National Audit Office

Report
by the Comptroller
and Auditor General

Network Rail, Department for Transport, HM Treasury

Network Rail's sale of railway arches

HC 2137 SESSION 2017–2019 2 MAY 2019

Key facts

£1.46bn	5,261	150 years
proceeds to Network Rail from the sale of the property portfolio	rental spaces sold across England and Wales	length of the lease agreement with the buyer as part of the sale and ongoing obligations for Network Rail

More than 50%	the percentage by which the sale price was higher than the government's retention value, which assumed no future investment in the portfolio
35	number of indicative offers in the first phase of the sale, a high level relative to comparable government asset sales
£500 million	the amount of sale proceeds HM Treasury agreed could contribute to Network Rail's funding shortfall for Control Period 5
Around £35 million	the amount spent on advisers and other transaction costs
40 months	the amount of time between the sale of the portfolio being considered and the sale completing
54%	the estimated rise in rents over the next three to four years for a sample of properties owing to market conditions and irrespective of a sale

Summary

Introduction

1 In February 2019, Network Rail completed the £1.46 billion sale of a commercial property portfolio to Telereal Trillium and Blackstone Property Partners. The portfolio consists of 5,261 rental spaces across England and Wales that Network Rail judged are not essential for running the railway. The portfolio is concentrated in the London area (60% by number of rental spaces) and most properties are converted railway arches (70% by number of rental spaces). The portfolio generated £83 million of rental income in 2017-18, with the top 100 tenants making up 24% of expected revenues. Around 100 staff have transferred with the portfolio, which was sold on a 150-year leasehold basis.

2 Network Rail plans its activity in five-year periods, called Control Periods. The sale is part of Network Rail's response to a funding shortfall in its investment programme for Control Period 5 (2014 to 2019) identified in 2015. Network Rail was reclassified as a public sector body in 2014. This prevented it from raising capital in the financial markets, as it had been able to in the past. The combination of cost increases and reclassification meant that Network Rail and the Department for Transport (the Department) considered that Network Rail was no longer able to deliver its programme within the available funding. This meant that the investment programme's renewal (replacing worn-out assets) and enhancement (improving the network) projects were underfunded and at risk of being delayed or cancelled.

3 In November 2015, Sir Peter Hendy, Network Rail's Chairman, published his recommendations on how to replan Network Rail's portfolio of work. Following this, Network Rail estimated that the cost of the work it intended to carry out by March 2019 exceeded available funding by £2.5 billion. Sir Peter Hendy's report proposed an asset disposal programme of around £1.8 billion and increasing the amount that it borrowed from the Department by £700 million.

4 This report looks at the main sale in Network Rail's asset disposal programme, the sale of a commercial property portfolio largely made up of railway arches. The sale had four objectives, to:

- not prejudice the safe and sustainable management of the railway infrastructure;
- reduce government's main fiscal measures, public sector net borrowing (PSNB; 'the deficit') and public sector net debt (PSND);
- maximise sale proceeds within the five-year Control Period 5 (ending 31 March 2019); and
- deliver value for money (compared with Network Rail retaining the portfolio).

5 Network Rail was responsible for preparing and executing the sale. The Department gave final approval, as Network Rail's shareholder. UK Government Investments (UKGI) advised the Department during the sale. HM Treasury was involved in setting the sale objectives, including the budgetary impacts of the transaction, and agreed the final decision to sell. And the Office of Rail and Road (ORR) took an interest in the transaction as the regulator of Network Rail.

Study scope

6 This report considers whether Network Rail achieved value for money in the disposal of a major part of its commercial real estate portfolio, including:

- the background and preparation for the sale (Part One);
- the process of and proceeds from the sale (Part Two); and
- the wider impacts of the sale (Part Three).

7 We have previously reported on the affordability and replanning of Network Rail's investment programme, including the decision to cancel three rail electrification projects. This report does not consider these other elements of the replan. The report also does not consider other sales in Network Rail's asset disposal strategy or the achievement of the strategy overall.

