

TRANSPORT FOR LONDON

POST-COMMERCIAL CLOSE CONSULTATION RESPONSE

14 JUNE 2002

On 14 May 2002, London Transport requested that Transport *for* London provide consultation comments on PPP documents that had been finalised on 8 May 2002, as part of commercial close of the PPP transactions. It is apparently London Transport's view that notwithstanding that the various documents have been signed and/or initialled as agreed by the parties thereto, London Transport nonetheless remains in a position to amend the various documents to take into account consultation comments it feels have merit. In other words, if the counter-parties to these documents (Tube Lines and Metronet) do not accept changes arising out of consultation that London Transport feel should be made, then London Transport will not proceed to financial close.

On 29 May 2002, London Transport commenced additional consultation, in relation to Tube Lines' draft finance documents, providing to LUL Tube Lines draft finance documents, together with a summary review of those documents by PricewaterhouseCoopers dated 24 May and a review by Freshfields dated 28 May. London Transport noted that it had taken only six days to review the Tube Lines finance documents, and therefore requested that Transport *for* London respond within 8 working days, by 12 June 2002, which was the then-agreed date for the 14 May consultation request to be answered.

In furtherance of our statutory duty to consult and cooperate we have reviewed the PPP contract documents and provide our consultation response below. Please note that a number of material contract terms remain open, as discussed further below, and that LT Board action to approve the final terms of the contract documents without providing TfL with an opportunity to review and comment on those changes would be inappropriate.

We are somewhat taken aback by the statement that London Transport and its advisors took only six days to review the Tube Lines finance documents, made in justification of the limited consultation period afforded to TfL in connection with these documents. The documents are highly significant to the likelihood of success of this PPP (indeed, for the reasons discussed below, in their current form they actually undermine the already remote likelihood of success of the PPP). The finance documents are also quite determinative of the likelihood that the 95% senior debt guarantee will or will not be called upon. They thus deserve the utmost scrutiny and considered judgment.

We also note that the JNP finance documents are incomplete and in draft form. We understand that various significant provisions, such as the extent of control the Lenders will exercise over Tube Lines' decision-making, and the terms of the Put Option, are still in the process of being negotiated. We also understand that certain documents necessary to evaluate the terms of the JNP financing documents, including documents that are key to understanding the governance powers that may be exercised by the mezzanine lenders over Tube Lines or Infraco JNP, and the terms of the loan to be provided by Tube Lines to Infraco JNP, have not yet been provided even to LUL. Clearly LUL is not yet in a position to make a decision whether to approve these documents. Consultation also seems premature. However, in the hopes that our consultation may help facilitate LT's further understanding of the risks inherent in the documents that have been provided, we provide a consultation response with regard to these draft and incomplete documents. As with the PPP contract documents, however, final documents should not be approved by London Transport unless and until TfL has had the opportunity to review and consult on those final documents.

Contract Documents¹

A. Identification of Open Items. We note that quite a number of open items remain, notwithstanding commercial close. These matters, which will likely require further consultation (before financial close), include:

Metronet

1. Agreement on the terms of the Put Option (as noted in correspondence during this Consultation round, the financing documents cannot be properly considered without an understanding of the terms of this Put Option and the Tube Lines Put Option), and consequential amendments to the transaction documents.
2. Final terms on which LUL may subscribe for equity (and debt) in the Infracos.
3. Base Case for Net Adverse Effects
4. Final dates for delivery of projects (see discussion below regarding interim position on this point)

¹ This Consultation Report is primarily concerned with changes since the Contract Documents were last reviewed. However, we note that in recent e-mail correspondence between TfL and LT, TfL has also raised its quite significant concern that the drafting in Section 10 of the Major Enhancement Agreement may theoretically be construed to allow an Infraco to argue that it has the exclusive right to design a Line Extension for which no Specified Line Upgrade is contemplated (e.g., the East London Line), and that such a Line Extension must be output specified. LT advised us that the clause was not intended to provide that right. *This must be clarified in the documents*. Along the same lines, if another provider designs and/or constructs such a Line Extension, the Infraco should not have the right to maintain that Line Extension even if the Line Extension is ultimately to be operated by LUL.

