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8 July 2014

Company Secretary  
Network Rail Infrastructure Limited  
Kings Place  
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N1 9AG

## **Network licence condition 4 (financial ring-fence): acquisition of Grand Central shopping centre**

### **Decision**

1. On 8 March 2014, Network Rail applied for consent under condition 4 of its network licence, proposing to acquire [REDACTED] the leasehold of the Grand Central shopping centre being developed immediately above Birmingham New Street station. We have decided not to grant to consent at this time.
2. The proposal has raised some significant issues for us to consider and you have provided us with supporting information which we have discussed with your key personnel. We explain our decision below.

### **Background**

3. The Grand Central shopping centre is being developed above Birmingham New Street station as part of the Birmingham Gateway regeneration scheme. It is expected to open fully in 2015 [REDACTED]

4. [REDACTED] The company believes this provides an opportunity to secure a new and significant property income stream to help support the railway.

5. There is considerable detail in and around Network Rail's proposal and the company has provided us with data and its analysis in response to our information requests, and also shown us the property in question.

## Analysis

6. The project is a contractual arrangement between Network Rail and BCC, with Network Rail responsible for the construction of the shopping centre. [REDACTED]

7. In considering this case, we have, in accordance with our usual procedures for processing financial ring-fence consent requests, borne in mind three overarching factors. We have previously shared these factors with Network Rail. They are:

- (a) whether the proposal would be likely to affect the operation of the railway;
- (b) whether there are any state aid or competition issues arising; and
- (c) any financial risks arising from the proposal.

8. With regard to (a), we note that if Network Rail were to have full ownership of the integrated railway station and shopping centre, it would have full control over pedestrian flows, allow it to maximise safety/evacuation procedures and have complete control of any future physical changes. The team have confirmed to us that they have no concerns about any inadequacy in Network Rail's access rights in the current agreement with BCC [REDACTED]

9. We have no concerns to pursue under (b) as Network Rail's investment hurdle rate was shown to reflect a commercial premium and DfT - the lead body for state aid concerns - has not raised any such issues.

10. The focus of our assessment has been on (c), as described below.

### *Financial risk*

11. Our approach to judging the financial risk presented by the proposed transaction has been to have regard to the following factors:

- (a) the particular risks presented by the size and structure of this transaction;
- (b) the strength of Network Rail's due diligence process, including in respect of assessing commercial risks; and
- (c) stress-testing of material assumptions relied upon in Network Rail's business case.

#### *a) Size and structure of the transaction*

12. We note that the structure of the asset, and the nature of the proposed transaction between BCC and Network Rail have several aspects that may affect risk. In particular the institutional/structural arrangements around the acquisition, and the existing close relationship with the vendor, have been material to our

assessment of the robustness of the due diligence that Network Rail has undertaken and the degree of assurance that we in turn can take from it.

- While the asset is [REDACTED], Network Rail has been responsible for the asset's construction and commercial operation, and so we are generally satisfied that Network Rail has a good understanding of it and of the remaining development risk prior to the asset entering commercial operation.
- This is a large investment, in excess of Network Rail's *de minimis* freedoms under condition 4 of its network licence. The purpose of the *de minimis* limit is to allow Network Rail some flexibility to carry out non-core activities without seeking our consent. The limits are to restrict Network Rail's exposure to financial risk, which, if left unrestricted, could impede the company's ability to resource its Permitted Business and deliver its required outputs. We consider that the scale of this transaction and the concentration of risk in a large single asset underlines the importance of conducting a robust risk assessment and stress-test of the business case, as discussed below.
- [REDACTED] with an existing close relationship between vendor and proposed purchaser, we consider it important that the vendor's proposed valuation is robustly tested and independently verified.

*b) Network Rail's due diligence process*

- BCC and Network Rail have either jointly appointed advisers on this transaction, or Network Rail is relying on advice commissioned by BCC. Network Rail has not sought comprehensive financial or commercial diligence independent of that provided by BCC's consultant, prior to its making its decision to invest and submitting the application to ORR. We have taken into account the further advice commissioned by Network Rail during the course of our review of this application.
- In our meetings with the project team, Network Rail explained its belief that it considered that its involvement in the project from conception tempered the need for a comprehensive due diligence process. However, since Network Rail's involvement has focused on construction and operation, we do not consider that this argument should reasonably apply to the issue of financial valuation and risk.

- [REDACTED]

- [REDACTED]
- [REDACTED] As described below, we have tested key assumptions in Network Rail's business case to understand if it includes a significant up-side margin or sufficiently low volatility in response to variation of material assumptions. This is to provide comfort that this internal valuation exercise is sufficient without recourse to independent expert advice.

*c) Stress test of Network Rail's businesses case*

- Network Rail's Board cleared the acquisition of the shopping centre following recommendation from its Investment Panel. Based on the information that has been provided to us [REDACTED]
- Given that there has been limited independent verification of Network Rail's business case assumptions, we consider the sensitivity of the business case to changes in the base case assumptions to be an important consideration in our assessment of the overall risk presented by this proposed transaction. We do not believe that Network Rail can be fully assured about the risks in its own business case based on the information provided to us.

**Reclassification**

13. There is an additional factor in this case concerning the company's impending reclassification on 1 September 2014 to a central government body in the public sector. We raised this issue with your team during our discussions, and I want to summarise it here.

14. The Railways Act 1993 requires ORR to have regard to the funds available to the Secretary of State, and this now has particular importance given reclassification as Network Rail's debt will become the government's debt.

15. Given this duty, we have shared our consideration of this application with Department for Transport (DfT) officials, and DfT has given us its preliminary view,

[REDACTED]

It added that its final view would be guided by our assessment of the business case.

## Reasons for decision

16. Network Rail's proposal represents a financial investment that is not required wholly for its Permitted Business<sup>1</sup>, and Network Rail has asked for our consent under condition 4.1 (*Financial ring-fence*) of its network licence. We have assumed Network Rail will generate [REDACTED] (in 2012/13 prices) from property rental and property income offset by commercial operating expenditure in CP5. In that context we are encouraged that the company is planning to meet that assumption [REDACTED]

17. Although Network Rail has provided modelled returns for the asset, it has not provided a persuasive investment case that demonstrates that this investment presents a risk/return profile that is more favourable than alternative assets (or portfolios of assets) in which it could invest.

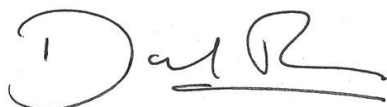
18. Our assessment is that the business case for the acquisition is not compelling. Network Rail has chosen not to seek a completely independent valuation in recent months. Nor are we satisfied that Network Rail's own due diligence process has included robust stress testing of the internal valuation and a comprehensive risk assessment. However, we consider that such a valuation and risk assessment was needed to ensure that Network Rail's business case and due diligence process was demonstrably robust.

19. Network Rail needs to invest where it considers that it will make the highest rate of return for that investment. On the basis of the data and models we have seen, the acquisition of the Grand Central shopping centre does not appear to provide sufficient value for money.

20. It is therefore our assessment that the best way to exercise our functions in compliance with our duties under section 4 of the Railways Act 1993 is to refuse consent to the proposed acquisition. In particular we have had regard to section 4(5)(c), that is, our duty to exercise our functions in a manner which we consider best calculated to "*have regard to the funds available to the Secretary of State for the purposes of his functions in relation to railways and railway services.*".

21. Therefore for the purposes of condition 4.1 of Network Rail's network licence we conclude that we do not give our consent to the proposal.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Daniel Brown', with a horizontal line underneath the name.

**Daniel Brown**

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<sup>1</sup> As defined in Part 2 of Network Rail's network licence.