Key findings

Outcomes of the sale

8 **Network Rail sold the portfolio for more than expected.** Network Rail valued retaining the portfolio in public ownership at around £950 million, and valued the portfolio from a buyer's perspective at around £1.17 billion. Network Rail's retain valuation is conservative as it assumes that Network Rail would not be able to invest in improving the portfolio because of the borrowing restrictions imposed by the Department and HM Treasury, and it discounts future earnings more heavily than the market. Using a market discount rate and assuming no investment restrictions the value of the portfolio is £1.4 billion.[1] The sale price of £1.46 billion exceeded Network Rail's valuations. In exchange for the sale proceeds Network Rail forgoes around £80 million of revenues per year. The sale means that Network Rail has balanced its funding position for Control Period 5. However, this also follows the cancellation of projects (such as electrification works), efficiency targets imposed in April 2017, and £1.8 billion of additional grant and loan funding from the Department. Following an earlier agreement with HM Treasury, the sale contributes around £500 million to Network Rail's funding shortfall for Control Period 5. The remaining proceeds were used to offset against expected borrowing from the Department (paragraphs 2.13 to 2.20 and Figures 9 and 10).

9 **The leasehold sale structure supports Network Rail's safe and sustainable management objective at the expense of deficit reduction.** HM Treasury stipulated that, to count towards reducing the funding shortfall, the sale would need to reduce the deficit. This meant the structure of the sale would need to meet certain financial accounting and reporting requirements; a freehold sale would have achieved this. However, Network Rail identified that only a leasehold sale would ensure the railway infrastructure could be managed safely and sustainably, as a lease would allow access to the properties in the future, for example, for maintenance. The ORR was satisfied that a leasehold sale could be structured in a way that would allow sufficient access to its railway infrastructure to continue to manage its condition. Network Rail and the Department did not engage with HM Treasury to discuss the fiscal impact until late in the preparation process. HM Treasury ultimately allowed some flexibility on the deficit reduction objective. The final sale structure – a 150-year lease rather than a freehold sale – gives Network Rail sufficient access to manage the railway infrastructure, but means that the sale did not fully meet the government's fiscal objectives (paragraphs 1.11, 1.15 to 1.19, 2.20 and 3.7).

1 'Discounted cash flow' is a way of estimating the value of an asset based on its future cash flows. Future cash flows are estimated and discounted to give a present value: the higher the discount rate, the lower the value of those future cash flows.

10 **The Department and Network Rail did not explicitly seek to deliver wider government policy objectives.** Objectives, such as business support, tenant protection or community cohesion, do not form part of Network Rail's licence conditions. Network Rail did not have such objectives before it was reclassified as a public sector body either. However, Network Rail did consider government's housing policy as a part of its wider disposal plan, and excluded land with known residential development potential from the sale so that this could be sold separately. The sale agreement did not include any provisions for protecting tenants, wider support for business, or community regeneration plans, although Network Rail considered them qualitatively in its business cases. It concluded that future owners will have economic incentives to invest in the portfolio, which means the portfolio will achieve a higher level of external impact than it would in Network Rail's ownership. The new owners also set out initiatives to support tenants, but these intentions are not legally binding. Support to tenants was negotiated in the final stages of the sale process (paragraphs 1.12, 2.14, and 3.8 to 3.12 and Figure 18).

11 **Network Rail expects the buyers to invest in the portfolio to increase revenue.** The portfolio offered investors the opportunity to become the largest landlord to small- and medium-sized enterprises in the UK and benefit from a diverse tenant base across England and Wales. Network Rail has forecast that the portfolio's total rental income will increase from £83 million in 2017-18 to £160 million in 2027-28, mainly resulting from a £250 million investment programme (£36 million of the forecast growth) and expected rent increases (£39 million). There are also opportunities to commercialise approximately 760 unrented spaces (around 15% of the portfolio). Network Rail's financial position did not allow it to exploit these opportunities before the sale. Following the investment programme replan in 2015, much of the £162 million of funds earmarked for investment in the portfolio was diverted to rail investment projects. Network Rail expects the new owners to have an incentive to invest in the portfolio to increase their returns, which in turn would benefit existing tenants, future tenants and community regeneration plans (paragraphs 1.13, 2.7, 2.14, 2.15, 2.18 and 3.8, Figure 3 and Figure 4).

