National Audit Office

Report
by the Comptroller
and Auditor General

Network Rail, Department for Transport, HM Treasury

Network Rail's sale of railway arches

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Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This report examines the value for money of Network Rail's sale of railway arches.

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Contents

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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.

Part One

Background and preparation for the sale

1.1 This part provides background information on Network Rail and the portfolio of rental spaces it sold. This includes a description of the sale objectives and the properties in the portfolio.

Background and wider context

1.2 Network Rail owns, operates and develops most of Britain’s rail infrastructure and is responsible for its maintenance, renewal and enhancement. It plans investment in the railway over a five-year ‘control period’, based on outputs that the Department for Transport (the Department) specifies and the funding available to achieve them. Network Rail’s plans for 2014 to 2019 (known as Control Period 5) were widely acknowledged as ambitious: the then Prime Minister described it as “the biggest modernisation of our railways since the Victorian era”.[2]

1.3 In September 2014, the Office for National Statistics (ONS) reclassified Network Rail as a public sector body because of changes in European statistical rules. The reclassification meant that Network Rail’s £34 billion debt now counted as government debt.[3] The Department and HM Treasury stopped Network Rail from raising new capital in the financial markets as it had done previously, as this would increase government debt at a time when the coalition government’s policy was to reduce it. Instead, during Control Period 5, Network Rail could borrow from the Department under a loan facility capped at £30.3 billion. This change in borrowing arrangements meant that Network Rail lost the flexibility to borrow to cover unexpected cost increases in its rail investment programme.

1.4 In June 2015, the then Secretary of State for Transport made public his concerns about the affordability of the Control Period 5 rail investment programme. The combination of cost increases and reclassification meant that Network Rail and 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. We have previously reported on the affordability of the programme.[4] The Secretary of State announced a major replan of the enhancements programme by Network Rail’s new Chairman, Sir Peter Hendy.

2 Department for Transport, *Investing in rail, investing in jobs and growth*, press release, 16 July 2012, available at: www.gov.uk/government/news/investing-in-rail-investing-in-jobs-and-growth
3 Amount of current and non-current borrowing as of March 2014.
4 National Audit Office, *Planning and delivery of the 2014–2019 rail investment programme*, Memorandum to the Committee of Public Accounts, September 2015, available at: www.nao.org.uk/report/pac-memorandum-planning-and-delivery-of-the-2014-2019-rail-investment-programme/

1.5 In November 2015, Sir Peter Hendy published his recommendations on how to replan Network Rail's works portfolio.[5] Network Rail estimated that the cost of the work it intended to complete by March 2019 (the end of the control period) exceeded the available funding by £2.5 billion. Sir Peter Hendy's report proposed addressing this shortfall through an asset disposal programme of around £1.8 billion – selling non-core and low-value assets – and increased borrowing from the Department of £700 million.

1.6 It is government policy to sell public assets where there is no policy reason to hold them. We have previously reviewed similar sales due to this policy.[6] In February 2016, Network Rail proposed a detailed asset disposal strategy, which outlined how it expected to generate £1.8 billion to support its investment programme. It considered a longlist of core and non-core assets that could be sold to generate proceeds during Control Period 5. The property portfolio discussed in this report is Network Rail's main sale in its asset disposal strategy. **Figure 1** provides a timetable of the events leading up to the sale and the sale process itself.

1.7 Following further development of the asset disposal strategy, Network Rail realised it was unlikely that the sales could be structured in a way to achieve its £1.8 billion target. In April 2017, the Department agreed to lower Network Rail's deficit-reducing receipts target to £800 million. The resulting £1 billion shortfall was to be made up from delaying or cancelling projects, efficiency savings and additional funding from the Department. **Figure 2** on page 14 provides a breakdown of Network Rail's additional funding from the Department and asset sales over Control Period 5.

Sale objectives

1.8 Network Rail presented its strategic business case to the Department in March 2016. This included high-level sale objectives and was endorsed by the Department's Board Investment and Commercial Committee and approved by ministers from the Department and HM Treasury. Network Rail's analysis indicated that the sale of the property portfolio was the largest of the assets identified for disposal that were likely to meet the objectives of the asset disposal strategy.

1.9 The sale of the property portfolio followed the objectives of the asset disposal strategy and focused on the following four specific 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')[7] and public sector net debt (PSND);[8]
- maximise sale proceeds within Control Period 5 (ending 31 March 2019); and
- deliver value for money (compared with Network Rail retaining the portfolio).

5 Sir Peter Hendy, *Report from Sir Peter Hendy to the Secretary of State for Transport on the replanning of Network Rail's Investment Programme*, Network Rail, November 2015.
6 The National Audit Office's past work on asset sales and privatisations is available from our website: www.nao.org.uk/search/pi_area/asset-sales-and-privatisation/type/report
7 Public sector net borrowing (PSNB) is a measure of government's annual borrowing. It is the difference between current expenditure and receipts. The measure excludes receipts from sales of non-financial assets.
8 Public sector net debt (PSND) is a measure of the amount the government owes less liquid assets such as cash.

Figure 1
Timeline of events for selling the arches portfolio

The sale of the arches portfolio began in 2017 and completed in February 2019

Key events leading up to the sale

April 2014	Control Period 5 begins, running until March 2019.[1]
September 2014	The Office for National Statistics reclassifies Network Rail as part of the public sector.
November 2015	The Hendy Review is published, recommending an asset disposal programme to raise £1.8 billion to help address a funding gap in Network Rail's investment programme.
March 2016	The Department for Transport (the Department) approves Network Rail's Asset Disposal Strategy, including the deficit reduction objective. It instructs Network Rail to raise £1.8 billion deficit-reducing receipts from asset disposals.
April to December 2016	Network Rail begins a clearance process to establish which rental spaces to include in the sale. The Department, HM Treasury and Network Rail continue to consider different sale structures to both ensure the safe operation of the railway and reduce the deficit.
January to October 2017	Original expected completion date of the sale (May 2017) delayed to August 2018 due to ongoing discussions about the sale structure and the volume of comments received during the clearance process. Preparation for the sale.
April 2017	The Department revises Network Rail's £1.8 billion deficit-reducing receipts target to £800 million. HM Treasury agrees Network Rail can use up to £500 million of the proceeds, regardless of the ultimate accounting treatment.
October to November 2017	The Department, HM Treasury and ministerial approval obtained of the outline business case for the sale.

Timeline of the sale process

November 2017	Sale launched, and expressions of interest accepted.
January to August 2018	Three-round competitive sale process.
September 2018	Sale announced at £1.46 billion to a consortium of two investors – Blackstone and Telereal Trillium.
February 2019	Sale completed.
March 2019	Control Period 5 ends.

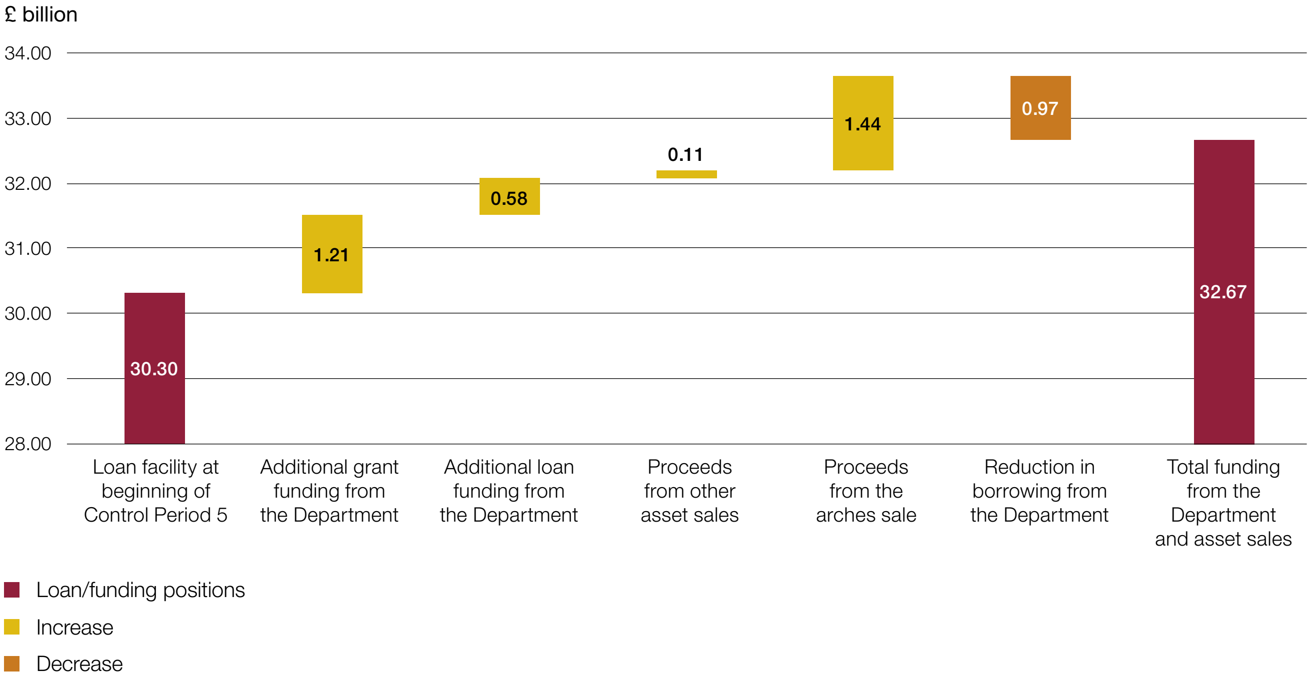
Note

1 Network Rail plans its activity in five-year periods, called Control Periods.

Source: National Audit Office analysis of key events

Figure 2
Funding from the Department for Transport and asset sales

Network Rail has balanced its funding position for Control Period 5 through assets sales, additional funding, cancellations and efficiencies[1]



Notes

1 Network Rail plans its activity in five-year periods, called Control Periods.

2 This figure represents funding from the Department and asset sales only. It does not include other sources of funding, such as income from stations.

