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Assessment of robustness of property income forecasts of NR in the Strategic Business Plan (SBP)

Prepared on behalf of
Office of Rail Regulation
March 2013

Status

DTZ has prepared this report for, and on behalf of, the Office of Rail Regulation (ORR). The figures reported are subject to various reservations, conditions and assumptions agreed with the ORR. Whilst DTZ has formed its own opinions on the scale of the potential property income, we have relied on certain information received from NR as being correct and having been provided in good faith. DTZ expressly disclaims any liability for any loss or damages of any kind to any third party resulting from reliance on the information this document contains.

Nothing contained within this report comprise opinions of Value as described by the Royal Institution of Surveyors (RICS) and whilst we consider the analysis to be sufficient to meet the agreed objectives, the figures and the assessment are not suitable for publication in any other context and should not be used for any other purpose.

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Executive Summary

- We have considered a lower and upper range of property income (this is not to say that these are 'limits' but rather low and high variations) based on various scenarios which is £1.539 - £1.833 billion.
- DTZ's base projection for CP5 income is moderately higher than Network Rail's (NR's) at £1.645 billion compared to NR's £1.578 billion.
- The lower and upper calculations are not based on extreme outcomes.
- NR's projections are based on assumptions that are broadly reasonable.
- Real growth rates assumed by NR are higher than property market return comparables (although, there is limitation as to their fit against such an individual portfolio as NR's). The property market comparison comes from IPD data.
- We consider that there is scope to derive higher income from Managed Station (MS) retail through:
    - Marginally higher real growth based on a greater correlation to passenger growth projections than used by NR.
    - Improved tenant mix and greater bias to turnover rents facilitated by a reduction in the number of leases within the security of tenure provisions of the 1954 Landlord & Tenant Act.
- The lease terms offered by NR on its Commercial Estate are appropriate to the market and results compare favourably with its peers in the commercial sector focused on secondary stock.
- Projections of Development and Sales income are relatively conservative and we consider that there is scope to significantly increase the proportion of sites achieving disposal or Joint Venture agreements within CP5.
- NR's development hurdle rates are generally reasonable and are lower than the wider market.
- The driver of the upper range of property income is low probability, high return projects, for example, Project Mountfield.

1 NR Control Period 5 (CP5) Forecasts and Strategy

NR has submitted the following property income forecasts for CP5:

Table 1: NR Property Income Forecasts for CP5

NR Projections in 2012/13 Prices (£000s)	2014/15	2015/16	2016/17	2017/18	2018/19	Total
MS Retail Income	103,712	108,159	110,764	113,539	116,326	**552,500**
MS Other Income	4,673	4,791	4,887	4,988	5,090	**24,429**
MS Advertising Income	19,286	19,772	20,166	20,584	21,005	**100,813**
Property Rental Income	95,928	96,444	97,072	98,085	99,101	**486,630**
Advertising Income	8,930	9,156	9,338	9,531	9,727	**46,680**
Other income	4,083	4,000	3,920	3,842	3,766	**19,611**
Concessions	11,446	11,734	11,969	12,217	12,466	**59,830**
Telecoms	13,375	13,374	13,372	13,371	13,369	**66,863**
Total PR Income Exc Sales & Developments	**261,432**	**267,430**	**271,488**	**276,157**	**280,849**	**1,357,357**
Net Property Sales & Developments	19,699	20,475	20,460	21,040	19,931	**101,604**
Non PR Income	6,276	15,687	23,029	30,440	44,254	**119,687**
Total	**287,406**	**303,593**	**314,976**	**327,637**	**345,035**	**1,578,647**

1.1 BASE BROUGHT FORWARD FROM CP4

We have requested (and received) the data relating to the calculation of the base PR income level for 2014/15 which relates to the last year of CP4 (2013/14). This is as follows (roundings are as provided and expressed in £000s):

Table 2: Base income (excluding Sales & Development) carried forward from CP4 (2013/14)

£000s 2012/13 Prices	Total	PR	Non PR
MS Retail Income	100,700	89,400	11,300
MS Other Income	4,600	4,100	500
MS Advertising Income	19,100	15,500	3,600
Property Rental Income	94,400	90,700	3,700
Advertising Income	8,900	7,800	1,100
Other income	1,300	1,300	0.0
Concessions	11,400	10,700	700
Telecoms	13,400	13,400	0.0
Total Income	**253,700**	**232,800**	**20,900**

This total PR and Non PR property income figure for 2013/14 of £253.7 million compares to the base PR forecast income figure for 2014/15 of £261.4 million. This is an uplift of circa £7.7 million from 2013/14 to 2014/15 in terms of total property income; if this is contrasted against the average year to year incremental total property income in CP5 (calculated as circa £18 million from Table 1), this seems low and indicates limited growth at the end of CP4.

In terms of the total income brought forward assumption, this relates to the income in 2011/12 (which is known) and projections for its performance until 2013/14 and then onto 2014/15 (analysed in Table 2). Therefore, we have reviewed data from NR relating to their projects for these two years. Table 3 illustrates the total income figure provided by NR; no breakdown of PR and non PR property income has been provided for 2011/12 and 2012/13 so we have assumed a flat line spread of non PR property income over CP4, taking into account the known NR projection for non PR property income in 2013/14. We have then applied a blended growth rate (to reflect the different income elements within the PR income) to the PR income from the 2011/12 base information to assess whether we get to a similar total income figure for 2013/14. We have not altered the assumption relating to net property sales and have not separated out real and incremental growth from NR’s numbers.

Table 3: Review of 2011/12 – 2013/14 NR Projections

2012/13 Prices (£000s)	2011/12	2012/13	2013/14
NR Projections			
NR PR & Non PR Income (exc Development & Sales)	245,800	252,500	253,700
Non PR	*16,200*	*21,600*	*20,000*
PR	*229,600*	*230,900*	*233,700*
Net Property Sales	29,200	36,800	37,900
TOTAL	**275,000**	**289,300**	**291,700**
DTZ Assessment*			
NR PR & Non PR Income (exc Development & Sales)		246,700	241,300
Assumed Non PR		*21,600*	*20,000*
Assumed PR		*225,100*	*221,300*
Net Property Sales		36,800	37,900
TOTAL		**283,460**	**279,200**

* DTZ IPD weighted real growth

Based on DTZ's growth projections and assuming that incremental (not real) growth is not significantly over circa £6m per annum (which based on NR's projections for CP5, would appear reasonable), the forecasts do not appear unreasonable.

1.2 MANAGED STATIONS

This incorporates all property rental income derived from the Managed Stations (MS) portfolio.

NR currently manages 17 major stations across the UK rail network. These stations are:

- London Cannon Street
- London Charing Cross
- London Euston
- London Fenchurch Street
- London King's Cross
- London Liverpool Street
- London Bridge
- London Paddington
- London St. Pancras International (NR manages this through the High Speed 1 operating contract but does not own, and the revenue does not form part of NR property income)
- London Victoria
- London Waterloo
- Birmingham New Street
- Edinburgh Waverley
- Glasgow Central
- Leeds
- Liverpool Lime Street
- Manchester Piccadilly

NR's income plans across CP5 assume that the MS portfolio remains consistent with this and they have made no assumptions regarding other station transfers due to the current uncertainty of the franchising process and due to lack of any current contractual commitment to enable such transfers. NR as highlighted that there is also the converse opportunity for a reduction in the number of "traditional" MS's. This uncertainty is noted. Nevertheless, it is feasible to contemplate some changes to the MS portfolio during CP5. From DTZ's discussions with NR during this review process, we understand that the potential stations whose status is under consideration include:

[redacted]

[redacted]

We recommend that a mechanism is agreed so that adjustments (including to regulated income) can be made should there be any significant changes to the MS portfolio during CP5.

MS Retail Income (£553 million for CP5, 35% of total property income)

This includes all retail rental income (shops, cafes, pubs) from inside the 17 MS. Retail units outside the railway station 'envelope' are not included within this category.

MS Retail Income is the biggest single income line within NR's projections and, along with the Commercial Estate makes up over 3/4 of NR's total property income and 2/3 of Periodic Review (PR) income. Therefore, it is a key driver for the CP5 projections, which NR forecasts will contribute circa £550 million over the period.

Key elements of NR's strategy for MS Retail Income during CP5 include:

- Improve the breadth of the retail offering for passengers, encouraging them to broaden their purchases beyond the immediate requirements of their journey.
- Attract consumers, other than rail users, to generate additional income and broaden the consumer base.
- Provide significant additional space at Euston, Paddington, Liverpool Street and London Bridge (plus certain refreshments to the existing offer at all other MS's).
- No new major stations are added to the NR portfolio during CP5 (see Section 1.1 regarding this) and no schemes of the magnitude of the Victoria Place acquisition.

NR view that within CP5, they will reap the self-funded investments undertaken in CP4, in terms of providing additional floorspace (e.g. Waterloo Balcony and Victoria Place) and information systems (deemed to enable NR to maximise the MS product offer). These are still tax payer funded and added to the Regulated Asset Base (RAB).

NR's real growth assumptions are high against most benchmarks, particularly compared to Investment Property Databank (IPD) retail rental forecasts and are predicated on a link between the (significant) passenger growth forecasts and retail spend, as opposed to linking this to more static Gross Domestic Product (GDP) forecasts. They consider that some of this real growth can be achieved through focusing on maximising footfall to less core areas through improved signage and other complementary strategies; conversely NR has pressure to reduce concourse congestion in the main station area.

NR state that a number of planned NR schemes (often in partnership with developers) including cinemas and anchor stores have proven to be impossible to deliver profitably within CP4 and they consider that this position will remain in CP5 due to a continued difficult market place for commercial property development.

During the review period, DTZ and the ORR have had a number of meetings with NR in order to understand and question their strategy in relation to MS Retail. There are three areas of the strategy which we have queried in particular.

Tenant Mix

Within NR's Property Strategy, they have highlighted a desire to attract non rail users to MS's to increase the range and number of potential consumers. A major part of the ability to attract new consumers in this manner is obviously driven by the mix of units offered. Although NR has stated a desire to gradually 'improve' the tenant mix, they consider that they are constrained in their freedom to do this and/or the potential revenue increase by:

- Limited quantum of space.

- NR wider remit which includes a requirement to provide core services for travellers' needs (for example the requirement borne out of the National Passenger Survey to provide newsagents, food and beverage retail).
- Although there is a differential between the rents paid in high street/ shopping centre locations by comparison retailers and the rates achievable from food and beverage retailers (higher for comparison retail), food and beverage operators have had a relatively strong recession and their proportional occupancy of shopping locations has increased in the last five years. NR considers that the performance of food and beverage operators is less volatile than comparison retail and we do not differ from this view.

Overall, NR considers that the category mix may change gradually over time in stations but that a transformative shift in tenant mix is unlikely in the short to medium term. NR highlighted that in the past they have undertaken research with companies such as Javelin, relating to optimising tenant mix and maximising spend (for the avoidance of doubt, DTZ have not been privy to any such information).

The existing tenant mix does have a number of advantages in terms of the consistency of the core group of retailers across the UK which minimises management time and allows familiarity with the lessee and their business model. A key risk however is the risk of any of these tenants going into administration/ having financial difficulties. If the retailers were to shut, then there would be a significant impact on NR's projected income. We understand from NR that it has a review process to assess the risks against key tenants and their credit worthiness. They consider that the current risk is low due to the largely well established tenants with good financial covenants.

Turnover Rents & Standard Leases

MS Retail Income is from a diverse range of sources with significant elements from a few major tenants with representation across NR's MS portfolio. The top five occupiers are responsible for around half of total income. Table 4 shows the revenue received from these five occupiers in 2012.

