

John Larkinson
Deputy Director of Access, Planning & Performance

Telephone 020 7282 2193

Fax 020 7282 2042

E-mail john.larkinson@orr.gsi.gov.uk



OFFICE OF RAIL REGULATION

21 July 2008

The Company Secretary
Network Rail Infrastructure Limited
40 Melton Street
London
NW1 2EE

Network licence condition 12 - consent for the establishment of a multi-site joint venture for the development of Network Rail stations and other property assets

1. On 11 September 2007, you applied to us for our consent under condition 12 of the network licence for the creation of a multi-site joint venture for the development of Network Rail stations and other property assets at sites in the south east of England. There have been a number of important issues for us to consider during this time, and we have had several discussions with you.

2. In considering this application, we have had regard to our duties under section 4 of the Railways Act, to the terms of your application and to other information supplied by you as licence holder. Subject to paragraph 3 below, we hereby consent under condition 12 of the network licence:

(a) for the purpose of condition 12.2, to the licence holder acquiring or retaining shares in:

(i) any relevant body corporate which is a subsidiary of the licence holder, such shares having been acquired or retained in order for that subsidiary to enter into a joint venture for the purposes set out in the application (the "subsidiary"); and

(ii) any relevant body corporate which only conducts business or carries on activities:

(1) as a general partner under the Limited Partnerships Act 1907; and

(2) for the purposes of the application;



(b) for the purpose of condition 12.1.1, to the licence holder entering into and procuring that its subsidiary enters into a joint venture for the purposes set out in the application.

3. Our consent under paragraph 2 above in relation to the application is subject to the following conditions:

(a) the licence holder and its subsidiary must establish and enter into the joint venture by way of a limited partnership or partnerships under the Limited Partnerships Act 1907 and in accordance with the corporate structure (including the shareholdings) set out in annex A to this consent; and

(b) the licence holder and its subsidiary must not, at any point in time, make contributions to or in connection with the joint venture proposed in the application that, taken together, exceed £50 million in total unless we otherwise expressly consent to this.

4. This consent does not prejudice your ability to use the *de minimis* facility under Condition 12.5.1 of the network licence in relation to contributions to or in connection with the joint venture proposed in the application that are over and above the financial cap imposed under paragraph 3(b) above.

5. This consent does not nullify the need for you to obtain our consent under condition 26 of the network licence for any disposal of land related to or in connection with this application. Nor does this prejudice any decision we might make subsequently under condition 26.

6. We may, at any time:

(a) revoke this consent if we issue a new consent relating to the conduct of businesses or activities of a similar type to those covered by this consent and you consent to such revocation; or

(b) after consulting you, modify or revoke this consent if it appears to us to be requisite or expedient to do so by reason of any change of circumstance, having regard to the duties imposed on us by section 4 of the Railways Act.

7. In this consent:

“application” means the proposal to develop property at and around certain sites in the south east of England, as described in the initial application dated 11 September 2007 (attached at Annex B to this consent) and in subsequent correspondence with ORR, including e-mails from the licence holder dated 4 October 2007, 22 November 2007, 14 April 2008 and 2 June 2008;

- “licence holder” means the holder of the network licence;
- “network licence” means the licence granted to Network Rail Infrastructure Limited (formerly known as Railtrack PLC) by the Secretary of State for Transport on 31 March 1994, as amended from time to time;
- “the Railways Act” means the Railways Act 1993 (as amended).
- “contributions” means any form of financial support or assistance given by the licence holder, whether on a temporary or permanent basis, including any commitment or liability (whether actual or contingent) to provide such support or assistance. Financial support or assistance includes, without limitation, the transfer of any asset, the making of any investment and the provision of any loan or working capital facility. Any financial support or assistance will be valued, as a minimum, at its market value. Any financial support or assistance will be net of any payments received by the licence holder in relation to that support or assistance.