3 'Additional grant funding from the Department' includes funding for Valley Lines Electrification and Gatwick, Thameslink, additional enhancements, and other projects funding by the Department.

4 'Additional loan funding from the Department' includes additional funding for electrification support and a reduction in loan funding for Valley Lines Electrification and Gatwick.

5 'Proceeds from the arches sales' are net of relevant transaction costs.

6 The final funding position reflects the fact that none of the arches portfolio sale proceeds are likely to meet the necessary financial accounting and reporting requirements to count against the funding shortfall. However, following an earlier agreement with HM Treasury, Network Rail can still count £500 million of the proceeds against its funding shortfall for Control Period 5.

Source: National Audit Office analysis of Network Rail financial information

1.10 Ensuring the safe and sustainable management of the railway infrastructure was a fundamental objective of the sale, and any sale option had to meet this objective. Network Rail determined that any sale option must preserve its ability to access and carry out works on the arches and surrounding property and prevent tenants from damaging or endangering the railway or its operations.

1.11 For proceeds to count towards reducing the funding shortfall, HM Treasury stipulated that any sale would need to reduce the deficit. Furthermore, only funds received in Control Period 5 could be used to fund the Control Period 5 investment programme. Therefore, to count against the revised £800 million deficit-reducing receipts target, proceeds would need to meet certain financial accounting and reporting requirements and be received before 31 March 2019.

1.12 Wider government policy objectives, such as business support, tenant protection or community cohesion, were not objectives of the sale. They are not objectives of either Network Rail or the Department, and do not form part of Network Rail's licence conditions agreed with the Office of Rail and Road (ORR). Network Rail told us that it seeks to operate its property division on a commercial basis. It did not have any wider policy objectives either before or after it was reclassified as a public sector body. However, as a part of its broader asset disposal strategy, Network Rail considered government's housing policy objectives. Network Rail has a target to dispose of land with capacity to build homes, which is part of the Department's target set by the Ministry of Housing, Communities & Local Government (MHCLG). Network Rail therefore excluded land with known residential development potential from the sale.

The sale portfolio

1.13 The sale portfolio consisted of 5,261 rental spaces across England and Wales. According to sale documentation, the portfolio's owner is the largest landlord to small- and medium-sized enterprises in the UK (**Figure 3** overleaf). Most of the properties are converted railway arches and other land and buildings adjacent to railway tracks. The portfolio is diverse in property type, use, location and tenants (**Figure 4** on page 17). It generated around £83 million in rental income in the 2017-18 financial year and required around 100 Network Rail staff to run.

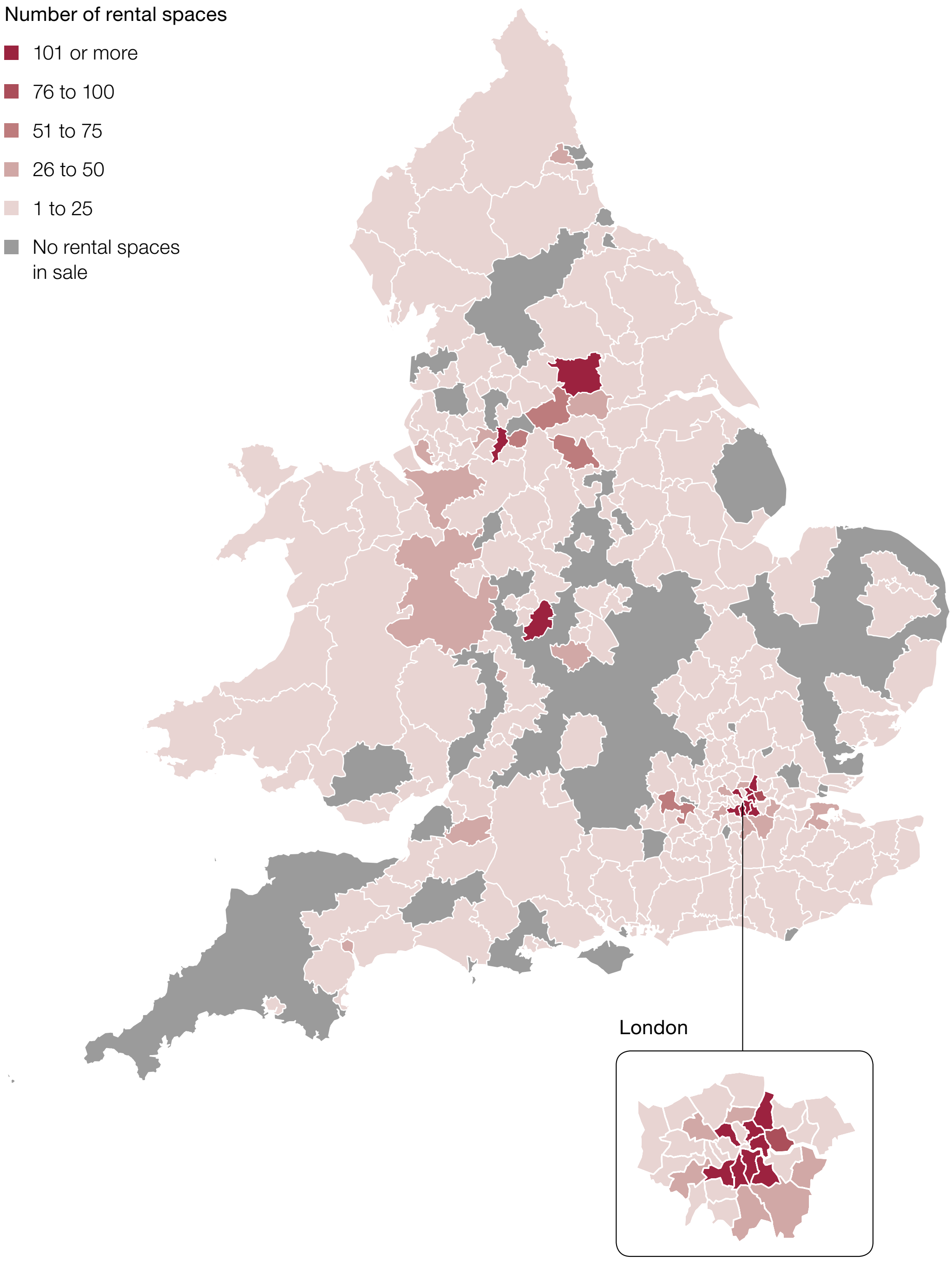
Selection of the rental spaces included in the portfolio for sale

1.14 Network Rail undertook an extensive internal clearance process to establish which rental spaces it would include in the portfolio for sale, starting with around 7,900 rental spaces within its commercial real estate division. Network Rail told us it received 21,000 comments from internal stakeholders, which raised issues relating to the sale of specific properties.[9] Most of these queries related to railway operational and maintenance matters or sites marked for future development.

9 The internal clearance process was undertaken with Network Rail's nine Routes divisions; the teams who are responsible for the day-to-day running of the railway.

Figure 3
Geographic spread of the rental spaces sold by Network Rail

The portfolio is clustered around key urban centres, near major transport hubs in the UK's major cities



Note

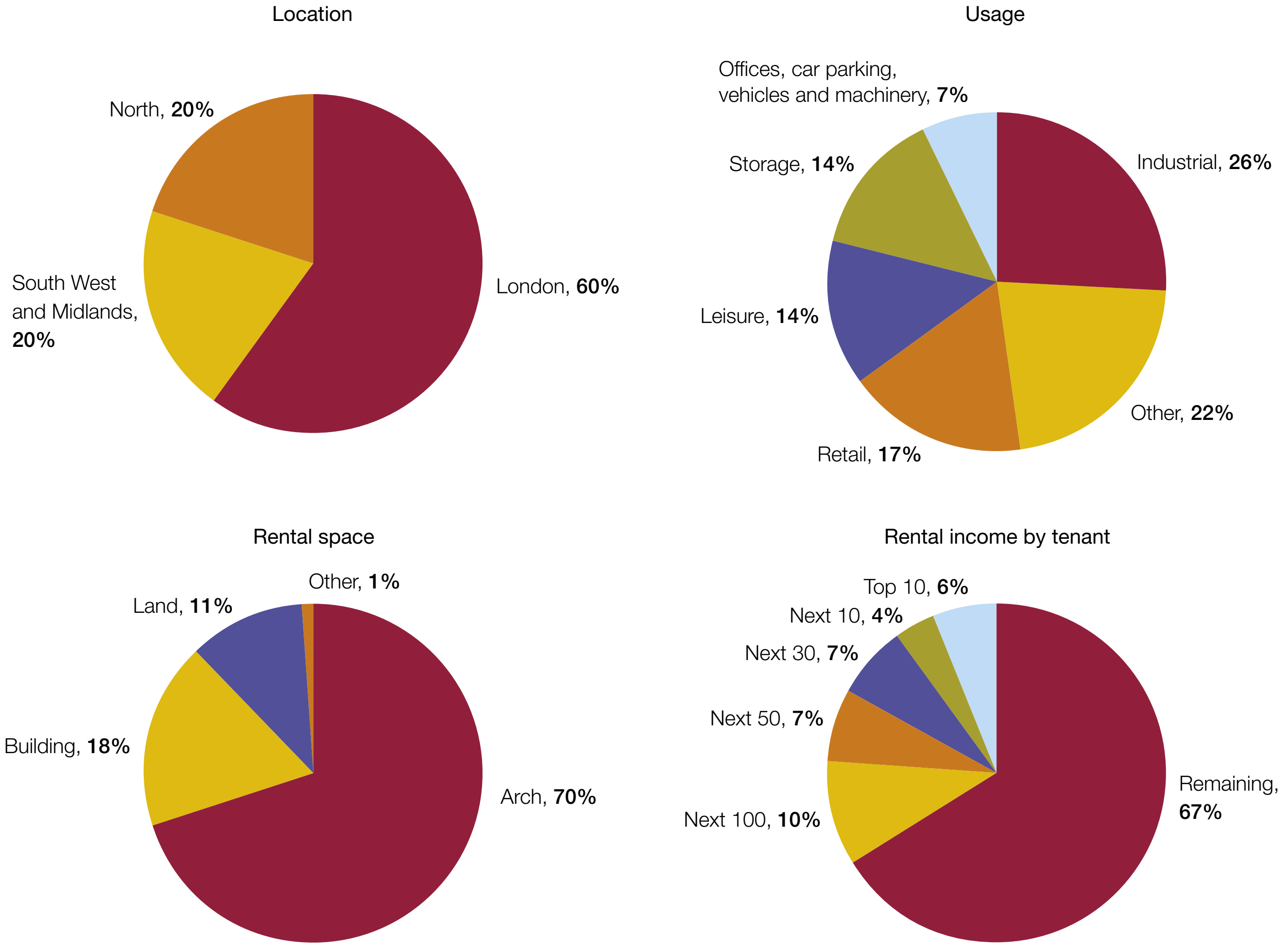
1 Scotland rental spaces were excluded from the sale.

