Research Update:

High Speed Rail Finance (1) PLC Debt Downgraded To 'BBB+' On Expected Eurostar Traffic Decline; Outlook Negative

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Rating Action Overview

- Traffic from Eurostar International Ltd. accounts for about one-third of HS1 Ltd.'s (ProjectCo's) regulated revenue and currently is significantly below pre-COVID-19 levels, owing to quarantine measures, generally reduced travel, and preference for personal vehicle travel.
- Absent visibility on Eurostar train paths in the next working timetable period (Dec. 2020-May 2021), we anticipate a 30% annual service decline, which, combined with reduced retail revenue, will result in a lower minimum annual debt service coverage ratio (DSCR) in March 2021 (1.33x) than we previously projected (1.53x).
- We are therefore lowering our rating on High Speed Rail Finance (1) PLC's (HSRF1's) senior secured debt to 'BBB+' from 'A-' and removing it from the CreditWatch, where we placed it with negative implications on July 31, 2020.
- The outlook is negative because we could lower the rating further if our estimate of project cash flow generation weakens, hit by a more severe or protracted decline in Eurostar traffic.

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 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 £54.7 million bank facility outstanding on Aug. 31, 2020, and due March 2022 (not rated) issued by HS1, and a total of £868.4 million private placements by High Speed Rail Finance PLC (not rated) due between March 2028 and December 2039. All the senior secured debt (£1,825 billion) ranks pari passu.

Strengths

- The project benefits from a supportive and transparent regulatory framework under which about 90% of total project revenue is regulated and track access charges annually increase in line with the retail price index (RPI).
- Approximately two-thirds of regulated revenue is generated by the domestic TOC London and South Eastern Railway (LSER) and is underpinned by the U.K. Secretary of State, which mitigates the project's exposure to the domestic market and volume risk. Also, the U.K. Department of Transport maintains step-in arrangements that would enable it to take over a failing TOC and directly operate its services.
- The project has a strong competitive position because it is the sole high-speed rail connection between London and continental Europe via the Dover-Calais crossing (known as the Eurotunnel).

Risks

- The project is exposed to revenue from international train paths, which has been hit by COVID-19-related traffic decline and the potential impact of Brexit, as well as showing some volatility owing to larger train sizes and after terrorist attacks in France and Belgium.
- The debt repayment profile is relatively back ended because the majority of the facilities do not start amortizing until 2027 or 2028. The last private placements issued in December 2016 shortened the concession tail to one year from two and include a £130 million bullet repayment in December 2039.

Criteria Exception

One or more of the ratings referenced within this article was assigned by deviating from S&P Global Ratings' published criteria. The exception relates to the application of "Project Finance Operations Methodology," published on Sept 16, 2014.

Our operations methodology (paragraph 65) provides for limited circumstances when we can ignore a weak financial period from our calculations, when we believe the low point in DSCR is abnormal and does not reflect the creditworthiness of the project. In particular, the reason for the weakness should be foreseeable and operational.

In this case, the shift in timing of payment by Eurostar is creating a one-off negative working capital effect on our DSCR calculation for September 2021. Although this was not foreseeable, we believe this abnormally low point does not reflect the creditworthiness of the project and we are using an exception to ignore this period from our calculation.

Rating Action Rationale

We expect Eurostar traffic will remain below pre-COVID-19 levels over the next few years, reducing our estimate of ProjectCo's cash flows. The decision by Eurostar on July 13, 2020, not to reserve any advanced train paths for the next working timetable (mid-December 2020-May 2021) has exposed HS1 cash flows to uncertain future revenue from the international TOC, which accounts for about one-third of ProjectCo's regulated revenue (see "High Speed Rail Finance (1) PLC 'A-' Rating Placed On CreditWatch Negative Amid Eurostar Train Paths Uncertainty," published on July 31, 2020).

Moreover, cross border rail traffic remains significantly below pre-COVID-19 levels, hit by quarantine measures the U.K. government reinstated in regard to France in mid-August, combined with generally reduced travel and preference for individual means of transport. We also anticipate that the risks of renewed but localized lockdowns, affecting general mobility, could slow the recovery of cross-border traffic.

We have therefore revised our estimate of cash flow available to service HSRF1's debt and we now project a 30% international train paths decline in 2021, combined with reduced unregulated revenue from retail and car parks. Under our updated base case, we anticipate a deterioration in the minimum historical annual DSCR, evidenced in the updated coverage of 1.33x in March 2022, compared with our 1.53x forecast last year.

The outlook is now negative and reflects the risk that prolonged quarantine measures, mobility restrictions, and the potential impact from Brexit could further hinder Eurostar's traffic recovery, weakening our annual DSCR forecasts beyond our expectations over the next few years.