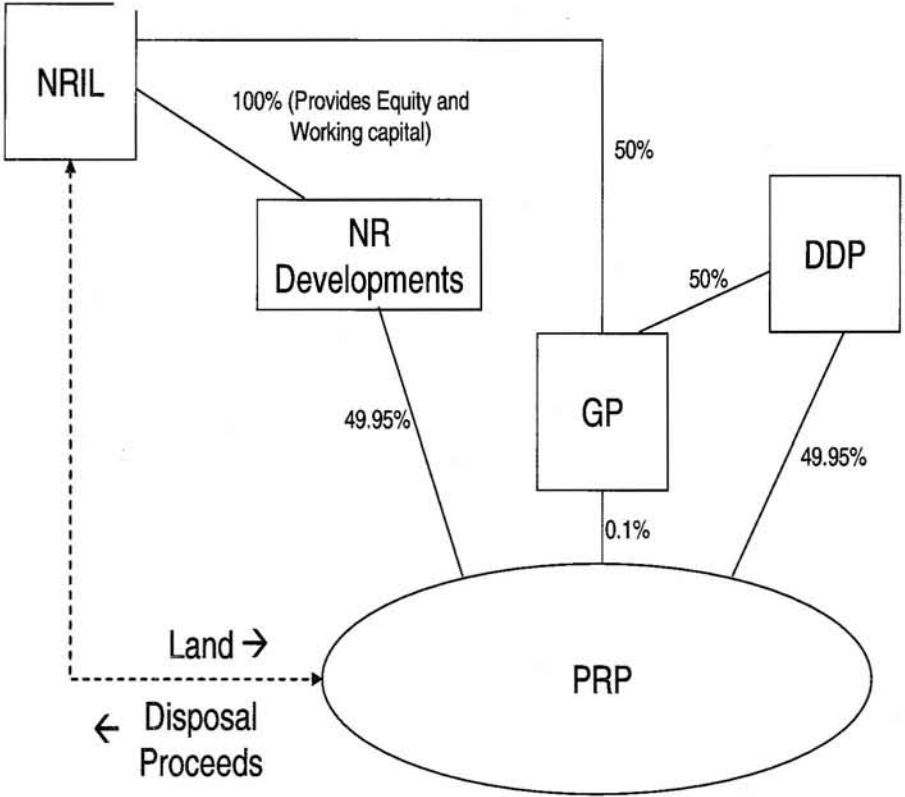
8. Terms and expressions defined in the Railways Act shall, unless the contrary intention appears, have the same meanings in this consent.
9. Granted this 21st day of July 2008.

A handwritten signature in black ink, appearing to read 'John Larkinson', with a stylized flourish at the end.

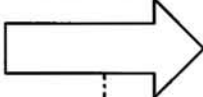
John Larkinson

For and on behalf of the Office of Rail Regulation

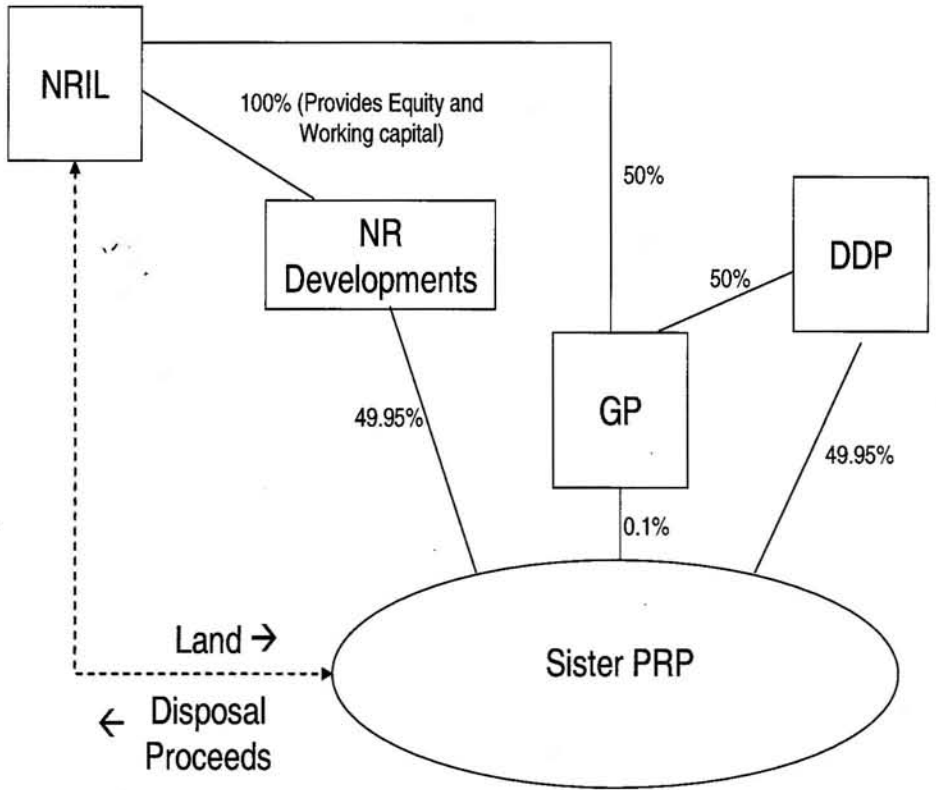
PRP – Limited Partnership Scheme value creation (with option to deliver)