Source: National Audit Office analysis of the portfolio of rental spaces sold

Figure 4

Analysis of the rental spaces sold by Network Rail

The portfolio has a diverse use and tenant base and is situated mainly in London



Notes

1 Chart based on number of rental spaces.

2 Totals may not sum due to rounding.

Source: National Audit Office analysis of the portfolio of rental spaces sold

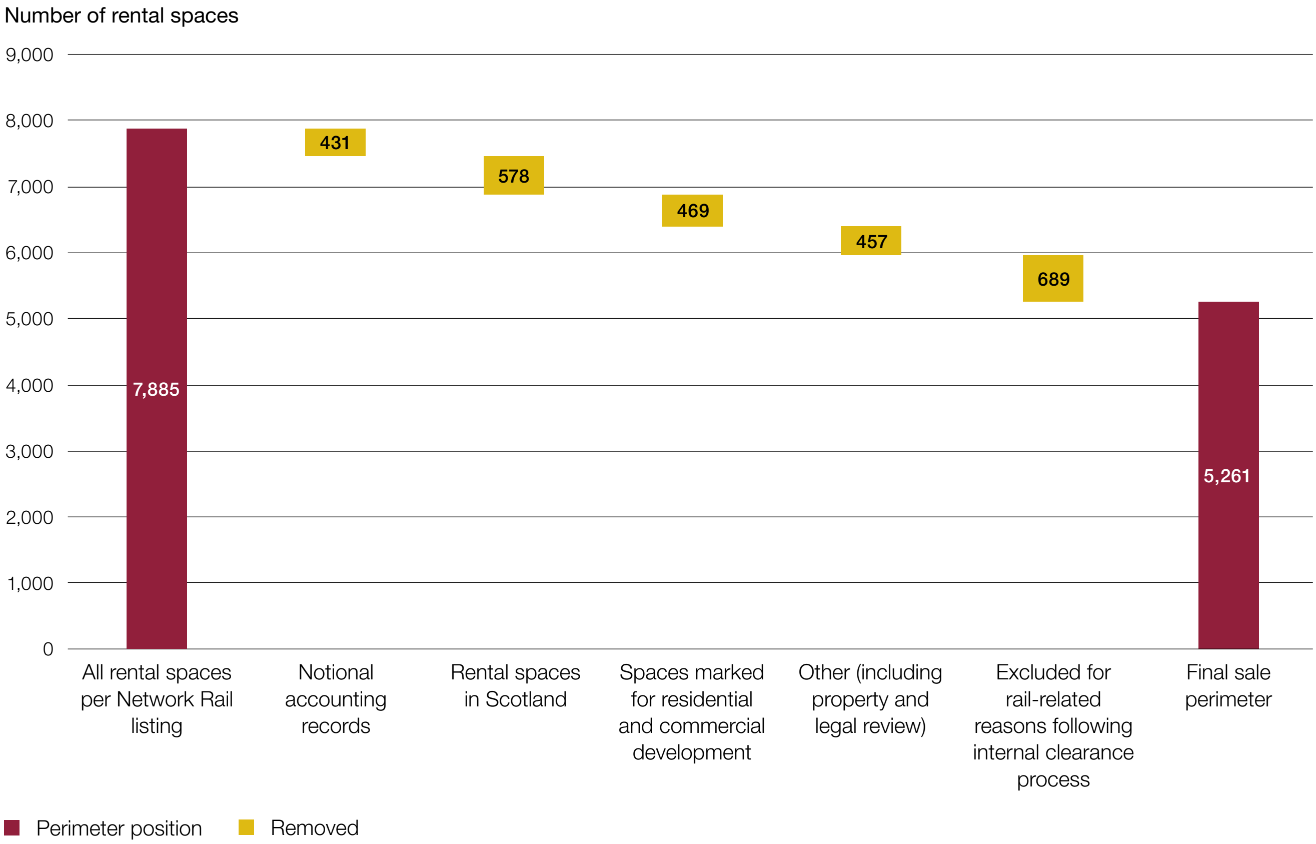
1.15 Alongside the clearance process Network Rail's legal advisers developed the lease agreement with the aim of ensuring the rights and protections were sufficient for Network Rail to continue to operate and maintain the railway. A Network Rail internal panel comprising representatives from across the organisation agreed on a site-by-site basis whether the risks identified could be mitigated through a sale. Where this was unlikely, sites were excluded from the sale. In addition, Network Rail retained sites marked for immediate or near future rail projects with committed funding, and sites with potential for residential development. In all, 1,158 were excluded due to safety concerns or development needs. Network Rail also agreed with Transport Scotland to exclude 578 rental spaces located in Scotland.

1.16 **Figure 5** below shows how Network Rail selected the rental spaces included in the sale.

Figure 5

Overview of how Network Rail selected the rental spaces included in the portfolio for sale

Network Rail's clearance process identified 5,261 rental spaces for sale out of 7,885



Notes

1 Notional accounting records – historical records of previously owned assets or duplicate entries.

2 The removal of Scotland from the portfolio, as agreed with Transport Scotland.

3 Other – rental spaces that it is not practical for a third party to maintain due to Network Rail's access needs.

Source: National Audit Office analysis of business case information

Selection of sale structure

1.17 The portfolio was sold under a 150-year long lease and the sale included the transfer of staff and related management infrastructure to the new owner. Network Rail decided that it needed to sell the portfolio on a leasehold rather than freehold basis because it needed to maintain sufficient access rights to ensure the continued operations and safety of the railway. Retaining the freehold means that Network Rail retains a degree of control over how the rental spaces are used and managed.

1.18 Network Rail's early analysis was that a leasehold sale could not be structured in a way that any of the sale proceeds would reduce the deficit. Only a freehold sale would transfer sufficient control of the portfolio to a new owner, and thus result in sale proceeds reducing the deficit. Throughout 2016 and early 2017, Network Rail and the Department continued to develop sale options that would maximise the impact of the sale on the deficit. Network Rail and the Department did not engage with HM Treasury classification experts until late 2016, almost 18 months after the deficit reduction objective was set. Network Rail and the Department considered selling the freehold of the portfolio, with legislation to ensure it maintained access rights, but legal advice obtained in May 2016 judged that this would be ineffective.

1.19 The Department and HM Treasury expected some of the sale proceeds to be classified as a deficit-reducing receipt, despite the leasehold nature of the sale. However, the ONS only provides a formal opinion on statistical treatment after a sale is completed. To address this uncertainty and ensure Network Rail could use the proceeds to fund its investment programme, HM Treasury agreed in April 2017 to take on the 'accounting risk' of the transaction. This meant that, even if the sale proceeds were ultimately not classified as deficit-reducing by the ONS, Network Rail would still be able to use up to £500 million of the proceeds to contribute to its funding shortfall in Control Period 5.

Part Two

Process of and proceeds from the sale

2.1 This part examines: the governance arrangements for the sale; the sale options that Network Rail and the Department for Transport (the Department) considered; sale preparation and execution; sale proceeds and how they affect public sector finances; and the transaction costs.

Governance arrangements

2.2 Network Rail was the main party responsible for preparing and executing the sale, which was led by two internal working groups. The Commercial Group monitored, evaluated and controlled the progress of the transaction, and the priorities, risks and decisions involved in the sale. The Change and Separation Group monitored the progress of work required to dispose of the portfolio and ensured that appropriate approval for decisions had been sought within Network Rail.

