Finance Committee

Date: **11 October 2023**

Item: **Enterprise Risk Update – Financial Resilience (ER07)**

This paper will be considered in public

1 Summary

1.1 This paper describes Transport for London`s (TfL’s) position on Enterprise Risk 07 (one of ten level 0 risks across TfL), Financial Resilience. This is the risk that changing market conditions, financial shocks, stakeholder relationships or internal delivery issues lead to TfL not having sufficient financial resources to make sufficient progress towards its strategic objectives.

1.2 This is the first time the risk has been presented to the Committee.

1.3 This paper outlines the scope of enterprise risk, current assessment, preventative controls, mitigation activities in place and improvement plans to reduce TfL’s risk across our financial activities.

1.4 A paper is included on Part 2 of the agenda, which contains exempt supplementary information. The information is exempt by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the business affairs of TfL. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

2 Recommendation

2.1 **The Committee is asked to note the paper and the exempt supplementary information on Part 2 of the agenda.**

3 Background

3.1 TfL has been on a journey to achieve financial sustainability since 2015/16 when the government confirmed that its revenue grant to TfL would be withdrawn. TfL responded by reducing its net operating deficit each year to 2019/20 and, as described in the 2019 Business Plan, was on trajectory to deliver an operating surplus by 2022/23.

3.2 This would mean generating sufficient operating income to cover operating costs, renewals and financing costs and creating an operating surplus for fund investment in new capital enhancements.

3.3 However, the pandemic had a devasting impact on TfL’s finances. This meant financial resilience was a strategic issue which was being actively managed by the Executive Committee. TfL was reliant on funding agreements with the government to continue to operate its services and deliver critical projects. A significant amount of senior resource, including considerable time from the Commissioner and Chief Finance Officer, was dedicated to securing these agreements with government.

3.4 Since the initial phase of the pandemic, TfL has again been rebuilding its finances, and has been on a declining trajectory of government funding support. This has been achieved through supporting the recovery of passenger demand by maintaining service levels, generating new revenue sources and maintaining strong cost control.

3.5 In 2023/24, TfL is currently on course to achieve financial sustainability and deliver an operating surplus. This has meant that financial resilience has reverted to being an Enterprise (Level 0) risk, rather than a live issue, and will be managed accordingly.

3.6 Although TfL's financial position has improved since 2020/21, there remain strategic risks to TfL's financial resilience. These are categorised as the Strategic (Level 1) risks: systemic risk, liquidity risk, solvency risk, credit risk and operating risk.

3.7 This paper outlines the risks in these five areas, along with their causes, consequences, controls and mitigations (sections 4-8).

4 Causes of risks

Systemic risk

4.1 Systemic risk refers to demand shock or changing market conditions leading to reduction in revenue, significant increase in costs or inability to access capital markets.

4.2 This can include recessions, factors that influence people's ability or willingness to travel, significant inflation shocks or the failure of capital markets to operate effectively.

Liquidity risk

4.3 Liquidity risk is a cash-flow mismatch creating the inability to meet liabilities as they fall due. This could be caused by a failure to correctly predict timing of material payments and receipts, changes in payment terms or delays to material receipts.

Solvency risk

4.4 Solvency risk is due to the failure to deliver a recurring operating surplus over the medium term which would mean debt levels becoming unsustainable, general fund reserves being run down and ultimately liabilities exceeding assets. As TfL is required to have and maintain a balanced budget, this would mean TfL is no longer able to meet this requirement.

Credit risk

4.5 Credit risk is described as failure to collect revenue that falls due to the insolvency of a material customer or, more likely in TfL's case, a systemic failure in a large number of customers to pay fares, charges or commercial income. It could also be due to the insolvency of a counterparty on investments.

Operating risk

4.6 Operating risk is the internal failure to deliver operations, processes and controls which leads to an inability to collect revenue or a significant drop in customer confidence. This could be caused by sustained industrial action, a significant safety incident or a significant technology failure.

5 Consequences

5.1 If any of the risks listed above materialised, this could result in various impacts for TfL, some with more significant consequences than others.

5.2 **Value for money**: a lack of financial certainty results in short-term planning horizons and an inability to plan effective and efficient delivery, with a particular impact on capital projects. This would also result in an increasing cost of finance due to a deteriorating credit rating, which would further exacerbate the issue. During the pandemic, our external auditors highlighted the impact of short-term funding agreements with government were having on our ability to deliver value for money.