Scheme Transfer



Sister PRP Site specific for delivery



NRIL – Network Rail Infrastructure Limited
 NR Developments – new company established to hold the investment in the JV
 GP (this is the General Partner as required by the legislation relating to Limited Partnerships) will be a new limited company 50% owned by NRIL and 50% owned by the DDP (Development Delivery Partner).
 Parentage shareholding is represented by the percentage number on the line connecting parent and subsidiary/partnership. For example, NRIL owns 50% of GP.



40 Melton Street
London
NW1 2EE
Tel: +44 (0) 20 7557 8233
Fax: +44 (0) 20 7557 9108

Les Waters
Manager, Network Regulation
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

11 September 2007

Dear Les

Establishment of a multi-site joint venture for the development of Network Rail stations and other property assets

Thank you for meeting with us on 25 July 2007 to discuss our proposals to improve the delivery efficiency and value of property developments at stations and on other Network Rail land through the establishment of a multi-site Joint Venture (JV). Following on from this useful meeting, we would now like to set out our proposal formally to you, with a view to obtaining any regulatory consents that may be required under the terms of our network licence and to enable us to pursue this business opportunity effectively. Within this letter we set out the details of our proposal more fully, highlight the benefits that we believe our proposal will deliver and discuss the process for further engagement with our JV partner moving forward. We conclude by discussing Network Rail's initial conclusions as regards any need to obtain regulatory consent to engage in this proposed activity.

Background

The creation of a multi-site JV for the development of Network Rail stations and other property assets, is aligned with our 'world-class' workstreams and our desire to ensure that we achieve the best possible value out of our railway estate, whilst maximising our opportunity to enhance the railway for passengers.

Historically, Network Rail has realised value from its property portfolio through identifying sites surplus to operational requirements and disposing of the sites, following a competitive tendering process, including by entering into sale contacts with developers conditional upon obtaining planning consent (and indeed regulatory consent) or unconditional depending upon the existence of regulatory consent and whether a planning consent has been obtained prior to marketing or not.

Sites in and around stations have similarly been considered for disposal via conditional contracts whereby Network Rail would receive an underlying land value from the development scheme in addition to securing station improvements.

Over the past few years, Network Rail has disposed of a considerable amount of its land-bank, and the main pockets of our remaining land that may be suitable for development, particularly in the south east of England, are located at or near to our stations. We believe that the establishment of a JV would enable Network Rail to benefit more fully from the disposal of land in these locations, through enabling Network Rail to create a commercial relationship with a developer, who would in turn bring development capability and vision, enabling Network Rail to maximise the land value of these remaining sites and facilitate extensive enhancement work in the vicinity of our stations.

The three main objectives of this proposal can be described as follows:

- 1) to capture greater land value;
- 2) to facilitate enhancement to Network Rail's assets and in particular its stations; and
- 3) to speed up project delivery by working closely with the property developer.

Network Rail has historically been unwilling to accept development risk and this has resulted in the current strategy of entering into conditional contracts with developers for the sale of sites in return for the underlying land value with overage and clawback agreements. The costs involved in the process from drawing up plans for a planning application right through the planning process to physical development on site have remained with the successful bidder, together with the associated risk of a changing property market. Development profit has therefore remained a receipt for the developer rather than Network Rail.