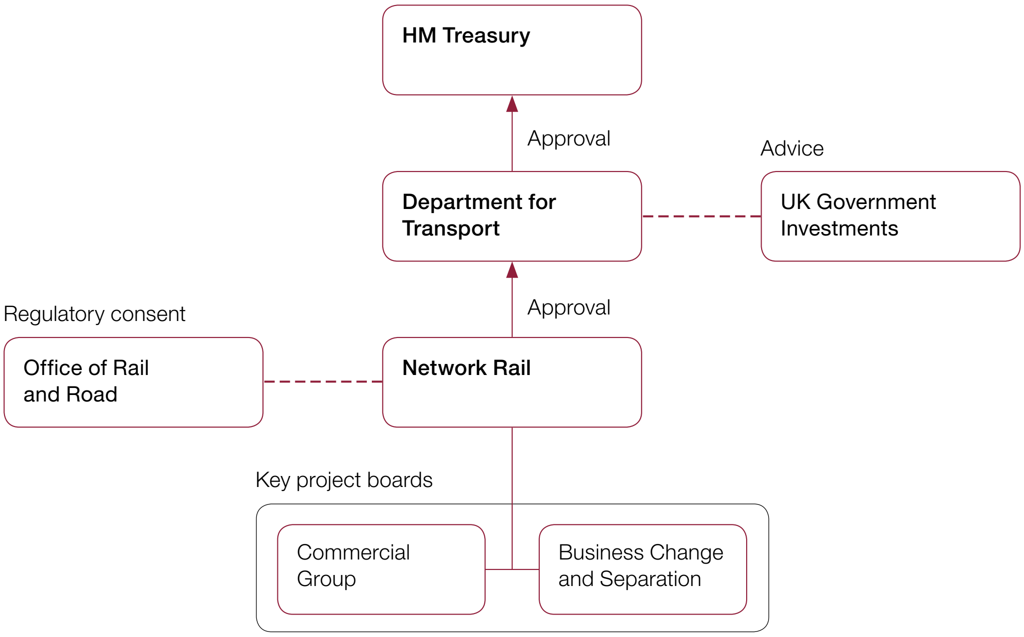
2.3 The Department – as Network Rail's shareholder – provided approval at key stages of the transaction. It approved the sale's rationale and objectives, its launch, and the selection of bidders. HM Treasury was involved in setting the sale's objectives and the accounting treatment, and also approved the launch and the decision to sell. In September 2018, ministers from the Department and HM Treasury gave final approval for the sale to go ahead, following approval by the Network Rail Board and other related project committees. **Figure 6** provides an overview of the governance arrangements. Appendix Three provides an overview of the roles of the main parties involved in the sale.

Sale options

2.4 In the September 2017 outline business case, Network Rail considered a wide range of options to achieve a sale that met government's objectives. All sale options assumed that Network Rail sold the leasehold rights and not freehold rights of the portfolio. These options included sale of the rental spaces as a single portfolio, multiple sales or sales on an individual basis, and other disposal options, such as forming a joint venture with a third party or selling the portfolio in the form of an initial public offering (IPO) of shares on a stock exchange (**Figure 7** on page 22).

Figure 6
Governance structure for the arches sale

Network Rail ran the sale with final approval from Department for Transport and HM Treasury



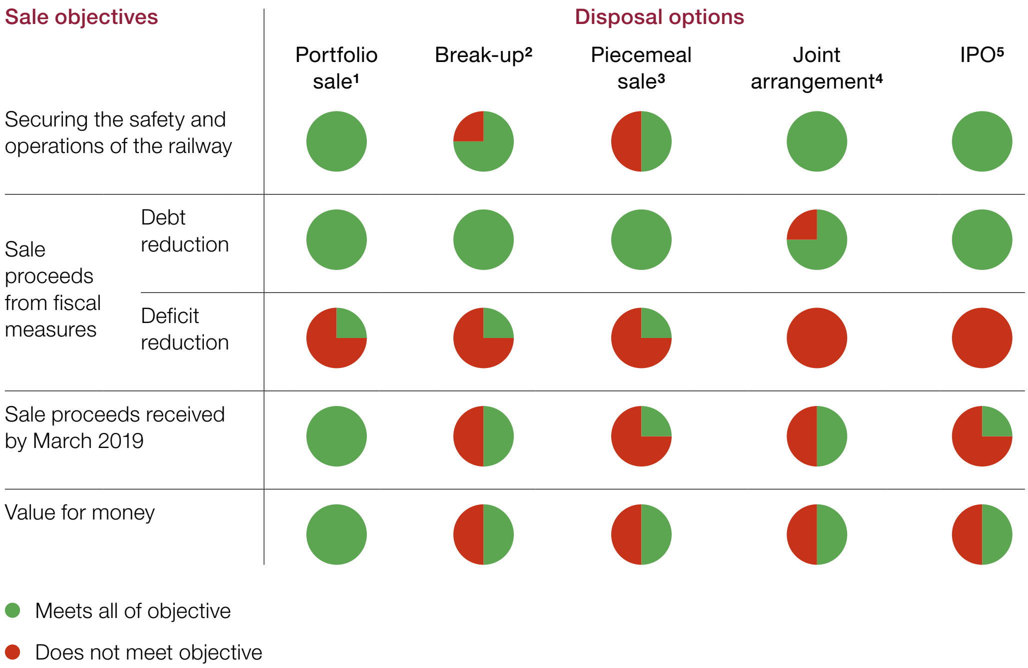
Source: National Audit Office analysis of business cases and other governance documents

2.5 Network Rail, the Department and UK Government Investments (UKGI) spent around nine months considering whether they could maximise value for money by selling the portfolio whole or piecemeal. Network Rail told us that continuity of staff at the Department and UKGI could have improved the process but acknowledged that they supported them fully in critical stages of the transaction. Network Rail's financial and property advisers suggested that, given the likely strong interest in the portfolio, the portfolio sale would gain a 'portfolio premium' as the premium value of the London properties would increase the value attributed to the non-London properties (relative to a series of smaller transactions). In addition, the advisers stated the large scale of the portfolio would be attractive to established global investors who were trying to build large UK property portfolios and had surplus capital. Network Rail and its advisers saw value in the uniqueness of the portfolio, and considered that dividing the portfolio would remove this. They also concluded that the cost to sell would be significantly higher for multiple transactions.

2.6 Network Rail concluded that a single sale presented the most attractive option, owing to the balance of: costs and complexity of managing the relationship with the new owners; the profile of risk and benefits; transaction costs; and completion before March 2019.

Figure 7
Disposal options from the outline business case

The portfolio sale had the best expected outcome of reaching all objectives



Notes

1 Portfolio sale – a large proportion of the portfolio to be sold as a single entity to a private buyer.

2 Break-up – the portfolio to be broken into several distinct businesses before being sold off to buyers.

3 Piecemeal sale – the portfolio to be sold on a rental space basis.

4 Joint arrangement – an arrangement by which two or more parties had joint control, one of which would have continued to be Network Rail.

5 IPO (Initial public offering) – the very first sale of stock issued by a company to the public.

Source: National Audit Office analysis of business case information

Sale process

2.7 Network Rail launched the sale in November 2017. The sale process was a three-round competitive auction, intended to create competitive tension among bidders (**Figure 8**). Network Rail presented the portfolio to investors as a "significant asset management opportunity". It forecast that the total rental income of the portfolio would increase from £83 million in 2017-18 to £160 million in 2027-28, mainly because of a £250 million investment programme (£36 million of the forecast growth) and expected rental increases (£39 million of the forecast growth). It received 143 formal expressions of interest, which the financial advisers conducting the process regarded as 'unprecedented', considering the type and size of transaction.

Figure 8
The sale process for Network Rail's sale of railway arches

The sale attracted substantial investor interest and competitive tension

Stage	Expressions of interest	Round 1	Round 1B	Round 2
Purpose	To advertise the sale and encourage wide involvement in the process.	To provide bidders with sufficient information to determine which bidders would go through to the next round.	To determine which bidders should be taken through to detailed due diligence.	To provide bidders with information before receiving final offers.
Timing	November to December 2017	January to March 2018	March to May 2018	June to August 2018
Information provided to bidders	A short teaser, setting out summary information on the opportunity.	An information memorandum containing detailed information on the portfolio. A summary of the key terms of the head lease. A financial model of the portfolio based on Network Rail's business plan.	Vendor due diligence reports. Information on specific investment opportunities and costs. Drafts of transaction documents and warranties and indemnities. Meetings with management and answers to queries.	Further due diligence reports and meetings with key advisers. Full access to data room with around 33,000 documents covering all aspects of the portfolio. Meetings with management, site inspections and answers to queries.
Bidder response	More than 140 parties formally registered their interest.	35 indicative offers.	Ten indicative offers.	Four firm offers.
Bid range (average)	n/a	£905 million to £1,350 million (median: £1,150 million)	£1,315 million to £1,575 million (median: £1,400 million)	£1,325 million to £1,461 million (median: £1,404 million)
Result	All parties that registered formal interest were admitted to the first formal phase of the process.	17 bidders were taken into the next round, based on price, deliverability and railway safety.	Five bidders were taken into the next round.	Two bidders were invited to submit their best and final offers. A consortium – Blackstone and Telereal Trillium – raised its bid by around 2.5% and was selected.

Source: National Audit Office analysis of business cases and advisers' reports

2.8 During Round 1, it received 35 indicative offers from a range of bidders, including institutional investors, private equity funds and property investment companies. Owing to the scale of interest during this round, Network Rail introduced an additional round of bidding before allowing bidders to undertake detailed due diligence. Network Rail also engaged an additional legal adviser, in part to increase capacity in response to the level of interest.