Table 4: Rental Revenue from the top five occupiers in MS in 2012 (£000)

Occupier	MGR*	Turnover	Total Income	Revenue based on retailers turnover
SSP**	[redacted] [redacted]	[redacted]	£ 30,374	[redacted]
WHSmith	[redacted] [redacted]	[redacted] [redacted]	£ 9,025	[redacted]
Boots	[redacted] [redacted]	[redacted]	£ 8,296	[redacted]
McDonalds	[redacted] [redacted]	[redacted]	£ 3,698	[redacted]
Caffe Nero	[redacted] [redacted]	[redacted] [redacted]	£ 2,590	[redacted]
Total	[redacted] [redacted]	[redacted]	**£ 53,984**	[redacted]

* Minimum Guaranteed Rent (MGR)

** Select Service Partners (SSP)

SSP are by far the largest rent payer which reflects that they run franchise operations for a multitude of major brands including Upper Crust and Caffe Ritazza and are a specialist in operating in railway stations and other transport related locations.

The balance between rent paid as MGR and as Turnover is circa 4:1. It is very difficult to find comparable information relating to this within the retail market, as landlords are reluctant to share such information; overall we consider it to be a relatively high percentage of turnover compared to a typical high street or shopping centre. However, NR is in a somewhat unique position with near guaranteed high, and growing, footfall levels and retailers who, in general are selling low value items and services. Therefore, there is an argument to say that if the ratio of turnover to MGR is higher, there may be greater growth prospects for NR. NR has themselves stated that retailers are generally less aware or convinced of the turnover growth potential offered by retail units in MS's.

NR's negotiating strategy in relation to the structure of retail leases overall is to:

- Seek the best terms possible in each case (as opposed to having a standard proforma)
- Flexibility between MGR and turnover rent split (NR consider that retailer's different strategies require this; e.g. phone shops would rather pay a market rent than have a turnover element).
- NR consider the total income from tenants based on their internal projections

NR consider that one of the benefits of high MGR's (and therefore, limited turnover provisions) is that it can help remove poorly performing retailers and incentives retailers who are struggling to improve their product offer (as opposed to having a low MGR where then incentive may not be as strong).

Table 5 shows the percentage of turnover payable as rent by retailer type and individual product type. Typically, turnover clauses within leases vary considerably from one lease to another. Our understanding (from discussions with NR) and assumption relating to the exact terms of a typical turnover provision in NR's MS retail leases is that a percentage is applied to sales to give the total rent which is subject to a MGR; this is the total rent that is paid by the retailer to NR. The actual position on some leases could be that a cap exists when turnover rents hit a defined amount or in some cases the turnover rent does not exceed the MGR; NR state that there is no cap on the turnover rents receivable. The actual turnover to be measured will be defined and we understand that this relates to exact sales data from individual units (e.g. doesn't include any allowance for internet sales assumed to be supported by the unit). The rates used below appear to be broadly reasonable and within the ranges that we would anticipate.

Table 5: MS Turnover Rates

Type of Retailer	Percentage of Turnover
Accessories	15% - 21.5%
Pubs & Bars	Food and Beverage 5% - 25% Tobacco 1% - 2% Confectionery 6% - 8% Nuts & Crisps 8% Phone Cards 4% Other Goods 20%
Books	Books 15%[redacted] Ebooks 5% [redacted]
Bread	Bread 12% - 22.5% Tobacco 2% Confectionery 8% Phonecards 4% Nuts & Crisps 8%
Cards & Stationery	17% - 30%
Clothing	10% - 20%
Coffee	Coffee 12% - 27% Tobacco 2% Confectionery 8% Phonecards 4%
Confectionary, Tobacco and Newspapers	Food 19% Other goods 11-15% Confectionery 13% News & Magazines 15% Kobo, Stamps, Lottery, Phonecards 2%
Technology	12% - 15%
Gifting	[redacted]e from 10% [redacted] Other 15% to 20%
Health & Beauty	Health and beauty 10.75%-12.5% Beauty 10% - 17% Hairdressers 10%-15% Gym 9%
Retail Services	Bureau 0.25% - 5% Amusements 27% Bookies 15% Dry Cleaners 15%
Fast Food	Burger & Chicken 12%- 24.5% Pasty 15%- 25%
Dining	8% - 24%
Specialist Food	14% - 22.5%
Supermarkets	0% - 6.0%

The lease summary in Table 6 shows the standard lease terms that NR seeks. As NR looks to negotiate the best deal with each individual tenant, the actual lease terms achieved will differ considerably. What it importantly does show, is the provision (which we understand is not flexible) that gross sales information is provided on a quarterly basis although NR are seeking to increase this frequency.

Table 6: Standard Retail Lease

Retail Lease	
Rent	• Quarterly in advance
Rent Review Process	• 3 year open market review
Security of Tenure	• Contracted out of the provisions of sections 24-28 of the LL&T Act 1954
Turnover	• Gross sales information must be provided to NR on a minimum of a quarterly basis
Use	• Not to be used for purposes other than the agreed use and a series of other uses including (but not limited to) auctions, the sale or trade of telecommunications products, facilities or phone cards (international or otherwise) or any similar ancillary or related products; or any other purpose which is illegal/immoral or which causes nuisance/disturbance to the Landlord, to any rail passengers or to any other person. • Property must be kept open for minimum trading hours, if not tenant must pay landlord by way of liquidated and ascertained damages a specific sum, as calculated in the lease
Alienation	• Not to assign, transfer, underlet, charge, hold on trust for another or part with or share possession or occupation of the Property except that (with the prior consent of the Landlord) the Tenant may share occupation with a Group Company, provided certain stipulations are met
Guarantor	• Surety is required • The rents reserved by this Lease will be duly paid and the covenants, obligations and agreements on the part of the Tenant will be performed and observed in the manner and at the times specified in this Lease. If there is any default in paying the rents or in performing or observing the Tenant's covenants, obligations and agreements in this Lease, then the Surety shall immediately be exercised by the Landlord. This will require rents to be paid and the Tenant's covenants, obligations and agreements to be met. • The Surety shall keep the Landlord indemnified against all costs, liabilities, claims, actions, demands, proceedings, damages and losses resulting from any failure by the Tenant to pay the rents or observe or perform any of the Tenant's covenants, obligations and agreements in this Lease.

Protected Leases

[redacted]

[redacted]

[redacted]

Passenger Growth

As highlighted above, NR's projections are correlated to the projections for passenger growth. Overall, NR is forecasting 16% growth in CP5 passenger numbers on top of the 20% growth in passenger train kilometres in CP4. Table 7 shows the projections for growth in the number of passengers to be accommodated into London termini during CP5. London termini make up the majority of the MS portfolio in terms in income. The forecast growth in passengers over CP5 is 21% in the Peak 3 hours and 19% in High Peak Hour.

Table 7: Number of arriving passengers to be accommodated into MS

	Peak 3 Hours		High Peak Hour	
London	**Forecast demand in 2013/14**	**Extra demand to be met by 2018/19**	**Forecast demand in 2013/14**	**Extra demand to be met by 2018/19**
Blackfriars Terminating	0	8,000	0	3,800
Blackfriars Through via Elephant & Castle*	21,100	-8,600	10,800	-5,000
Euston	24,300	2,400	11,500	1,200
Fenchurch St	24,100	2,000	13,000	900
Kings Cross*	17,300	-4,600	8,000	-3,300
Liverpool St Terminating*	66,800	-4,400	34,600	-2,300
Liverpool St Crossrail	0	33,000	0	16,500
London Bridge Kent routes	92,300	13,600	48,700	8,000
London Bridge Sussex routes	45,300	24,600	23,500	11,800
Marylebone	11,400	1,000	5,100	500
Moorgate*	13,200	-2,300	7,400	-1,100
Paddington Terminating*	26,300	-2,400	12,100	-1,900
Paddington Crossrail	0	23,600	0	11,800
St.Pancras Terminating	9,600	400	4,300	200
St. Pancras Thameslink	19,700	15,400	10,500	6,500
Victoria (Southeastern)	20,100	900	10,100	400
Victoria (Southern)	47,700	6,700	23,200	1,300
Waterloo	100,100	9,700	45,700	4,900
Birmingham	37,500	3,900	19,200	1,800
Leeds	25,400	5,100	13,000	2,800
Manchester	28,100	6,200	13,600	2,600
Others	34,800	4,900	16,500	2,000
Total	**665,100**	**139,100**	**330,800**	**63,400**

Taken from Railways Act 2005 Statement for Control Period 5

* These stations are predicated to see a reduction in passenger numbers due to various new stretches of railway which are being commissioned that will take some trains (and their passengers) that currently terminate in dead-end platforms and project them onto new through lines under London during CP5. This covers Blackfriars and King's Cross (and, indirectly, Moorgate) onto Thameslink plus Liverpool Street and Paddington onto Crossrail.

MS - Other Income (£24 million for CP5, 2% of total property income)

This income stream incorporates MS rental ancillary income including offices, retail storage facilities and space used by the Train Operating Companies (TOC's).

This is a minimal part of total PR income (2%). NR's CP4 strategy has been to invest in opportunities to bring unused or low income-generating space to a more profitable use, in particular serviced offices. NR consider that this strategy will build their income base for CP5 and that they may be able to take advantage of further long-term opportunities for growth through continued investment in the next Control Period.

Within this income line sits revenue from NR's hotels (leased to third parties). NR currently has hotels with two niche providers:

- Grasshoppers – hotel in Glasgow
- Sleepers – hotels in Cardiff and Newcastle

[redacted] The buildings within which they are operating are relatively unique and provide limited opportunities for other uses (one of the benefits of hotel occupation is the maintenance of the buildings). There are very limited opportunities for additional hotel space within the MS estate (NR view) and hotel opportunities are more likely to be by way of development and sales, with NR potentially retaining an interest (e.g. Solum joint venture).

In terms of the opportunity for serviced office income, NR have undertaken a number of schemes with The Office Group to provide space in a number of stations (including Paddington and Euston) and feel that is works well as part of the holistic MS offer. NR consider that this is a potential growth area for them and they would like to generate more income and facilities from this (in the case of new provision, this will obviously be non PR property income for CP5). Within CP5 income, they have included Paddington (which is 96% let), Kings Cross East and Leeds. A major constraint in providing expanded facilities within stations is the competition in MS's from other, higher value uses (e.g. retail) on 1st floor level; there are also franchising constraints on changing the 1st class lounges offered by TOC's, although the development at Euston is going ahead relating to this. Given the potential for alliances in the future and a better relationship with TOC's, there could be an increased number of opportunities.

MS Advertising Income (£101 million for CP5, 6% of total property income)

This includes all advertising income generated by NR at its MS. The remainder of the advertising portfolio income is contained within the 'Advertising Income' line.

NR's partner in relation to rail side advertising is JC Decaux through a non exclusive concession agreement due to expire in 2015. NR considers that they are maximising income through investing in new technology and seeking imaginative ways of utilising existing sites. The agreement provides for uncapped income and an MGR. NR envisages that these arrangements will continue through CP5 subject to the outcome of competitive tendering upon their expiry.

Real growth figures are taken from their par, long term projections and they plan to generate incremental income from investment in enhanced delivery media. The major element of incremental income is £15 million allowed for, which relates t[redacted] (non-PR however).

Traditionally, advertising spend generally rises at a faster rate than GDP although industry spend has been partly diverted towards on-line media. Given the nature of the NR advertising portfolio DTZ would expect advertising spend to be closely related to GDP but with opportunities for NR to grow this through new advertising space and better use of technology. The nature of the NR advertising portfolio is that it has high footfall and is based on traditional media so growth is more likely to be linked to GDP than have the opportunity for exponential growth.

NR have iterated their view that the existing agreement with JC Decaux is at very favourable terms to NR and that there are limited growth opportunities in CP5 due to CP4 being a period of high investment which has already yielded additional returns, intrinsic within the brought forward figure. NR strategy for the re-tender process will be to keep in mind the volatile nature of the sector and risk of smaller, unestablished operators trying to enter the market through contracting with NR but not having the balance sheet and security to meet their commitments. A significant part of advertising income is generated from sites within, or adjacent to MS stations and therefore, the passenger growth forecasts are relevant.