5. Supply Chain Contracts to be agreed as efficient and economic for purposes of Schedule 1.9 (if any)
6. Final position on Mezzanine Debt and final proportions between equity and shareholder subordinated debt, and the effect of those items on the ISC (see discussion below regarding interim position on this point)
7. Final pricing of bank debt (see discussion below regarding this point).
8. Protection for divergence between the inflation rate assumed by the Statutory Arbiter and actual inflation (see discussion below regarding this point)
9. Agreement on a process to enable the financial model to reset the ISC at and perhaps after Completion, to reflect bid, transition and mobilisation costs, changes in financing costs, changes in inflation, and changes in spreads since CFO
10. Agreement on amendments to the Inter-Infraco Assets and Facilities Agreement
11. Agreement on Development Fees
12. Potential supplier price changes and corresponding ISC adjustment if financial close does not occur by 31 July

Tube Lines

1. Agreement on the terms of the Put Option (as noted in correspondence, the financing documents cannot be properly considered without an understanding of the terms of this Put Option), and consequential amendments to the transaction documents.
2. Agreement on the terms of the Northern Line Train Services Contract restructuring (see discussion below)
3. Final terms on which LUL may subscribe for equity (and debt) in the Infracos.
4. Base Case for Net Adverse Effects
5. Unspecified adjustments if Financial Close occurs after 30 June 2002

6. Agreement on amendments to the Inter-Infraco Assets and Facilities Agreement
7. Scope of Tube Lines' deemed knowledge of environmental matters relating to Jubilee Line Extension
8. Protection for divergence between the inflation rate assumed by the Statutory Arbitrator and actual inflation (see discussion below regarding this point)

In addition, for both bidders, the final terms regarding the circumstances under which LUL can (or must) serve a Mandatory Sale notice, remain to be resolved.

B. Observations on Changes in 8 May documents, supplied 14 May

Further Deterioration of Scope and Risk Transfer

1. District Line Trains. The Update to the Final Assessment Report (the "U-FAR") discusses the reduced scope for the 2008 refurbishment of District Line Trains, noting that the price for this reduction in scope would be finalised after financial close, with an LUL right to revert to dispute resolution if it did not agree with the price offered by Metronet at the time. Metronet estimated the price to be £16 million. In response to our query as to where we might find the drafting which would enable LUL to obtain a credit for this reduced scope, we were advised that there was to be no credit; that the reduced scope was already reflected in the CFO bids.

It is not clear to us what is to be agreed after financial close, if the CFO pricing already reflects the reduced scope. There appears to be no drafting preserving any LUL right as suggested by the U-FAR. It seems that this item simply represents another reduction from the scope of works at BAFO, agreed without competitive bidding. However, given the timing of this item (CFO bids came in January; this change was first brought to our attention in May), it seems clear that LUL received no value whatsoever for this reduction in scope. While the amount in question may seem non-material in relation to the transaction as a whole, even 16 million pounds should not be squandered needlessly. LUL and LT have a duty not to allow scope to be reduced without an appropriate price reduction.

2. Train Enhancements. The Specifications for certain Train Enhancements in Appendix 7B to Schedule 2.1 of the Metronet PPP Contracts have been reduced (the minimum functionality requirements for the visual electronic information display panel in Train carriages (Metronet only), the

requirements for live and pre-recorded announcements to be made to platforms and routeways (Metronet and JNP); and the requirements for security monitoring equipment (Metronet only)). Again it seems clear that LUL received no value for this further scope concession to the bidders, and it should be eliminated.

3. Enhanced Station Refurbishments. We have discussed in previous consultation reports that the station modernisation programme has been largely gutted during the procurement. LUL has responded that the bidders now have an obligation on many stations to perform an Enhanced Station Refurbishment, rather than simply a refurbishment to avoid insidious decline. This provides no basis for comfort that the elimination of over 125 modernisations from the programme has been ameliorated, since the scope of Enhanced Station Refurbishments has largely been left for determination after financial close. (See Appendix 15, Section 1.1.) This should be resolved in advance of financial close.