By employing a more holistic and strategic approach to property development and maintaining a longer involvement with development schemes, we believe that Network Rail will be able to increase its share of development proceeds. This would allow Network Rail to oversee the strategic elements of the property activity whilst still fulfilling the wider objectives of the organisation and ultimately of our network licence.

As we highlighted at our recent meeting, we believe that our proposed multi-site JV will promote a position by which, moving forward, we get the best value out of the railway estate and continue to enhance the railway (particularly at stations) to the benefit of the travelling public. Recognising that Network Rail is not a property developer, we believe that the creation of such a JV would best allow us to achieve the three core objectives as set out above.

Creating the JV

As the initial start-up costs of this proposal are likely to be significant, Network Rail proposes a multi-site joint venture, with a total expected land value of between £50-£100m (this is an estimated figure which is still subject to confirmation). Work is currently under way to identify the most suitable sites (mostly stations located in the

South East of England). It is expected that we will proceed with between 8 and 12 sites (again this is an estimated figure that is subject to confirmation) and we are hoping to start the procurement of a development partner through the OJEU process in October 2007 with an appointment planned in the summer of 2008.

As and when the final sites for inclusion within the JV are selected, a business plan and business case for each site will be prepared. This will require approval by both Network Rail and the developer. It is currently our intention to use deadlock clauses to protect Network Rail against risk (which is discussed in more detail later in this letter) and to protect our railway assets. We will also ensure that our JV partner is fully aware of the regulatory context within which it would be working. Network Rail has appointed the leading property agent in this area, King Sturge, to help us establish the terms of the JV.

Regulatory Consents

Under the terms of condition 12 of our network licence, Network Rail is not, except with the written consent of ORR, to conduct any business or carry on any activity other than the Permitted Business. We recognise that the definition of Permitted Business contains limitations as regards the exploitation of land. However, as you will of course be aware, Network Rail already holds a consent (dated 8 June 2005, extended 6 June 2006) to engage in specified property activities.

This consent also enables us to hold shares in a company which conducts business for the purposes of our consented activities. However, the JV structure that we are currently envisaging does not involve a shareholding. In order to engage in the JV, we propose to establish a limited partnership under the Limited Partnership Act 1907, which is not a corporate entity, but under which one party contributes funding or assets with limited liability for the debts of the partnership. This structure will enable Network Rail to engage in the development of some important sites whilst minimising our exposure to risk. This structure is seen as the most appropriate delivery vehicle as it meets the following requirements:

- The limited liability partnership structure is a well understood vehicle used by the property market, e.g. institutions (life and pension funds), banks and property companies;
- The structure has been used on other Property Regeneration Partnerships (PRPs), e.g. Berkeley Homes and Prudential and British Waterways PPP, and has been shown to be a successful vehicle;
- The partners are taxed as if they own the assets themselves and this is particularly attractive to life and pension funds (due to their tax exempt status) who are likely to bid for the role of Development Delivery Partner (DDP);
- Implementation of corporate governance and reporting functions to enable transparent operation and monitoring;

- The structure allows the investment partners to have their liability capped at their equity/additional funding contribution; and
- A limited partnership is regulated by the Financial Services Authority and must operate within strict parameters and reporting requirements: it must be open, transparent and accessible. Monitoring of the progress of the PRP can therefore be easily undertaken through a pre-agreed reporting format.

We believe that this approach is consistent with our obligations as set out under LC7 of our network licence to 'secure...the improvement, enhancement and development of the network...in accordance with best practice and in a timely, efficient and economical manner'. The question which therefore follows is whether the activities that the proposed JV is to carry out are consistent with what we are already permitted to carry out under our existing consent. Our thoughts on this matter are set out more fully below.

First, it should be noted that the JV will only cover Network Rail's properties. Our existing consent permits disposals and also envisages (within financial constraints) development of the commercial let estate. We are not envisaging that other properties will be brought into the JV, although there is the possibility that acquisition of leasehold interests affecting our property, or neighbouring property which is required to complete a scheme involving our property, may be entailed. This is just as at present, where paragraph 7 of schedule 1 of our consent permits acquisitions within parameters.