1.3 PROPERTY RENTAL INCOME (£487 MILLION FOR CP5, 31% OF TOTAL PROPERTY INCOME)

Property Rental Income incorporates the following main areas:

- A variety of easements and wayleave agreements with various utilities and other stakeholders.
- Income from freight sites as well as miscellaneous asset portfolio income from access rights, garden extensions and other minor items which NR retains for operational reasons.
- The business space income consists mainly of the portfolio previously known as Spacia. The most significant use is industrial and storage purposes but the portfolio also includes offices, retail and leisure and some residential.

The vast majority of NR's property rental income is derived from their business space portfolio which was formerly branded under the Spacia name; the £487 million equates to over1/3 of projected CP5 property income.

The business space portfolio is generally referred to as the Commercial Estate (CE) and the most significant end usage is for industrial and storage purposes with an element of offices, retail and leisure and residential occupancy. The retail income is from arches and units outside the cartilage of railway stations (as this income would be allowed for within MS Retail income, or if at a non MS, retained by the TOC).

NR's CE has a low (by industry standards) vacancy rate when compared to operators such as Workspace Group; over their full estate, NR has 7,500 Solutions tenants with a 5% void rate. The Department of Trade (UK Trade & Investment) are promoting NR's Solutions 'product' as a leading provider to the Small and Medium Size Enterprise market (SME).

The real growth being projected within CP5 by NR for the CE is above their (and DTZ's) inflation expectations and consensus GDP growth forecasts; on average it is 0.8% above inflation. The rate applied to easement and wayleaves matches inflation and the retail elements are grown as per the MS Retail Income (at a trend rent matching passenger growth).

NR plan to fund investment to grow their underlying income base with a similar level of viable enhancement spend to CP4. Their renewal spend in the latter of half of CP4 is predicted to be relatively high in order to arrest a decline in income due to a deterioration of the condition of their estate (DTZ has not be able to verify the validity of this); they expect this level of expenditure to continue through CP5. We would expect this to feed through to relatively positive growth rates within NR's figures.

NR views the opportunities for generating incremental income from the CE as primarily:

- Change of use of certain assets where a higher value can be achieved (identified by portfolio assessment)
    - It should be noted that this income will likely be classed as non PR for accounting purposes unless the same tenant remains with limited works. It all adds to the Regulated Asset Base (RAB) however.
- Striving to optimise the rents/ vacancy ratio to maximise value
    - Some constraint in that having high occupancy rates is deemed to provide operational benefits (e.g. in reducing vandalism)
- Conversion of some tenancies (in locations where operational access is of limited importance) to higher paying, standard, institutional leases. NR consider that this has limited relevance to Solutions tenancies as there is a clause which means that at 5 yearly rent review points, if open market rental growth has exceeded indexation rises, then this is reflected in the revised rent.

In terms of easements and wayleaves, DTZ has not been privy to a breakdown of this as NR do not have a summarised breakdown and the full list is mainly constituted of small, low level receipts which we do not consider are material with the overall magnitude of revenue assumptions. NR's strategy is to simplify agreements and renegotiate charges when existing agreements expire (where non statutory). This process has commenced during CP4 and NR believes some further benefits can be delivered during CP5.

A significant element of NR's strategy and DTZ's analysis of it has been related to the flexible leases available on the CE. Specific commentary relating to this follows below.

Solutions Leases

Solutions Leases are the standard lease on the majority of the CE and therefore, the terms within them are key to maximising property revenue and understanding NR's strategy fully. Table 8 below summarises the key terms.

Table 8: Summary of Solutions Lease Template

NR Solutions Agreement	
Rent	• Negotiated on each individual property
Rent Review Process	• RPI indexed review clause; multiple of this negotiated in each individual case • On every 6th anniversary of tenancy start date for as long as the tenancy continues
Security of Tenure	• Outside the security of tenure provisions of the 1954 Landlord & Tenant Act. • Both parties to sign a clear statement excluding a lease from the security of tenure provisions of the act.
Use	• Not to be used for purposes other than the agreed use • Not to be used for dangerous, illegal activities etc which may cause damage, nuisance etc to other tenants or neighbouring occupiers • Must not apply or put into effect planning permission without written permission. • Planning applications must be made in both NR and the tenants name
Alienation	• Must not transfer, sublet, charge or part with possession of the whole or any part of the property
Access	• Full access to inspect and repair arches by NR personnel

NR'S strategy in using 'Solutions' tenancies is based on what they consider to be the key benefits to themselves and total property income:

- Robust rent review provisions with link to RPI
- Ease in achieving vacant possession
- Ability to service and check arches
- Low management costs on rent reviews

In terms of the offer to the market, DTZ would agree with NR that the Solutions tenancy matches the demands of SME's. The last ten years has seen a dramatic reduction in the average lease length on commercial property based on the demands of occupiers.

Freight Income

NR's Property Strategy Document provides no specific information on their freight income strategy and the figure is not broken down within Property Rental Income. NR has applied no real growth (or decline) to freight income over CP5 as it considers it has limited room for manoeuvre due to the regulatory environment.

DTZ has previously been advised (January 2012) that £6 million of revenue per annum is derived from freight and similar sites offering rail access. There is some limit to the ability to improve income through asset management due to the proportion of freight sites which are regulated and for which NR receives only a peppercorn rent. Where sites are retained for future freight use they are let for other purposes. However, these sites are usually let on a short term basis to safeguard future freight use and this limits the income that can be secured.

Based on the ORR's own figures, the 12 months to June 2012 saw a double-digit growth in freight volumes; we understand there to be a general trend for freight traffic to increase at a rate significantly above GDP growth due to rising fuel prices and improvements to cargo infrastructure which are accelerating the shift from road to rail. The Financial Times reported that NR considers that freight traffic could increase by more than 140% over the next decade whilst the Rail Freight Group has calculated growth over the last ten years of almost 50%.

NR considers that its ability to convert freight traffic to income is constrained by the ability of other property owners with assets adjacent to the network to develop freight sites by paying an access charge (regulated). Additionally, NR considers that income from freight sites is not directly related to freight traffic, in particular because it predicts that freight traffic will be concentrated on the same routes (i.e. existing freight assets being used more efficiently) as opposed to a growth in freight sites across all routes. A significant amount of the growth being created in the market today is being done by private operators where NR does not receive a return.

1.4 ADVERTISING INCOME (£47 MILLION FOR CP5, 3% OF TOTAL PROPERTY INCOME)

This includes all advertising income generated by NR on its property portfolio outside the MS's. This element is purely the Roadside advertising (primarily billboards) whilst the Railside advertising (primarily advertisements within and around railway stations) is accounted for in MS Advertising income.

NR has an existing contract in place with Primesight for Roadside advertising and will be retendering this contract in 2016. Much of the same commentary applies here as to MS Advertising Income and NR has not distinguished its strategy between the two elements.

We understand that Primesight bid for this concession assuming growing demand with a 9% margin. The growth assumed by Primesight has not materialised (advertiser demand for the roadside subsector has declined) and their payments to NR have yet to exceed MGR level. Occupancy rates are at 85%.

Real growth figures are largely based on NR's long term projections and also match the growth rate applied to MS Retail Income to factor in an element of passenger growth.

1.5 CONCESSIONS (£60 MILLION FOR CP5, 4% OF TOTAL PROPERTY INCOME)

This income stream incorporates all car parking income that NR generates from its portfolio (NR has combined both MS and non MS car parking income to ensure the most efficient management structure) as well as left luggage facilities.

Car Parking

NR's car parks have been subject to investment during CP4 which is reflected in the circa 15% increase in revenue from CP4. Its car park charges are unregulated and it projects that additional income will be generated through price increases and higher utilisation rates although we have not received data on the specific assumptions behind this.

Total concessions income in 2014/15 is circa £11.5 million and we understand (from historic conversations with NR) that circa £8 million of this relates to car park income. NR envisages that its new car park developments will be mainly related to non MS, outside the TOC's station boundaries, and as such new income would form part of the Facility Charge income and not PR income. We understand that all non PR MS concessionary income for CP5 relates to additional car parking facilities. The real growth applied by NR correlates to passenger growth forecasts, which is higher than GDP forecasts.

There is a target in Better Rail Stations (DfT, 2009) for an additional 10,000 spaces per annum. This is an aspirational target and in our view it is not a reasonable assumption that this level of new spaces will be income producing during CP5 given the shear amount of space required on often, very constrained sites. Also, NR may be able to generate additional car parking spaces but this income will likely form part of the facility charge income and not affect NR's income. The wider industry plan to have more alliancing between NR and TOC's may allow greater opportunity for car park development.

Left Luggage Facilities

There have been no recent changes in left luggage facilities. Fenchurch Street, which has comparatively low passenger volumes and caters mainly to local commuter traffic, is currently the only MS with no facility. A facility was provided at Cannon Street during the Olympics but this has since been removed and the temporary facility at London Bridge has been removed to allow for higher rental uses, such as food outlets. We understand that total income is circa £3.5 million per annum for the 14 Facilities in place in MS's.

The majority of MS left luggage facilities are sited in secondary areas which are less attractive to retailers but within the station envelope and typically on the concourse level. It may be feasible therefore for some additional revenue to be generated by moving these facilities at some locations to free up concourse space although NR consider that this has been largely been done and there is limited scope. Whilst this additional concourse space would not typically be prime it is likely to provide a higher rental income than left luggage facilities. Any change with regards to the positioning of left luggage would have to be balanced against the wider service provided by NR and the inconvenience of left luggage not being on concourse level (likely to require lift access).

Outside the MS's, NR consider there to be very limited opportunities to increase left luggage income as to be useful it is likely to have to reside within the TOC's station lease boundaries. This is an area where we would expect that NR could use alliancing to help it meet its business objectives.

1.6 TELECOMS (£67 MILLION FOR CP5, 4% OF TOTAL PROPERTY INCOME)

Telecoms income consists largely of mast sites and linear easements.

NR expects some growth in real terms over CP5 due to renegotiated renewal terms and the rollout of 4G technology. Overall, DTZ considers NR's assumptions to be reasonable due to subdued economic conditions and the number of available competing sites open to operators.

1.7 PROPERTY SALES & DEVELOPMENTS (£102 MILLION FOR CP5, 6% OF TOTAL PROPERTY INCOME)

Within this category there are a variety of income generators to NR from outright sale of assets, Joint Ventures (JV) with third party developers, land CPO'd by Local Authorities and Central Government, major developments and shared value receipts.

Net Property Sales & Development Income constitutes 6% of NR property income (£102 million); NR's IIP submission was at a much higher level (£160 million). NR has made this significant adjustment between IIP and SBP due to the lack of the predicted (in 2010) recovery in the development market. This is a significant (over 1/3 drop) in two years from a property market that (in 2010) was not in a overly positive position in any event.

NR considers that the reduced demand from occupiers and the limited availability of debt finance will continue, apart from selective hotspots such as Central London. NR propose to address current market conditions by focusing on JV type arrangements, enabling NR to gain a share of development profits in addition to land proceeds; this delays receipts but they consider that it generates greater value in the medium to long term; this is particularly relevant in relation to 'difficult' sites where returns can be related to housing delivery (where relevant). They propose the launch of a second joint venture in CP5 to add to the existing 'Solum' agreement with Kier Plc.

A less favoured option (but one with nearly half the Net Property Sales & Income for CP5) is outright disposals; however, this option is only considered when it can be proven that it represents value for money. For all Net Property Sales & Income, NR undertakes an accounting split between cash and assets in lieu of cash (i.e. hypothecated gains). This is outlined further below but fundamentally it means gaining assets such as ticket barriers and functions connected to the railway instead of cash and is determined in conjunction with the operation side of NR.

NR has forecast £25 million in shared value transactions over CP5. These are transactions when a developer requires access over NR land and NR has no control over the timing of these transactions (and considers that it cannot be seen to be benefitting from so called 'ransom strips'). The projections are based our projections on NR's historic run rate.

NR will continue to not undertake speculative development in their own right although some direct development may come forward if it is pre-let and the most advantageous option. For example, NR are progressing with its own equity a retail park type scheme in [redacted] adjacent to the station, with pre-lets in place to [redacted] The developer was unable to get funding so NR is self funding the scheme (circa £5.5 million build costs). The benefit to the railway is through new, improved access.

