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Transaction Update: High Speed Rail Finance (1) PLC

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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

Project Description

U.K.-based special-purpose entity High Speed Rail Finance (1) PLC (HSRF1) is a finance vehicle for High Speed 1 Ltd. (HS1, the project operating company), the operator of the U.K.'s sole high-speed rail line. HS1 operates under a 30-year concession agreement (CA) 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 the South East of 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, 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, issued by HS1 (not rated) and a total of £879 million private placement (PP) 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.

HS1's secured ring-fenced operating group is ultimately owned by a consortium of funds managed by Equitix Investment Management Ltd. (Equitix, 35%), and third-party funds managed by InfraRed Capital Partners Ltd (InfraRed, 65%) following their acquisition of the group in September 2017. The £500 million of new holding company (holdco) debt issued at Betjeman Holdings Ltd. at the time of the acquisition sits outside of the ring-fenced operating group and is fully subordinated to the senior secured debt.

Rationale

Our 'A-' long-term issue rating on HSRF1's debt reflects S&P Global Ratings' view of the project's operations-phase stand-alone credit profile (SACP), which we assess at 'a-'. The project entered into operations in 2007, and hence there is no construction risk.

Operations phase SACP: a-

The project benefits from a transparent and supportive regulatory framework that helps to mitigate operational risk and, combined with a strong competitive position and very low market risk, leads to a strong operational performance.

The rating is supported by the following strengths:

- The project has a strong competitive position as the sole high-speed rail connection between London and Continental Europe, via Eurotunnel.
- The majority of the project's revenues (about 90%) come from highly stable, regulated track and station related charges that are inflation-linked paid by the two train operators: the domestic train operator, LSER (trading as Southeastern); and the international train operator, Eurostar International Ltd (EIL).
- Domestic rail services are underpinned by the U.K. Secretary of State, which in our view mitigates the project's exposure to the domestic market risk. Furthermore, the project could, if required, fully cover its debt service based on revenue from the domestic agreement alone.
- Regulated revenues are supplemented by income from unregulated retail, car-parking, and commercial operations, which make up around 10% of total revenues. We do not factor in nominal revenue growth of nonregulated activities in our rating.
- The project's market exposure on international routes is mitigated by the obligation for train paths to be booked up to 12 months in advance and paid for irrespective of whether the service is run. The same advanced booking and payment requirement applies to domestic and freight services. There is robust demand for EIL services. We therefore assess market risk as very low.
- The project continues to deliver strong operational performance in terms of safety and track availability.
- The cost of operations is largely passed through to the track users. The track user charges are paid in advance of scheduled train services and include a fixed investment recovery charge (IRC), plus a regulated operations and maintenance renewals charge (OMRC) to cover the cost of the operations, maintenance, and renewal of the project's track infrastructure. Power and station usage charges are also applied. The regulated OMRC is reviewed every five years by the ORR and allows for virtually full cost pass-through.
- HS1 places the renewal component of the OMRC and of the station use charge into escrow accounts to cover renewal of the track and the four stations.
- The capital structure of the secured ring-fenced group is predominantly fixed-rate debt. The only floating debt is the £58 million index-linked U.S. private placement tranche C maturing in March 2031, in addition to the £65 million working capital facility (which is drawn and repaid periodically over a financial year). The remaining interest rate and currency exposure is largely mitigated via a portfolio of swaps.
- At the time of the new shareholder acquisition, HS1 put in place a £58 million 3.14% revenue retail price index (RPI) swap (settled twice a year) to lock in a minimum inflation increase on the underpinned domestic revenues.
- The debt benefits from a relatively high cash distribution covenant set at an annual debt service coverage ratio (ADSCR) of 1.20x.
- The project is supported by adequate liquidity in the form of a 12-month debt service reserve facility.
- The project demonstrates robust financial performance under our base case, with a minimum ADSCR of 1.44x and average ADSCR of 1.55x. This, combined with the relatively simple operations of the asset, very low market risk, and a strong competitive position, results in a preliminary operations-phase SACP of 'a-'.
- As a result of the contractual protections summarized above, the project is strong under our downside scenario, leading us to factor in a one-notch positive adjustment to our assessment of the preliminary operations-phase SACP.

The rating also reflects the following weaknesses:

- The project is exposed to revenues from international train paths, which have shown some deterioration in 2017, with the impact of terrorist attacks in France and Belgium and, potentially, Brexit being contributing factors. The continued uncertainty around these two factors has led us to adopt prudent assumptions in our base-case and downside-case analysis, under which the 'A-' rating continues to be supported.
- The amortization of the debt is relatively back-ended for a project reliant on growth assumptions, and we reflect this weakness by applying a one-notch negative debt structure adjustment to the preliminary operations-phase SACP. The December 2016 debt issuance has shortened the concession tail to one year from two years, and includes a bullet repayment of £130 million in December 2039.
- Despite HS1's November 2017 security trust and intercreditor deed (STID) amendment to offset the revenue RPI-linked income of the new revenue RPI swap against operating cash flows, we continue to treat net swap payments as scheduled debt service, in line with our project finance criteria. Consequently, a prolonged period of materially high inflation could weaken the financial ratio profile under our analysis, particularly towards the back-end of the concession. Finance performance under our base-case and downside-case assumptions is not impacted however.
- The rail line requires relatively complex maintenance services. However, we think this risk is largely offset by the subcontracting of these services in full the NRHS under a fixed-price agreement until 2047, beyond the term of the debt, which is subject to price adjustment every five years.
- The rating on the project's debt is weak-linked to the ratings on the interest rate, currency and revenue RPI swap counterparties, but none of these counterparties' ratings is currently a rating constraint.

