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Research Update:

High Speed Rail Finance (1) 'BBB+' Rating Affirmed And Removed From Under Criteria Observation; Outlook Stable

January 31, 2023

Rating Action Overview

- On Dec. 14, 2022, S&P Global Ratings published its revised criteria for rating project finance transactions, "General Project Finance Rating Methodology" and "Sector-Specific Project Finance Rating Methodology."
- At the same time, we placed the ratings on several project finance issuers' debt, including that of High Speed Rail Finance (1) PLC (HSRF1), under criteria observation (UCO).
- We completed our UCO review and deviated from our revised criteria to reflect the dependency of the project to its two main revenue counterparties.
- We therefore affirmed the rating on the debt at 'BBB+'. We also removed the rating from UCO.
- The stable outlook reflects the ongoing support from the U.K.'s rail regulatory regime and our expectations of improving operating and financial performance amid a recovery in traffic despite high inflation and potential shifts in consumer confidence.

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Project Description And Key Credit Factors

U.K.-based special-purpose entity HSRF1 issued £610 million senior secured fixed-rate bonds and £246.5 million senior secured index-linked bonds due Nov. 1, 2038, to partially refinance the existing acquisition debt facilities of its sister company HS1 Ltd. (HS1), the ProjectCo. ProjectCo 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 (SoS) 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.

Strengths

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

Risks

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

Rating Action Rationale

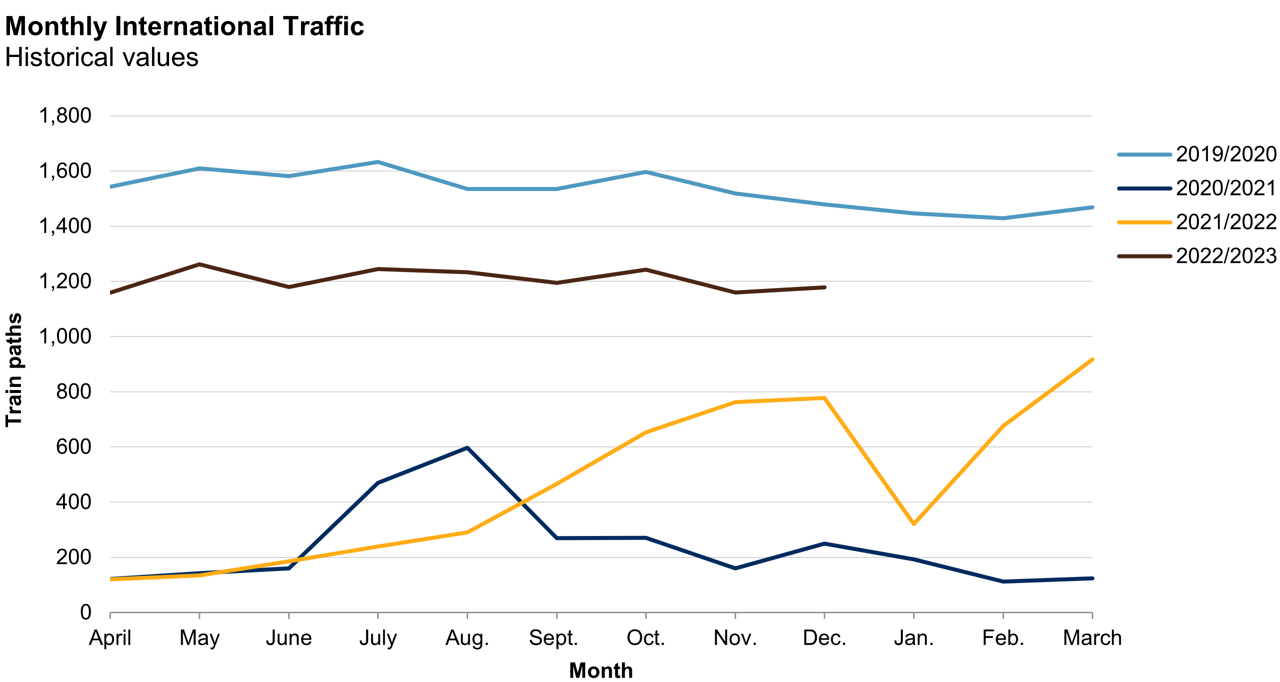
We affirmed the 'BBB+' rating referenced within this article by deviating from S&P Global Ratings' published criteria. HSR1's regulated revenues are generated by SE and Eurostar, two TOCs that currently use the track. TOCs running on the tracks have to enter into a track access agreement (TAA) with HS1, and pay a regulated charge that accounts for about 90% of total revenues. We view the project's exposure to the counterparties as material and our analysis to assess the dependency of the project to these counterparties adopts a criteria exception approach, where we determine the revenue counterparty dependency assessment as the weighted average of creditworthiness of the two counterparties in proportion to their regulated revenue contribution. This approach does not constrain the debt rating.