4. Milestone Schedule for Specified Line Upgrades. Purportedly in response to Transport for London's concerns about the lack of binding scope and schedules for capital works for which it is obligated to pay, LUL advised in the Fall of 2001 that a provision was being added to the PPP Contracts, that would allow LUL to take steps if the Infracos did not meet contractual milestones towards achieving those Specified Line Upgrades. We have now been provided with those Milestone Schedules, which do not address our concerns in any meaningful way. Years go by under these schedules with no milestone occurring on a project, and the milestones are stated so generally that they are virtually impossible to enforce. (For example: Tube Lines is to award a contract for new rolling stock on the Jubilee Line by 1 April 2003. There are no milestones of a type that are customary in rolling stock contracts which commit the vendor to the completion of design, procurement and testing activities by specified dates, with financial sanctions if the dates are not met. There is not even any specification as to the number of trains to be covered by the contract. The next milestone for Jubilee Line rolling stock occurs over three years later, when the first train is to be delivered.)

The reliance on the Milestone schedules for assurance that the anticipated work will be accomplished is thus misplaced. Meaningful, substantive and industry-standard milestones, that will truly provide assurance that work is being accomplished as expected, should be included in the contracts. The need for assurance that work is progressing as anticipated is only heightened by the recent addition of Infraco exit opportunities at periodic review.

5. Benchmark Adjustments. Section 2.2.14 of the U-FAR discusses new provisions for the resetting of capability benchmarks, which were apparently described to the LT Board at its April meeting. The U-FAR does not discuss new provisions for the resetting of Ambience and Availability benchmarks in the Metronet transaction.

The provisions for resetting the Ambience benchmarks are particularly interesting. As reported in Section 8.1.6 of LUL's Final Assessment Report, the ambience benchmark is set above recent average performance (apparently, 2.2 points above the recent average performance score for SSL and 2.9 above the recent average performance score for BCV.) Now, if performance by the publicly controlled Infracos has improved beyond a certain level, the ambience benchmark will be set at only 1.8 points above the recent average performance for SSL and 2.3 points above the recent average performance score for BCV.) Conversely, if performance by the publicly controlled Infracos has deteriorated beyond a certain level, the ambience benchmark will be raised above the recent average performance score by 2.6 for SSL and 3.5 for BCV. The result is that bonuses may be easier or harder to achieve than was originally contemplated depending on recent average performance.

LUL must be aware, based on its access to recent performance scores, whether this new language is likely to work in its favour or in Metronet's favour. If Infraco BCV and Infraco SSL have improved their ambience scores during shadow running, then this provision will make it easier for Metronet to earn bonuses (and avoid abatements) than was previously contemplated. This advantage, and the access to increased bonuses, would continue throughout the term of the 30 year contract, which is a very long time to be rewarding a private sector Infraco for improvements generated as a result of improvements made while the Infracos were under public control. Thus the likely effect of this new language in light of the actual state of affairs on the Underground should be considered by LT.

It was unclear from the new formula for adjusting the Availability benchmark, and from LUL's response to our inquiry regarding the effect of this language, whether a similar circumstance may arise as a result of this new formula. An inquiry by the LT Board is warranted in this regard.

6. Date Adjustments. While the explanation of date adjustments is tied to delay in financial close, which seems innocuous enough, the actual date adjustments in the conformed contract documents you sent us do not all seem consistent with this. For example, we note that Victoria Line Train Refurbishment deadline has moved from 31 March 2011 (already changed from the BAFO date of 2008) to 1 September 2012. This date should at a minimum be restored to the date at CFO (subject to any further delay in financial close).

7. Letter of Credit. The circumstances under which LUL will be required to provide letters of credit in the event of a Change in Control or a Guarantee Transfer expanded dramatically between the BAFO documents and the CFO documents (8 February 2002). The amount of the letters of credit has now been identified with some particularity, and it is clear that the amount across the three Infracos will be well in excess of £5 billion (with no more than £250 million from

any one financial institution). Such letters of credit could potentially increase the costs of the transaction to LUL by close to £100 million per year. This change appears to have been agreed without any analysis or due diligence as to LUL's actual ability to obtain letters of credit aggregating this amount. This analysis and due diligence should be a prerequisite to proceeding to financial close. The analysis should take into account that the many banks who would be protected by such a letter of credit are unlikely to provide such a letter of credit, thus significantly narrowing the pool of potential Letter of Credit issuing banks.