Secondly, the structure of the JV envisages a contractual relationship of partnership, and we do not see that, if its activities are what we could undertake in any event, the existence of that structure necessarily makes a difference to their permitted status. The developer would be bringing in resources, but we could have brought in resources through acquiring temporary personnel by secondment or otherwise (although without incentivisation advantages that the JV relationship would bring). It is the underlying activity, we believe, that counts.

Thirdly, it should be recognised that it is envisaged that the JV will actually carry out development work on the selected sites as appropriate, rather than contracting with or selling on to developers to do so, although this may remain an option depending on the circumstances at any given site. As you will appreciate, the relationship between commercial development and our consented activities has evolved over time. Our consent does not explicitly cover development as a separate activity, although we believe that:

- a level of development is anticipated under item 1 of schedule 2 of our consent, which comprises "The activity of management of Network Rail Group's let estate...comprising...its...development" – subject to investment under this item and under other Schedule 2 activities being together subject to an annual ceiling of £63.3m plus 10%; and

- development (where it is undertaken via a developer, including the provision of railway works, in exchange for the grant of an interest in the land – i.e. under a dealing where Network Rail receive hypothecated gains as well as, or instead of, a cash consideration) is something which may be pursued within our permitted sales activity.

The constraints afforded by these existing arrangements are such that we would wish to enable flexibility for the JV, in order that:

- in relation to the "Spacia development" aspects of our existing consent, we would, in enjoying consent, have greater certainty that what is presently provided by reference to our "let estate" (although we are still only concerned with land owned by Network Rail and ancillary acquisitions as mentioned above);
- in lieu of treatment within the Schedule 2 financial ceiling, the extent and acceptability of risk and financial commitment for Network Rail's engagement in the JV could be considered separately;
- In relation to the existing sales activity, the JV would not be constrained from undertaking preliminary development, rather than this having to be tied in with the sales terms so as to be directly funded as consideration for the disposal. We appreciate that where direct development does not involve the disposal of land, then the *de minimis* facility may be available to give regulatory sanction to the incurral of expenditure and liabilities. However, an express consent would give greater clarity to the position where the relationship between preliminary development and eventual disposal may shift over time.
- Network Rail was able to capture value through the exit process, for example by purchasing assets which came out of any development, where appropriate. This would afford Network Rail the possibility of retaining income generating assets at stations and other sites as opposed to taking a capital sum, thus increasing our income in the longer term.

Network Rail's approach to managing risk

Perhaps the most important consideration is that this proposal does not expose Network Rail to unnecessary commercial risk. It should therefore be noted that the PRP will carry and address the risks associated with holding assets and undertaking development.

In order to manage the risks associated with the project effectively, a risk register will be implemented which will identify all the risks associated with the project and will calculate the risk based on the severity, and likelihood, of each factor taking place. It will then look at measures which can be introduced to lower the probability and re-calculates the new risk level. There are three grades of risk: low, medium and high. The risk register can be adapted throughout the project, with new risks added, and used as a management tool for the project team. It will be the responsibility of the PRP to ensure that the risk register is kept up to date and adapted throughout the project. Network Rail considers that the two key risks

associated with the project will be in terms of financial risk and operational risk. We set out how we will deal with these issues under separate headings below.

Financial Risks

The financial risks include changes in interest rates, inability to raise third party finance secured on the property, changes in taxation treatments and changes in legislation surrounding limited partnership. As regards these:

- the risks associated with changes in interest rates will be reduced through the use of appropriate hedging instruments;
- the risk of not being able to raise third party finance secured against the property is low given the requirement of the PRP to match Network Rail's funding available;
- mitigating the risk of changes in taxation treatment or changes in legislation surrounding limited partnerships is difficult. In the event that such changes fundamentally undermine the viability of the PRP, provision will be made to allow the partners to terminate the vehicle at any time or re-structure the vehicle to a more appropriate legal entity.

In addition to these financial risks, there are financial risks associated with the property market. Property market risks, including the possibility that there is a down turn in the property market (with associated effects on development activity) or occupancy rates fall, rental growth is slow and/or capital growth is slow, must be considered. Essentially, the structure of the proposed PRP is such that these risks will be carried primarily by the development partner, not Network Rail. The financial structure of the vehicle will transfer the majority of the risk of owning property away from Network Rail by fixing the guaranteed value to be received for the properties committed at the outset and receiving first ranking security over the assets transferred into the vehicle.