Our revised project finance criteria will not affect the project's creditworthiness. The new project finance criteria does not affect our view of HSR1's operational risk and financial assessment. Therefore, we affirmed the rating and removed the project from UCO.

Performance Update

International traffic continues to improve in line with our expectations, but future bookings seem to be recovering faster than we previously forecast. The performance of international traffic over 2022-2023 is significantly above that in 2020 and 2021, and we expect it will be back to pre-pandemic levels by 2024-2025. Eurostar has already booked close to 80% of 2019's train paths in advance for the period from May-December 2023. This level translates into approximately 14,000 paths, way above the 9,900 forward booking table we previously expected for the eight-month period. That said, we continue to expect total international traffic above 16,000 paths for the 12 months to March 2024 with a higher share of forward booking paths that would benefit from working capital movements in the short term.

Chart 1



We expect domestic services will be underpinned by the Department for Transport until March 2025. Domestic revenues continue to be supported by the increase in SE's submitted timetables, as part of the agreement signed with the SoS that secures revenues at about 95% of the pre-pandemic domestic timetable until 2025. Despite ongoing strike actions, we also do not expect severe service disruptions to affect timely payments from SE. Since late 2021, the train operator has been owned by the Department of Transport (via DfT OLR Holdings), which exercised its right to step-in and take over the franchise's operations from the Go-Ahead Group.

We currently do not foresee challenges arising from proposed rail reforms in the U.K. Although the Transport Bill still must be discussed in parliament and there are no concrete measures currently in place, we expect HS1's operations to remain unaffected by the intention to integrate U.K. railways operations. ProjectCo operates under a concession agreement directly signed with the SoS maturing by year-end 2040, which establishes the charging framework to recover investments and services provided.

Outlook

The stable outlook indicates that we expect HSR1's operating and financial performance to continue to improve in the next 12-24 months amid a full recovery in traffic to pre-pandemic levels by 2024-2025. It also reflects continued support from the U.K. rail regulatory regime that would allow the project to withstand challenging macroeconomic conditions.

Downside scenario

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

Upside scenario

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

Base Case

Assumptions

- International train paths: A combination of forward and spot bookings until March 2025, but a higher share of forward bookings. Total train paths in 2023 (12 months to March 2024): 14,000 as per Eurostar's submitted commitment and additional 2,200 booked on the spot; 2024: 16,566; 2025: 18,461; 2026: 18,665; resumption of spot bookings of 130 train paths per year and around 300 on forward bookings from 2027 onward.
- Domestic train paths: Until March 2025 (fourth-quarter 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-pandemic.
- Freight train paths: About 450-500 train paths per year.
- Unregulated revenue from retail and carparks for March 2022-March 2024: We applied the following stresses to 2019 actual footfall:
- --Until March 2023: -20%;
- --Until March 2024: -10%;

