



OFFICE *of the*
RAIL REGULATOR

**CONSULTATION ON PROPOSED
MODIFICATIONS TO
RAILTRACK'S NETWORK LICENCE:
DISPOSAL OF ASSETS AND RING-FENCING**

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Regulator's foreword

1. This consultation document contains my proposals to modify Railtrack's network licence in two respects. The first is about placing appropriate limitations on the company's freedom to dispose of its assets. The second concerns the ring-fencing of the business of Railtrack PLC.
2. Earlier this month, I published proposals for two other network licence modifications. At that time I explained that in my view the company's network licence is not fit for the purpose of the effective regulation of a company in Railtrack's position in the private sector. I said that I intended to take the steps necessary to remedy the shortcomings in the licence. This consultation document completes the publication of my proposals to achieve that objective.
3. The first condition in this document concerns asset disposal. There has been considerable disquiet expressed by the railway industry and others about Railtrack's freedom to dispose of, or otherwise deal with, its assets in ways which may promote the company's commercial objectives but at the expense of the public interest. The concerns have focussed mainly on Railtrack's land holdings, but the principle of the company having limitations on its freedom to deal with its other assets in ways which frustrate or hinder the public interest in the efficient and economical operation and development of the railway applies with equal force to all its railway assets. The existing limitations in Railtrack's network licence on dealings with relevant assets do not go far enough. My proposals are to replace them with a single condition.
4. The second condition deals with ring-fencing. The new condition would require Railtrack to ensure that it is properly resourced to carry out its licensed activities. It would also prevent Railtrack PLC (the licensed subsidiary of the Railtrack group) from investing in businesses which are unconnected with its core activity. I believe it is important to provide a clear distinction between the regulated and unregulated activities of Railtrack group, and that is what this proposed condition would achieve. It will also help to ensure that the regulated business continues to have ready access to finance at a reasonable cost.
5. Both proposed licence conditions are modelled largely on the corresponding conditions in the licences of other regulated network businesses.

6. I shall welcome the views of the railway industry and others on the public interest case for or against these proposals, and on the specific questions in this document.

TOM WINSOR
Rail Regulator
September 2000

1. Introduction

Purpose

- 1.1 This document explains two licence modifications that the Regulator proposes to make and invites comments from interested parties. The modifications would:
- (a) place controls on the disposal of Railtrack's assets, including land (Chapter 2); and
 - (b) put in place arrangements relating to the financial ring-fencing of Railtrack PLC's business on a basis similar to many other regulated networks (Chapter 3).

Background

- 1.2 The background to the current exercise to modify Railtrack's network licence was set out in a document published by the Regulator on 15 September 2000¹. In brief, he considers that the network licence requires a number of changes in order to make it fit for the purpose of regulating a private sector company. The document published earlier this month contains the Regulator's proposals to amend Railtrack's network licence to require it to maintain an asset register, and to develop and comply with a code of behaviour in its dealings with third parties. He has separately sought comments on other proposed licence modifications².

Consultation

- 1.3 Consultees are invited to comment on the proposed licence modifications and the specific questions raised in this document. Consultation responses should be sent to:

¹ *Proposed Modifications to Railtrack's Network Licence*, Office of the Rail Regulator, London, September 2000.

² See *Periodic Review of Railtrack's Access Charges: Provisional Conclusions on the Incentive Framework*, Office of the Rail Regulator, London, April 2000 and *Periodic Review of Railtrack's Access Charges: Draft Conclusions*, Office of the Rail Regulator, London, July 2000.

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by 3 November 2000.

- 1.4 Respondents should indicate clearly if they wish all or part of their responses to remain confidential to ORR. Otherwise it is expected that they will be published in the ORR library and on its website and they may be quoted from by the Regulator. Where a response is made in confidence, it should be accompanied by a statement which can be published as described above, summarising the submission but excluding the confidential parts. The Regulator may also publish the names of respondents in future documents and on the ORR website, unless a consultee indicates that he wishes his name to be withheld.
- 1.5 Copies of this and other ORR documents referred to in this document can be seen on ORR's website (<http://www.rail-reg.gov.uk>) and in the ORR library.

2. *Asset disposals*

Background

Inadequacy of existing arrangements

- 2.1 Railtrack owns a number of assets that are crucial to the current operation of the network as well as some that may be necessary to or expedient for the future operation and development of the network. Railtrack has a strong commercial incentive to maximize income from its property (including through disposals) although the benefits are shared with the industry through the operation of the Property Allowance Scheme (PAS).
- 2.2 The controls on disposals of assets in Railtrack's network licence are relatively narrow in scope. They are found in Condition 10. The Condition requires the consent of the Regulator for Railtrack to deal with any relevant asset (including land) in a manner which makes it unable to meet its obligations under any access agreement. However, this does not prevent Railtrack from disposing of assets not required to meet its current obligations. Nor does it prevent the sale and leaseback of assets for the duration of its current obligations, so that they are not available to those wishing to use them after the end of a current access contract.
- 2.3 The only other controls are found in a contractual agreement between Railtrack and some freight train operators governing the utilisation and disposal of land that has been identified as of strategic value for the development of rail freight. It is an unregulated contract, and not in the public domain (although the list of sites has been made public). The commercial interests of the parties are not necessarily aligned with the public interest and only a small number of major freight train operators are party to the agreement. It is enforceable by the parties only, and remedies may offer insufficient protection against breach. For all of these reasons, the Regulator is not satisfied that this arrangement is adequate to protect the public interest.
- 2.4 The Regulator does not consider that these controls are appropriate for a private sector company using public funds. As explained in the document published earlier this month, Railtrack's network licence was issued at a time when it was expected to remain in public ownership, and to be subject to controls that would enable the broader public interest to be taken into account. In this connection it should be noted

that the Transmission Licence for the National Grid Company PLC, Transco's Public Gas Transporter Licence, the proposed standard licence conditions for the electricity distribution companies and the licence conditions of certain water companies contain conditions restricting the disposal of assets.