NR is also looking to change operational strategy to concentrate on key projects and sell minor sites (through an internal transfer to Property Services). NR has made no provision for receipts from DBS sites in CP5 based on the element of uncertainty surrounding the transfer.

Hypothecated Gains

NR looks to maximise overall value to the railway, and will accept assets in lieu of cash if this provides the best value. NR Routes seeks to receive value in the form of benefits at stations as opposed to cash, which reduces the burden on NR to fund these railway related elements. The split is decided on a case by case basis.

DTZ has sought to understand the rationale behind the split applied between hypothecated gains and income and the process followed for such decisions. NR examines each project on a case by case basis and follows the rationale of delivering best value overall for NR, whilst still ensuring that there is a sustainable development remaining and seeks to find the 'natural level' required to achieve stakeholder buy in. On the basis of information provided to DTZ we consider that the balance between land receipts and hypothecated gains is based on a subjective assessment (we have been provided with, and reviewed, the document relating to 20 Station Road, Cambridge). Although this could give rise to decisions being artificially weighted towards increasing the Regulatory Asset Base, DTZ is not aware of any such instances where this has occurred and we are advised that the decisions are based on open discussions between NR Property, NR Route and the relevant TOC.

NR's strategy will always have to balance the need to maximise revenue whilst understanding NR's wider corporate position. This means that it has incentives to work constructively with Local Authorities and get their, and NR Routes' buy in. Another consideration is the need to maintain operational flexibility and to not hinder and compromise future railway works.

Development & Sales Schedule

NR has provided DTZ with the detailed Development and Sales schedule which sits behind and feeds their forecasts. This contains just over 600 individual property assets. This includes all assets which are deemed to be surplus to the operational needs of the railway and also property assets attached to the railway which have the potential to generate additional revenue to NR through more intensive/ altered development.

NR's analysis in the spreadsheet calculates the total estimated net profit to NR should the scheme or sale happen within CP5. A 'percentage chance' of schemes coming forward is then ascribed to each individual property asset, following the respective below criteria:

- 12% - pre feasibility stage (early stage of a project with significant uncertainties)
- 37% - project where some preparatory work has been completed but significant issues still exist
- 62% - project has satisfied a proportion of hurdles and objectives and there is reasonable confidence that the scheme can and will proceed. NB – the CP5 Strategy document highlights a figure of 67% as opposed to the 62% utilised in the detailed schedule; discrepancy to be checked with NR.
- 87% - 'virtually there' and the project is into the last elements of legal documents
- 100% - high degree of certainty, may reflect a deferred payment

This risk adjusted figure is what goes into the NR forecast. There is also an element of project specific risk adjustment made within the initial net profit calculation which reflects wider market value risk. As part of our assessment, we have requested sample information on two schemes at each 'percentage chance' level within the NR schedule to ensure that the scheme is consistent with the figure prescribed to it; this information is contained within Appendix 4. We have identified two of the sample projects [redacted] with Appendix 4 as potentially being at the incorrect 'percentage chance' level of 12%. If both of these projects are reclassified, this adds circa £6. 7 million to the forecasts which is reflected in the upper forecast of property income.

The total within the risk adjusted schedule is £67 million; the additional £33 million is termed as 'overlay' in the schedule (at circa 50% of the specific project list) which gives a total of £100 million. We understand that the additional £2 million (to reach the SBP figure of £102 million for Net Property Sales & Development Income) is derived from low value, small sales which are outside of this analysis. We understand that the 'overlay' figure has two purposes: a management tool to push performance and address any 'pessimism bias' within the individual assessments; and to allow for shared value receipts which NR deem to be unpredictable (forecast at circa £25 million in CP5).

The £33 million is largely accounted for by the £25 million in shared value revenue which NR has projected; NR's view as to the other £8 million is that this is a stretching target for their business although it does not seem an unreasonable stretch based on the £67 million base figure and the risk of pessimism bias in internal, individual site assessments. The £8 million reflects a 12% uplift on the £67 million.

Developments

Our understanding of NR's hurdle rates for development is as follows. NR has a minimum required regulatory IRR of 4.75%. For the purposes of investment appraisal of property refurbishment projects and developments fully controlled by NR, a higher hurdle rate of [redacted] is used to allow for commercial risk. Joint developments with third parties, where NR has less control over the outcome, have a hurdle rate of [redacted] This results in projects being accepted which have a lower NPV than would be funded if NR had an investment rate more similar to private sector comparator organisations.

Developments are related to direct property development on NR land or air rights (sometimes involving adjacent land owners) and undertaken either by NR directly or with one or more third party developers (JV's are specifically mentioned in the next Section). Such developments may be supported by a combination of pre-let and speculative letting deals. NR classifies its developments as being of comparatively high risk as they are likely to involve significant additional commercial, construction and funding risks ranging from more complex planning, design, commercial, funding and disposal risks.

NR contends that its most straightforward, high value sites have already been developed and the majority of the remaining sites have challenges in terms local market appetite and/or delivery constraints from the operational railway.

NR does not envisage that CP5 enhancement schemes will require any external funding, although joint ventures may require this.

We are advised that it is NR Corporate, not NR Property, that deal with the TOCs in relation to the Investment Framework and this is not included in NRs assessment.

[redacted]

In terms of structure of receipts, NR has said that it would prefer to retain income as opposed to taking capital in a number of cases but has very limited flexibility in this area. For instance, NR consider that a number of the developments have minimal to no value, particularly in the case of urban extensions and infrastructure heavy projects due to the reduction in value during the recession. However, there may be long term returns which are only realised once the development is established. NR seek to be flexible with developers but consider that there can be a propensity for them to push the 'political button' to seek advantageous commercial terms from NR which they wouldn't seek from a standard, profit maximising operator in a comparative position.

Joint Venture Strategy

NR sees an opportunity to build on the existing Solum JV (with Kier). This is driven by two main factors which have already been highlighted, namely the difficulty for developers in obtaining debt finance and the wider 'depressed' property market.

NR can help address these issues by assisting development with deferring much of the upfront funding requirements. This is seen more by NR as a conventional way of doing business, and will be the standard approach going forward. They gain exposure to the equity risk of the development while enabling them to work more closely with the developer bringing their railway related skills. They consider that higher returns long term returns can be generated from having an equity stake and NR staying involved, adds value to the developer in having knowledge of and contacts to the operational railway to address potential constraints.

Examples of JV's which NR is pursuing include:

- West Hampstead (joint with Ballymore); [redacted]
- Kew – [redacted]

DTZ has questioned NR as to if there are structural reasons that they have not pursued more development and sales through JV's in areas where the market remains relatively buoyant (e.g. London). NR consider that the majority of significant sites within growth areas are being advanced; where they are not, this is due to operational constraints that even in a strong market, make it very difficult to release value. The cost of developing over the operational railway is such that the specific location and covenant strength of occupiers has to be very strong in order for development to come forward. We would generally not disagree with NR that there are very limited 'super prime' sites available to them to develop which they are not already bringing forward. Taking the example of the railway line north of Euston station, where development has been proposed for many years; the values achievable from commercial space users drops off dramatically north (as opposed to in front) of the station which is where the majority of potential development space sits.

Shared Value

Table 9 – NR Shared Value Receipts

£000s	2009/10	2010/11	2011/12	Total	Average
All	5,100	16,500	10,300	31,900	10,600
Excluding Southend Airport	5,100	6,500	10,300	21,900	7,300

NR has provided Shared Value information for receipts in the 2009/10 – 2011/12 period as per Table 9. 2010/11 contains a single item (Southend Airport) hypothecated gain of £10m which NR consider to be an exceptional 'one off' receipt. However, the nature of Shared Value receipts is such that they are often going to produce one off receipts. In providing this information, NR has stated "Due to current market conditions these figures should not be seen as a guide for future prospects, neither should they be used for any purpose other than verification of the Property CP5 submission. NR's total forecast for CP5 is £25m, which equates to circa £5m per annum.

Unforeseen Purchases

In some cases NR will respond to changes in the markets and purchase assets without having flagged the prospect at the start of the Control Period. This was the case with the purchase of Victoria Place, which was not mentioned at all in the 2008 PR, as it was not foreseen.

With this example, NR considers that they took advantage of the market opportunity and this was not predictable at the beginning of CP4. This was treated as an enhancement and in CP4, unidentified/ unpredictable enhancements have been accounted for in the enhancement plan. Other options which have been looked at include [redacted] which was considered as an enhancement purchase; this was ultimately discounted.

NR reiterated that these are genuinely unforeseeable, and result from market shifts after the determination.

1.8 NON PR INCOME (£120 MILLION FOR CP5, 8% OF TOTAL PROPERTY INCOME)

This relates to income which is anticipated to be generated within CP5 following investment within this period split between the MS's, Advertising Income, Property Rental Income and Telecoms. This is separate to any development and sales income as NR will continue to control the developed asset and derive revenue from it, whether it is the refurbishment of arches, improvements in advertising infrastructure, reconfiguration of retail units or cost saving investments.

Table 10 shows the relative PR and Non PR property income in CP4 and CP5 (we have not been provided with the split between PR and Non PR property income for CP5 relative to individual income streams). This shows that NR forecast a significant increase in non PR property income, both as an absolute figure and relative to PR income.

Table 10 – Split between PR and Non PR property income in CP4 and CP5

2012/13 Prices (£000s)	CP4		CP5	
	Non PR	**PR**	**Non PR**	**PR**
Managed Station Retail Income	46,200	444,100		552,500
Managed Station Other Property Income	1,300	20,700		24,429
Managed Station Advertising Income	4,700	91,100		100,813
Property Rental income	18,300	461,800		486,630
Advertising Income	2,600	41,900		46,680
Other Income	-	8,000		19,611
Managed Station Concessions	800	52,100		59,830
Telecoms	-	63,800		66,863
Total Income	**73,900**	**1,183,500**	**119,687**	**1,357,357**
% of Total Income	**6%**	**94%**	**8%**	**92%**

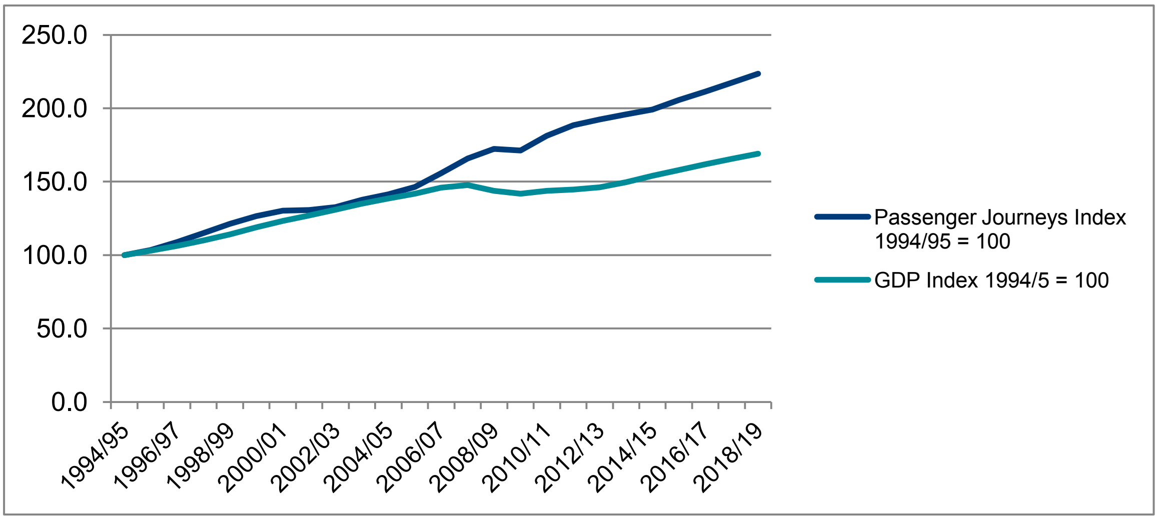
The total non PR income of £120 million compares against the £231 million that NR has projected for capital expenditure for enhancements. We do not have access to the disaggregated figures for the direct relationship between the non PR income and capital expenditure and it should be noted that some of the non PR income generated will be from schemes where the capital expenditure came mainly from CP4 (although, equally, some of the capital expenditure in CP5 will not generate income until CP6). However, at a high level of analysis, generating average income of circa £24 million per annum over the period from an investment of £231 million is a reasonable level of return (over 10%), particularly considering that the capital expenditure is unlikely to be fully front loaded (and therefore won't generate receipts until the end of CP5).

