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14 May 2010

Hazel Walker  
Company Secretary  
Network Rail Infrastructure Limited  
Kings Place  
90 York Way  
London N1 9AG

Dear Hazel

**Network licence conditions 4 and 5 – consent in respect of various arrangements in connection with the provision of operation, maintenance and renewal services in respect of High Speed 1**

**Context**

1. We have had various discussions since last summer about the restructuring of the arrangements currently in place between Network Rail and High Speed 1. Changes to these arrangements are being made in preparation for the sale of HS1 Ltd (“HS1”). You applied to us for our consent under conditions 4 and 5 of the network licence for Network Rail Infrastructure Limited (“NRIL”) and its subsidiary, Network Rail (CTRL) Limited (“NR (CTRL)”) to enter into various arrangements in connection with the provision by NR (CTRL) of operation, maintenance and renewal services to HS1 in respect of High Speed 1 – the line between St Pancras International and the channel tunnel (the “application”) on 9 October 2009 as subsequently modified by your letters of 13 January 2010 and 6 May 2010.

2. You have particularly sought consent for:

- (a) NRIL and NR (CTRL) to enter into new financial arrangements, including changes to the capitalisation of NR (CTRL) and entering into a further intercompany loan agreement and deed of charge;
- (b) NR (CTRL) to enter into a revised Operator Agreement with HS1;
- (c) NR (CTRL) and NRIL to enter into an Operator Direct Agreement with the Secretary of State for Transport and HS1;
- (d) NR (CTRL) to secure insurance coverage with NRIL’s captive insurance company in respect of the risks arising under the revised Operator Agreement;

- (e) revisions to the St Pancras concession agreement involving removal of the Services Fee currently payable by HS1 to NR (CTRL) and associated amendments;
- (f) NRIL to enter into a Deed of Guarantee and Indemnity with HS1; and
- (g) NRIL to have an interest in the ownership and/ or operation of railway vehicles to be used on High Speed 1,

(together, the "NR (CTRL) arrangements"). You have provided further supporting information in respect of your application in particular by way of letter and attachments dated 11 March 2010 and subsequent correspondence with us, including in a meeting with us on 25 March 2010 and 8 April 2010.

### **Reasons for consent and conditions**

3. In considering your application, we have had regard to our duties under section 4 of the Railways Act 1993 (as amended) (the "Act") and in particular our duty to have regard to the funds available to the Secretary of State, to the terms of your application and to other supporting information supplied by you concerning the NR (CTRL) arrangements. We have had particular regard to the fact that this application relates to a re-negotiation of existing long-term arrangements to which we have previously consented. We have sought to strike an appropriate balance between providing for appropriate commercial freedom for these arrangements to operate effectively and limiting the potential for cross-subsidy and risk to NRIL's customers and funders in view of the overall Network Rail not for dividend corporate structure. We have therefore had particular regard to the limitations on liability of NRIL and NR(CTRL) under the various NR (CTRL) arrangements and the activities that NRIL and NR(CTRL) would be undertaking. The conditions which we have attached to this consent and the provisions relating to revocation and modification in paragraph 16 reflect these considerations and in particular our view that these arrangements will require on-going regulatory oversight.

4. Subject to the terms set out in this letter, we hereby consent under conditions 4 and 5 of the network licence to NRIL and NR (CTRL) entering into the NR (CTRL) arrangements.

### ***Information on the NR (CTRL) arrangements underpinning the consent***

5. We have been provided with the near final forms of the NR (CTRL) arrangements. To enable us to reach a fully informed judgment on your application, you have confirmed to us, by way of a letter dated 12 May 2010, that you believe that you have provided us with all relevant information in support of your application and that the terms of the final NR (CTRL) arrangements will not differ materially from those presented to us. We require you to send us signed copies of the principal documents entered into by NRIL and/or NR (CTRL), including the revised Operator Agreement, Operator Direct Agreement and the revised St Pancras concession agreement and any other documents which have a material bearing on the issues we are consenting to within 14 days of such documents being executed. Moreover, once the NR (CTRL) arrangements have been entered into, we require you to keep us informed of any material changes to the NR (CTRL) arrangements going forward prior to any such changes being made. We understand that you are considering whether modifications to the provision of services agreement between NRIL and NR(CTRL) may need to be made to reflect the changes to the NR(CTRL) arrangements. If this is the case we require you to provide us with the final form of any

such modifications to this agreement for our consent prior to entering into the revised agreement.

### ***Financial arrangements between NRIL and NR (CTRL)***

6. As explained above, you have sought consent for NRIL to enter into revised financial arrangements with NR (CTRL). Such arrangements include changes to the capitalisation of NR (CTRL), at around the same time as the revised Operator Agreement is entered into, and entering into a deed of charge and an additional intercompany loan agreement. You have provided an explanation for these arrangements in your letter dated 10 May 2010. We understand that these arrangements are intended to provide flexibility in respect of the funding of NR(CTRL) going forwards at the same time as providing additional security for NRIL through the deed of charge.