Views expressed by other parties

- 2.5 Having received a number of reports about land disposals that were alleged to be against the public interest, in May 2000 the Regulator sought the views of train operators, funders, local authorities and representatives of passengers and freight users on particular cases of concern to them.
- 2.6 Passenger operators sought arrangements which would enable them to be consulted about potential land disposals by Railtrack and to make the case against such disposals where appropriate. They identified a significant number of sites owned by Railtrack with potential for development for railway purposes. Passenger operators said that:
- (a) the existing arrangements for consultation on planned disposals of land were voluntary and haphazard. They were not always consulted on land disposals. There was no requirement upon Railtrack to consult passenger operators on land disposals, nor any means of preventing such disposals by Railtrack even if they foresaw a potential railway use;
 - (b) they could not afford to acquire railway land in competition with developers seeking land for non-railway purposes;
 - (c) not all of them knew what land Railtrack owned which might be of relevance to their future plans. Railtrack should be required to compile a register of landholdings which could be inspected by rail industry parties³; and
 - (d) they were particularly concerned that land adjacent to station car parks should be retained, given the growth in passenger traffic and demand for parking spaces.

³ It is intended that landholdings will form part of the proposed asset register. See *Consultation on Proposed Modifications to Railtrack's Network Licence*, Office of the Rail Regulator, London, September 2000.

2.7 Freight operators and the Rail Freight Group listed a number of sites which they considered had potential for freight use which had either been sold, or were being considered for disposal. English Welsh & Scottish Railway Limited (EWS) pointed out that:

- (a) land is a finite asset, and once sold, is lost to the rail industry. While housing, industrial, retail and leisure developments are not tied to particular locations, land for railway use has to be located close to the existing network;
- (b) railway development is a lengthy process, so the potential use of land for railway purposes might not become evident for some time;
- (c) the existing arrangements to protect strategic sites are not adequate. They place the onus on freight users to challenge any decisions that Railtrack might take to dispose of land. This can be a time-consuming, costly and difficult exercise for freight operators unless they can demonstrate that a customer wanted to use a site proposed for disposal. The Rail Freight Group echoed these concerns; and
- (d) notwithstanding the arrangements in the EWS track access agreement allowing it to bid for Railtrack sites put on sale, it is unlikely that EWS will be able to afford to compete with bids which value such sites for non-rail development.

2.8 Passenger Transport Executives (PTEs) were keen to see regulatory restraints on the disposal of land by Railtrack. Among the points made by PTEs were that:

- (a) they are not always consulted on the disposal of railway sites of interest to them. They quoted examples of planned disposals that only came to light by chance and which would have prejudiced PTE plans had the plans proceeded;
- (b) even where informal arrangements to be consulted on proposed land disposals were in place, they would welcome the comfort that regulated arrangements would afford; and
- (c) they were not aware of what land Railtrack owned. PTEs wanted information about all Railtrack's landholdings, not simply those intended for disposal.

- 2.9 Local authorities were keen to protect the options for promoting rail travel and freight traffic, and identified a number of sites which they considered important to these objectives. While some indicated that they would use their planning powers to prevent the inappropriate development of such sites, others pointed out that the planning regime was not effective or appropriate in many cases. If proposed land disposals did not come to light before a planning application was submitted, it was often too late to take effective action. There was significant support from local authorities for restrictions on Railtrack's freedom to dispose of land. Several suggested that it was vital that Railtrack should be required to consult local planning and transportation authorities on planned disposals; not all had information about relevant Railtrack landholdings. In response to an enquiry from one local authority⁴, Railtrack had said that, while it would consult train operators and the shadow Strategic Rail Authority (sSRA) about disposals of operational land, 'it was not their intention to provide interested parties with details of [its] ongoing programme of land disposals'.
- 2.10 The sSRA said that, as a matter of principle, there should be a measure of control over the manner in which Railtrack disposes of its land. It noted that land is a limited resource of immense value to the development of the rail network for both passengers and goods and considered that it was important that there was an opportunity to consider any land disposals in the context of relevant sSRA strategies. Responding to Railtrack's view that concerns about the disposal of land were not matched by reality, the sSRA said that it did not consider these concerns sufficient grounds for not proceeding with a licence condition. Neither did it consider that the Network Change procedure under the Track Access Conditions provides an adequate alternative to a licence condition. The sSRA did not consider at present that the condition should cover assets other than land. However, it expressed concern 'in relation to innovative financing schemes which may involve a disposition of assets. Reductions in the cost of raising finance are to be welcomed but need to be balanced against a potential loss of flexibility'⁵.
- 2.11 The Rail Passengers Council welcomed the consultation and said that if it resulted in a decision 'to progress with a modification to Railtrack's Network Licence as a matter of public interest we would of course support such a move'⁶. It noted that 'the acquisition of land remains one of the most important issues - and biggest costs - as

⁴ Letter from Railtrack to Mr Ed Vokes, Essex County Council, dated 15 June 2000.