2 Review of Strategic Business Plan in Relation to Property

2.1 CONSISTENCY OF NR FORECASTS

The nominal growth rates used by NR across the various elements of property income are well above the closest IPD projections and in this respect are not consistent with exogenous property market factors and GDP projections. However, NR (and DTZ) considers there to be a strong link between passenger journey growth and MS income which may be a more relevant comparison; Figure 1 below, illustrates how passenger journey growth has outstripped GDP since 1994 and is expected to continue to do so. The basis of the growth rates applied by NR on MS income is passenger journey number growth. The growth rate applied to the CE is not as high but is also above wider market predictions; NR has largely based this on analysis undertaken for them by GVA Grimley and they consider that the higher rate is based on the flexible lease terms available on their estate (which is a strong fit with the demands of tenants in the current market).

Figure 1 – Rail passenger journeys and GDP (rebased at 100 in 2005/6)



We have details going back to 1994/5 for rail passenger journey numbers and we have taken this and real GDP data (both rebased to 100) from this date plus projections up to 2018/19. It is clear that passenger journey numbers growth markedly outstrips GDP growth since 2004/5 (over 50% in this time period compared to less than 20% GDP growth) after both have risen at similar rates since 1994/5.

[redacted] [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

2.3 INCOME VERSUS CAPITAL

NR has highlighted to DTZ that they consider a shift to allow them greater freedom to receive income as opposed to capital would be beneficial to long term returns by allowing them to benefit from the predicted growth in railway usage; we understand that this is determined by the regulatory framework while NR are expected to make decisions based on its ability to efficiently run their business.

One significant way to shift NR's bias to capital receipts would be the securitisation of elements of NR's property income. We have discussed this with NR, which has undertaken analysis and 'market testing' discussions with potential investors. The rationale for undertaking this form of agreement would be that NR could recycle the capital into high return projects allowing NR to capture value. The capital receipts would also be a significant one off benefit to NR's property balance sheet. NR's investigation of the opportunity to do this has not reached an advanced stage as they consider there to be too many major constraints on them:

- The cost of capital to NR is low (4-4.5%) which limits the benefit of capital receipts
- Limited demand from institutions at yields which are better than NR cost of capital and based on the restrictions placed on them (to safeguard railway operational flexibility).
- It is not necessarily that most assets are required for railways purposes, but more that they are physically indivisible from this.
- The NR portfolio doesn't lend itself to having 'ring fenced' income streams which are separate to the needs of the operational railway; having an additional party with rights is restrictive
- Tax issues
- Significant pressure on management time

The core view of NR in relation to this is that the majority of income generating assets are required for the operation of the railway and are therefore indispensable, and unable to be switched from income to capital. The assets that they deem to be disposable are assessed on whether they will generate significant capital in the short term which outstrips long term income generation potential.

2.4 NR & THE WIDER PROPERTY MARKET

NR has a very bespoke and unusual portfolio. A potential comparator to NR's specialist portfolio is British Airports Authority (BAA) who control Heathrow, Stansted and Glasgow airports (amongst others). NR's view is that it does not provide a good comparator as dwell times are so much higher in airports and the MS portfolio is more similar to a shopping centre environment. Other transport related portfolios (e.g. motorway service stations) are different in their policy of allowing monopolistic pricing; NR does not allow new operators to differentiate their prices in MS's from their high street operations (although some retailers with historic leases do).

NR considers that the two fundamental needs of its tenants are flexibility and security which largely drives NR's performance and strategy. This makes comparison difficult to institutional property owners who put a high value on secure income and long term lease agreements; in the recessionary period since 2007, this has proved particularly popular with tenants and the low vacancy rate highlighted earlier in this report (5%). We understand that Workspace Group (a nationwide owner and manager of secondary business space, with similar characteristics to the CE) has a circa 11% vacancy rate. The CE is primarily secondary in nature and long term leases are less likely to be achieved than on institutional grade property. Another point relates to NR's strategy on lease agreements and rent reviews which is to have Solutions leases and minimise management time in negotiating terms with tenants; we consider this to be a reasonable approach giving the minimal size of many of the assets in NR's portfolio.

NR prefers to structure its contracts to be income driven, rather than a fixed rental rate and this brings them into conflict with the valuation approach of institutions (NR do this because they cannot easily sell assets). Retail leases in the MS portfolio have a significant turnover element (although we consider that this has the potential to be increased) with 55% of units paying turnover rent on top of the MGR; circa 15% of MS retail income is turnover rent. The vacancy rate on the Managed Station retail is circa 1% which is low compared against even prime or super prime UK shopping centres. This is a positive in the sense of a very low rate of lost income but it can be seen as an indicator that NR are 'under renting' units and are not demanding as much from retailers as could be achievable; there is always a balance to be struck between maximising rents and minimising void rates in any portfolio. DTZ are advising on major (prime) retail centres which have long term vacancy rates in excess of this.

In DTZ's discussions with NR we have sought to explore options to remove/ reduce the operational and legal restrictions placed on developments which would allow NR to realise more income and how the property section interacts with the operational part of NR. NR's position in relation to this is:

- Review schemes together with operational business
- Safety issues will always be paramount to NR and will limit property income opportunities
- Working collaboratively with developers to help them constructively engage with the operational element of NR (the move towards more JV's is part of this)
- They are making an internal budget available to train NR property staff on wider NR infrastructure projects
- NR are seeking changes to freight railway regulations which restricts opportunities on a number of sites and reduce growth opportunities but they have not quantified the potential uplift

2.6 TOC COLLABORATION

The move towards greater alliancing between TOC's and NR has reduced time spent negotiating in NR's experience with greater co-operation and common understanding. The benefits of alliancing are taken into account in NR's submission although NR view alliancing as an enabling policy as opposed to a significant revenue generator. A side benefit will be to make making the split between cash and hypothecated gains more transparent.

NR and Stagecoach South Western Trains entered into a "deep" alliance at the end of April 2012. In relation to property, the alliance remit and sharing mechanism extends to charges arising from the regulated station and depot contracts. We understand that there is no other commercial property income included in the alliance arrangement – this continues to be managed by NR Property and is held outside the alliance arrangement. The alliance engages with NR Property in a similar manner to other TOC's.

2.7 NR'S CURRENT INVESTMENT APPRAISAL HURDLE RATES

At a high level, NR's position is that most assets are part of the operational railway and therefore there is a predisposition that unless a site is going to provide significant returns (a capital multiplier of circa 1.5 over the short-medium term) then it will not be subject to significant and detailed investigation. The detailed assessment splits investment hurdle rates into three categories which broadly correspond to the definitions below:

- NR has a minimum required regulatory IRR of 4.75%
- Investment appraisal of property refurbishment projects and developments fully controlled by NR is [redacted]
- Joint developments with third parties, where NR has less control over the outcome, have a hurdle rate of [redacted]

NR seeks investment to payback over [redacted] years and enhancement schemes must payback within [redacted] years. The issue is that as the hurdle rate is reduced, the payback period increases.

Other businesses do not openly publish data on their internal hurdle rates, making comparison with NR's hurdle rates difficult. Clearly, the internal rate that a business will accept is also driven significantly by the nature and risk of the project, the cost of capital and the alternative returns that might be expected by deploying that capital elsewhere in the business. Notwithstanding the lack of published data, DTZ does have significant experience of working with a variety of property developers and investors and understands the key drivers.

Our overall impression of NR's hurdle rates compared to private operators is that they are relatively low. For sites which are subject to planning risk and letting risk, we would expect typical operators to seek a minimum of 10% IRR and in reality, probably higher than this. A range of 10-15% would be our typical assumption for publically listed, major developers, developing prime assets. In the scenario where the development is of a more secondary nature or in an unproven location, then a rate of over 15%, up to circa 20% is likely to be applicable. It is unusual to see hurdle rates of sub 10% and the scenario to bring this about would be where a lot of the risk of the project has been removed/ mitigated; in particular this relates to planning risk and letting risk, whilst the sector in which the development is part, is also key (e.g. foodstore schemes would typically have a lower hurdle rate). As well as reviewing the IRR, developers will typically review the development yield (annual income as a proportion of total development costs).

It should be noted our commentary relates to ungeared returns and the actual structure of the developer and investor can have a major impact on the hurdle rates and approach followed. For instance, some developers have their own construction arm and will consider a lower hurdle rate as a cross subsidy to the potential profits available from operator as the contractor.

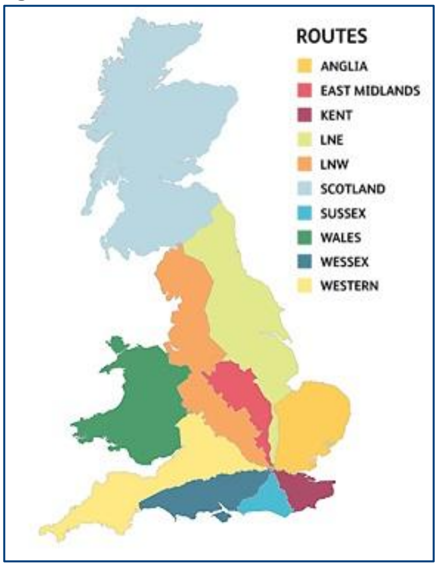
Even though infrastructure is seen as relatively low risk, many investors are still seeking equity-like returns with lower liabilities and less volatility; Australian Super for instance, is reported to achieve a 12.5% return net of tax and fees. This rate is on the high side but generaly commensurate with our understanding of the rates sought in the UK. OECD research has identified hurdle rates of 8-12%.

Based on the above analysis, we consider that the [redacted] applied to joint developments with third parties appears low (and at the very least, certainly not too high), as does the [redacted] or projects within NR's sole control.

2.8 DEVOLUTION

This relates predominately to the devolution within NR by route; as far as possible they are seeking to manage operational and property issues on this basis. In relation to property income, NR considers that this is uneconomical for the majority of their major income streams:

Figure 2 – NR Routes



- MS Income: the majority of the 17 stations are in London but as shown by Figure 2, these stations would be split into 7 different NR Routes if they were to be managed in this way. We agree with NR's view that this would be uneconomical, particularly as the majority of tenants are represented across the portfolio and are likely to undertake negotiations on multiple units in different locations.
- Property Rental Income: 40% of income is generated from Solutions tenancies which is an abbreviated (but not fully centrally managed) process. Unlike MS's, there is more of an argument that this could be arranged fully on a route by route basis from a market facing perspective than for MS income although this would be very difficult in London and some English regions.
- Advertising Income; contracts are negotiated with two parties on a UK wide basis and we do not consider that it would be appropriate to split this on a route basis, considering the economies of scale in procuring UK wide partners and maximising NR returns.
- Property Sales & Developments; the majority of NR's projected income in this regard is based in and around London which leads to similar issues as managing the MS income on a route basis. NR's move towards more JV type structures for developments means that specialist management knowledge and negotiation will be required and it is likely to be beneficial to have a centralised single NR team to maximise value. Managing smaller schemes and sales on a route basis has more of a logic and we consider that NR could feasibly move in this direction below a certain threshold.