2.9 Ten of the 17 bidders taken into Round 1B submitted revised bids. Network Rail assessed these bids against price, deliverability and railway safety. Five bidders were taken to Round 2 and began 10 weeks of detailed due diligence. Bidders were given access to around 33,000 documents covering all aspects of the portfolio and offered further meetings with management and advisers, site inspections and answers to queries. Four firm offers were received, and the two leading bidders were invited to submit their final and best offers.

2.10 Network Rail selected a consortium of two investors – Blackstone and Telereal Trillium – that formed a joint venture called 'The Arch Company'. The sale formally completed on 4 February 2019 for £1.46 billion.

Sale proceeds

2.11 This section considers the financial outcomes of the sale. Part Three looks at the wider impact of the sale on the safe operation of the railway, and the impact on communities and existing tenants.

Sale price compared to valuations

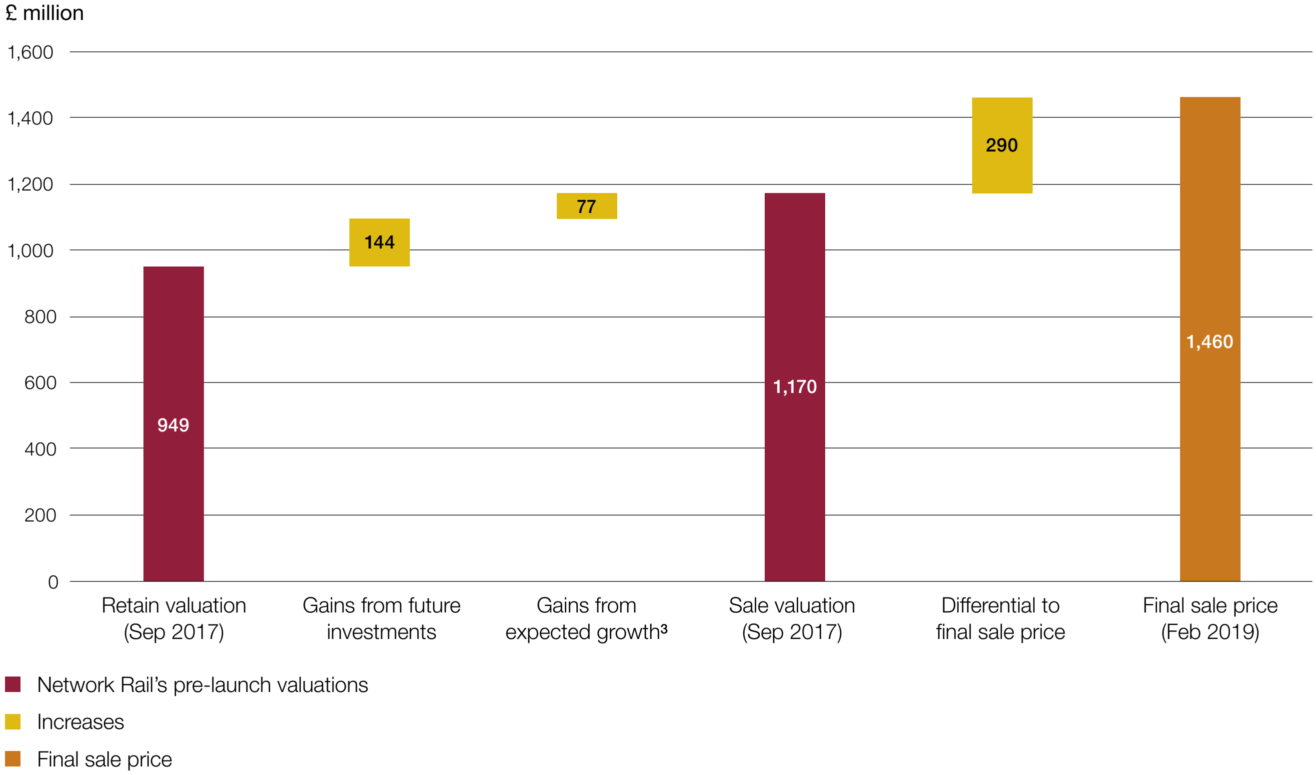
2.12 Network Rail performed multiple valuations which can be classified into two categories:

- **Retain valuation:** This valuation represents the value of retaining the portfolio in public ownership and takes account of Network Rail's limited ability to invest in the portfolio. Government used this valuation to determine whether to sell or retain the portfolio.
- **Sale valuation:** This valuation represents the price Network Rail expects potential buyers to offer and takes full account of the investment opportunities identified by Network Rail's management. It is used to determine whether the price offered by a potential buyer is fair for the portfolio being sold.

2.13 Network Rail sold the portfolio for cash proceeds of £1.46 billion. This was more than 50% higher than Network Rail's retain valuation (around £950 million) and 27% higher than its pre-launch sale valuation (around £1.17 billion) (**Figure 9**).

Figure 9
Comparison of the sale price to Network Rail's pre-launch valuations

The final sale price was 54% higher than Network Rail's retain valuation, which was influenced by its limitation to invest and the use of a higher discount rate



Notes

1. Retain valuation – this valuation represents the value of retaining the portfolio in public ownership and takes account of Network Rail's limited ability to invest in it. It is used to determine whether it is more valuable to sell or retain the portfolio. It assumed limited investment in the portfolio, based on Network Rail's actual investment plans for the property portfolio. As Network Rail is constrained in its ability to invest in development opportunities, it cannot take advantage of the increase in rent due to improving the assets.
2. Sale valuation – this valuation represents the price Network Rail expected potential buyers to offer and takes full account of the investment opportunities identified by Network Rail's management. It is used to determine whether the price offered by a potential buyer is fair for the portfolio being sold. It assumes that the owner does not have any investment constraints and takes account of all development opportunities identified.
3. Expected gains from market rent growth – the retain case assumes that after three years, rents will fall by 1% per year as the portfolio deteriorates due to limited capital expenditure.
4. This figure excludes transaction costs.

Source: National Audit Office analysis of business cases and advisers' reports

2.14 Network Rail's retain case valuation assumed that it would not be able to invest money in developing the portfolio in future years. Before the sale, Network Rail produced a development plan for improving the portfolio, which required around £250 million of investment over the next eight years. This development plan would affect more than 500 rental spaces and is expected to offer an average return of around 10%. Network Rail is limited in its ability to invest in the portfolio, and it told us it would have been difficult to justify investing in the portfolio at the expense of core railway-related projects.[10] Network Rail expected the offers of potential buyers to reflect the full value of this development potential and in its sale valuation it assumed the buyer would not have investment constraints. Network Rail's sale valuation reflects the potential of the portfolio and makes it more comparable with how a potential investor would value the portfolio. Network Rail conducted these valuations at the outline business case approval stage to assess whether or not to go ahead with a sale.

2.15 Network Rail's valuations use the Social Time Preference Rate (STPR) to discount cash flows, in line with HM Treasury's *Green Book* guidance. This rate is often higher than the rate a buyer would use to value an asset in an acquisition. The higher discount rate reduces the present value of the future cash flows, and explains some of the £290 million differential between the sale valuation and final sale price. Therefore, while Network Rail's use of the STPR is compliant with government's methodology, this makes the valuation conservative. We have previously commented on the use of this rate in other government asset sale valuations.[11]

2.16 Network Rail's financial adviser also valued the portfolio by applying a discount rate based on comparable companies and assuming no investment restrictions; using a discount rate of 6.75% implied a sale valuation of £1.4 billion, which was significantly closer to the final price achieved in the sale. This comparison assumes only changes in the discount rate. The other main factor affecting the present value of future cash flows is the expectation of future rental income; the new owners made their own forecasts and did not use the management forecasts. **Figure 10** illustrates the values of the portfolio based on different valuation cases and discount rates.

2.17 There is inherent uncertainty in the value of commercial rents over the long term and therefore the value of the portfolio. In our recent report *The Ministry of Defence's arrangement with Annington Property Limited*, we found that the Ministry of Defence lost out on billions of pounds worth of increases in asset values due to price increases the scale of which could not have been foreseen at the time of the deal.[12] In Network Rail's case, the future rents will affect the price it would need to pay the new owners in order to temporarily or permanently take back the assets. If rents increase by more (less) than expected a take-back could cost more (less) than the proceeds it received from the sale.

10 Network Rail's original business plan for Control Period 5 included £162 million for investment in the portfolio. This was subsequently reduced to £82 million by late 2015, substantially below the level of investment potential of the portfolio. Network Rail conducted multiple retain case scenarios to reflect potential changes to its ability to invest in the future.

11 The National Audit Office's past work on asset sales and privatisations is available from our website: www.nao.org.uk/search/pi_area/asset-sales-and-privatisation/type/report

12 Comptroller and Auditor General, *The Ministry of Defence's arrangement with Annington Property Limited*, Session 2017–2019, HC 762, National Audit Office, January 2018. Available at: www.nao.org.uk/report/the-ministry-of-defences-arrangement-with-annington-property-limited/

Figure 10

Summary of Network Rail’s valuations

The higher valuations assume that all investment projects are funded and use a market rate to discount cash flows

Type of valuation	Cash flow assumptions	Discount rate assumptions	Valuation
Retain valuation (September 2017)	No funding available to invest in the portfolio. Rent growth falls after Year 3 due to underinvestment. Only 80% of the potential rent uplift to market prices is achieved. Unlettable rental spaces remain vacant.	Based on Social Time Preference Rate[2] (8.6%)	£949 million
Sale valuation (September 2017)	All investment projects are funded. Only 80% of the potential rent uplift to market prices is achieved. Unlettable rental spaces remain vacant.	Based on Social Time Preference Rate[2] (8.6%)	£1.17 billion
Sale valuation using a market discount rate[3] (August 2018)	The same as the sale valuation.	Based on broker research of comparable listed peers (6.75%)	£1.4 billion
Full business case valuations (August 2018)	The same as the sale valuation with various investment and growth scenarios modelled.	Ranges between 6.5% to 8.75%	£1.1 billion to £1.4 billion
Final sale price (Agreed in September 2018)	–	–	£1.46 billion

Notes

1 Network Rail’s main valuations are based on a discounted cash flow approach. The cash flows of the portfolio (for example, rental income, management costs) are forecast over a 10-year period, from 2018 to 2028, and then a terminal value was used. These cash flows are then ‘discounted’ to estimate what these future cash flows are worth today. The ‘discount rate’ used to do this is based on benchmarking and professional judgement.

