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Research Update:

High Speed Rail Finance (1) Debt Rating Affirmed At 'A-' On Robust Operational Performance; Outlook Stable

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Overview

- U.K.-based HS1 Ltd. (HS1), the operator of the U.K.'s sole high-speed rail connection between London and the Channel Tunnel, continues to exhibit strong operational and safety performance, along with robust financial ratios under our base case and downside case.
- HS1's transparent and supportive regulatory framework helps to protect the project from any potential negative financial impact of Brexit.
- As a result, we are affirming the 'A-' long-term issue rating on the senior secured debt issued by High Speed Rail Finance (1) (HSRF1), a finance vehicle for HS1.
- The stable outlook reflects our view that the project will continue to deliver strong operational performance despite the potential challenges posed by Brexit and maintain a minimum annual debt service cover ratio (ADSCR) of at least 1.4x under our base case.

Rating Action

On Nov. 21, 2018, S&P Global Ratings affirmed its 'A-' long-term rating on the senior secured bonds due in September 2039 issued by High Speed Rail Finance 1 (HSRF1). The outlook remains stable.

U.K.-based special-purpose entity 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 to 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, 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, 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.

Rationale

The affirmation follows our review of the project's operations, which continue to exhibit strong operational and safety performance. Financial performance is robust and in line with our expectations, underpinned by HS1's transparent and supportive regulatory framework. We consider that HS1 is well protected from any potential negative financial impact from Brexit. The 'A-' rating continues to reflect 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 and paid by the two train operating companies (TOCs): the domestic train operator The London & South Eastern Railway Ltd. (LSER; trading as Southeastern); and the international train operator, Eurostar International Ltd (EIL).
- The U.K. Secretary of State underpins domestic rail services, which in our view mitigates the project's exposure to domestic market risk. Furthermore, the project could, if required, fully cover its debt service based on revenue from the domestic agreement alone.
- 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 quarterly in advance, 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.
- Regulated revenues are supplemented by income from unregulated retail, car parking, and commercial operations, which make up about 10% of total revenues. We do not factor in nominal revenue growth of nonregulated activities in our rating.
- The project continues to deliver strong operational performance in terms of safety and track availability.
- HS1 passes the majority of the cost of operations through to the track users. The track user charges are paid quarterly in advance of scheduled train services and include a fixed investment recovery charge (IRC), plus a regulated operations, maintenance and renewals charge (OM&RC) to cover the cost of the operations, maintenance, and renewal of the project's track infrastructure. Power and station usage charges are also applied. In addition to the option for an in-control period reopener, the regulated OM&RC is reviewed every five years by the ORR and allows for

virtually full cost pass-through.

- HS1 has limited exposure to capital expenditure (capex) and places the renewal component of the OM&RC and of the station use charge paid by the TOCs into escrow accounts to cover the 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 U.S. private placement tranche C maturing in March 2031, in addition to the £65 million working capital facility (which HS1 draws and repays periodically over a financial year). A portfolio of swaps largely mitigates the remaining interest rate and currency exposure.
- 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 senior secured debt benefits from a 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 1.49x and average ADSCR of 1.63x. HS1's reported DSCR for March 2018 was 2.21x. 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, 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 the past, with the impact of larger trains, terrorist attacks in France and Belgium and, potentially, Brexit being contributing factors. The continued uncertainty around these two factors is reflected 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, with amortization of the majority of facilities not starting until at least 2027. 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 adjustment.
- The rail line requires relatively complex maintenance services. However, we think this risk is largely offset by the subcontracting of these services in full to 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 operational and financial counterparties, but none of these counterparties' ratings is currently a rating constraint.

HS1 regulated revenues are generated by two TOCs: LSER and EIL. 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.

Base-case assumptions

Our base-case forecasts for train paths, operating costs, and macroeconomic assumptions for 2018-2040 are:

- International train paths: 17,780 total services in the year to March 2019, and flat at 18,000 through to March 2024. 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, 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.
- 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: £36 million in March 2019; zero nominal growth thereafter.
- Operating costs: In line with management's forecast, with cost pass-through of OM&RC, power, and station costs.
- Retail price index: In line with S&P Global Ratings' latest forecasts: 3.5% for 2018, 3.1% for 2019, 3.0% for 2020, and 3.9% for 2021. We assume inflation of 3.4% in 2022-2026, 3.1% in 2027-2031, 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.

- Corporate tax rate: 19% for 2017-2019, and 17% from 2020.
- 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.

Downside-case assumptions

- 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 a 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 guaranteed by the U.K. government (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 (as per international train paths).
- Spot train paths: None.
- Unregulated revenue: 20% below our base case.
- Unregulated costs: 20% above our base case.
- Retail price index: 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).

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 life cycle risk. The combined balance on these escrow accounts stood at £110 million in the financial year ending March 30, 2018, and we forecast that this will rise to about £120 million at the end of the current 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 rating on HSRF1's debt is 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 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 ratings 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 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.

Ratings 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: De-linked (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 Transaction Structure Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Operations 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 - 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

Ratings List

Ratings Affirmed

High Speed Rail Finance (1) PLC	
Senior Secured	A-/Stable

Additional Contact:
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.