Sale execution

12 **The transaction was managed and executed professionally and generated a large amount of market interest.** Network Rail undertook an extensive process to identify properties for sale. It excluded around 2,500 rental spaces because they were either required for the operation of the railway or marked for future development. The resulting portfolio was large for a single transaction, but indications of high investor demand supported the decision to pursue a single sale. A single transaction also increased the likelihood of Network Rail achieving its objective to complete a sale by March 2019. The sale generated substantial interest from investors and strong competitive tension between bidders. More than 140 investors expressed an interest, and Network Rail received 35 indicative bids in the first round. Network Rail narrowed the bidders down to 17 for the second round and five for the final round (paragraphs 1.14 to 1.16, 2.5 to 2.10, Figure 5 and Figure 8).

13 **The sale took longer than expected and transaction costs exceeded those estimated at the outset.** The process completed two years later than the indicative timeline in the department's asset disposal strategy (March 2016), and less than two months before the March 2019 deadline. Main contributors to the delay included: the decision-making process between Network Rail, the Department and HM Treasury in relation to the sale structure and accounting treatment; and selection of the properties for sale. Transaction costs were around £35 million, or 2.4% of the overall proceeds. At sale launch, Network Rail expected costs to be around £20 million. The costs were affected by the choice of the leasehold sale structure, which added complexity; the inclusion of an additional round in the sale process in response to high bidder interest, which increased the cost of legal advisers; and the cost of separating the property portfolio from Network Rail's retained assets (paragraphs 2.19 to 2.21 and Figure 11).

Future considerations

14 **Market conditions mean rents are likely to increase, irrespective of the sale. Some tenants will change and the impact of the sale depends on the buyers' future activities**. The new owners have taken over the existing contracts with tenants. As they implement their new business and investment strategy, the tenants may change over time. The new owners have committed to adopting a 'Tenants' Charter' to guide their practices in relation to tenants and their leases. The Department suggested a charter quite late in the process and it is not legally binding. The transaction's wider impact in terms of regenerating communities and creating jobs will depend on the level and timing of any buyer investment, but is not set out contractually. Network Rail highlighted to prospective buyers the upside potential of rents: it estimated a 54% rental increase for a sample of properties over the next three to four years owing to market conditions and irrespective of a sale (paragraphs 3.8 to 3.16 and Figure 13).

15 **Network Rail continues to have an obligation to inspect and maintain the railway infrastructure.** To ensure that the railway infrastructure is managed efficiently and safely, Network Rail will have to manage its obligations over the 150-year lease term, such as managing the inspections of the rail infrastructure, landlords' consent for alterations to the properties, and temporary or permanent repurchase of the properties (which could be at a premium to the sale price). Network Rail has established a dedicated team that will manage the relationship with the new owners and ensure that they comply with the lease agreements. Network Rail estimates this team to cost around £1 million per year. Network Rail and its legal advisers believe that the legal framework in place to ensure the safe operation of the railway has strengthened as a result of the sale (paragraphs 1.17, 3.2 to 3.7 and Figure 17).

Conclusion on value for money

16 Government's policy is to sell assets where there is no policy reason for continued public ownership. Network Rail sold this property portfolio in pursuit of that policy and did so in a way that achieved the primary sale objective of not prejudicing the safe and sustainable management of the railway infrastructure. Based on this outcome, and the fair price paid for the portfolio, the sale was value for money. It is, however, of some concern that the impact on tenants was not an explicit sale objective and was only considered late in the sale process. The long-term value for money of this transaction will depend upon several factors, including how Network Rail manages its ongoing relationship with the leaseholder and the impact of the sale on stakeholders, including tenants, and local economies.

Recommendations

17 We recommend:

a Before disposing of assets, HM Treasury and the selling department should consider the potential impact of the disposal on wider government policy delivery. Where the impact could be significant, the Department should engage with policy leads in other departments to consider broadening the sale's objectives.

b The selling department should engage early with stakeholders that are likely to be (or perceive to be) affected by an asset sale – even in cases where this is unrelated to the objectives of a sale – to reduce the risk of the transaction and allow their views to be considered by other parts of government.

c The selling department should consider and document on a timely basis whether contracting with the new owners in areas such as future investment plans and explicit customer protections provides value for money.

d Network Rail, and any department selling assets, should monitor whether future owners comply fully with the commitments they made in their final bid to hold them to account irrespective of whether these commitments form part of the final sales contract.