2 HM Treasury’s *Green Book* guidance recommends discounting future cash flows using the Social Time Preference Rate that reflects the value to society of cash today rather than in the future.

3 The market comparison uses a discount rate based on comparable companies. It does not apply a premium for the specific risk of the portfolio.

Source: National Audit Office analysis of valuation information

2.18 The portfolio also contains 762 properties that are not currently rented out and could potentially be commercialised by future owners. These make up about 15% of the overall portfolio. Network Rail told us that some of these properties are not currently lettable, but it expects that many of the issues can be resolved through negotiation, for example to gain rights of access, or investment. Network Rail did not fully quantify the additional returns the new owners might expect for bringing these properties into use. We expect that the value of this development potential is also reflected in the difference between Network Rail's sale valuation and the final sale price.

Timing and impact on the public finances

2.19 The sale process was completed during Control Period 5, which was a sale success criteria. However, it completed two years later than the indicative timeline in the Department's asset disposal programme strategy (March 2016), and less than two months before the 31 March 2019 deadline. In all the process took 40 months, between the sale of the portfolio being considered in the Hendy Review and the sale completing. Main contributors to the delay included the decision-making process between Network Rail, the Department and HM Treasury in relation to the sale structure (paragraph 1.18), accounting treatment (paragraph 1.19), and selection of the properties for sale (paragraph 1.14 and 1.16).

2.20 While Network Rail and the Department initially expected some proceeds to reduce public sector net borrowing (PSNB; 'the deficit'), the sale is unlikely to meet the required financial accounting and reporting requirements. The sale agreement includes a transfer of staff, and Network Rail and the Department only realised the impact of this transfer on the accounting treatment in March 2017. This feature means the sale proceeds will likely not reduce the deficit. 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, Network Rail is able to use £500 million of the proceeds to contribute to its funding shortfall for Control Period 5. This will increase the deficit by £500 million. The remaining proceeds were used to offset against expected borrowing from the Department, by reducing the loan facility available to Network Rail. The sale reduced public sector net debt (PSND) by £960 million.

Advisers and other transaction costs

2.21 The total cost of the transaction was around £35 million, or around 2.4% of proceeds (**Figure 11**). When the sale was launched costs were expected to be £20 million. The costs in this case were affected by the choice of the leasehold sale structure, which added complexity (see paragraph 1.17); 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 costs of separating the property portfolio from Network Rail's retained assets.

Figure 11

Transaction and adviser costs for Network Rail's sale of railway arches

Business separation and legal cost made up more than half of the external cost of the transaction

Costs	Description	Total (£)
Internal team	Network Rail team running the sale	**6,800,000[1]**
External		
Financial advisers	Rothschild & Co, EY	**9,463,229**
Legal advisers	Clifford Chance, Eversheds	**8,838,326**
Business separation	BAE Systems and other suppliers	**7,881,786**
Other transaction costs	Other due diligence, property and transaction support	**1,858,177**
Total external costs		**28,041,518**
Total costs		**34,841,518**

Notes

1 This includes costs up to full business case stage (August 2018).

2 Of total external costs, around £11.7 million relates to the preparation of the transaction (including the cost of preparing the business for sale and separating it from Network Rail) and around £16.3 million relates to the sale process and the execution of the transaction.

Source: National Audit Office analysis of full business case and further cost updates

Part Three

Future considerations

3.1 This part looks at the wider impact of the sale on the safe operation of the railway, and the impact on communities and existing tenants.

Ensuring the safe operation of the railway

3.2 Network Rail must ensure the operations and safety of the railway, irrespective of whether the portfolio was sold. As much of the portfolio is either physically connected or adjacent to the railway, there will be an ongoing relationship between Network Rail and the future owners over the whole length of the 150-year lease. There are four key transaction documents in relation to the sale. The most important in relation to the protective provision of the railway is the head lease (see Appendix Three, Figure 16).

3.3 The head lease contains the railway protective provisions and sets out Network Rail’s and the new owner’s obligations (see Appendix Three, Figures 18 and 19). It also includes provision to allow Network Rail to inspect the arches, to carry out works required for the repair and renewal of the railway infrastructure, and to prevent occupational tenants from damaging or endangering the railway or its operations. Network Rail performed these activities before the sale. After the sale, it will engage in new activities, such as monitoring whether the future owners comply with these lease terms.

3.4 Network Rail has set up an interface team to manage its obligations after the sale and interact with future owners (see Appendix Three, Figure 17). Network Rail identified this post-sale relationship as low risk, following mitigation, on its risk register. It did note that an adequately resourced interface team, with clear roles and responsibilities, is essential to ensure that the future relationship between Network Rail and the new owners is successful. Network Rail expects the cost of the team to be around £1 million per year and the terms of the head lease provides incentive for the interface team to act efficiently.

3.5 The head lease allows the new owner to sell on parts of the portfolio. This is limited to 10 parts, which must each contain at least 500 rental spaces. The size constraints ensure that any future owners have the substance and financial standing to protect Network Rail’s ability to enforce the railway-protective provisions. This also limits the future burden on Network Rail’s interface team by limiting the number of parties it needs to interact with.

3.6 The head lease also gives Network Rail the ability to take back rental spaces as required to deliver railway-related projects. Should Network Rail temporarily or permanently take back rental spaces for railway purposes, it will need to pay compensation either in the form of missed rent for the period required or by buying back the properties at market value. Network Rail has not estimated how much this is likely to cost over the length of the lease. If the new owners improve the portfolio and rents go up, this will increase the cost of taking back rental spaces in the future, the opposite is also true.

3.7 In July 2017, before launching the sale, Network Rail met with the Office of Rail and Road (ORR) to present the rights and protections within the key transaction documents. 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. The key transaction documents simplify and standardise Network Rail's framework compared with the individual leases it had in place before a sale. ORR was content that the key proposed lease terms were consistent with Network Rail's existing approach to letting properties. On that basis, ORR agreed that the proposed sale terms were consistent with the general consent for land disposals under Network Rail's licensing conditions (except for a small number of properties that required specific consent).

Impact on communities and existing tenants

3.8 The portfolio represents the largest provider of space to small- and medium-sized enterprises (SMEs) in the UK, with a diverse tenant base spread across England and Wales (paragraph 1.13). Network Rail recognised the importance that the portfolio has on businesses, communities and the continued economic growth of Britain. But it was not able to quantify this importance, so in its sale business case it sought to assess the non-monetary impacts of the portfolio in relation to regenerating the community and creating jobs. It concluded that, owing to Network Rail's inability to invest fully in the portfolio, private ownership should provide greater benefits in these areas. Network Rail judged that the new owners would have sufficient incentive to invest to maximise their returns, and was concerned that asking for specific commitments may impact the sale price (paragraph 2.14). As a result, Network Rail did not ask for binding investment commitments.

3.9 In July 2018, the Guardians of the Arches, an association of tenants that represented about 6.5% of the overall tenants at the beginning of 2019, met with the then rail minister. Following the meeting, they formally raised their concerns in a letter. Their demands included formal recognition as a tenants' association, ability to purchase discrete parts of the portfolio, more favourable rental terms and security of tenure. Network Rail objected to most of the issues raised on the basis that acting on them would conflict with HM Treasury's *Managing Public Money* principles.[13] However, Network Rail obtained non-binding commitments from the new owner, including that it will adhere to good practice and standards in a tenants' charter. These commitments were given late in the process and at the Department for Transport's (the Department's) request. Network Rail felt that stronger tenant protections were unnecessary as the sale agreement ensures that existing leases remain in place, and that stronger protections would contravene its requirement to act commercially and could raise the risk of a judicial review or State Aid challenge. We understand from the new owners that they intend to publish a charter before summer 2019.

13 HM Treasury, *Managing Public Money*, June 2013. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/742188/Managing_Public_Money__MPM__2018.pdf

3.10 The new owner sees significant alignment between its interests, Network Rail's interests and objectives and those of SMEs and local communities. The new owner believes that the sale will have an "overwhelmingly positive" impact on current and future occupational tenants within the portfolio and has committed to initiatives to support tenants, including:

- a Tenants' Charter, which would set out the principles of tenant relations;
- a tenant engagement team to interact with tenants on a highly responsive and transparent basis;
- a protocol to provide financial and other support for long-tenured SME tenants that are facing, or may face, acute financial pressure; and
- an "environment where SMEs can prosper", through bringing several hundred spaces deemed as 'unlettable' by Network Rail into use and, following considerable capital investment, create more and better space for SMEs.

