Why investors should be cautious of planners wearing rose-tinted spectacles

In July, the credit rating agency Standard & Poor’s published a commentary entitled ‘Fare’s Fair? Why Tram Projects are on a Bumpy Road’. Carol Debell talked to Robert Bain, the report’s author and an Associate with the Infrastructure Finance Ratings team at Standard & Poor’s, London, about project risks, credit drivers and an unhelpful industry trend that he describes as ‘uncertainty denial’.

There is a view that trams are smart. This view is not confined to the UK where the 10 Year Transport Plan flagged up, up to 25 new light rail or tram lines in major cities. There are some 450 tram systems operating around the world and plenty more in the pipeline. They go under a variety of names – tramways, light rail, light rapid transit, streetcars, metro – but what they have in common is that they are relatively modern, they run on rails and they often involve a mix of street and segregated running. In the eyes of many planners and policy makers, they represent a better quality mode of public transport than the bus. As a result, there is a tendency to optimistically view forecasts of patronage and revenue through rose tinted spectacles.

That, anyway, is the conclusion of a special report that has been written by the credit rating agency, Standard & Poor’s. The author, Robert Bain, is a credit analyst whose background lies in transport consultancy, with extensive international experience.

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So what was it about trams, or light rail, that captured the analysts’ attention? Bain explains that along with other analysts in the transportation team, he is routinely looking at sectors such as rail, the bus industry, airports and airlines, and toll roads. ‘As part of our rating responsibilities we are constantly monitoring our individual sectors, reviewing business, financial and credit trends. When these trends have implications for credit, we publish commentaries.’

He says that he has been looking at trams for some time now and that some of the figures coming across his desk make pretty grim reading. In the UK alone, we have Tramtrack Croydon recording an increase in pretax losses of 34% to just under £10 million. In Manchester Altram has experienced spiralling losses and returned the concession to the Greater Manchester Passenger Transport Executive. In the West Midlands, the Midland Metro tram has reported losses of about £16 million since it started operation in 1999. And the South Yorkshire Supertram in Sheffield is known to have experienced considerable difficulty in the early years with revenues reaching only about 30% of forecasts. Even today it is operating well below capacity.

What all this suggests to Bain is a failure to recall that forecasts are simply a view of the future given certain simplified inputs and if those inputs change, or fail to happen as anticipated, then the outputs will change too. Uncertainty at the input level typically serves to magnify uncertainty at the output level, although such risks are downplayed by scheme proponents and promoters. This we call ‘uncertainty denial’, the tendency to place more confidence in forecasts than any rigorous analysis of the predictive process would support.

The reality of course is that decisions, about whether or not to go down the tram route, are usually taken at a political level. With his analyst’s hat on, Bain explains that policy concerns are not a rating agency’s primary focus. ‘Our interest as analysts is in the attributes of a transaction and its inherent creditworthiness, that is the ability and willingness to service debt obligations in full and on time. If a deal is structured with strong security and protective provisions, limiting investor risk, it is more likely to be highly rated. As the risk profile deteriorates – and this includes exposing the investor to uncertain patronage and revenue forecasts – the probability of failing to meet these obligations increases and this is reflected in a lower credit rating.'
Robert Bain is concerned that planners can overestimate the novelty value of a new form of transport and hence its competitive market position in their desire to have a new transport initiative adopted, and turn a blind eye to the risks.

For further information or to receive a copy of the Standard & Poor's report contact Robert Bain: robert_bain@standardandpoors.com or call +44 (0) 20 7826 3520.

What is a credit rating agency?
A rating agency specialises in credit risk analysis and provides an objective, informed and independent opinion about a company's ability and willingness to repay its debts in full and on time. This is expressed by letter-grade ratings linked to specific probabilities of default. Ratings are usually assigned to debt securities (bonds, bank loans etc.) issued by a company. A 'AAA' obligation by a company. A 'AAA' obligation has an extremely low probability of default. The letter-based scale runs from AAA, AA and A down to BBB. Below BBB minus lies what is called 'non-investment grade' companies. By the time you get down to CCC, the company in question is pretty likely to default on its debt obligations in the near future.

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