⁵ Letter from Mr Terence Jenner, shadow Strategic Rail Authority, dated 17 August 2000.

⁶ Letter from Mr Stuart Francis, Chairman, Rail Passengers Council, dated 25 May 2000.

far as the future development of the rail network is concerned, and disposals for short-term profit now may have unfortunate consequences for the railway in the longer term'. The Rail Passengers Committee for Scotland said that there was an argument for a mechanism 'to oblige Railtrack to consult statutory bodies such as the Rail Passengers Committees before disposing of any land'⁷ and pointed out that 'any less than judicious selling of land may possibly hinder a future reopening scheme'. The Rail Passengers Committee for the Midlands noted that it was 'not routinely made aware of Railtrack's intention to dispose of property within its region'.⁸

2.12 Railtrack accepted that there was an arguable case that some future sales might be inappropriate and said that there might be merit in strengthening existing controls. It did not intend to dispose of land that may have a future railway-related use and has policies and procedures to prevent this. Railtrack emphasised that relevant parties were consulted before land was sold and that land disposal was frequently linked to the provision of improved transport facilities. It did not consider that a licence condition was warranted and said that no case had been made to regulate the disposal of assets other than land. Finally, it said that the imposition of a total prohibition on land disposals, with exceptions provided for in a general consent, would cause uncertainty about Railtrack's ability to deal with its property.

2.13 The Regulator has concluded that given that:

- (a) assets (including land) in which Railtrack PLC has an interest may be important to the continuing operation and future development of the network; and
- (b) public funding is provided to Railtrack to maintain, renew and develop these assets,

there is a *prima facie* case for modifying Railtrack's network licence to strengthen safeguards against the disposal of assets.

⁷ Letter from Mr Robert Samson, Rail Passengers Committee for Scotland, dated 8 June 2000.

⁸ Letter from Mr Paul Fulwood, Rail Passengers Committee for the Midlands, dated 14 June 2000.

Draft licence condition

2.14 In drafting the licence condition, the Regulator has had regard to similar licence conditions in the licences referred to in paragraph 2.4 above and given the similarities of circumstance, believes the proposal is uncontentious.

Scope of the controls

2.15 The draft licence condition at Annex A provides that Railtrack may not dispose of or relinquish operational control over its assets without the prior approval of the Regulator. It specifies the assets that are covered (paragraph 5) and requires notice, with relevant information, to be provided to the Regulator if there is an intention to dispose of those assets (paragraph 2).

2.16 Under the condition relevant assets may only be disposed of, or control relinquished over them, if the Regulator confirms in writing that he consents to such disposal or relinquishment (paragraph 4). The Regulator has two months in which to give such consent and failure to do so within that period allows the disposal or relinquishment of the asset to proceed (paragraph 4(b)).

Proposed general consent

2.17 The draft licence condition contemplates the issuing of a general consent providing that assets which are specified ('excluded assets') or specified transactions in relation to relevant assets may proceed without the specific approval of the Regulator (paragraph 3). The objective of the general consent would be to reduce the administrative burden on both Railtrack and the Regulator to ensure that the control is not only effective but also efficient.

2.18 Such a general consent could be varied by the Regulator in the light of experience of its operation to permit more (or fewer) disposals to proceed without specific approval. The Regulator seeks views from Railtrack and interested parties on the terms of the general consent.

2.19 However, the Regulator is currently minded to permit Railtrack to dispose of assets that are redundant or obsolete provided that they are worth less than a given value (either individually, or in aggregate with other assets which were intended for disposal) and provided that Railtrack has advertised its intentions in advance and

notified the Regulator and the sSRA, so that interested parties can have an opportunity to object. However, this consent would not apply if a replacement asset, where required to maintain the continuing functionality of the network, has not been installed, or where the asset is intended to remain in operational use but not under Railtrack's control.

Impact on Railtrack revenues

2.20 The expected revenues from property sales are netted off Railtrack's revenue requirements as part of the periodic review. In addition, any unexpected benefits of property sales are shared with the industry through the PAS. The proposed licence condition could therefore result in a loss of revenues to Railtrack. As explained in the July 2000 periodic review document, the Regulator proposes to make a provision for adjusting the workings of the PAS such that, if the Regulator were to exercise his powers to block a sale under the proposed licence amendment, he would be able to take this into account in approving payments made to train operators under the PAS⁹.

Issues for consultation

- 2.21 Consultees are invited to comment on the proposed licence condition at Annex A, and in particular on:
- (a) the public interest and commercial reasons for or against a licence condition requiring Railtrack to seek approval for the disposal of assets;
 - (b) whether controls should be applied to all assets, or to land alone, and the reasons;
 - (c) the scope and content of the general consent, and whether the licence itself should exclude particular classes and descriptions of transaction or assets from the controls; and
 - (d) the processes by which Railtrack should make known proposed land disposals to interested parties, and by which disposals would be permitted or refused.

⁹ See paragraph 12.12 of *Periodic Review of Railtrack's Access Charges: Draft Conclusions, Volume I*, Office of the Rail Regulator, London, July 2000.