8. Reduction of Payment Abatements for Late Delivery. Previous consultation reports and letters have discussed the significant deterioration of risk transfer to the Infracos for failure to deliver various projects on time. This deterioration has continued with the addition of Section 6.3.2A of Schedule 4 to the PPP contract, whereby abatements for late delivery of Train Refurbishments on a given line are forgiven if the deadline for that delivery coincides with the deadline for a Specified Line Upgrade on the same line. There was no corresponding increase to the abatements for late delivery of the Specified Line Upgrade. It seems that at least one, and perhaps three, of the Metronet train refurbishment delivery deadlines was changed to enable Metronet to take advantage of this very clause.

There is no justification for this new protection, and it should be eliminated.

9. Indexation. LUL and the bidders have not yet agreed on the extent to which there will be protection against a mismatch between the Statutory Arbitrator's estimate of inflation and actual inflation as reflected in RPIX, but they have agreed that such protection should be provided. LUL has advised us in correspondence that the paragraphs in the Letters of Understanding discussing this protection were intended only to provide protection in respect of Fixed Amounts, even though the paragraphs in fact make no reference to Fixed Amounts. Until drafting is provided, we cannot evaluate the effect of this intended change to the documents. In the meantime, we note that any protection to the bidders from inflation in excess of RPIX would represent yet another deviation from the ITT risk matrix², which provided that the Infracos would be fully at risk for inflation in excess of RPIX. Clearly, basic risk transfer provisions should not again be changed in favour of the bidders.

10. Northern Line Train Services Contract. The drafting provided in regard to the NLTSC is not finalised in key respects, including the extent to which LUL will be obliged to indemnify Infraco JNP in connection with unspecified risks, and addressing concerns raised by Lenders and, most surprisingly, Sponsors. We understand that it is firmly agreed that Infraco JNP will not be entitled, directly or indirectly, to claim relief from any performance abatements

² The ITT risk matrix, which was part of the Invitation to Tender, set forth LUL's intended allocation of risk as of the beginning of the procurement.

(availability, capability, ambience) or service points, and that under no circumstances will LUL be obliged to both pay performances bonuses under the PPP in respect of the Northern Line and to reimburse Infracore JNP for bonuses it will owe to the Northern Line Train Services Contractor. We believe the drafting should be made more clear in both of these regards.

We are concerned that LUL's other remedies in respect of the Northern Line (for example, its rights to abatements for delivery of specific projects) are significantly weakened by this new drafting, and indeed that there may be spillover effects to specific projects for other lines. We will provide more extensive comments once we receive NLTSC language that is acceptable to LUL, Tube Lines, Tube Lines' Sponsors, and Tube Lines lenders. We would appreciate it if, at the time, we were also provided with LUL's analysis of the risks to specific projects associated with the NLTSC restructuring.

Lastly, we understand it is LUL's intention to restructure and transfer the Northern Line Train Services Contracts prior to financial close and that the consequences of not doing so have thus not been worked out. Should LUL be unable to achieve its objective, we assume it will advise us of its analysis of proceeding under these circumstances.

Pricing Changes

The proposed pricing changes to the documents have not yet been identified, except that a new Tube Lines financial model has been agreed.³

The Letters of Understanding between LUL and Tube Lines and, to a much greater extent, LUL and Metronet acknowledge that further pricing changes may arise out of a variety of causes, including a change to Metronet's financial model, changes to the price of Metronet's bank debt, changes to supplier prices (for both bidders), and changes to Metronet's final position on mezzanine debt and final proportions as between equity and shareholder subordinated debt. In other words, pursuant to the Metronet Letters of Understanding, it seems that pricing changes may arise for virtually any cause.