The Scotland NR route has a minimal sales and development projection for CP5 and we have sought (and received) clarification from NR as to the reasons behind this. The opportunities which NR foresees are really only in the central belt between Glasgow and Edinburgh and even within this area, they consider that the vast quantum of available sites in the market means that there is limited demand for NR's sites; there is less pressure on land than in England (and South East England in particular). The two significant opportunities in the pipeline which have been discounted by NR include:

- Edinburgh Waverley Station; constrained site with limited opportunities for development
- Glasgow Central; well served with existing retail

[redacted]

3 DTZ Forecasts for CP5

Appendix 2 indicates how we have disaggregated the data provided by NR in order to consider three specific areas of their forecasts and make our own assumptions where relevant:

- Inflation assumption
- Real growth
- Incremental growth

Appendix 3 contains a detailed breakdown of the figures which make up DTZ's forecasts and also an upper and lower range. For the avoidance of doubt, the commentary and forecasts within this Section relate to the base case scenario only unless otherwise stated.

3.1 INFLATION

This is important in regards to how we 'strip out' the real growth assumed by NR and calculate the incremental income. NR have used a flat figure of 2.75% per annum from 2014-2019. This does not exactly correlate to the Retail Prices Index (RPI) which averages 3.10% in the corresponding period. As NR's forecasts are bespoke to, and agreed within, the rail industry, we have utilised this in breaking down their figures. We have also used these figures in order to disaggregate where appropriate our own property market forecasts which are published in nominal terms (as advised by the ORR).

3.2 REAL GROWTH

We consider that overall the real growth figures assumed by NR are relatively high compared to other property market comparators. Therefore, DTZ's IPD data has lower growth rates for both retail related income and commercial estate related income. However, as indicated by Table 12 below, we have assumed that as per NR's assessment, there is a significant correlation to passenger growth numbers in relation to MS retail income which justifies a higher growth forecast.

MS Retail Income Real Growth

In our assessment of the IIP Property Income Forecasts we highlighted the potential link between passenger growth forecasts and station retail revenue. Therefore, for retail related income in the MS portfolio, we have assumed 4% passenger growth per annum (as per the mid-point between the peak hour passenger and peak 3 hour growth forecasts for the MS Stations highlighted earlier) with a weighting of 80% to the forecast, plus a 20% weighting for DTZ's IPD data forecast for South East High Street retail income.

The growth projections utilised by NR in their projections do not match those provided to DTZ by the ORR (sourced from the High Level Output Specification statement) which shows beginning and end figures for MS passenger numbers during the 3 hour and 1 hour peaks. We understand that the NR figure is an internal projection which has not necessarily been ratified by the ORR and hence we have used the figure understood by the ORR. DTZ do not have access to off peak rail passenger growth forecasts but NR has suggested they are marginally below peak rail passenger growth forecasts; assuming the difference is marginal, we consider it to be reasonable to use the average of the 3 hour peak and 1 hour peak numbers and round down to the nearest %.

We have not been provided (or able to source) any annual forecasts for passenger numbers so have flat lined the overall 20% growth over 5 years. NR's own forecast shows annual passenger growth which ranges from 1.7 - 3.3% and is not back ended (the peak growth year is 2015/16) so we consider this to be a reasonable assumption based on the data available.

We accept that growth in passenger numbers does not correlate exactly to growth in rent. This is factored into DTZ forecasts as we have not applied a 100% weighting to passenger growth and have added in DTZ's negative real growth projections for South East High Street (which are largely driven by the view of UK economic growth). In relation to leases trading below MGR, we consider that as a generally principle, a move to higher turnover rents and lower MGR's is desirable and would allow NR to achieve higher growth.

Other Income Real Growth

We consider that NR's forecasts adequately reflect the potential real growth potential for commercial estate related income and other non MS retail income. We therefore believe there to be limited scope to outperform the base case real growth figures in these areas apart from in MS advertising, where we have applied a 5% 'kicker' to reflect the potential quantum shift in income arising from the renegotiation of the advertising contracts. We have applied this in the year of tendering for the new contract only. We consider this to be reasonable, particularly when weighed against the identical real growth that NR are applying to their MS and Roadside advertising elements despite the projected growth in passenger numbers which prima facie, we expect to mean a higher growth rate on the MS advertising.

We have not applied any kicker in relation to other advertising income which relates to NR's Roadside advertising contract with Primesight. We accept NR's position that the existing contract indicates limited opportunities for significant uplift.

Table 11 – Real Growth Assumptions

	NR/ DTZ	2014/2015	2015/2016	2016/2017	2017/2018	2018/2019	Average
Retail Related Income	**NR**	0.85%	2.55%	2.05%	2.15%	2.15%	1.95%
	DTZ IPD Index	*-1.17%*	*-1.09%*	*-1.17%*	*-1.17%*	*-1.17%*	*-1.15%*
	Passenger Growth Assumption	*4.00%*	*4.00%*	*4.00%*	*4.00%*	*4.00%*	*4.00%*
	DTZ*	2.97%	2.98%	2.97%	2.97%	2.97%	2.97%
Commercial Estate Related Income	**NR**	0.55%	0.52%	0.67%	1.08%	1.08%	0.78%
	DTZ	-0.32%	-0.27%	-0.31%	-0.27%	-0.17%	-0.27%
Other	**NR**	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	DTZ	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

*DTZ APPLIED growth rates based on an 80% weighting to an assumed 4% growth in passenger numbers per annum plus a 20% weighting to the IPD forecasts of South East High Street Retail (for retail related income); secondary industrial (commercial estate related income) and RPI (for other income) as we consider these to be the nearest comparable forecast data available.

3.4 INCREMENTAL INCOME

This relates to incremental growth through asset management initiatives such as rent reviews, increased use of turnover rents, indexation of income streams and additional or better use of rentable space. In relation to Net Property Sales and Development Income all income is 'one off' and therefore, classed as incremental income. We have made the following amendments to NR's projections

- MS; we have inserted incremental income from 2016/17 based on NR re-negotiating an assumed 1/3 of leases currently inside the provisions of the Act. We have made the assumption that this will allow a 15% revenue uplift per annum on this proportion of MS income based on an improved tenant mix and a higher ratio of turnover rents (and total rents).
  - We consider that the potential for an improved tenant mix strategy is being overly discounted. Despite the strength of the food and beverage market and the relatively poor performance of fashion operators in recent times, the performance of the retail market in relation to London, prime and super prime retail centres continues to be strong. Given that the MS portfolio is heavily weighted towards London, we consider that there are more transformative steps that could be taken to increase income. We consider that the significant differentiation between the rents on food and beverage units (which are lower) and fashion operators is such that even a small shift in the tenant mix of the MS portfolio could significantly increase income. To be clear, this relates to incremental demand created by having a greater number of comparison (as opposed to convenience) goods retailers in stations.
  - There seems to be a limited, joined up strategy relating to turnover rents. Considering that NR is relatively 'bullish' on footfall and real growth projections, and has a much deeper knowledge base than any retailer operator in its stations, we question why there is not a more concerted effort to move tenants to lower MGR's and greater turnover provisions. This would allow NR to take a greater upside of the increased passenger numbers which its operation division is seeking to achieve. In saying this, we do accept that there is always a balance to be struck in terms of introducing greater risk into the portfolio but given the strength of the MS offer, NR has significant bargaining power with major retailers who tend to favour less turnover related agreements. The NR approach appears to be relatively cautious.
  - [redacted]

- Property Rental Income;
  - In relation to easements and wayleaves, we have assumed incremental income progressively increased by £10,000 per annum to reflect expected effect of increased efficiency and collection through standardisation on easements.
  - DTZ considers that the freight portfolio should perform in line with the CE and that the predicted significant growth in railway freight should bring some uplift in revenue. We have adjusted our forecasts to include £10,000 per annum in additional income.

- Development and Sales Income
  - For this item, there is always going to be a significant range of outcomes based on wider NR strategy and the vagaries of the property market. We do not, as a principle, disagree with NR's stated desire to have more freedom to receive income as opposed to capital returns.
  - There has been over a 1/3 reduction in NR's development and sales income forecast between its 2010 IIP submission and the SBP. We accept that the market has downturned further from this point but 2010 was not a particularly buoyant market in itself and we consider that a drop of this magnitude has not been fully explained by NR in its strategy or subsequent discussion.
  - The drive toward additional JV's should provide for greater returns in future but there are also significant opportunities to achieve a greater level of disposals in CP5.
  - NR's forecast reflects an average 23%, 31% and 24% success rate in converting identified potential CP5 income generating opportunities in the Solum, Disposals and Shared Value (identified projects) income streams. We consider that this understates the potential to crystallise these opportunities. We acknowledge that the rate at which the pipeline will be converted is uncertain but we consider that the weighted approach adopted by NR understates the potential by circa half (i.e. we consider it more likely that NR will convert circa 45% of potential disposals during CP5. We consider this to be reasonable. In terms of the individual income streams (which make up the vast majority of Development and Sales Income):

    1. Solum receipts increase from £11 to £15 million.
    2. Disposal receipts increase from £44 to £65 million.
    3. Shared value (identified projects) increase from £7 to £13 million.

  - In terms of shared value receipts which come from projects which are yet to be identified, we understand that this is within the overlay figure applied to the forecasts by NR. Based on the most recent yearly receipts evidence available (see Table 9), we have assumed an average of circa £7 million per annum relating to this, less circa £7 million for the revenue from identified projects. Therefore, the shared value receipts from non identified projects are set at circa £30 million over 5 years.

  - Therefore, we calculate total development and sales income to increase by £44 million from NR's forecasts. To put this into context; assuming that CPO and Major Developments income stays as per NR's forecasts and Shared Value receipts from non identified projects are as per DTZ's analysis; the circa £93 million forecast for Solum, Disposal and Shared Value (identified projects) receipts would be achieved by the sale of the top 10 sites for disposal in the development and sales schedule.

  - Overall, this means the average percentage likelihood of a receipt coming forward (across all sub sectors) equates to 42% as opposed to the 25% from NR's analysis.

3.5 DTZ FORECASTS

DTZ considers that NR's 2014/15 starting estimate for CP5 is generally a robust baseline to which we have then applied adjustments where appropriate as follows:

- Changes in the assumptions to incremental growth through asset management initiatives; and
- Changes to NR's 'real' growth forecasts as an assessment of where NR is expected to outperform economic growth.

The adjustments that we have made to each income stream are shown in Appendix 3 and are referenced to NR's assumptions as a comparison.

DTZ has considered a lower and upper range of property income based on various scenarios which is £1.539 - £1.833 billion. The basis of our assessment of the lower and upper ranges is set out in Appendix 3. These are based on reasonable adjustments to the core assumptions and do not represent the most extreme outcomes possible – for example we have not envisaged a wholesale disposal of the commercial estate or a separation of the property function and we have assumed that there will not be a radical reduction in the amount of retail space at the MS to reduce passenger congestion. We have not taken into account the full impact of changes that might arise from significant shifts in industry practice including initiatives outlined in the McNulty report (apart from initiatives specifically mentioned) which are outlined in Appendix 5. Our base projection is moderately higher than NR's (NR: £1.578 billion; DTZ: £1.650 billion).

Overall, based on the information provided by NR, we have concluded that NR's overall approach has been robust and its projections are based on assumptions that are broadly reasonable.

A significant element of the change between NR's IIP and SBP submissions is the lower income being brought forward from CP4. DTZ has assessed the validity of an element of these figures but the ORR should continue to monitor this potential 'brought forward' income to ensure that NR does not hold back receipts in CP4 in order to bring them forward in CP5, in order to be seen as delivering outperformance.

Table 12 – DTZ Forecast for CP5

DTZ adjusted Projections in 2012/13 Prices (£000s)	2014/15	2015/16	2016/17	2017/18	2018/19	Total
MS Retail Income	105,888	108,614	113,876	118,681	123,608	570,667
MS Other Income	4,673	4,791	4,887	4,988	5,090	24,429
MS Advertising Income	19,286	20,752	21,142	21,561	21,981	104,723
Property Rental Income	95,928	96,465	97,113	98,146	99,182	486,832
Advertising Income	8,930	9,156	9,338	9,531	9,727	46,680
Other income	4,083	4,000	3,920	3,842	3,766	19,611
Concessions	11,446	11,734	11,969	12,217	12,466	59,830
Telecoms	13,375	13,374	13,372	13,371	13,369	66,863
Total PR Income Exc Sales	**263,608**	**268,886**	**275,616**	**282,337**	**289,189**	**1,379,636**
Net Property Sales & Developments	28,499	29,275	29,260	29,840	28,731	145,604
Non PR Income	6,276	15,687	23,029	30,440	44,254	119,687
Total	**298,382**	**313,849**	**327,904**	**342,617**	**362,175**	**1,644,927**

The detailed breakdown of these forecasts in contained within Appendix 3.