Transaction Structure

- Parent linkage: Delinked
- Structural protection: Neutral

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 capital expenditure, 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 life cycle risk. The combined balance on these escrow accounts stood at £91 million in the financial year ending March 30, 2017, and we forecast that this will a rise to over £120 million at the end of the next control period in March 2020.

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 ADSCR of at least 1.4x under our base case is sustainable. The ratings on HSRFI's debt are supported by the project's strong contractual structure, including advance train path reservation and payment by train operators and an agreement guaranteed by the U.K. government underpinning domestic train paths. These factors help to provide performance resilience against stressed operating conditions.

Downside scenario

We could lower the rating on HSRFI's debt if the project's financial profile weakened, for example, as a result of operational underperformance or reduced demand for international train paths, causing the minimum ADSCR to fall below 1.4x along with a weakening of performance under our downside scenario. 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 ratings, if the project becomes exposed to additional counterparty risk, as a result of a fall in the ratings on swap counterparties or working capital facility providers to below the project 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. The account bank counterparty must be rated at least 'BBB-' to not constrain our 'A-' rating on the notes.

Upside scenario

A positive rating action is unlikely, in our view, without further significant improvement in our base-case projection of the minimum ADSCR. 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.

Operations-Phase Base-Case And Downside-Case Assumptions

Base-case assumptions

S&P Global Ratings' base-case forecasts train paths, operating costs, and macroeconomic assumptions for 2017-2040:

- International train paths: 18,873 services in 2017, falling to 17,500 services in 2018, and recovering to 18,000 services in 2019. No growth from 2018 to 2023, followed by cumulative steady total growth of 4,000 train paths through to the end of the concession in 2039. This profile reflects the tough operating conditions facing international traffic demand in the short term in light of larger train sizes, terrorist events in France, and the potential impact of Brexit. 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, which is just below the 2017 level (55,800).
- Freight train paths: Flat 800 train paths of per year.
- Spot train paths: Flat 130 train paths per year for both domestic and international operators.
- Unregulated revenue from retail and carparks: Moderate average growth in revenue for 2018, and zero nominal growth thereafter.
- Operating costs: In line with management's forecast.
- RPI: In line with S&P Global Ratings' latest forecasts: 3.5% for 2017, 2.9% for 2018, 2.9% for 2019, 3.4% for 2020, and 3.6% for 2021. We assume inflation of 3.1% in 2026-2030, followed by 3.0% growth thereafter.
- Corporate tax rate: 19% for 2017-2019, and 17% from 2020.

- Interest income: None, in line with S&P Global Rating's 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.

Base-case key metrics

- Minimum ADSCR: 1.44x in March 2025
- Average ADSCR: 1.55x
- The minimum forecast ADSCR remains above 1.40x, which supports a preliminary 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.

Downside-case assumptions

- International train paths: 17,500 services in 2018; 18,000 services in 2018. No growth thereafter, plus two two-year shocks starting in 2021 and 2035, to reflect the impact of an incident, such as a tunnel fire for example, that results in partial tunnel closures and capacity being constrained by 20% in two consecutive semesters. Traffic steadily resumes to pre-stress levels in the third year.
- Domestic train paths: Train paths at the underpin level (53,248 train paths per year).
- Freight train paths: No change from our base case, plus three-year train path shocks in 2021 and 2035, due to an incident in the tunnel, such as a fire, that constrains track capacity with the same 20% impact as on international trains.
- 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 first 10 years. Then 3.0% from 2028.

Downside-case 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 1.2x at all times, supporting a downside assessment of 'aa'.
- We incorporate a one-notch positive adjustment to the preliminary SACP to reflect the strong financial performance of the project 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.

Operations Update

The OPBA of '4' remains unchanged and reflects our view of the project's transparent and supportive regulatory framework that helps to mitigate operational risk and, combined with a strong competitive position and very low market risk, leads to a strong operational performance. None of the operational developments that have occurred over the last year affects our assessment of the project's operational risk profile.