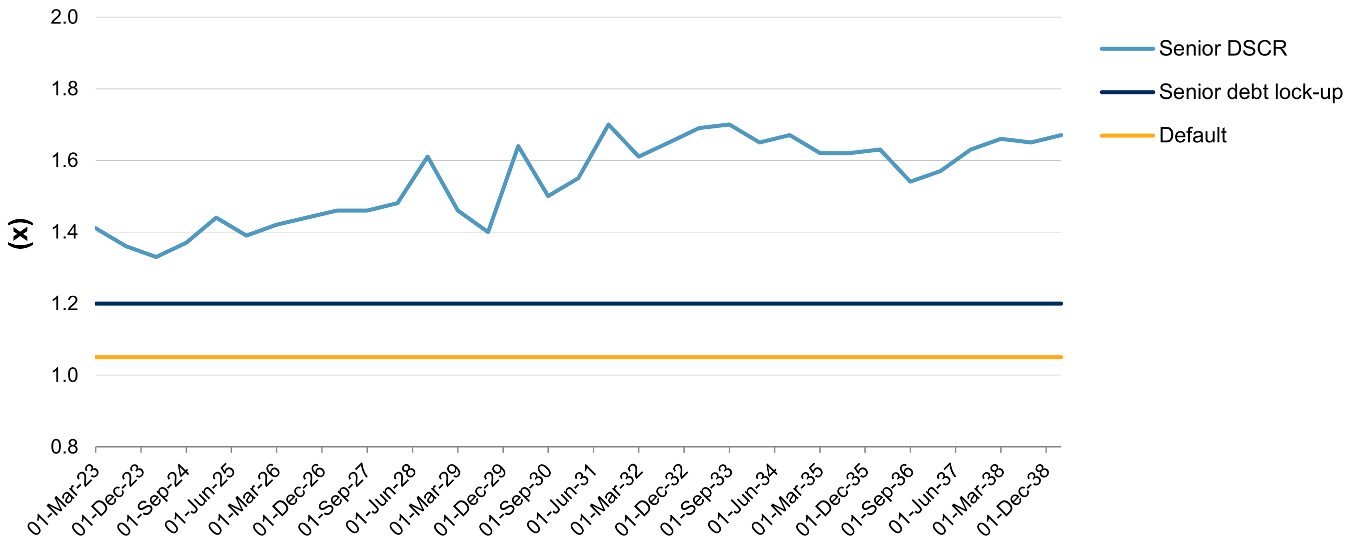
- --Until March 2025: -5%; and
- --April 2025 onward: As per actual footfall in 2019.
- Operating costs: In line with management's forecast, with cost pass-through of the OMRC, power, and station costs.
- A recessionary period between 2035 and 2038, in line with our assumptions in the peer project, Channel Link Enterprise Finance PLC, which is designed to replicate the stress on the underlying volumes in 2008-2009.
- Cost of letter of credit (LoC): To ensure comparability in our cash flow analysis, we assume that the liquidity facility is drawn on an amount equal to the next six months of debt service. We also consider £51 million of the working capital facility as drawn, in line with the project's actual balance.
- Tax rate: 2020-March 2023: 19%; from April 2023: 25%, as per the 2021 U.K. budget announcement.
- RPI: 11.5% for 2022; 7.3% for 2023; 2.1% for 2024; 2.5% for 2025; 2.6% for 2026-30; 2.5% for 2031-35; and 2.7% 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 1.33x in March 2024, reflected in a 'bbb' preliminary operations phase stand-alone credit profile (SACP).
- The median ADSCR is significantly higher, at 1.57x, which we reflect through a one-notch positive adjustment to the preliminary operations phase SACP. However, we see this adjustment as temporary until DSCRs fully recover and better reflect the preliminary operations phase SACP. In our view, the robustness of the median is not enough to indicate complementary resilience throughout the life of the transaction, however, we expect minimum ADSCR to recover in the short term and bounce back to historical levels without needing this temporary adjustment.

Chart 2

S&P Global Ratings' Base-Case DSCR



DSCR--Debt service coverage ratio.