3. *Ring-fencing*

Background

Existing provisions

- 3.1 Condition 10 of Railtrack's network licence requires that Railtrack shall not, except in so far as the Regulator may otherwise grant or consent:
- (a) conduct any business other than the Permitted Business;
 - (b) guarantee the obligations of any other person;
 - (c) create any encumbrance over any relevant asset to secure any obligation of any such other person; or
 - (d) deal with any relevant asset in a manner which makes the licence holder unable to meet its obligations under any access contract or installation access contract.
- 3.2 This condition does not prevent the licence holder from having an interest in or participating in a business by way of an interest in investments. In addition, subparagraphs (b) and (c) do not apply to guarantees or encumbrances existing immediately after the coming into force of Railtrack's network licence. Finally, the Regulator has given his consent, subject to conditions, to allow Railtrack PLC to net its daily bank account with that of Railtrack Group PLC and specified subsidiaries of Railtrack Group PLC.
- 3.3 Condition 10 of Railtrack's network licence also contains provisions relating to the maintenance of accounting records. The Regulator has already published proposed licence modifications relating to Railtrack's regulatory accounts¹⁰ and the existing provisions would be removed if the modification is made.

¹⁰ *The Periodic Review of Railtrack's Access Charges: Draft Conclusions*, Office of the Rail Regulator, London, July 2000.

Developments in utility regulation

3.4 Since Railtrack was privatised, the licences held by many regulated network businesses in the UK have either been modified to introduce more detailed ring-fencing provisions or such modifications are currently under consideration. In some cases this has followed a takeover of the regulated business by another company (*e.g.* in the case of the regional electricity companies and some water and sewerage companies). In other cases, proposed licence modifications have followed the expansion of a company's own non-regulated activities (*e.g.* following proposed takeovers by National Grid Group and Scottish Power) or a restructuring of the group (*e.g.* Transco).

Initial consultation

3.5 The December 1999 periodic review document¹¹ indicated that the Regulator intended to consider whether and how Railtrack's network licence should be modified to require appropriate ring-fencing of its regulated business. He indicated that he believed it would be appropriate to introduce conditions similar to those that have been adopted for other regulated network businesses for the reasons given below.

3.6 Railtrack indicated that it believed that the issues surrounding the form and scope of the financial ring-fence are best dealt with outside the periodic review process and that it would expect the Regulator to publish a formal consultation paper on the issues involved at a later date. It also argued that Railtrack's existing licence conditions are similar to those which existed at privatisation in the water and electricity industries and that the concerns which have led to modifications to those licences are not applicable in Railtrack's case (*e.g.* because the ultimate holding company is not outside the UK and because most of Railtrack's unregulated activities involve the development of the British rail network and, hence, involve Railtrack meeting wider public interest obligations and government policy objectives).

3.7 The Regulator accepts that this issue can and should be dealt with outside the periodic review process. His present view is that Railtrack's arguments about the need for revised ring-fencing provisions are not persuasive. In particular, he considers that there is now a considerable degree of consensus about the appropriate ring-fencing arrangements for regulated network businesses.

¹¹ *The Periodic Review of Railtrack's Access Charges: Provisional Conclusions on Revenue Requirements*, Office of the Rail Regulator, London, December 1999.

- 3.8 Railtrack's core objection to the proposed licence condition seems to be the timing of its introduction. However, the Regulator anticipates that Railtrack may wish to develop its non-regulated business following the periodic review, and that it would be appropriate for the relevant ring-fencing arrangements to be introduced before, rather than after, significant non-regulated business activities have been developed.
- 3.9 The Regulator recognises that some of Railtrack's non-regulated activities may be related to the British rail network. However, he considers that it is important for any non-regulated activities of the Railtrack group to be ring-fenced from the regulated Network Business so that customers of the regulated business do not bear costs or face exposure to risks arising elsewhere in the group.
- 3.10 Few other respondents to the December 1999 periodic review document provided detailed comments on the proposed ring-fencing arrangements. However, those respondents who did comment were generally supportive of the need to adopt best practice in this area.

Potential licence modifications

- 3.11 Against the background described in the previous section, and given the limited scope for competition in most of Railtrack's activities, the Regulator considers that there is a case for modifying the ring-fencing arrangements in Condition 10 of Railtrack's network licence to reflect best practice in other regulated network businesses in the UK. He believes that this would improve regulatory effectiveness and transparency by providing a clearer distinction between the regulated and non-regulated activities of the Railtrack Group. He also believes that this would assist in ensuring that the regulated business continues to retain ready access to necessary finance at a reasonable cost.
- 3.12 Annex B contains draft licence modifications based primarily on the approach adopted for other regulated network businesses. These conditions need to be considered in conjunction with the proposed asset disposal licence condition discussed in Chapter 2. The main provisions are summarised below.

Ring-fence: restriction of activities and financial ring-fence

3.13 Condition 10A would prohibit Railtrack PLC without the Regulator's consent from:

- (a) carrying on, without the Regulator's consent, any activities other than the Network Business, the stations business and the independent rail safety activity as defined in the proposed modified Condition 3 (the Regulator is considering whether Railtrack PLC should be permitted to carry on other activities, up to a *de minimis* limit, without the Regulator's consent); or
- (b) holding or acquiring investments of any kind except for investments in companies that carry on one or more of the activities permitted to Railtrack PLC or subsidiary companies formed solely for the purpose of raising finance for these activities.

Ring-fence: prohibition on cross-default, encumbrances and disposals

3.14 Condition 10B would prohibit Railtrack PLC from:

- (a) entering into any agreement containing cross-default provisions (*i.e.* a provision where Railtrack can be required to pay or repay, or accelerate or increase any amount due, by reason of a third party's default) unless the provision is referable solely to default by a controlled subsidiary which carries on only activities which are permitted to Railtrack PLC; or
- (b) entering into any transaction with affiliates except for certain permitted transactions on an arm's length basis and on normal commercial terms.