7. Given Network Rail's financial structure and the financial indemnity provided by the Secretary of State for Transport, we consider it is necessary to limit the potential for cross-subsidy from NRIL's core business (supported solely by NRIL's customers and funders) to NR (CTRL) in the event of cost overruns under the revised Operator Agreement going forward and other risks arising under the revised NR(CTRL) arrangements. Moreover, we are concerned to limit NRIL's exposure arising as a result of the NR(CTRL) arrangements.

8. We consider that NR (CTRL), as a contractor to HS1, should stand or fall on its own merits. It is therefore a condition of our consent, to the NR(CTRL) arrangements, which include the intercompany loan agreement, deed of charge and NRIL Guarantee, that no further contributions to NR (CTRL) shall be made unless we otherwise expressly consent to this<sup>1</sup>. We also require you to seek our prior consent to any modification to the intercompany loan dated 20 February 2006, the additional intercompany loan agreement, the deed of charge and NRIL Guarantee following their execution.

### ***Additional Services and Specified Upgrades***

9. With regard to your application for consent for NR (CTRL) to enter into a revised Operator Agreement with HS1, we note that in our meeting of 25 March 2010 we asked that you provide additional details about how "Additional Services" (as defined in the revised Operator Agreement) are to be treated because we were concerned at the potential scope for NR(CTRL) or NRIL to become involved in activities which go beyond the core OMR functions under the NR(CTRL) arrangements. You provided further information on this issue by way of email dated 26 March 2010. Having considered the information provided by you, we consent to the provision by NR (CTRL) of:

- (a) all "Additional OMR Services" as defined in the draft revised Operator Agreement (and as more particularly detailed in Clause 18 and Schedule 2 of the same);
- (b) all "Additional Services" as defined in the draft revised Operator Agreement which are referred to in clauses 7.12, 18.5 and 33.1.5 of the Operator Agreement;
- (c) any "Additional Service" as defined in the draft revised Operator Agreement, (other than those referred to in paragraphs (a) and (b) above), provided that the total

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<sup>1</sup> All monetary values given in April 2010 prices in this consent can be rebased each year in the future using the all items retail prices index (RPI).

expenditure incurred by NR (CTRL) in respect of all such "Additional Services" does not exceed £3 million from the date of this letter and does not exceed £1 million in any single year (both in April 2010 prices<sup>2</sup>); and

- (d) any "Specified Upgrade" or other upgrade, as defined in Schedule 10 of the draft revised Operator Agreement, provided that the total expenditure incurred by NR (CTRL) in respect of all such "Specified Upgrades" or other upgrades does not exceed £10 million from the date of this letter and does not exceed £4 million in any single year (both in April 2010 prices).

NR (CTRL) shall apply to us for prior consent before carrying out any "Additional Service", "Specified Upgrade" or other upgrade as defined in the draft revised Operator Agreement which exceeds the threshold levels referred to in paragraphs (c) and (d) above respectively. Any future application for consent must be accompanied by a detailed explanation of the proposed activity and the terms upon which it is to be provided. NR (CTRL) will notify us at least annually of the expenditure on "Additional Services" and "Specified Upgrades" or other upgrades as referred to in paragraphs (c) and (d) above and if it considers that it will exceed the limits.

### ***Front Office Activities/ HS1 Reserved Actions***

10. Clause 7.4 of the Operator Agreement contemplates that NR(CTRL) could perform Front Office Activities if this was agreed with HS1 Limited. Front Office Activities include a number of activities from marketing HS1, managing stakeholder relations and publishing the network statement which go beyond NR(CTRL)'s core OMR responsibilities for HS1. Our prior consent would be required before NR(CTRL) undertakes any Front Office Activity as defined in the Operator Agreement. The Operator Agreement does not include a similar provision in respect of HS1 Reserved Actions but if a modification was proposed to enable NR(CTRL) to undertake these responsibilities this would also require our prior consent. We note that the Operator is entitled to undertake the three HS1 Reserved Actions referred to in Clause 7.7.4 of the Operator Agreement if it reasonably believes that this is necessary in order to comply with the Safety Authorisation and/or any Law on an urgent basis. We confirm that NR(CTRL) does not need to obtain our consent prior to carrying out such actions.

### ***Assignment***

11. Clause 37.3 of the Operator Agreement permits assignment or transfer of NR(CTRL)'s rights and obligations under the Operator Agreement in certain circumstances. No assignment or other arrangement under any of the provisions in Clause 37.3 is permitted without our prior consent because of the possible change in the liability of other members of the NRIL Group that could arise as a consequence of any such transaction.