That LT agreed to proceed to commercial close in these circumstances, and to a virtually unconditional obligation to pay at least 90% of the bidders' "eligible costs" (i.e., costs of due diligence, financial, legal and technical advice and other internal costs incurred since the shortlisting of bidders after ITT, i.e., since well before BAFO) is surprising. LT has placed LUL at risk of having to bear almost all of the bidders costs, even if the bidders deliver unacceptable

³ This new agreed Tube Lines financial model appears to result an increase in both aggregate sponsor distributions and scope costs, as well as a small net increase in the ISC. It also contains the information on the development costs which is discussed below.

contract terms to LUL. It seems that eligible costs may exceed £54 million for Tube Lines alone.

The refusal to include a final value for money condition precedent to close, as urged in previous consultation reports, is also inexplicable in light of the potential pricing changes.

We assume that Transport *for* London will be provided with an opportunity to consult further with regard to final pricing and final financial models. Failure so to consult would be a breach of LT's statutory obligations. We reiterate our view that LT must undertake a new Value for Money Assessment once final pricing and financial models have been established, if it is to have any basis to claim that the transaction satisfies a Value for Money test.

Development Costs and Increasing the Returns on Equity

In reviewing the revised Tube Lines financial models, it came to our attention that the financial model included an amount in excess of £169 million in Development Costs. LUL has advised that Tube Lines has proposed that £109 million of this be paid to it shortly after financial close, under language in the Share Purchase Agreements that was added in only April 2002. (The balance is seemingly excessive fees in connection with the debt and debt insurance; see discussion below.) While LUL has also stated that, based on another change it made in response to our last Consultation Report, it still has the right to approve this amount, one must question that premise given that the financial model which includes these amounts has already been approved. At a minimum, these Development Costs have been approved for LUL reimbursement as part of the ISC in the first 7.5 years of the contract. They may have also been approved for immediate distribution to Tube Lines after financial close.

The breakdown of the £169 million is thus worth considering carefully. It should be remembered that this amount represents only Tube Lines' Development Costs; the proposed Metronet Development Costs are yet to be disclosed. What is London paying for under the PPP, in addition to the cost of the work, returns on equity, and debt service on financing necessary to carry out the works?

First, London is paying a "success fee" to the Tube Lines sponsors (£36 million, plus financing costs associated with this amount).

Second, London is paying a "success fee" to unspecified Tube Lines' financial advisors (£ 8.72 million, plus financing costs associated with this amount.), and a success fee to other Tube Lines' advisors (£1.97 million, plus financing costs associated with this amount.). London is also reimbursing Tube Lines for an upfront rating agency fee of £480,000.

London is also paying £54.89 million in other “development costs”, plus financing costs associated with this amount.

And London is paying £60.77 million in bank fees and loan insurance fees (notwithstanding that the insurance is for £600 million in debt, 95% of which is intended to be guaranteed by the public sector. It appears that London may be paying over £30 million in loan insurance costs, where only £30 million is expected to be materially exposed in the first place.)

The £36 million Sponsor “success” fees merit special consideration. This amount effectively reduces Tube Lines’ sponsors’ equity commitment from £135 million to £99 million. The effect on the Tube Lines’ rate of return is phenomenal, bringing it from the already excessive 26% to an unconscionable rate of return of 32%.

In TFL’s Third Interim Consultation Report, we noted that new language in the Share Purchase Agreement provided a mechanism for the Sponsors to extract returns from the project in excess of the Agreed Rate of Return. We had no idea at the time that we were talking about a Golden Handshake under the new language (putting aside bank fees and credit wraps) in excess of £100 million in one competition alone. We certainly had no idea this included an amount *in addition to* incurred costs – that it included “success fees”. It is inexcusable to include these fees in this transaction. They should not only be excluded from any payment under the Share Purchase Agreement; they (and their associated financing costs) should be excluded from the ISC. Similarly, excessive credit wrap fees for debt that is intended to be guaranteed by a AA credit should be eliminated from the transaction.

TFL’s concern with the £60 million in fees associated with debt and credit wraps is heightened by yet another aspect of Tube Lines’ approved financial model. It appears that the model assumes refinancing of various senior debt facilities in 2003. One must seriously question the reasonableness of these fees, and particularly the £27 million in up-front fees, in light of the likelihood that much of the debt will be refinanced within a year.