Availability of resources

3.15 Condition 10C would require Railtrack PLC to:

- (a) conduct its affairs at all times in a manner calculated to ensure that it has adequate management and financial resources and financial facilities to carry on its authorised activities and to comply with its obligations under the Railways Act 1993;

- (b) submit annual certificates regarding the adequacy of these resources and facilities for the following year; and
- (c) before making a dividend payment submit a certificate that it is in compliance in all material respects with the ring-fencing conditions and confirming that the making of the distribution would not cause any material breach of the conditions either alone or in conjunction with any other reasonably foreseeable event.

Ring-fence: credit rating

3.16 Condition 10D would require Railtrack PLC to use all reasonable endeavours to maintain a specified credit rating. Other regulated network businesses have been required to maintain an investment grade credit rating. The Regulator is considering whether such arrangements would be appropriate for Railtrack.

Ring-fence: undertakings from ultimate holding company

3.17 Under Condition 10E, Railtrack PLC would be required to obtain from Railtrack Group legally enforceable undertakings that it:

- (a) will do nothing to cause Railtrack PLC to breach any condition of its network licence; and
- (b) will provide all information that Railtrack PLC may reasonably require to be able to comply with a requirement of the Regulator for the provision of information.

3.18 The Regulator is considering whether these conditions would need to be modified further to reflect Railtrack's circumstances and whether simpler arrangements should be adopted. In particular, he considers that it is important that the proposed licence conditions facilitate the efficient financing of Railtrack's regulated activities. In this regard, it should be noted that the licence conditions adopted in other sectors would allow the Regulator to consent to arrangements that would otherwise be prohibited. In some cases, however, it may be appropriate for the licence conditions to contain specific provisions. The Regulator will also need to assess whether the arrangements should be modified to take account of Railtrack's current corporate structure and existing activities rather than allowing for alternative structures and wider activities.

Next steps

3.19 The Regulator proposes to discuss the draft licence condition contained in Annex B with Railtrack once the periodic review has been finalised. In considering whether simpler arrangements should be adopted, he also recognises that it will be necessary to take account of any relevant company-specific circumstances, including Railtrack's plans in relation to the financing of its activities following the periodic review. Following discussion with Railtrack and responses from other interested parties he would therefore expect to make formal licence modification proposals on this issue in the first half of next year.

Issues for consultation

3.20 Consultees are invited to comment on whether modifications are required to the existing Condition 10 of Railtrack's network licence to bring it more closely into line with ring-fencing arrangements for other regulated network businesses and, if so, what form these modifications should take.

Annex A: Text of draft condition on disposal of Railtrack assets

Condition []: Disposal of relevant assets

1. The licence holder shall not dispose of or relinquish operational control over any relevant asset otherwise than in accordance with the following paragraphs of this Condition.
2. Save as provided in paragraph 3, the licence holder shall give to the Regulator not less than two months prior written notice of its intention to dispose of or relinquish operational control over any relevant asset, together with such further information as the Regulator may request relating to such asset or the circumstances of such intended disposal or relinquishment of control or to the intentions in regard thereto of the person proposing to acquire such asset or operational control over such asset.
3. Notwithstanding paragraphs 1 and 2, the licence holder may dispose of or relinquish operational control over any relevant asset:
 - (a) where:
 - (i) the Regulator has issued directions for the purposes of this Condition containing a general consent (whether or not subject to conditions) to:
 - (aa) transactions of a specified description; or
 - (bb) the disposal of or relinquishment of operational control over assets specified in the directions as excluded assets; and
 - (ii) the disposal or relinquishment of operational control of the assets in question is effected pursuant to a transaction of a description specified in such directions or the relevant asset in question is specified in such directions as an excluded asset and the disposal or relinquishment of operational control is in accordance with any conditions to which the consent is subject; or

- (b) where the disposal or relinquishment of operational control in question is required by or under any enactment.
4. Notwithstanding paragraph 1, the licence holder may dispose of or relinquish operational control over any relevant asset as is specified in any notice given under paragraph 2 in circumstances where:
- (a) the Regulator confirms in writing that he consents to such disposal or relinquishment (which consent may be made subject to the acceptance by the licence holder or any third party in favour of whom the relevant asset is proposed to be disposed or operational control is proposed to be relinquished of such conditions as the Regulator may specify); or
- (b) the Regulator does not inform the licence holder in writing of any objection to such disposal or relinquishment of control within the notice period referred to in paragraph 2.
5. In this Condition:

“asset”	includes property, real or personal, heritable or moveable, tangible or intangible, in which the licence holder has a relevant interest;
“disposal”	includes any sale, assignment, gift, lease, licence, the grant of any right of possession, loan, security, mortgage, charge or the grant of any other encumbrance or the permitting of any encumbrance to subsist or any other disposition to a third party, and “dispose” shall be construed accordingly;
“excluded asset”	means any asset which is specified as such in directions issued under paragraph 3 of this Condition;
“relevant asset”	means an asset in which the licence holder has a relevant interest, but does not include excluded assets; and
“relevant interest”	in relation to an asset means an interest of the licence holder in that asset (including as owner, licensee occupier, operator, lessee (of whatever rank) or the holder of any other right), legal or beneficial.