3.11 The actual wider economic impact will depend on the business and investment strategy of future owners. The new owner is currently developing its business strategy, and expressed the following guiding principles:

a Asset management – focus on rent review where the properties do not require further material investment. Such reviews would take account of affordability and apply a (yet to be developed) protocol to provide financial and other support for long-tenured small business tenants that are facing, or may face, acute financial pressure.

b Letting the vacant units – a significant focus on ensuring that units that are currently vacant are converted to a lettable standard swiftly.

c Minor enhancement – undertake site inspections to identify properties for refurbishments.

d Enhancement projects – undertake a full viability study on larger investment projects before investing meaningful capital in the portfolio.

3.12 The new owner has taken on Network Rail's existing lease agreements and tenants' contractual obligations are therefore unchanged. **Figure 12** provides an overview of the type of contracts currently in place. As the new owner implements its business and investment strategy, the mix of tenants (see Figure 4) and contracts in place may change over time. In September 2018, the buyer committed to writing to tenants once a year setting out the number of arches which have had a change of use as well as the number of units that have been refurbished in each case during the previous 12-month period.

Figure 12
Summary of lease terms of the property portfolio by type

The portfolio is made up of a range of leases that in general have a three- to six-yearly rent review and three- to six-month break clauses

Lease type	Number	£ million[2]	Description	Tenant break	Landlord break	Rent review
Fixed-term lease	748	29.7	A lease over a fixed amount of time (term) where tenant benefits from rights and protections under the Landlord & Tenants Act 1954 (L&T Act). If the landlord opposes renewal at the end of the term, they must demonstrate the statutory grounds outlined in section 30 of the L&T Act. This type of agreement is used where both landlord and tenant want additional security and longevity to invest (tenant may also have right to assign). Typically rent reviews occur every five years.	Subject to negotiation	Subject to negotiation	✔
Fixed-term (contracted out)	681	21.7	A fixed-term lease (as above), although explicitly 'contracted out' of the L&T Act. Used where ability of Network Rail to obtain possession quickly, cheaply and without challenge is important (for example, where a major enhancement may be planned). Typically rent reviews occur every three years.	3 or 6 months	6 months	✗
Rolling-term lease	818	17.8	A rolling tenancy which continues indefinitely until either landlord or tenant serves notice to break the agreement (usually with six months' notice period). For the landlord to break these agreements requires demonstration of statutory grounds outlined in section 30 of the L&T Act. Typically rent reviews occur every three years.	Rolling 6-month	Rolling 6-month	✔
Rolling-term lease with indexation	1,498	16.7	As above but with annual index linked rental uplifts. Typically rent reviews occur every six years.	Rolling 3-month	Rolling 6-month	✔
Total	**3,745**	**85.9**				

Notes

1 Total number of leases (rental agreements) in place at time of completion was 3,745 of a total of 5,261 rental spaces. The remainder is made up of 762 spaces which are not able to be let, 445 spaces which are available to be let, 135 'Other', 93 under development and 81 leased by Network Rail.

2 The financial information presented here shows the expected rental income under the lease agreements in place at sale completion. This may differ from actual rental income owing to a number of reasons, for example, rental spaces being vacant for parts of the year or, and rent increases during the year. The portfolio generated £83 million of rental income in 2017-18.

Source: National Audit Office analysis of the portfolio of rental spaces sold

3.13 Most of the lease contracts include a rent review event every three to six years, and some contracts include annual increases in line with the retail prices index. **Figure 13** illustrates the profile of future rent reviews of the portfolio. At a rent review event, the owner and tenants renegotiate the rent. Rents are set in line with comparable properties in the local area and tenants have the right to arbitration if they disagree with the proposed rental level. Actual rents may differ from market rents owing to the time between when rents are set and when they are reviewed.

3.14 Between 2014 and 2017, rent increases at review events averaged 26% for existing tenants and 39% for new tenants. There were strong variations over time, with averages ranging between 9% and 77%. Rental increases on individual rental space in some areas in London were above these averages. A small number of tenants – introduced to us through the Guardians of the Arches – told us they have noted a more commercial approach to setting rents in advance of the sale; however, during our audit we found no further evidence to suggest that Network Rail's approach had changed. According to Network Rail's framework agreement with the Department, it must follow HM Treasury's *Managing Public Money* principles when setting rents with tenants. These stipulate that rents need to be set on commercial terms.[14] Because of rising market rents, tenants who are less secure financially may be priced out of their rental contracts.

3.15 Network Rail sampled 388 rental spaces, representing about 37% of the total portfolio's income. It estimated that this group of tenants were being charged around 31% below market rents as market rents had risen since the last rent review date (see paragraph 3.13). In its communication to potential buyers Network Rail estimated that, for the same sample of rental spaces, rents could increase by 54% over the next three to four years irrespective of a sale. The estimate varies significantly depending on location; for example, it is around 16% for properties in Wandsworth, yet up to 70% for properties in the City of London and Islington. These increases are based on expectations of future rental price developments and, assuming Network Rail acts commercially, would occur even if the portfolio remained in public ownership.

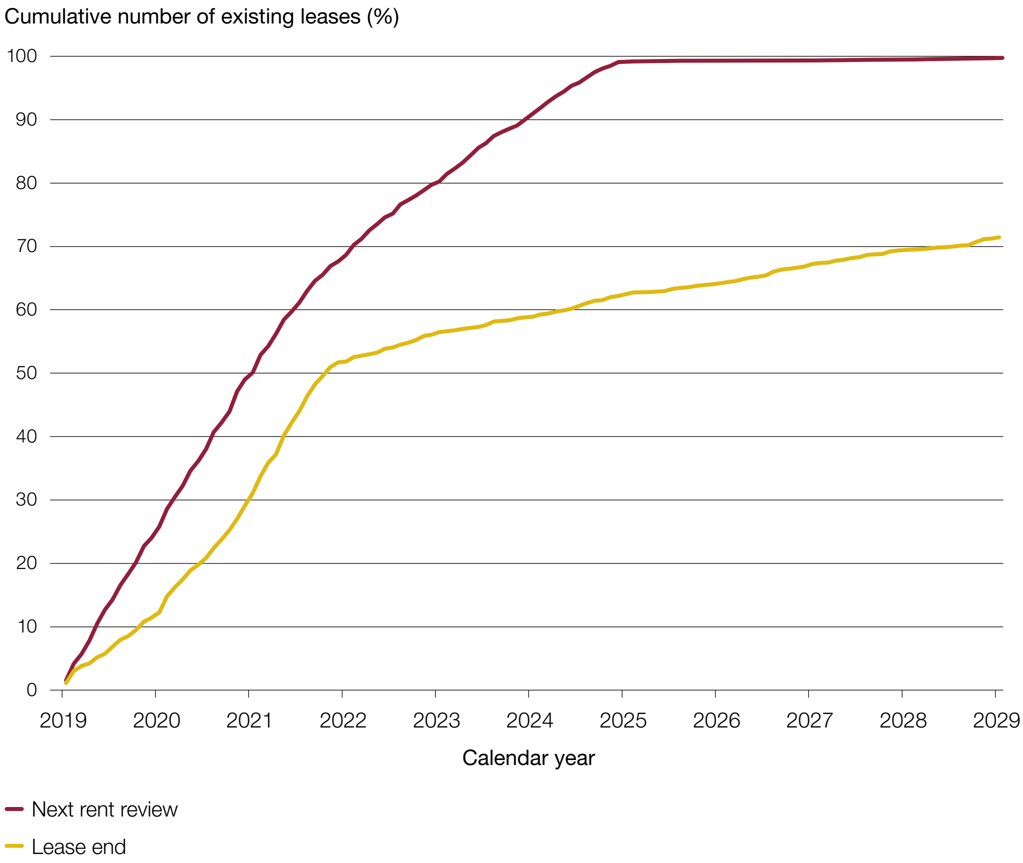
3.16 Around 18% of the current leases are outside of the Landlord and Tenants Act 1954 (L&T Act). The L&T Act provides tenants with greater security of tenure and improves the financial incentive for tenants' investments in the properties. Network Rail told us that the L&T Act negatively affects Network Rail's safety objective and, as a result, Network Rail sought to renegotiate lease contracts outside of the L&T Act when they came due. The head lease agreed with the new owners requires them to contract new leases with tenants outside of the L&T Act.

14 Comptroller and Auditor General, *The Ministry of Defence's arrangement with Annington Property Limited*, Session 2017–2019, HC 762, National Audit Office, January 2018. Available at: www.nao.org.uk/report/the-ministry-of-defences-arrangement-with-annington-property-limited/

Figure 13

The timing of future rent reviews and lease renewals

More than half of the existing leases are due for renewal by 2022, and almost all will undergo rent review by 2024



Notes

1 This figure is based on the existing leases within the portfolio sold as at sale completion.

2 Network Rail's data are incomplete. The analysis is based on the following populations: next rent review information is available for 1,955 leases (of a population of 3,745 leases), and lease end dates are available for 1,328 leases (of a population of 1,429 leases).

Source: National Audit Office analysis of the portfolio of rental spaces sold

Appendix One

Our audit approach

1 The study examined the value for money of Network Rail's sale of railway arches. We reviewed the preparation, process and proceeds of the transaction, to provide an opinion on:

- how Network Rail prepared for and ran the sale process to secure value for money;
- how Network Rail will ensure the safe operation of the railway in the future; and
- the impact of the sale on communities and existing tenants.

2 **Figure 14** gives our evaluative criteria. Our evidence base is described in Appendix Two.

Figure 14

Our audit approach

The objective of government

In response to a large funding shortfall in its investment programme identified in 2015, Network Rail sought to raise around £1.8 billion of funds through an asset disposal programme. The main sale in Network Rail's programme was the sale of a commercial property portfolio largely made up of railway arches.