The LT Board should also evaluate the effect of this assumed refinancing on Tube Lines’ overall expected returns on this project. In addition to the returns Tube Lines is generally expected to receive from the PPP (currently, 32%), Tube Lines will enjoy at least 50% of the “Refinancing Benefits” associated with that refinancing. It is commonly understood in PFI projects that the private sector may establish its original price based on expensive (and possibly excessive) debt, and then later refinance that debt as a means to pocket all or a portion of the financial efficiencies achieved through the financing, financial efficiencies that would have been enjoyed by the public sector in the first instance if the original debt had been properly structured. The contemplated Tube Lines refinancing suggests that this is exactly what Tube Lines has in mind.

This expected refinancing has the potential to increase Tube Lines' return on this project exponentially, and should be considered very carefully by the LT Board. Approving this transaction cannot be based solely on an analysis of the ISC; the LT Board has the fiduciary responsibility to ensure that it is not creating an easy opportunity for returns to Tube Lines far in excess of market rates, returns that rightly belong to the public.

Conditions to Close

The Metronet Share Purchase Agreements now include as a condition precedent to financial close that all conditions precedent to making the financing available to Infracos SSL and BCV have been satisfied or waived. A similar condition precedent must be included for the Tube Lines Share Purchase Agreement, to avoid financial close without any assurance that funds will be actually available to Tube Lines. Clearly, any decision to proceed must be premised on the assumption that the financing will indeed become available to the Infracos.

Further, there is new language in the Share Purchase agreements regarding the potential waiver of the condition to financial close that was inserted to prevent an inadvertent "mixed solution". We understand from our correspondence with you that this condition precedent will not be waived if there is any risk that such waiver could in fact result in a mixed solution. If that does not continue to be LUL's position, TfL should be advised immediately.

JNP Finance Documents

As noted above, we have been asked to consult on incomplete and draft documents that do not reflect positions that are acceptable to LUL, as evidenced by the Freshfields and PwC recommendations that certain lender proposals be resisted. Thus it is unclear for what purpose we are now consulting. We should of course be consulted on final and complete contract terms when they are deemed acceptable to LUL, subject to the results of statutory consultation.

Pending that consultation, we offer the following observations:

Effect of JNP Financing Documents on LUL's Practical Ability to Enforce its Contract Rights

There are numerous and far-reaching events of default under the JNP finance documents. These include, by way of a very few examples:

- The breach by Infraco JNP of various cover ratios (CTA, Section 20.14), and

- Litigation or dispute resolution processes against JNP Infraco or any “Major Project Party” that can have a material adverse effect on the business or financial condition of Infraco JNP or any Major Project Party, on the ability of the Borrower or any Major Project Party to perform its obligations under any Finance Document or any Major Project Document, or on the Project as a whole. (CTA, Section 20.12). “Major Project Party” includes most subcontractors and, under the current drafting, LUL; *it may also apply to the other Infracos given both the various inter-Infraco agreements and the open drafting of various definitions.*⁴

Since an event of default can trigger LUL’s obligation under its 95% Guarantee of the indebtedness in question, *LUL will necessarily be deterred from taking actions that might result in Infraco being in breach of its cover ratios or pursuing claims that might materially adversely affect the Infraco (or another Infraco.)*

LUL’s expectation that it will be able to enforce its rights in the event it is faced with problematic performance by Infraco JNP, and its expectation that it can rely on the Statutory Arbiter for the establishment of prices that LUL will pay after Periodic or Extraordinary Review, are unrealistic in light of these events of default.

LUL must thus first revisit its analysis of the practical availability of its rights and remedies in the event of poor Infraco performance. In Transport *for* London’s view, these financing document provisions render LUL’s rights and remedies largely meaningless, as they can only be exercised at great risk to LUL. (Any suggestion that the JNP Financing is effectively cross-defaulted with the success of the other Infraco projects should obviously be eliminated from the finance documents.)

LUL must also seriously reconsider whether it can realistically expect to be able to benefit from the Statutory Arbiter’s pricing determination at Extraordinary Review or Periodic Review, rather than simply having to pay a price in each instance that will keep the specified financial ratios satisfied.⁵ It seems clear to TfL that LUL will simply have to pay what it takes to keep the Lenders in the deal, even if that price far exceeds what it would have to pay a Notional Infraco.