Annex B: Text of draft condition on ring-fencing

Condition 10A: Restriction of activities and financial ring-fence

1. Subject to paragraphs 3, 4 and 5, except with the written consent of the Regulator, the licence holder shall not, and shall procure that its subsidiary undertakings shall not, conduct any business or carry on any activity other than the Network Business, the stations business or the independent railway safety activity as set out in Condition 3.
2. The licence holder shall not acquire or retain, without the written consent of the Regulator, shares in any related undertaking after the relevant date except:
 - (a) shares in any body corporate which is a subsidiary of the licence holder such shares having been acquired or retained for the purpose only of facilitating the financing of activities of the licence holder or of its subsidiaries falling within sub-paragraph (a), (b) or (c) of the definition of permitted purpose;
 - (b) shares acquired in a body corporate to which is transferred an activity that ceases, or is to cease, to be for a purpose within sub-paragraphs (a), (b) or (c) of the definition of permitted purpose; or
 - (c) shares in a body corporate which conducts business only for a purpose within sub-paragraph (a), (b) or (c) of the definition of permitted purpose;
3. The licence holder shall use reasonable endeavours to cease to conduct or carry on any such business or activity prohibited by paragraph 1 which it was conducting or carrying on at the relevant date and shall submit to the Regulator by [30 June] in each calendar year a report setting out details of the endeavours it has made to cease to conduct or carry on such business or activity in the period of twelve months ending on the preceding [31 March], provided that for so long as the licence holder is making such reasonable endeavours, it may continue to conduct any such business or carry on any such activity.

4. Nothing in this Condition shall prevent:
- (a) any affiliate of the licence holder from conducting any business or carrying on any activity;
 - (b) the licence holder from holding shares as, or performing the supervisory or management functions of, any investor in any body corporate in which it holds an interest consistently with the provisions of the licence;
 - (c) the licence holder from performing the supervisory or management functions of a holding company in respect of any subsidiary in which it holds an interest consistently with provisions of the licence;
 - (d) the licence holder from carrying on any business or conducting any activity to which the Regulator has given his consent in writing.
5. (a) Nothing in this Condition shall prevent the licence holder or any subsidiary of the licence holder conducting any business or carrying on any activity other than businesses or activities falling within sub-paragraph (a), (b) or (c) of the definition of permitted purpose (in this paragraph "the *de minimis* business") so long as the limitations in this paragraph are complied with, namely-
- (i) the aggregate turnover of all the *de minimis* business does not in any period of twelve months commencing on [1 April 2001] and in any subsequent year exceed 2.5 per cent. of the turnover of the Network Business as shown by its most recent accounting statement produced under Condition []; and
 - (ii) the aggregate amount of all investments (determined in accordance with sub-paragraph (c) below) made by the licence holder or any of its subsidiaries in all the *de minimis* business does not at any time after [31 March 2001] exceed 2.5 per cent. of the sum of share capital in issue, share premium and consolidated reserves of the licence holder as shown by its most recent consolidated financial statement then available; and

- (iii) the business is conducted employing persons or assets first employed or acquired for a purpose within sub-paragraph (a) or (b) of the definition of permitted purpose.
- (b) For the purpose of sub-paragraph (a) of this paragraph, "investment" means any form of financial support or assistance given by or on behalf of the licence holder or any of its subsidiaries for the *de minimis* business whether on a temporary or permanent basis including (without limiting the generality of the foregoing) any commitment to provide any such support or assistance in the future; and
- (c) At any relevant time, the amount of an investment shall be the sum of -
 - (i) the value at which such investment was included in the audited balance sheet of the licence holder as at the latest financial year to have occurred prior to [31st March 2000] (or, where the investment was not so included, zero);
 - (ii) the aggregate gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred by the licence holder or any of its permitted subsidiaries in respect of such investment in all completed financial years since [31st March 2000];
 - (iii) all commitments and liabilities (whether actual or contingent, contingent liabilities being estimated and disclosable in the manner provided in Financial Reporting Standard 12 as issued by the Accounting Standards Board (as the same may be amended or replaced to be consistent with prevailing UK GAAP)) of the licence holder or any of its subsidiaries relating to such investment outstanding at the end of the most recently completed financial year; and
 - (iv) the amount of any dividends (if any) paid by that business or activity in all completed financial years since [31st March 2000],

less the sum of:

- (v) the amount of turnover generated by that business or activity in all completed financial years since [31st March 2000]; and
 - (vi) the value of disposal proceeds on disposal of that business by the licence holder or a subsidiary of the licence holder other than to a subsidiary of the licence holder:
- (d) Any business or activity so designated in writing by the Regulator shall not be considered a *de minimis* business for the purpose of the limitations in this paragraph 5.