The development partner's returns are entirely dependent on profits being generated. Hence, the partner will be incentivised to develop and manage the asset portfolio to extract optimum performance of the asset.

Network Rail will share in profits generated by the vehicle 50/50 with the development partner. As profits will only be generated when the vehicle has paid Network Rail the transfer value for the assets, the development partner is incentivised to maximise the value of the assets; otherwise they will receive no returns. Further, as the development partner pays equity at the outset, it is incentivised to generate returns as soon as possible.

The PRP will enable Network Rail to extract funds from the assets in a more structured way compared to selling the assets on a piecemeal basis. The structure can also allow a degree of flexibility around these returns should this be necessary.

In addition to the non-pecuniary benefits of the PRP structure, the vehicle also demonstrates higher financial returns over the other options, which accounts for the higher level of risk that Network Rail would be exposed to. Whilst the financial structure of the PRP mitigates as much risk as possible, Network Rail will still carry

a certain level of property exposure, albeit less than owning the properties directly. We believe that we are able to manage these risks effectively.

Operational Risks

The risk of Network Rail not fulfilling its objectives will, to a large extent, be mitigated by the control mechanisms embodied in the business plans for the assets, in the partnership documentation and also by the deadlock provision that will exist. The partnership agreement will also include provisions to mitigate the risk of the partner using his wider influence to affect the successful operation of the PRP.

The objectives of Network Rail will be secured through the limited partnership's contractual structure when the PRP is established. This will set out the parameters within which the PRP will be able to operate. If there is a divergence of views over the direction the PRP should take, there will be a deadlock provision which in effect is reinforced by Network Rail and its development partner having equal shareholdings and thus the ability to exercise countervailing power.

The operation of a limited partnership is dictated by formal documents and can be monitored by strict reporting requirements. Combined with the management structure envisaged, control is achieved at three levels:

- A partnership agreement that binds the partners together and sets out the way in which they can act. This is at a strategic level and is crystallised in the investment agreement (which will contain the Policy Implementation Framework) and partnership Business Plan agreed at the outset of the PRP;
- At an operational level, the general partner governs how the PRP actually manages the portfolio. The general partner will be a limited company and both its Memorandum and Articles of Association and the investment agreement of the limited partnership will dictate the parameters within which it can operate; and
- Finally, the general partner will sub-contract all of the day to day management of the properties to a discrete management company. This company's operation will be governed by the contract between it and the general partner.

All of these controls will be overseen by the Operator of the limited partnership (an independent organisation fulfilling the regulatory role for the limited partnership in accordance with the Financial Services and Markets Act 2000) and will be responsible for producing reports on how the PRP is operating.

As Network Rail will have equal control with the development partner at both the partnership and general partner level, its interests and objectives can be secured. Additionally, all partnership documentation will be reviewed by Network Rail prior to commencement of the PRP.

The risk of increasing construction costs during the development of the assets will also be mitigated via means of the pre-agreed required development criteria and business plans for each site at the establishment of the limited partnership

contractual structure. Again, we believe that we are able to manage effectively the operational risks associated with the delivery of the JV.

As Network Rail continues to mature as an organisation we consider that the creation of the proposed JV represents the best way forward in terms of delivering substantial improvements to our property portfolio for the benefit of the travelling public.

Our existing property consent was established in circumstances where it was recognised that many property activities substantively did not require consent, but it was not possible to divorce them from elements which did. Accordingly the consent was granted for the activities without differentiation between the relevant activity elements. We believe that there is some analogy with the present situation in that it may be possible to engage in this activity under the terms of our existing property consent, but that the level of flexibility sought is such that it would be appropriate for consent to be provided.

We would therefore be grateful if ORR could accept this letter as our formal application for consent to establish and undertake a multi-site joint venture for the development of our stations and other property assets under Condition 12 of our network licence.

Network Rail is hoping to announce this proposed initiative publicly on 22 October and we would like to have resolved any issues as regards obtaining any regulatory consent that may be necessary by this time.

Yours sincerely

Jonathan Haskins
Regulatory Legal Specialist