We anticipate Eurostar's shift in timing of payment will have a negative working capital impact on HS1's cash flows, although we consider it as a one-time event. Starting from mid-December 2020, Eurostar will book services on a spot basis. This decision allows the TOC to have more flexibility over the level of services it offers, because access charges for spot bookings are due only if services are actually run rather than if the train path is reserved. Spot services are billed monthly in arrear rather than quarterly in advance.

We anticipate the shift in timing of payment will have a temporary negative impact on HS1's cash flows when calculating coverage metrics at the next calculation dates. We estimate the historical annual DSCR would decline to 1.23x in September 2021 given the combination of reduced traffic and negative working capital impact. Nevertheless, we see this as a one-time event, not representative of the project's credit quality. Therefore, we excluded the period from our analysis, and use the 1.33x minimum annual DSCR of March 2022 mentioned above.

We expect Eurostar to continue booking train paths on a spot basis over the next few years because we understand there is not a tariff incentive to reserve train paths quarterly in advance. Absent the entrance of any competitor, there is enough capacity on the network to satisfy Eurostar's demand for services. In our analysis, we assume some of these conditions may change and the operator may return to advanced booking at the end of the current regulatory cycle, in 2025, which explains the temporary increase in our forecast ratios, on the back of the positive working capital effect.

The project continues to benefit from LSER's unchanged reserved train paths, revenue from which we estimate could service HSRF1 debt even absent Eurostar traffic. The project's exposure to traffic risk continues to be mitigated by the domestic TOC LSER continuing advanced reserved train paths, which are underpinned by the U.K. Secretary of State. LSER generates about two-thirds of HS1's regulated revenue and, all other things being equal, we estimate in our base case that it could service HSRF1 debt even absent Eurostar traffic.

This helps support the ratios in our downside scenario and maintains our view of very low market risk exposure.

The significant decline on train volumes as a result of the pandemic, combined with the unprecedented decision by Eurostar to stop reserving train paths in advance, has triggered a contractual review event in December 2020. Operations, maintenance, and renewal charges (OMRC) have so far been allocated among the train operators under the regulatory framework according to their advanced reserve booking. OMRC are designed to recover the costs related to the maintenance of the rail network. We expect the project to continue recovering these costs and, absent payments by Eurostar, we assume they will be paid in full by LSER or rebased through a regulatory review process.

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic.

The current consensus among health experts is that COVID-19 will remain a threat until a vaccine or effective treatment becomes widely available, which could be around mid-2021. We are using this assumption 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.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety

Outlook

The negative outlook reflects the uncertainties related to Eurostar's traffic levels and pace to recovery, which could reduce HS1's cash flows in the next 12 to 24 months more than we currently anticipate.

We take into account in our analysis some general traffic recovery of Eurostar services starting from the end of this year, combined with a recovery of retail unregulated revenue over the next few years. Rating downside could arise from worse-than-expected ability or propensity to travel, as well as harsher macroeconomic conditions or potential impact from Brexit.

Downside Scenario

We could lower the rating on HSRF1's debt by one notch if our estimate of project cash flow generation results is weaker than we anticipate, because of a more severe or protracted traffic decline at Eurostar.

This could materialize, for example, if we anticipate the minimum annual DSCR will decline toward 1.20x or the average ratios profile deteriorates toward 1.40x.

Upside Scenario

We could revise the outlook to stable if we have visibility over the ability of Eurostar to maintain traffic levels at least in line with our current assumptions, with reduced risk of cash flow volatility for the ProjectCo. Absent any commitment by Eurostar, we would expect this to be backed by a record of traffic recovery.

