BBB-' or to be replaced within 60 days. Assuming that the definition of 'days' is 'calendar days', our criteria requires the account bank to be rated at least 'BBB-' to avoid constraining our 'A-' rating.
- The ratings on the project debt are weak-linked to the ratings on the six £65 million working capital facility providers, each of which provides £10.8 million: The Royal Bank of Scotland PLC, Lloyds Bank, Canadian Imperial Bank of Commerce, Scotiabank (Ireland), BNP Paribas, and Export Development Canada. We rate these entities at least one notch higher than HSRF's debt, with the exception of Scotiabank (Ireland). We believe that the size of the facility is in excess of requirements and hence we can exclude these two weakest financial counterparties without affecting the liquidity position of the project. Hence, the ratings on the working capital financial counterparties do not constrain the rating on the project's debt rating.

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 (principal and interest, including amortization and interest of the offsetting swaps). In addition, the project maintains a £65 million working capital facility through March 2020 that is more than sufficient to meet its working capital needs. We assume that the project will readily renew or replace the working capital facility at its maturity.
- For the maintenance of the assets and replacement capex, the project maintains escrow accounts, into which it places the renewals component of the regulated revenues. The cost-pass-through nature of these charges largely mitigates lifecycle risk. The combined balance on these escrow accounts stood at £128 million in March 2019, and it is forecast to rise to about £150 million at the end of the current control period in March 2020.

Other Modifiers

- As described above, we apply a one-notch negative debt adjustment due to amortization of the debt being relatively back-ended.

Related Criteria

- 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

- Criteria | Corporates | Project Finance: Project Finance Transaction Structure 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 - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Criteria - Corporates - Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Transaction Update: High Speed Rail Finance (1) PLC, Dec. 10, 2019