5.3 **Delivery**: as a large proportion of TfL's operating costs are fixed, in the short-term capital expenditure could need to be slowed, deferred or cancelled to maintain a balanced budget. Reducing new capital enhancements would impact TfL's ability to make progress towards its strategic objectives. Reducing capital renewals would lead to deteriorating asset condition, increasing maintenance costs and decreasing service reliability. Operating cost reductions take longer to deliver, but service reductions could lead to decreasing demand as services are less frequent and reliable, which further increases financial risks.

5.4 **Colleague**: financial uncertainty could lead to lower engagement and increasing employee turnover. It would also make it increasingly difficult to attract and retain talent, and TfL are already experiencing recruitment challenges in certain areas.

5.5 **Supply chain**: decreasing supplier confidence due to lower certainty around our delivery pipeline would increase costs and decrease credit terms, creating further financial pressures. Small and medium suppliers dependent on TfL could become insolvent which would have a ripple effect on jobs across the country.

5.6 **Expenditure and new agreement controls**: TfL is required to set and maintain a balanced budget. If this is not possible, the statutory Chief Finance Officer would need to consider if it is necessary to prepare a report under section 114 of the Local Government Finance Act 1988, which would be presented to the Board to consider. This would also require the implementation of tight controls over new expenditure agreements, which could impact our ability to deliver services and investment.

6 Current Controls

6.1 A number of controls are currently in place under each risk, to reduce the probability of the risk materialising.

6.2 Systemic controls include:

(a) demand forecasting, including the use of independent economic forecasts;

(b) customer research to understand changing customer behaviours;

(c) horizon scanning for potential market disruption;

(d) scenario planning to test business plan under different scenarios;

(e) maintaining budget contingency and borrowing facilities to maintain operations and investment during temporary demand shocks;

(f) use of hedging on interest rate and foreign exchange rate risk exposure;

(g) scenario planning to test business plan under different scenarios;

(h) reporting on savings delivery; and

(i) quarterly reporting of pension fund valuation.

6.3 Liquidity controls include:

(a) short-term (12 week) direct cashflow forecasting;

(b) medium- to long-term indirect cashflow forecast;

(c) daily cash reporting;

(d) maintaining target of 60 days operating expenses as minimum cash levels in business planning;

(e) maintaining minimum strategic reserve of £900m cash reserves; and

(f) bank overdrafts and standby credit facilities are not used in the normal course of business but are available to address short-term liquidity needs.

6.4 Solvency controls include:

(a) annual balanced budget approved by the Board;

(b) prudential borrowing limits approved by the Board;

(c) use of credit rating agencies to provide external assurance on borrowing levels;

(d) scenario planning to test business plan under different scenarios; and

(e) maintaining general fund reserve at minimum of £500m.

6.5 Credit controls include:

(a) Treasury Management Policy-based overriding principle being the prioritisation of security before liquidity and liquidity before yield, including defined counter-party exposure limits;

(b) revenue reporting on fare revenue, road user charging and rental collections; and

(c) arrears reporting on rental collections.

6.6 Operating controls include:

(a) Internal Audit reviews and annual Head of Internal Audit Opinion; and

(b) periodic analysis of variances against budget.

7 Mitigations

7.1 TfL is also taking mitigating actions to better prepare TfL and reduce the severity and length of the impact should one of the risks above materialise.

7.2 Systemic mitigations:

(a) development of customer strategy to focus efforts to grow customer demand;

(b) growing new sources of revenue to reduce dependence on fare revenue;

(c) case-making to government for future funding;

(d) further improvement on business planning process to include more long-term scenarios; and

(e) improvement to savings reporting.

7.3 Liquidity mitigations:

(a) an internal programme ‘Making Cash Count’, aimed at improving cashflow forecasting and cash reporting, to drive accountability and responsibility for cash across the organization.

7.4 Solvency mitigations:

(a) further improvement on prudential borrowing process to more explicitly and transparently set limits based on range of ratios; and

(b) further improvement on business planning process to include more long-term scenarios.

8 Next Steps

8.1 The Chief Finance Officer’s leadership team will improve the effectiveness of its controls where necessary to reduce the probability of each risk materialising, and continue developing its mitigating actions.

List of appendices to this report:

A paper containing exempt supplementary information is included on Part 2 of the agenda.

List of Background Papers:

None

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