### ***Insurance***

12. In your application and your letter of 11 March 2010, you have provided information about NR (CTRL)'s increased exposure to insurable risks arising under the revised

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<sup>2</sup> All monetary values given in April 2010 prices in this consent can be rebased each year in the future using the all items retail prices index (RPI).

Operator Agreement and have sought express consent for NRIL's captive insurance company, Network Rail Insurance Limited, to provide insurance cover to NR (CTRL) in respect of such insurable risks. We discussed this proposal further with you in our meeting of 25 March 2010. We confirm that, at this point in time, we have no objection to NR (CTRL) obtaining insurance cover from Network Rail Insurance Limited in respect of risks arising under the revised Operator Agreement. However, we reserve the right to reconsider this position to the extent that any market testing is to be undertaken, as envisaged by the terms of the draft Operator Direct Agreement. NRIL will provide evidence to us that it has entered into these arrangements on an arm's length basis, that there is no cross-subsidy from NRIL to NR (CTRL) and that Network Rail Insurance Limited has appropriately priced the risks taken.

### ***NRIL Guarantee***

13. You have also sought consent for NRIL to enter into a Deed of Guarantee and Indemnity with HS1 (the "NRIL Guarantee"). We understand that at the time the NRIL Guarantee becomes effective it replaces a guarantee which is currently provided by Network Rail Limited dated 3 October 2002. Although entering into the NRIL Guarantee would increase NRIL's exposure it has more favourable contractual terms than the current guarantee, including payment to NRIL of market standard guarantee fees. In addition, the pre-existing guarantee does not include a contractual limitation on the amounts that can be claimed per event and per year in the manner proposed in the NRIL Guarantee. Under the NRIL Guarantee NRIL would guarantee both performance and payment obligations as is the case for Network Rail Limited under the existing guarantee but NRIL would have the right to terminate this guarantee if at any time it has expended more than £15 million in paying or performing its guarantee obligations in any control period for HS1 under clause 21.

14. Having considered the information which has been provided to us we consent to NRIL entering into the NRIL Guarantee subject to the following conditions:

- a. We require you to notify us of any claims, including potential claims, which are made by HS1 under the NRIL Guarantee as soon as these are received by NRIL.
- b. If NRIL performs an obligation instead of making a payment to HS1 pursuant to the NRIL Guarantee we require evidence of how the cost of such performance has been determined in accordance with clause 2.3 of the NRIL Guarantee.
- c. NRIL must give a notice under clause 21.1 of the NRIL Guarantee if a termination event (as defined in the NRIL Guarantee occurs) unless we consent otherwise at the time.
- d. Without prejudice to paragraph 16 below, NRIL must not agree to any increase in its liabilities upon the occurrence of an insolvency event in the manner contemplated by clause 15.2 of the NRIL guarantee without our prior written consent.

## ***Rolling stock***

15. You have also sought consent for NRIL to have an interest in the ownership and/ or operation of railway vehicles to be used on High Speed 1. Having considered the information provided in your letter of 9 October 2009, we consent to NRIL having an interest in the ownership and/ or operation of railway vehicles to be used on High Speed 1. This consent does not diminish in any way the obligations on Network Rail under condition 1 of its network licence.

## ***Revocation or modification***

16. We may, at any time after consulting you and any other interested person including the Secretary of State:

- (a) revoke this consent if we issue a new consent relating to the provision of services by NR (CTRL) to HS1 under the revised Operator Agreement and you consent to such revocation;
- (b) modify or revoke this consent to the extent that the final NR (CTRL) arrangements entered into are materially different to the NR (CTRL) arrangements as presented to us at the date of this letter;
- (c) modify or supplement this consent once the NR (CTRL) arrangements have been entered into to the extent that a material change is proposed to any of those arrangements; or
- (d) modify or supplement this consent if it appears to us to be requisite or expedient to do so by reason of any material change of circumstance, having regard to our duties under section 4 of the Act.

## ***Definitions***

17. In this consent:

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| “contributions”                   | means any form of financial support or assistance given by NRIL or any affiliate or related undertaking of NRIL, whether on a temporary or permanent basis, including any commitment or liability (whether actual or contingent) to provide such support or assistance;   |
| “expenditure”                     | means the gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred and all commitments and liabilities (whether actual or contingent) relating to such services or upgrades as appropriate; and  |
| “financial support or assistance” | includes, without limitation, the acquisition of shares, the transfer of any asset, the making of any investment and the provision of any loan or working capital facility or guarantee. Any financial support or assistance will be valued, as a minimum, at its market value and net of any payments received by the relevant entity in relation to that support or assistance. |

18. Terms and expressions defined in the Act and the network licence shall, unless the contrary intention appears, have the same meanings in this consent.

Handwritten signature of John Thomas in blue ink.

**John Thomas**

For and on behalf of the Office of Rail Regulation