Operational developments

The most important operational development has been the reduction in international train paths year on year to March 2017, which reduced by 2.1% to 18,873 services from 19,285 in the year to March 2016. The reduction in train paths was to some extent anticipated due to the introduction of new larger e320 trains, which have a 20% larger passenger capacity. However, terrorism and the Brexit vote have also played a role. The continued uncertainty around these two factors and our expectation that the reduction will be more pronounced in the year to March 2018 (8.7%) has led us to adopt prudent assumptions in our base-case and downside-case analysis, under which the 'A-' rating continues to be supported.

HS1 is financially well protected from any negative impact that may arise from the Brexit vote in the short and longer terms, due to the U.K. government-underpinned domestic services that make up 75% EBITDA. With respect to its international train path exposure, the potential move of businesses out of London and into Europe could lead to a demand for increased train services to Europe by U.K. business travelers. Hence, we do not expect the impact to be material. Under a worst-case scenario, we expect senior secured DSCRs would remain above 1x even, if there are no international services.

The London & South Eastern Railway Ltd. (LSER, trading as Southeastern), franchise bid process has been launched, with intention bids due imminently. LSER was awarded its current franchise agreement in September 2014 to run passenger rail services for three years and nine months until June 24, 2018, with an optional extension up to January 2019. LSER has run a successful service to date, including a very successful commuter service. Total train paths are around 2,000 trains per year above the underpin level of 55,400 trains per year. We do not expect replacement of LSER, should it happen, to impact the domestic revenue receipts, as seen when LSER was put in place in 2014. Additionally, the four train operating company (TOC) failures in the U.K. since 1994 have resulted in immediate remediation and access charges paid in full.

HS1's nonregulated retail and car-parking income, which directly impacts cash flow available for debt service, continued to increase in the year to March 2017 up to £32 million, with HS1 forecasting continued growth to £35 million in the year to March 2018. Growth is driven largely by the retail activities at the St. Pancras international station, but also by car parking at the Ebbsfleet and Stratford stations. Our rating is not supported by the assumption of nominal revenue growth from nonregulated activities.

HS1 appointed a new group CEO, Dyan Crowther, in December 2016, following the departure of the former group CEO, Nicola Shaw, who left in June 2016 to become Executive Director at National Grid PLC. Additionally, Mark Farrer has taken over as Finance Director, following the retirement of Graeme Thompson. There is no impact on the rating from the changes in management, as the team is experienced, highly competent, and continues to run the company expertly.

HS1 continues to deliver a strong operational and safety performance, as demonstrated by the two key performance indicators (KPIs) that it measures. The moving annual average delay per train from HS1 infrastructure incidents moved in the year to March 2017 was 5.03 seconds, down from 10.1 seconds the previous year. The improvement reflects the benefit of successful initiatives put in place by HS1, NRHS, and the British Transport Police, which include initiatives to prevent trespassers thereby reducing delays and ensuring the public's safety. The percent of train delays over five minutes for the year up to March 2017 was 0.26%, down from 0.42% in the previous year, and substantially above the 13% annual contractual performance floor.

Group developments

On Sept. 7, 2017, there was a change in ultimate shareholders of the HS1 Group when the existing shareholders Ontario Teachers' Pension Plan and Borealis Infrastructure sold 100% of their shares. The new shareholder structure comprises a consortium of funds managed by Equitix Investment Management Ltd. (Equitix, 35%), and third-party funds managed by InfraRed Capital Partners Ltd (InfraRed, 65%). The secure project company is ring-fenced from the activities and credit quality of the shareholders, and hence the rating on HSRF1's debt is not impacted by the sale. We do not anticipate a change in the strategic direction of the regulated business. The £500 million of new holdco debt issued at the time of the acquisition sits outside of the ring-fenced operating group and is fully subordinated to the senior secured debt. The £58 million revenue RPI swap (settled twice a year), issued at Betjeman Holdings Ltd. was transferred to HS1 Ltd. post completion of the shareholder acquisition. A small portion of the holdco debt proceeds were used to prepay £19.6 million of the £98 million bank facility at HS1, which has been factored into our financial analysis with minimal impact on ratios.

Other Modifiers Update

There are no other modifiers that have an impact on the rating.

Rating Score Snapshot

Operations-Phase SACP (Senior Debt)

- Operations-phase business assessment: 4 (1=best to 12=worst)
- Preliminary operations-phase SACP: a-
- Downside analysis: aa (+1 notch)
- Debt structure: Negative (-1 notch)
- Liquidity: Neutral (no impact)
- Comparable ratings analysis: Neutral (no impact)
- Operations-phase SACP: a-

Modifiers (Senior Debt)

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

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 Operations Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Transaction Structure Methodology, 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 - 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Bulletin: U.K.-Based HSRF And HSRF1 Debt Ratings Unaffected By Sale Of Indirect Holding Company, Helix Holding Ltd, Sept. 12, 2017
- New Issue: High Speed Rail Finance PLC, Dec. 15, 2016
- Research Update: High Speed Rail Finance New Senior Secured Debt Rated 'A-'; Outlook Stable, Dec. 15, 2016

Related Entities (As Of November 30, 2017)*
High Speed Rail Finance Plc (HSRF)

*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.

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