Condition 10B: Ring-fence: prohibition on cross-default, encumbrances and intra-group transactions

1. From the relevant date, the licence holder shall not without the written consent of the Regulator:
 - (a) enter into an agreement or arrangement incorporating a cross-default obligation; or
 - (b) continue or permit to remain in effect any agreement or arrangement incorporating a cross-default obligation subsisting on the relevant date save that any cross-default obligation in existence at that date may remain in effect for so long as and provided that:
 - (i) the cross-default obligation is solely referable to an arrangement or agreement entered into prior to the relevant date and the terms on which that loan or those facilities have been made available or of that agreement or arrangement as subsisting on that date are not materially varied to the detriment of the licence holder or otherwise made more onerous or where there is a material change in terms, such change is outside the licence holder's effective control; and
 - (ii) the licence holder shall no later than three months from the relevant date procure that an affiliate of the licence holder shall agree to indemnify the licence holder in respect of its liabilities and potential

liabilities under the cross-default obligation on terms approved in writing by the Regulator which terms shall include an obligation that the person granting the indemnity shall maintain, at all relevant times, a satisfactory credit rating; and

- (iii) the licence holder shall enforce the terms of the indemnity, if so directed in writing by the Regulator.
- (c) The provisions above shall not prevent the licence holder from giving any guarantee permitted by and in compliance with the requirements of paragraph 2(a) of this Condition.
2. Save with the written consent of the Regulator after full disclosure of all material facts, the licence holder shall not after the relevant date:
- (a) create or continue or permit to remain in effect any mortgage, charge, pledge, lien or other form of security or encumbrance whatsoever, undertake any indebtedness to any other person or guarantee any liability or obligation of another person otherwise than:
 - (i) on an arm's length basis;
 - (ii) on normal commercial terms;
 - (iii) for a permitted purpose; and
 - (iv) (where relevant) in accordance with Condition [] (Disposal of Relevant Assets);
 - (b) transfer, lease, licence or lend any sum or sums, asset, right or benefit to any affiliate of the licence holder otherwise than by way of:
 - (i) a dividend or other distribution out of distributable reserves;
 - (ii) repayment of capital;

- (iii) payment properly due for any goods, services or assets provided on an arm's length basis and on normal commercial terms;
- (iv) transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an arm's length basis and on normal commercial terms;
- (v) repayment of any loan or payment of any interest on a loan not prohibited by sub-paragraph (a);
- (vi) payments for group corporation tax relief or for the surrender of Advance Corporation Tax on a basis not exceeding the value of the benefit received; or
- (vii) an acquisition of shares in conformity with the restriction on the acquisition of shares set out in the licence, made on an arm's length basis and in accordance with normal commercial terms.

Condition 10C: Sufficiency of resources

1. The licence holder shall at all times act in a manner calculated to secure that it has sufficient management resources, financial resources and financial facilities to enable it to carry on the Network Business and the stations business and the independent rail safety activity and to comply with its obligations under the Act and its licence.
2. In each year commencing from [1 April 2001], the licence holder shall submit to the Regulator on [30 June] a certificate as to the adequacy (or otherwise) of its management resources and financial resources and facilities for the period of twelve months commencing on the date of the certificate. Each certificate shall be in one of the following terms:
 - (a) "After making enquiries, the directors of the licence holder have a reasonable expectation that the licence holder will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient management resources and financial resources and financial facilities to enable the licence holder to carry on the activities authorised by the licence in

accordance with its obligations under the Act and under the licence for the period of 12 months referred to in this certificate.”

- (b) “After making enquiries, the directors of the licence holder have a reasonable expectation, subject to the factors set out below, that the licence holder will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient management resources and financial resources and financial facilities to enable the licence holder to carry on the activities authorised by the licence in accordance with its obligations under the Act and under the licence for the period of 12 months referred to in this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the licence holder to carry on the activities authorised by the licence as aforesaid.”
 - (c) “In the opinion of the directors of the licence holder, the licence holder will not have available to it sufficient management resources and financial resources and financial facilities to enable the licence holder to carry on the activities authorised by the licence in accordance with its obligations under the Act and under the licence for the period of 12 months referred to in this certificate.”
3. The licence holder shall submit to the Regulator with that certificate a statement of the main factors which the directors of the licence holder have taken into account in giving that certificate.
4. The licence holder shall -
- (a) notify the Regulator in writing immediately if its directors become aware of any circumstance that causes them no longer to have the reasonable expectation expressed in the certificate in the terms set out in paragraph 2(a); and
 - (b) subject to compliance with the listing rules (within the meaning of Part IV of the Financial Services Act 1986) of the Stock Exchange, publish its notification to the Regulator in such form and manner as the Regulator may direct.

5. Save in so far as they relate to management resources, the licence holder shall use its best endeavours to obtain and submit to the Regulator with each certificate provided for in paragraph 2 a report prepared by its Auditor and addressed to the Regulator stating whether or not the Auditor is aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which he obtained during its audit work.

6. The directors of the licence holder shall not declare or recommend a dividend, nor shall the licence holder make any form of distribution within the meaning of section 263 of the Companies Act 1985, unless prior to the declaration, recommendation or making of the distribution (as the case may be) the licence holder shall have issued to the Regulator a certificate complying with the following requirements of this paragraph.
 - (a) The certificate shall be in the following form:

“After making enquiries, the directors of the licence holder are satisfied:

 - (i) that the licence holder is in compliance in all material respects with all obligations imposed on it by Conditions 10A, B, C, D and E of the licence; and

 - (ii) that the making of a distribution of [amount] on [date] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the licence holder to be in breach to a material extent of any of the obligations imposed on it by Conditions 10A, B, C and D of the licence in the future.”

 - (b) The certificate shall be signed by a director of the licence holder and approved by a resolution of the board of directors of the licence holder passed not more than 14 days before the earliest of the dates on which the declaration, recommendation or payment will be made.

 - (c) Where the certificate has been issued in respect of the declaration or recommendation of a dividend, the licence holder shall be under no obligation to issue a further certificate prior to payment of that dividend.