⁴ The provisions in CTA, Section 20.26 that limit the effect of Events of Defaults that occur in relation to Major Project Parties, provide little protection, as they require Infraco JNP to have in place arrangements satisfactory to the Majority Lenders to replace the affected Major Project Party within 20 business days. This is obviously highly unrealistic. Moreover, given the breadth of the definition of Major Project Party discussed above, in the case of at least some arrangements, it is not clear that Infraco JNP will have the power to put any replacement Major Project Party in place.

⁵ We certainly agree with PwC’s view that cover ratios should under no circumstances be any higher than those forecast as of the Transfer Date. Even this, however, will not protect LUL from the greatly diminished influence of the Statutory Arbiter by virtue of the existence of any cover ratio event of default.

Similarly, the senior lenders' obligation to provide financing is conditional on (among other things) there being no Warning Notice subsisting at the time a draw is requested. This provision significantly reduces the likelihood that LUL will ever issue a Warning Notice even if doing so would, in the absence of this clause, be the only sensible thing to do. Issuance of a Warning Notice creates a grave risk that Infraco JNP will be unable to perform any further obligations that require financing – i.e., virtually all of its obligations. Thus the calculus underlying LUL's contract administration is significantly – too significantly – affected by this provision. The provision should be unacceptable to LUL.

Effect of the JNP Financing Documents on Infraco's Ability to Make Independent Business Decisions and on the Likelihood that the PPP Contracts will Operate as a Partnership

The JNP Lenders will have significant controls over the business decisions of Infraco JNP. These include, among others: 1) those identified in the 62 page Controls Matrix, which identifies well over a hundred decisions Infraco JNP must take if the Lenders' direct it to or that Infraco JNP cannot take if the Lenders' direct it not to; 2) the Lenders' right of approval of all significant subcontracts; and 3) the Lenders' right of approval of changes to Infraco JNP's capital works programme and Project Costs.

The Controls Matrix alone fundamentally undermines LT's subjective assumptions that decisions by the Infraco will be made in a spirit of partnership, and that the number and scope of disputes between experienced in shadow running represent an indication of how PPP will work when the Infracos are privately owned and subject to the controls of the lenders. For example: The Specified Right to require acceleration of the Jubilee Line Upgrade to a date agreed by the parties requires not only Infraco JNP agreement, but also Lender agreement. Infraco JNP must serve a default notice on LUL if the banks direct it to. Infraco JNP must initiate an Extraordinary Review if the banks direct it to. Infraco JNP cannot settle a dispute under the Disputes Resolution clause without Lender consent. In many circumstances, Infraco JNP must seek higher compensation from LUL if the Lenders direct it to.

With this degree of Lender control, it cannot be suggested with any seriousness that all will proceed smoothly and that decisions will be made in a spirit of partnership. ***Even the purported incentives to make investment decisions based on principles of whole life asset management are jeopardised by these controls.*** Will the lenders seek the best technology, or the technology which best serves a lender with a limited time horizon when they are approving subcontracts? The Lenders are certainly not bound into the contract for thirty years. Indeed, they have a clear exit opportunity at each

Periodic Review. The Lenders also cannot be said to be properly incentivised by either the performance regime or whole life asset costing considerations.

It is appalling that the Senior Lenders, who in reality have very little exposure under this transaction, will nonetheless have significant control over the Infraco's decision-making while LUL, which not only has at risk 95% of Approved Debt⁶ but which also must operate and live with the decisions made by the private sector, has agreed to cede virtually all of its decision-making authority. That the Lenders want this degree of control over Infraco decisions only underscores how foolhardy it is for LUL to cede this same control. Indeed, in our view, this ceding of control represents an extraordinarily inappropriate abdication of public sector responsibility.

The absurdity of ceding control is further underscored by the proposed mezzanine documents. There, certain breaches by the Infraco of its obligations to the mezzanine lenders allow the mezzanine lenders to take complete control over Infraco JNP's board. We understand why a mezzanine lender, fully subordinated to the Senior Lenders, would want to do so; we cannot understand why LUL would not want similar protections, since its rights (indeed, its future) are also effectively subordinated to the Senior Lenders. Instead, LUL has agreed to live with very watered down Partnership Director rights, and extremely limited Special Share rights. We urge you to reconsider this agreement, and to insist on rights at least equivalent to those of the Lenders in the event of Infraco breach of their obligations.