Appendix 1 - Glossary of Property Terms

The below table gives a definition to a number of the property specific terms used in the report. Please note that these definitions are specific to this report and do not necessarily apply to other DTZ research and reports.

Table 13 – Glossary of Property Terms

Term	Definition
Anchor Store	A destination store (normally a department store) which acts as the major draw to a retail centre and which other stores like to trade close to.
Incremental Growth	Increases due to specific asset management practices such as rent reviews, altering tenant mix and renting out additional space.
IRR	Internal Rate of Return – the discount rate which reduces the net present value of an income stream to zero. Used to measure and compare project returns.
Nominal Growth	Growth without discounting for inflation.
Real Growth	Growth over and above inflation which is achieved on the existing portfolio of assets without CAPEX (apart from ongoing maintenance).
Recovery Rates	This relates to the percentage of non rent costs which are recovered from tenants (i.e. utility costs, security, management, etc).
Rent Review	A standard lease of more than 5 years will include provisions for the rent to be changed at set intervals (usually every 5 years) by way of either a formula (say RPI plus x%) or Open Market Rent Review.
Retail Mix	The strategy followed in order to create an appropriate mix of different retailers (e.g. food, clothing, convenience items) and the desired price point of the operators. This reflects the fact that the rents achievable from tenants will depend in large part on the retailers trading near them.
Void Rate	The percentage (generally in terms of net lettable area) which is vacant at given time.
Turnover Rents	Retail rental agreements can include (or in exceptional cases be fully made up of) an element of rent being directly correlated with the turnover rent that the store generates. This shares an element of risk and return between the parties.
Yield	The annual income of an asset divided by its value. A higher yielding property is one which is perceived to reflect a higher risk.

Appendix 2 – Breakdown of NR CP5 Forecasts

Table 14 – NR Forecast Property Income for CP5 (in 2012/2013 prices)

NR Projections in 2012/13 Prices (£000s)	2014/15	2015/16	2016/17	2017/18	2018/19	Total
MS Retail Income	103,712	108,159	110,764	113,539	116,326	552,500
MS Other Income	4,673	4,791	4,887	4,988	5,090	24,429
MS Advertising Income	19,286	19,772	20,166	20,584	21,005	100,813
Property Rental Income	95,928	96,444	97,072	98,085	99,101	486,630
Advertising Income	8,930	9,156	9,338	9,531	9,727	46,680
Other income	4,083	4,000	3,920	3,842	3,766	19,611
Concessions	11,446	11,734	11,969	12,217	12,466	59,830
Telecoms	13,375	13,374	13,372	13,371	13,369	66,863
Total PR Income Exc Sales	**261,432**	**267,430**	**271,488**	**276,157**	**280,849**	**1,357,357**
Net Property Sales & Developments	19,699	20,475	20,460	21,040	19,931	101,604
Non PR Income	6,276	15,687	23,029	30,440	44,254	119,687
Total	**287,406**	**303,593**	**314,976**	**327,637**	**345,035**	**1,578,647**

All forecasts are in 2012/13 prices and as such:

- Include incremental growth through asset management initiatives such as rent reviews, increased use of turnover rents, indexation of income streams and additional or better use of rentable space; and
- Include 'real' growth forecasts where NR expects its portfolio to outperform economic growth (as measured by OEF's GDP forecasts).

In order to assess these forecasts, DTZ has sought to disaggregate the figures to understand the basis of NR's growth projections. NR's nominal growth forecasts for each income stream are as follows:

Table 15 – NR forecast growth factors for CP5

NR Growth Factors - Nominal	2014/15	2015/16	2016/17	2017/18	2018/19
MS Retail Income	3.6%	5.3%	4.8%	4.9%	4.9%
MS Other Income	3.6%	5.3%	4.8%	4.9%	4.9%
MS Advertising Income	3.6%	5.3%	4.8%	4.9%	4.9%
Property Rental Income	3.3%	3.3%	3.4%	3.8%	3.8%
Advertising Income	3.6%	5.3%	4.8%	4.9%	4.9%
Other income	2.8%	2.8%	2.8%	2.8%	2.8%
Concessions	3.6%	5.3%	4.8%	4.9%	4.9%
Telecoms	2.8%	2.8%	2.8%	2.8%	2.8%
Non PR Income	2.8%	2.8%	2.8%	2.8%	2.8%

In order to extrapolate the real growth forecasts (used by NR in its projections), DTZ has netted off the GDP forecasts which NR has provided as follows:

Table 16 – NR inflation factors for CP5

Underlying inflation	2014/15	2015/16	2016/17	2017/18	2018/19
Inflation (NR Assumption)	2.75%	2.75%	2.75%	2.75%	2.75%

The real growth forecasts are therefore extrapolated as follows:

Table 17 – NR real growth forecasts

NR Growth Factors - Real	2014/15	2015/16	2016/17	2017/18	2018/19
MS Retail Income	0.9%	2.6%	2.1%	2.2%	2.2%
MS Other Income	0.9%	2.6%	2.1%	2.2%	2.2%
MS Advertising Income	0.9%	2.6%	2.1%	2.2%	2.2%
Property Rental Income	0.6%	0.5%	0.7%	1.1%	1.1%
Advertising Income	0.9%	2.6%	2.1%	2.2%	2.2%
Other income	0.0%	0.0%	0.0%	0.0%	0.0%
Concessions	0.9%	2.6%	2.1%	2.2%	2.2%
Telecoms	0.0%	0.0%	0.0%	0.0%	0.0%
Non PR Income	0.0%	0.0%	0.0%	0.0%	0.0%

Stripping out this real growth implies that NR's baseline forecast of annual incremental growth is as follows:

Table 18 – DTZ calculation of NR pre-growth baseline (i.e. NR forecasts of incremental growth only)

DTZ calculation of NR pre inflation and pre organic growth (i.e. Incremental income only)	2014/15	2015/16	2016/17	2017/18	2018/19	Total
MS Retail Income	102,838	105,470	108,539	111,149	113,878	541,873
MS Other Income	4,634	4,672	4,789	4,883	4,983	23,960
MS Advertising Income	19,123	19,280	19,761	20,151	20,563	98,878
Property Rental Income	95,403	95,941	96,425	97,037	98,039	482,845
Advertising Income	8,854	8,928	9,150	9,330	9,522	45,784
Other income	4,083	4,000	3,920	3,842	3,766	19,611
Concessions	11,349	11,442	11,728	11,960	12,203	58,682
Telecoms	13,375	13,374	13,372	13,371	13,369	66,863
Total PR Income Exc Sales	**259,659**	**263,107**	**267,684**	**271,723**	**276,323**	**1,338,497**
Net Property Sales & Developments	19,699	20,475	20,460	21,040	19,931	101,604
Non PR Income	6,276	15,687	23,029	30,440	44,254	*119,687*
Total	285,633	299,270	311,173	323,203	340,509	1,559,788

Appendix 3 – Detailed Breakdown of DTZ Analysis

Below is a breakdown of the various income lines and DTZ's analysis for base, upper and lower figures. The brought forward figure for each income line from CP4 is as per NR's provided figures. Within this report, we have queried whether this fully reflects the opportunities for income within CP4 but it is not within the remit of this report to undertake the detailed analysis required to fully benchmark this assumption. The analysis within this report suggests that the brought forward figure may be at the slightly lower side of expectations based on average annual uplift.

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Managed Station Retail Income - CP5 start	102,838							Incremental growth based on approximately 1/3 of retail leases currently within the L&T 1954 Act opting out and allowing for a 20% value uplift from 2016/17 on affected leases. DTZ assumed real growth rate based on an 80% weighting to an assumed 4% growth in passenger numbers per annum plus a 20% weighting to the IPD forecasts of South East High Street Retail (for retail related income).
BASE	Incremental growth		2,632	5,126	4,667	4,785			
	sub total	*102,838*	*105,470*	*110,595*	*115,263*	*120,048*			
	Real Growth	3.0%	3.0%	3 0%	3 0%	3.0%			
	DTZ Forecast	105,888	108,614	113,876	118,681	123,608	**570,667**	**0%**	
UPPER	Incremental growth		2,632	10,885	10,426	10,544			Incremental growth based on approximately 2/3 of retail leases currently within the L&T 1954 Act opting out and allowing for a 40% value uplift from 2016/17 on affected leases. This gives the same incremental growth (and total figure) as the Base assessment for the first 2 years of the control period as we do not consider that meaningful change to the landlord and tenant relationship can be achieved prior to 2016/17. DTZ assumed real growth rate based on an 80% weighting to an assumed 4% growth in passenger numbers per annum plus a 20% weighting to the IPD forecasts of South East High Street Retail (for retail related income).
	sub total	*102,838*	*105,470*	*116,354*	*126,781*	*137,325*			
	Real Growth	4.0%	3.0%	3 0%	3 0%	3.0%			
	DTZ Forecast	106,951	108,614	119,805	130,541	141,398	**607,309**	**6%**	
LOWER	Incremental growth		2,632	3,069	2,611	2,728			Retain NR incremental growth assumption as valid. Real growth as per DTZ forecast for South East High Street retail as this factors in no passenger growth statistics.
	sub total	*102,838*	*105,470*	*108,539*	*111,149*	*113,878*			
	Real Growth	-2.9%	-2.7%	-2.7%	-2.7%	-2.7%			
	DTZ Forecast	99 890	102 666	105 586	108 116	110 768	**527,025**	**-8%**	

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Managed Station Other Income - CP5 start	4,634							Incremental growth as per NR, position considered valid. Real growth as per NR due to more bespoke index than DTZ PD.
BASE	Incremental growth		38	117	94	100			
	sub total	*4,634*	*4,672*	*4,789*	*4,883*	*4,983*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	4,673	4,791	4,887	4,988	5,090	**24,429**	**0%**	
UPPER	Incremental growth		888	967	944	950			Incremental growth assumes that 10,000 sq ft of space at 17 Managed Stations see an uplift of £5 psf which delivers circa £0.9m pa. Real growth as per NR index than DTZ PD.
	sub total	*4,634*	*5,522*	*6,489*	*7,433*	*8,383*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	4 673	5 663	6 622	7 593	8 563	**33,113**	**36%**	
LOWER	Incremental growth		38	117	94	100			Incremental growth as per NR. Real growth as per DTZ forecast for South East High Street retail.
	sub total	*4,634*	*4,672*	*4,789*	*4,883*	*4,983*			
	Real Growth	-2.9%	-2.7%	-2.7%	-2.7%	-2.7%			
	DTZ Forecast	4,501	4,548	4,659	4,750	4,847	**23,304**	**-5%**	

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Managed Advertising Income - CP5 start	19,123							Incremental growth as per NR plus 5% 'kicker' at contract re-tender in 2015/16. Real growth as per NR.
BASE	Incremental growth		1,113	481	390	412			
	sub total	*19,123*	*20,236*	*20,717*	*21,107*	*21,519*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	19,286	20,752	21,142	21,561	21,981	**104,723**	**0%**	
UPPER	Incremental growth		2,069	481	390	412			Incremental growth as per NR plus 10% 'kicker' at contract re-tender in 2015/16. Real Growth as per NR + 2% per annum.
	sub total	*19,123*	*21,193*	*21,674*	*22,063*	*22,475*			
	Real Growth	2.9%	4.6%	4.1%	4 2%	4.2%			
	DTZ Forecast	19,668	22,157	22,551	22,979	23,408	**110,763**	**6%**	
LOWER	Incremental growth		157	481	390	412			Incremental income as per NR. No real growth.
	sub total	*19,123*	*19,280*	*19,761*	*20,151*	*20,563*			
	Real Growth	0.0%	0.0%	0 0%	0 0%	0.0%			
	DTZ Forecast	19 123	19 280	19 761	20 151	20 563	**98,878**	**-6%**	

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Property Rental Income	95,403							Incremental growth progressively increased by £20k pa to reflect expected effect of increased efficiency and collection through standardisation on easements and increased freight income.
BASE	Incremental growth		559	504	632	1,023			
	sub total	*95,403*	*95,961*	*96,465*	*97,097*	*98,119*			
	Real Growth	0.6%	0.5%	0.7%	1.1%	1.1%			Real growth as per NR.
	DTZ Forecast	95,928	96,465	97,113	98,146	99,182	**486,832**	**0%**	
UPPER	Incremental growth		18,039	2,984	6,112	3,503			Low probability, high return projects are brought forward. An example is Project Mountfield, which could deliver £15m incremental income in rent (rising to £18 m in 2017/18) plus £2 5m in development value per annum.
	sub total	*95,403*	*113,441*	*116,425*	*122,537*	*126,039*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	96,213	116,334	118,812	125,171	128,749	**585,280**	**20%**	Real growth as per NR retail index.
LOWER	Incremental growth		539	484	612	1,003			Incremental growth as per NR.
	sub total	*95,403*	*95,941*	*96,425*	*97,037*	*98,039*			
	Real Growth	-0.3%	-0.3%	-0 3%	-0 3%	-0.2%			
	DTZ Forecast	95,097	95,680	96,128	96,778	97,877	**481,560**	**-1%**	Real growth as per DTZ secondary industrial comparator index.