7. To the extent that the licence holder procures any of the resources or facilities referred to in paragraph 1 from any ultimate holding company or any subsidiary undertaking of such ultimate holding company (other than subsidiaries of the licence holder) the licence holder shall ensure that the arrangements for procuring those resources or facilities do not involve an unjustified cross subsidy from the Network Business or the stations business to any ultimate holding company or to any subsidiary undertaking of such ultimate holding company (other than the subsidiaries of the licence holder).

Condition 10D: Ring-fence: Credit rating

1. The licence holder shall use all reasonable endeavours to ensure that the licence holder as issuer of any corporate debt maintains a satisfactory credit rating.
2. For the purpose of this Condition 10D "satisfactory credit rating" means -
 - (a) [to be agreed]; or
 - (b) an equivalent rating from any other reputable credit rating agency which, in the opinion of the Regulator, notified in writing to the licence holder, has comparable standing in the UK and the USA.

Condition 10E: Undertakings from ultimate holding company

1. The licence holder shall procure from each company or other person which is at any time an ultimate holding company of the licence holder a legally enforceable undertaking in favour of the licence holder in the form specified by the Regulator that that ultimate holding company ("the Covenantor") will refrain from any action, and will procure that every subsidiary of the Covenantor (other than the licence holder and its subsidiaries) will refrain from any action, which would then be likely to cause the licence holder to breach any of its obligations under the Act or the licence. This undertaking shall be obtained within 7 days of the company or other person in question becoming an ultimate holding company of the licence holder and shall remain in force for so long as the licence holder remains the holder of the licence and the Covenantor remains the ultimate holding company of the licence holder.
2. The licence holder shall procure from each and every ultimate holding company of the licence holder a legally enforceable undertaking in favour of the licence holder in such form as may be specified by the Regulator requiring that holding company to give to

the licence holder and to procure that each subsidiary from time to time of that holding company (other than the licence holder and its subsidiaries) will give to the licence holder, all such information as may be necessary to enable the licence holder to meet its obligations under the Act and under the licence to produce documents and furnish information to the Regulator.

3. The licence holder shall:
 - (a) deliver to the Regulator evidence (including a copy of all such undertakings) that the licence holder has complied with the obligation to procure any undertaking pursuant to paragraphs 1 or 2;
 - (b) inform the Regulator immediately in writing if the directors of the licence holder become aware that any undertaking procured pursuant to paragraphs 1 or 2 has ceased to be legally enforceable or that its terms have been breached; and
 - (c) comply with any direction from the Regulator to enforce any of the undertakings procured pursuant to paragraphs 1 or 2.
4. The licence holder shall not, save with the Regulator's written consent, enter (directly or indirectly) into any agreement or arrangement with any ultimate holding company of the licence holder or any subsidiary of such ultimate holding company (other than a subsidiary of the licence holder) at a time when (a) an undertaking required pursuant to paragraphs 1 or 2 is not in place or (b) there is an unremedied breach of such undertaking.

Condition 10F: Interpretation

1. In this Condition there shall be inserted the following definitions:

“auditor” means the licence holder's statutory auditor from time to time;

“corporate debt” means any unsecured and unsubordinated borrowing of money having an initial maturity of five years or more;

- “cross-default obligation” means a term of any agreement or arrangement whereby the licence holder’s liability to:
- (a) pay or repay any debt or other sum; or
 - (b) to do anything pursuant to a term of any agreement or arrangement to which the licence holder is a party
- arises or is increased or accelerated or is capable of arising, increasing or of being accelerated by reason of a default (howsoever such default may be described or defined) by any person other than the licence holder, unless that liability;
- (a) can arise only as a result of a default by a subsidiary of the licence holder; and
 - (b) the licence holder holds a majority of the voting rights in that subsidiary and has the right to appoint or remove a majority of its board of directors; and
 - (c) that subsidiary carries on business only for a permitted purpose.
- “information” shall include any documents, accounts, estimates, returns, forecasts or reports (whether or not prepared specifically at the request of the Regulator) of any description specified by the Regulator.
- “permitted purpose” means the purposes of any or all of the following:
- (a) the Network Business;
 - (b) the stations business;
 - (c) the independent rail safety activity established pursuant to Condition [] of this licence;

(d) any *de minimis* business described in paragraph 5 of Condition 10A; or

(e) without prejudice to the generality of sub-paragraphs (a) to (d) any payment or transaction lawfully made or undertaken by the licence holder for a purpose within sub-paragraphs (i) to (vii) of paragraph 2(b) of Condition 10B;

“relevant date” means [];

“stations business” means the business of the licence holder conducted pursuant to the Station Licence dated 31st March 1994 granted by the Secretary of State under the Railways Act 1993, as from time to time amended;

“subsidiary” shall bear the same meaning as that attributed to it in Section 736 of the Companies Act 1985;

“subsidiary undertaking” shall bear the same meaning as that attributed to it in Section 258 of the Companies Act 1985; and

“ultimate holding company” means each of:

(i) a holding company of the licence holder which is not itself a subsidiary of another company;

(ii) where a holding company of the licence holder which is not a subsidiary of another company has entered into an agreement relating to the exercise of voting rights in or the appointment or removal of directors of the licence holder or any company of which the licence holder is a subsidiary, every party to that agreement; and

(iii) where the exercise of voting rights in or the appointment or removal of directors of a holding company of the licence holder which is not a subsidiary of another company is controlled by an agreement, every party to that agreement.