Effect of the JNP Finance Documents on the Likelihood that the 95% Guarantee will be Called Upon

Without having seen the JNP Put Option Agreement, we cannot fully evaluate the risk to LUL that its agreement to provide a 95% senior debt guarantee will materialise. Pending receipt of that Put Option, we are working under the reasonable assumption that whenever there is an Event of Default under the Loan Documents, it is significantly likely that the 95% senior debt guarantee will be called upon. To that end, we note that the extraordinary reach of the Events of Default under the JNP Loan Documents place LUL at significant risk.

For example, events of default include certain financial troubles of any Major Project Party (see discussion above on the breadth of this clause), or any breach of a Major Project Document (which includes all major subcontracts as well as other as yet undefined documents), or any litigation against a Major Project Party that if adversely determined, would have a material adverse effect

⁶ Contrast this to the funds at risk for "Majority Lenders", who will have most of the decision-making power under the Loan Documents. "Majority Lenders" are loaning far less than all of the Approved Debt. With the T/L guaranty, they will thus collectively have far less than even 5% of Approved Debt at risk.

on the Borrower or any Major Project Party (as described above) or the Project as a whole.

Using a simple example, it seems that if any of the “key” subcontractors that JNP Infracore selects (subcontractors that will be selected without LUL input), falls into material difficulties, then LUL and TfL are at risk. This should not be acceptable to LUL or LT. LUL and TfL are the true credit parties for the PPP transaction. The Lenders should have very limited rights to exit from the transaction and thus to put LUL and TfL at risk of having to pay off billions of pounds of debt as well as the other costs of a failed PPP experiment.

Event of Default Tied to Availability of EIB Funding

There is an event of default under the JNP Financing documents that relates to the availability of EIB Funding. This is triggered by a “change in or affecting the Project” which causes it to cease to comply with the requirements for eligibility for funding by EIB or with certain articles of the EIB statute. The documents do not specify what constitutes a change in the Project. In light of the breadth of the drafting, there is necessarily a concern that any occurrence that renders EIB financing unavailable would be a change affecting the Project. This language should be clarified to eliminate this concern.

Moreover, full due diligence should be carried out into all possible triggers for this event of default and the probability of such trigger events occurring. LT cannot properly decide whether to approve language of this type (or even consult on such language in any meaningful way) until it has properly identified the nature of the risks which agreement to such terms would necessarily impose on LUL and, ultimately, TfL, and satisfied itself that such risks should be accepted in the context of this transaction.

TfL Deliverables

The JNP finance documents contemplate various deliverables from TfL, including among others, an opinion of counsel (potentially), Board resolutions (potentially), and consent to the security created by the Debenture. There also seems to be a suggestion that the LT guarantee will actually be delivered by TfL.

We have not seen forms of any opinion, resolutions, documents or other deliverables from TfL. We trust that the LT Board will not proceed to financial close without first satisfying itself that any TfL deliverables are acceptable to TfL and indeed will be deliverable and delivered by TfL. To proceed otherwise would be to transfer Infracore JNP to the private sector without any assurance that the finance necessary to make the project a success will ever be made available.

Similarly, we note that it is an Event of Default under the JNP Finance Documents if the Tfl Guarantee ceases to be in full force and effect or, it seems, if it is repudiated. We strongly recommend that before committing to this transaction you obtain an unqualified opinion of leading counsel that LT or Tfl may lawfully provide such a guarantee in the first place (as you know, we believe they cannot in the absence, at the minimum, of meaningful assurances from the Secretary of State as to the availability of future funding) and if so, whether upon transfer of LUL to Tfl, there is no question but that the guarantee, executed and delivered by LT, will indeed continue to be in full force and effect. (It is our understanding that Tfl's counsel would not be prepared to give such an opinion.) To do otherwise, while agreeing to this default trigger, would place LUL at enormous risk.

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