How this will be achieved

Network Rail's objectives were to maximise deficit-reducing proceeds received before the end of the control period (31 March 2019) while ensuring the safe operation of the railway was not compromised in the sale. Network Rail considered a number of sale structures and undertook an internal clearance process to establish which rental spaces it would include in the portfolio for sale. It ran a competitive auction to create tension among bidders.

Our study

The study examined whether the sale secured value for money.

Our evaluative criteria

Preparation	Process	Proceeds
Were there clear sale objectives, and did government prepare well?	Was the sale process run effectively?	Were the intended outcomes of the sale achieved, and what is the wider impact?

Our evidence

(see Appendix Two for details)

- We interviewed officials in Network Rail and the Department for Transport and reviewed their advice to ministers.
- We reviewed the business cases and the analysis provided by advisers and also interviewed them.
- We interviewed representatives from the new owner and wider stakeholders, including existing tenants.

Our conclusions

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.

Appendix Two

Our evidence base

1 Our conclusion was reached following an analysis of evidence collected between January and April 2019. Our main methods are outlined below:

Document review

2 We reviewed key documents, including:

- the original and final business cases;
- advice from advisers involved in the sale;
- data room provided to bidders during the sale;
- submissions to ministers; and
- other transaction documents.

Interviews

3 We undertook audit interviews, including:

- officials involved in the preparation and sale process at Network Rail, the Department for Transport, HM Treasury and UK Government Investments;
- officials at the Office of Rail and Road;
- government's advisers involved in the sale;
- representatives of the new owner of the portfolio and management of The Arch Company; and
- wider stakeholders, including existing tenants.

Data analysis

4 We performed data analysis, including:

- analysing a database of leases in place at the time of the sale; and
- analysing the valuation approaches and the methods underpinning them.

Appendix Three

Supporting information

Figure 15

Roles of the main parties involved in the sale of the Arches

Party	Roles
Network Rail	Responsible for ensuring the safe operation of the railway. Owned the portfolio and acted as landlord to tenants. Responsible for preparing and executing the sale.
Department for Transport	The shareholder of Network Rail, overseeing its operations. Approved the project business case in advance of sale launch and before the preferred bidder was selected. Worked with Network Rail and HM Treasury on determining a sale structure that would satisfy government's objectives.
HM Treasury	Approved the business case in advance of sale launch and before the preferred bidder was selected. Worked with Network Rail and the Department for Transport on determining a sale structure that would satisfy government's objectives.
UK Government Investments	Acted as advisers to the Department for Transport during the preparation of the sale and the sale process. Regularly attended key commercial board meetings at Network Rail during the preparation for the sale and the sale process.
Rothschild & Co	Acted as financial adviser to Network Rail throughout the preparation for the sale and the sale process. Its role included leading the execution of the sale, valuation of the portfolio, and advice on the sale structure and sale options.
EY	Acted as financial adviser, providing an independent opinion of the market value of the portfolio. Also provided vendor due diligence and accounting advice.
Eversheds	Acted as legal adviser to Network Rail during the preparation for the sale and the sale process. Developed the portfolio lease, including the railway safety protections. Worked jointly with Clifford Chance on other legal documents.
Clifford Chance	Acted as legal adviser to Network Rail during the sale process. Developed the business sale agreement and led interactions with bidders during the sale process. Worked jointly with Eversheds on other legal documents.
JLL	Acted as property adviser to Network Rail during the preparation for the sale. Reviewed the lease from a buyer's perspective and advised on sale structure.
Office of Rail and Road	Regulator of Network Rail. Agreed that the proposed sale terms were consistent with the general consent for land disposals under Network Rail's licensing conditions.

Source: National Audit Office analysis of business cases and related documents

Figure 16
Key transaction documents

The table below provides a short summary of the key terms in the main transaction documents

Document and purpose	Key terms
Agreement for Lease Provides for the sale of the portfolio and the payment of the lease premia	• Sets out payment mechanics including the mechanism for calculating the amounts being transferred and how balance sheet items will be allocated between parties. • Requires a deposit of 5% of total consideration payable on signing, with the balance due on completion.
Business Sale Agreement Provides for the transfer of the non-property assets, comprising goodwill, equipment, records, certain contracts and employees	• A small amount of total consideration will be allocated to the non-property assets, with the balance being payable under the Agreement for Lease. • Contains most of the warranties and indemnities provided by Network Rail.
Portfolio Lease (Head Lease) The main head lease, governing the vast majority of the portfolio (other than rafts and assets dealt with under bespoke leases)	• Entered on completion of the sale for a term of 150 years. • Contains railway protective provisions, including rental compensation and buy-back considerations.
Raft Lease Head lease governing rafts and related land	• Similar terms to the portfolio lease, including railway protective provisions, with certain raft-specific amendments. • Allows rafts to be taken back (at market value) if repairs to the raft required to ensure railway safety are deemed uneconomic by Network Rail.
Bespoke Leases Small number of bespoke leases covering certain non-standard assets	• Bespoke terms relevant to the specific assets, including railway protective provisions to the extent relevant.

Source: National Audit Office analysis of business case information

Figure 17
Interface team's ongoing role

Summary obligations of Network Rail's interface team after the sale

Inspections	• To assess the condition of viaduct structures, Network Rail will undertake inspections of arches in normal circumstances at 12-yearly intervals, which will require access. • These inspections require access to the underside of the barrel vault, and generally existing occupational leases in use across the estate require tenants to remove any fixtures and fittings as necessary to allow such inspections to take place. • The duration of an inspection varies depending on the nature of individual rental spaces but they typically last two to three weeks. • Network Rail will be liable for any loss of rental income by the purchaser during the inspection, as well as any costs incurred in the inspection. • If the barrel vault on the underside of the arch is lined, removal will normally be required to allow the structure to be assessed. The cost of the removal will, in general, be paid by the party that installed the lining.
Repairs	• Network Rail will typically provide 20 business days' notice if repairs are expected to be conducted, except in emergency situations where no prior notice is needed. • Network Rail will compensate the purchaser for any loss of rental income due to repairs.
Rail enhancement projects	• Network Rail retains the right to take temporary or permanent possession of any rental space to undertake such improvements. • In case of rail enhancement, the purchaser will receive compensation equating to the loss of rental income for the period of the works. • If a rental space is taken back permanently by Network Rail, the purchaser will receive compensation equating to the diminution in market value of its assets based on the prevailing market value.

Source: Network Rail's information memorandum provided to bidders

Figure 18
Purchaser obligations

Summary of the future owners' obligations

Repairs	• The purchaser must keep each part of the premises in such a state of repair and condition so as not to adversely affect the safety function and/or operation of the railway.
Allow entry	• The purchaser must allow entry to any part of the premises immediately on (verbal) notice where determined by Network Rail to be required for the safety function or operation of the railway. • The purchaser must allow entry immediately in emergency scenarios or on 20 business days' notice in non-emergency scenarios.
Removal of fit-out/chattel	• Where at least 20 business days' notice is given by Network Rail, the purchaser must, at its own cost, remove any arch fit-out (excluding any arch lining), ancillary structures, loose items and/or building, works or structures on the relevant part of the premises in or on such property in order to facilitate maintenance and/or repairs. • If Network Rail requires removal of any of the items referred to above on less than 20 business days' notice then Network Rail will be responsible for the costs of removal and reinstatement.
Alterations	• No works, alterations or additions will be permitted without consent unless expressly permitted in the Arch Technical Specification. • Consent is not required for arch fit-out or internal works that do not involve excavation or affixation/attachment to the viaduct. • Network Rail's consent will be required for most alterations.
Dealings	• Assignment of the whole of the leases will be permitted. • Assignment of parts will be permitted subject to a minimum size of 500 rental spaces being included in each assignment of part.
Sub-lettings	• Sub-lettings of parts of the estate on a premium sub-lease will be permitted so long as at any time no more than 50% of the properties comprised within a reversionary interest may be subject to an underlease at a premium. • Usual occupational sub-letting will be permitted without consent using model leases in a form pre-agreed with Network Rail.

Source: Network Rail's information memorandum provided to bidders

Figure 19
Network Rail's obligations

Summary of Network Rail's obligations

Viaduct retention	Network Rail must keep each viaduct in such a state of repair as necessary to ensure the safe operation of the railway.
Entry safeguards	Network Rail must, when exercising any landlord entry rights, repair any physical damage caused to the property or fit-out. Where Network Rail has given 20 business days' notice to the tenant requiring removal of any fit-out or tenant's fittings there is no liability on the part of Network Rail in respect of any damage to items that should have been removed. Where Network Rail requires removal of a standard Network Rail arch lining when exercising its rights, it will meet the costs of removal and reinstatement.
Rental compensation	Where any let rental space or part thereof becomes inaccessible and/or materially incapable of occupation/use as a result of Network Rail exercising its rights of entry for railway works, then Network Rail will pay compensation equivalent to the rent that would otherwise have been paid by the occupational tenant of the relevant rental space.
Void periods and vacancy windows	If Network Rail has indicated that it will exercise its entry and occupation rights during a void period but subsequently (after it enters the premises to exercise its rights) the space is let then Network Rail will be entitled to a further seven days without compensation after which compensation will be payable at the rental rates reserved pursuant to the new lease.
Break rights	Network Rail retains the right to take back part of the premises by way of break of part of the Long Leases when required for railway purposes. When break rights are exercised, compensation calculated by reference to diminution of market value is to be independently determined and paid to the purchaser. If compensation is payable to occupational tenants or premium sub-tenants then the purchaser will be responsible for paying this out of compensation paid by Network Rail.

Source: Network Rail's information memorandum provided to bidders

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