Downside Case

Assumptions

- International train paths: A combination of forward and spot bookings with heavier reliance on spot bids. We model a slower recovery path in international train paths than under our base case.
- 2023: 14,000 Eurostar's submitted commitment and no spot bids.
- 2024: 16,566; 2025: 18,461; 2026: 18,665; resumption of spot bookings of 130 train paths per year and around 300 on forward bookings from 2027 onward.
- This is followed by a second shock from 2035 based on our base case:
- --January 2035–December 2035: -15%
- --January 2036–December 2036: -10%
- --January 2037–December 2037: -5%
- Domestic train paths: Train paths at the underpin level of 52,806 per year through the life of the project.
- Freight train paths: No change from our base case.
- Unregulated revenue: 10% below our base case in 2022-2025, followed by a 20% decline below our base case after 2025.

- Regulated costs: As per the base case.
- Unregulated costs: 20% above our base case.
- RPI: One percentage point above our base case for 2023-2027. Thereafter, in line with the base case (including the recessionary period 2035-2039).
- Cost of LoC: We assume LIBOR at 6% throughout the life of the project.

Key metrics

- The project performs strongly under our downside-case scenario, with a minimum base-case ADSCR that remains above 1.10x supporting a resiliency assessment of 'high'.

Rating Score Snapshot

Operations phase SACP (senior debt)

- Asset class operating stability: 3
- Operations phase business assessment: 4

Preliminary operations phase SACP: 'bbb'

- Downside resiliency assessment and impact: High (+1 notch)
- Median DSCR impact: Positive (+1 notch)
- Debt structure impact: Negative (-1 notch)
- Liquidity impact: Neutral
- Future value modifier impact: Neutral
- Holistic analysis impact: Neutral
- Structural protection impact: Neutral
- Counterparty assessment impact: Neutral

Operations phase SACP: 'bbb+'

Parent linkage and external influences (senior debt)

- Parent linkage: Delinked

Project SACP: 'bbb'

- Extraordinary government: Not applicable

- Sovereign rating limits: 'AA'
- Full credit guarantees: Not applicable
- Senior debt issue rating: BBB+/Stable

Operations counterparties

- As mentioned above, we consider both SE and Eurostar to be material revenue counterparties, and we calculate the exposure through the weighted average creditworthiness.
- We consider the operations and maintenance counterparty, Network Rail High Speed (NRHS), to be irreplaceable, and we weak link the issue rating on the project's debt to the credit quality of NRHS, which is not a rating constraint. NRHS retains performance risk and the responsibility for safety under railway regulation, in line with the operator's role in transport projects. NRHS' payment and performance obligations benefit from a guarantee from its parent company, Network Rail Infrastructure Ltd. (Network Rail). Network Rail is funded by the debt program of Network Rail Infrastructure Finance PLC, which is a government-related entity, and which we rate in line with our rating on the U.K. government.
- U.K. Power Networks (UKPN) operates the electricity distribution infrastructure and supplies electricity under a finance lease agreement (through to 2057) with HS1. The electricity distribution market is wide in the U.K., and we believe that UKPN could be replaced, if necessary, without material disruption. We therefore do not weak link the debt rating on the project to the credit quality of UKPN.
- The ratings on the project debt are weak linked to the ratings on the swap counterparties and working capital facility providers because the terms of the swap and liquidity facilities do not fulfil our criteria requirements for collateral and timely replacement. However, the rating on these counterparties does not constrain the rating on the project's debt.

Liquidity

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

Other modifiers

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

Related Criteria

- Criteria | Infrastructure | General: Sector-Specific Project Finance Rating Methodology, Dec. 14, 2022
- Criteria | Infrastructure | General: General Project Finance Rating Methodology, Dec. 14, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology Applied To Bank Branch-Supported Transactions, Oct. 14, 2013
- Criteria | Structured Finance | General: Global Derivative Agreement Criteria, June 24, 2013
- General Criteria: Global Investment Criteria For Temporary Investments In Transaction Accounts, May 31, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Certain Project Finance Issue Ratings Placed Under Criteria Observation Following Criteria Update, Dec. 14, 2022
- High Speed Rail Finance (1) Outlook To Stable On Expected Traffic Recovery And Supportive Regulation; Rating Affirmed, May 6, 2022.

Ratings List

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