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Advertising - CP5 start	8,854							
BASE	Incremental growth		74	222	180	192			Incremental growth as per NR.
	sub total	*8,854*	*8,928*	*9,150*	*9,330*	*9,522*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	8,930	9,156	9,338	9,531	9,727	**46,680**	**0%**	
UPPER	Incremental growth		74	886	180	192			
	sub total	*8,854*	*8,928*	*9,814*	*9,994*	*10,186*			Incremental growth as per NR plus 7.5% 'kicker' at contract re-tender in 2016/17.
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	8,930	9,156	10,015	10,209	10,405	**48,715**	**4%**	
LOWER	Incremental growth		74	222	180	192			
	sub total	*8,854*	*8,928*	*9,150*	*9,330*	*9,522*			Incremental income as per NR. NR growth minus 0 5%.
	Real Growth	0.4%	2.1%	1 6%	1.7%	1.7%			
	DTZ Forecast	8 885	9 111	9 292	9 484	9 679	**46,451**	**0%**	

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Other Income - CP5 start	4,083							Incremental growth as per NR.
BASE	Incremental growth		-83	-80	-78	-76			
	sub total	*4,083*	*4,000*	*3,920*	*3,842*	*3,766*			Real growth as per NR.
	Real Growth	0.0%	0.0%	0 0%	0 0%	0.0%			
	DTZ Forecast	4,083	4,000	3,920	3,842	3,766	**19,611**	**0%**	
UPPER	Incremental growth		-83	-80	-78	-76			Incremental growth as per NR.
	sub total	*4,083*	*4,000*	*3,920*	*3,842*	*3,766*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			Real growth as per NR retail related income.
	DTZ Forecast	4,118	4,102	4,000	3,925	3,847	**19,992**	**2%**	
LOWER	Incremental growth		-83	-80	-78	-76			Incremental growth as per NR.
	sub total	*4,083*	*4,000*	*3,920*	*3,842*	*3,766*			
	Real Growth	-0.3%	-0.3%	-0 3%	-0 3%	-0.2%			Real growth as per DTZ secondary industrial index.
	DTZ Forecast	4,070	3,989	3,908	3,832	3,760	**19,558**	**0%**	

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Concessions - CP5 start	11,349							
BASE	Incremental growth		93	286	232	244			Incremental growth as per NR (additional car parking income assumed to be recieved as part of facility charge).
	sub total	*11,349*	*11,442*	*11,728*	*11,960*	*12,203*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			Real growth as per NR.
	DTZ Forecast	11,446	11,734	11,969	12,217	12,466	**59,830**	**0%**	
UPPER	Incremental growth		93	286	232	244			Incremental growth as per NR projections (additional car parking income assumed to be recieved as part of facility charge).
	sub total	*11,349*	*11,442*	*11,728*	*11,960*	*12,203*			
	Real Growth	2.9%	4.6%	4.1%	4 2%	4.2%			
	DTZ Forecast	11,673	11,963	12,203	12,456	12,710	**61,004**	**2%**	Real growth as per NR +2% per annum to reflect improved market conditions.
LOWER	Incremental growth		93	286	232	244			Incremental growth as per NR projections (additional car parking income assumed to be recieved as part of facility charge).
	sub total	*11,349*	*11,442*	*11,728*	*11,960*	*12,203*			
	Real Growth	-1.2%	0.6%	0.1%	0 2%	0.2%			
	DTZ Forecast	11,219	11,505	11,734	11,978	12,222	**58,657**	**-2%**	Real growth as per NR -2% per annum to reflect worse market conditions.

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Telecoms - CP5 start	13,375							
BASE	Incremental growth		-1	-2	-1	-2			Incremental growth as per NR projections.
	sub total	*13,375*	*13,374*	*13,372*	*13,371*	*13,369*			
	Real Growth	0.0%	0.0%	0 0%	0 0%	0.0%			Real growth as per NR.
	DTZ Forecast	13,375	13,374	13,372	13,371	13,369	**66,863**	**0%**	
UPPER	Incremental growth		-1	-2	-1	-2			Incremental growth as per NR projections.
	sub total	*13,375*	*13,374*	*13,372*	*13,371*	*13,369*			
	Real Growth	2.0%	2.0%	2 0%	2 0%	2.0%			
	DTZ Forecast	13,643	13,642	13,640	13,639	13,637	**68,201**	**2%**	Real growth as per NR +2% per annum.
LOWER	Incremental growth		-1	-2	-1	-2			Incremental growth as per NR projections.
	sub total	*13,375*	*13,374*	*13,372*	*13,371*	*13,369*			
	Real Growth	-2.0%	-2.0%	-2 0%	-2 0%	-2.0%			
	DTZ Forecast	13,108	13,107	13,105	13,104	13,102	**65,526**	**-2%**	Real growth as per NR -2% per annum.

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
BASE	**Net Property Sales & Developments per Annum**	28,499	29,275	29,260	29,840	28,731			Income from 45% of all sites assumed to be Solum, Disposal and Shared Value come forward.
	DTZ Forecast	28,499	29,275	29,260	29,840	28,731	**145,604**	**0%**	
UPPER	**Net Property Sales & Developments per Annum**	34,699	35,475	35,460	36,040	34,931			
	DTZ Forecast	34,699	35,475	35,460	36,040	34,931	**176,604**	**21%**	Income from 60% of all sites assumed to be Solum, Disposal and Shared Value come forward.
LOWER	**Net Property Sales & Developments per Annum**	19,699	20,475	20,460	21,040	19,931			
	DTZ Forecast	19,699	20,475	20,460	21,040	19,931	**101,604**	**-30%**	NR base assumption considered the minimum reasonable.

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
	Non PR Income - CP5 start	6,276							
BASE	Incremental growth		9,411	7,341	7,412	13,814			NR assumption on incremental growth. Real growth as per NR.
	sub total	*6,276*	*15,687*	*23,029*	*30,440*	*44,254*			
	Real Growth	0.0%	0.0%	0 0%	0 0%	0.0%			
	DTZ Forecast	6,276	15,687	23,029	30,440	44,254	**119,687**	**0%**	
UPPER	Incremental growth		9,411	7,341	7,412	13,814			NR assumption on incremental growth. Real growth follows NR retail related income.
	sub total	*6,276*	*15,687*	*23,029*	*30,440*	*44,254*			
	Real Growth	0.9%	2.6%	2.1%	2 2%	2.2%			
	DTZ Forecast	6 329	16 087	23 501	31 095	45 206	**122,218**	**2%**	
LOWER	Incremental growth		9,411	7,341	7,412	13,814			NR assumption on incremental growth. Real growth as per DTZ South East High Street retail.
	sub total	*6,276*	*15,687*	*23,029*	*30,440*	*44,254*			
	Real Growth	-2.9%	-2.7%	-2.7%	-2.7%	-2.7%			
	DTZ Forecast	6,096	15,270	22,402	29,609	43,046	**116,424**	**-3%**	

	DTZ Forecast	2014/15	2015/16	2016/17	2017/18	2018/19		Percentage Change from DTZ Base	
BASE	**CP5 start (net of sales)**	259,659							- Assumes economic conditions are as per current day forecasts. - 4% passenger growth per annum in the MS. - No significant structural change to NR Property. - Retail revenue assumed to be increased by better tenant mix and a greater correlation to passenger growth forecasts. - Low probability, high return projects do not happen. - Development & sales returns increased by circa 45% from NR figure.
	Incremental growth		4,425	6,654	6,116	6,676			
	sub total	*259,659*	*264,084*	*270,737*	*276,853*	*283,530*			
	Real Growth	*3,949*	*4,802*	*4,878*	*5,484*	*5,660*			
	Real Growth %	*1.5%*	*1.8%*	*1.8%*	*2.0%*	*2.0%*			
	Net Property Sales & Developments per Annum	*28,499*	*29,275*	*29,260*	*29,840*	*28,731*			
	Non PR Income	*6,276*	*15,687*	*23,029*	*30,440*	*44,254*			
	DTZ Forecast	298,382	313,849	327,904	342,617	362,175	**1,644,927**	**0%**	
UPPER	**CP5 start (net of sales)**	259,659							- Assumes improved economic conditions from todays forecasts (and hence higher real growth rates). - 4% passenger growth per annum in the MS. - No significant structural change to NR Property. - NR negotiates the majority of tenants out of security of tenure provisions and applies a more agressive change in tenant mix within the MS portfolio. - Low risk, high return projects taken forward. - NR operates a more agreesive development and sales programme, with income 75% higher than their projection. - This scenario does not represent the most extreme possible outcome.
	Incremental growth		23,711	16,407	18,205	15,765			
	sub total	*259,659*	*283,370*	*299,777*	*317,981*	*333,747*			
	Real Growth	*6,210*	*8,260*	*7,872*	*8,531*	*8,969*			
	Real Growth %	*2.4%*	*2.9%*	*2.6%*	*2.7%*	*2.7%*			
	Net Property Sales & Developments per Annum	*34,699*	*35,475*	*35,460*	*36,040*	*34,931*			
	Non PR Income	*6,329*	*16,087*	*23,501*	*31,095*	*45,206*			
	DTZ Forecast	306,896	343,193	366,609	393,647	422,853	**1,833,198**	**11%**	
LOWER	**CP5 start (net of sales)**	259,659							- Assumes worsened economic conditions from todays forecasts and no passenger growth. - No significant structural change to NR Property. - NR is unable to change tenant mix and renegotiate any tenants out of security of tenure provisions within the MS portfolio. - Low risk, high return projects are not taken forward. - NR can only meet its internal development and sales programme projections. - This scenario does not represent the most extreme possible outcome.
	Incremental growth		3,449	4,577	4,039	4,600			
	sub total	*259,659*	*263,107*	*267,684*	*271,723*	*276,323*			
	Real Growth	*-3,766*	*-3,222*	*-3,512*	*-3,532*	*-3,506*			
	Real Growth %	*-1.5%*	*-1.2%*	*-1.3%*	*-1.3%*	*-1.3%*			
	Net Property Sales & Developments per Annum	*19,699*	*20,475*	*20,460*	*21,040*	*19,931*			
	Non PR Income	*6,096*	*15,270*	*22,402*	*29,609*	*43,046*			
	DTZ Forecast	281,687	295,631	307,034	318,841	335,794	**1,538,987**	**-6%**	

Appendix 4 – Sample of Development & Sales Cases

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Appendix 5 – Property Opportunities and Potential Barriers Identified in the McNulty Report

regulator