Base Case

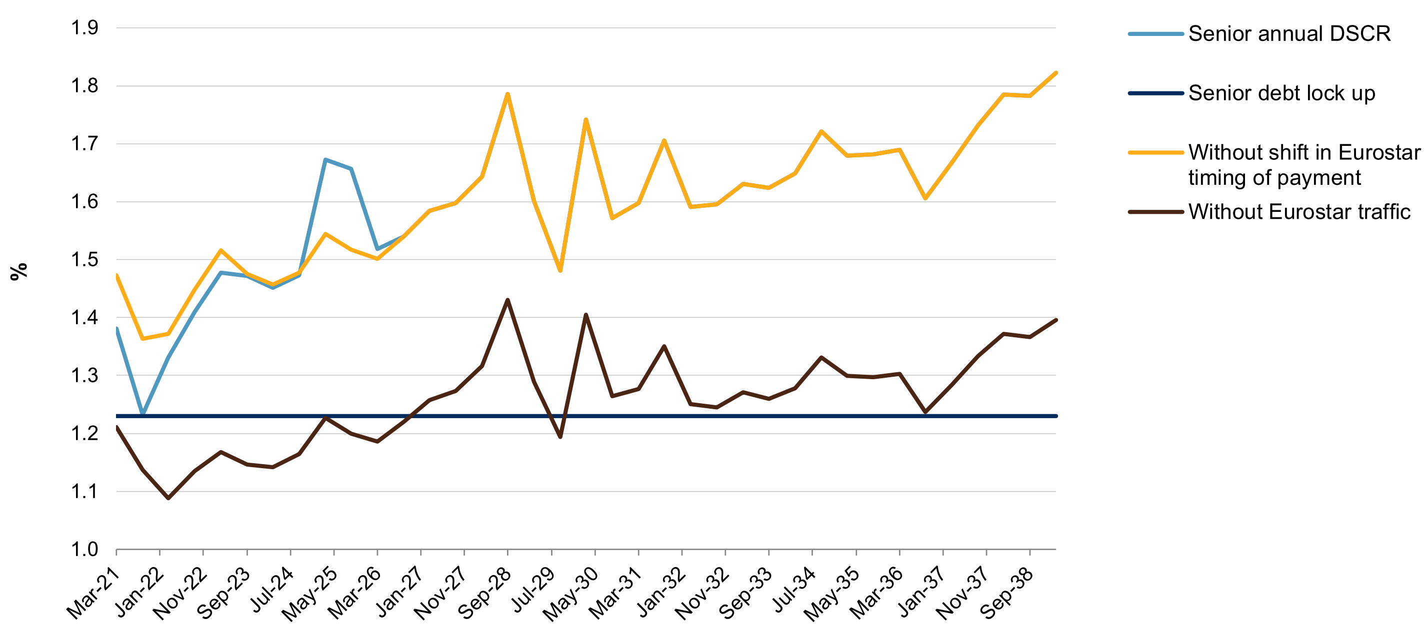
Assumptions

- International train paths: 18,000 total services, which we assume will have reduced by 40% between January and June 2021, followed by a 20% decline until June 2022. 18,000 train paths assumed thereafter, with a linear total growth of 4,000 train paths by 2039, through the end of the concession. We assume spot booking will remain in place until March 2025, which is the end of the current regulatory cycle. Our medium-term growth forecast models the introduction of new services by Eurostar or the entrance of 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.
- Unregulated revenue from retail and carparks: reduced to £24 million in the 12 months started March 2021, recovering to £36 million in March 2022; zero real growth thereafter. This reflects COVID-19-related effects on traffic and on renegotiated contracts with retailers.
- Operating costs: In line with management's forecast, with cost pass-through of the OMRC, power, and station costs.
- RPI: 1.2% for 2020, and 2.4% for 2021. We assume inflation of 3.2% in 2022, 3.5% in 2023, 3.2% for 2024-2028, and 3.1% growth thereafter, in line with S&P Global Ratings' macroeconomic forecasts.
- A recessionary period between 2035 and 2039, in line with the assumptions in the peer project, Channel Link Enterprise Finance PLC, which is designed to replicate the stress experienced on 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.

Key metrics

- The project's minimum annual DSCRs, calculated in accordance with our criteria, is 1.33x (in March 2022, 12-months backward looking), reflected in a 'bbb' preliminary operations phase SACP.
- The average annual DSCR is significantly higher, at 1.60x, which we reflect through a one-notch positive adjustment to the preliminary operations phase SACP.

S&P Global Ratings' Base-Case DSCR for HSRF1



Downside Case

Assumptions

- International train paths: 18,000 total services reduced by 50% between mid-December to June 2021, followed by a 30% decline until June 2022 and a 20% decline until June 2023. Second three-year shocks starting in 2035, with traffic declines of 20%; 13%, and 7%, followed by a recovery to 18,000 train paths in the fourth year. No introduction of new services by Eurostar or entrance of a new operator assumed.
- 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).
- Unregulated revenue: 10% below our base case in 2020-2023 (which is already reflecting traffic decline impact), followed by a 20% decline below our base case after 2023.
- Unregulated costs: 20% above our base case.
- RPI: 1 percentage point below our base case for 2021-2025. Thereafter, in line with the base case (including the recessionary period 2035-2039).

Key metrics

- The project performs strongly under our downside-case scenario, supported by the 12-month debt service reserve facility. The minimum base-case annual DSCR remains above 1.10x most of the time, supporting a downside assessment of 'a'.
- 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 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: 'a' (+1 notch)
- Debt structure: Negative (-1 notch)
- Forecast Average ADSCR: +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 there is not, in our opinion, a rating dependency 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, it is the IRC that fuels HS1's profitability.
- The majority of the IRC (approximately two-thirds) is provided by the domestic TOCs and is directly underpinned by the U.K. government under the agreement effective since January

2015. Furthermore, the Department For Transport 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 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 counterparty, Network Rail High Speed (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 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 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 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 September 2020, fully undrawn). In addition, the project maintains a £65 million working capital facility which was extended to March 31, 2022 (£47 million drawn as of September 2020).
- 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 because the amortization of the debt is relatively back ended.

Related Criteria

- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- 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: Key Credit Factors For Road, Bridge, And Tunnel Project Financings, 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 | Corporates | Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
High Speed Rail Finance (1) PLC		
Senior Secured	BBB+/Negative	A-/Watch Neg