Chief financial officer's review of 2019/20

This financial year was the first of Network Rail's five-year spending plan. In the first 11 and a half months, we saw more efficient delivery, more services added to the timetable, increased asset management activities, improvements in train performance and a profitable start to the control period.

Network Rail made a good start with its ambitious £3.5bn five-year efficiency programme, to deliver its operating, maintenance and investment programmes within budget, and improve its annual cost-base by £385m. This was also reflected in our financial performance measures (FPM).

The year ended with unprecedented measures in place to minimise the spread of Coronavirus. The response to the pandemic has changed the lives of passengers, suppliers and staff. It has also impacted our operations, ways of working and project delivery. We have worked hard to keep the infrastructure running and support the businesses in our supply chain, so that they can return to normal service levels as soon as it is advisable. The company remains on a firm financial footing and the action taken by the Department for Transport (DfT) and Transport Scotland to support train operator franchises has secured the financial position of our key customers.

Key financial highlights

(The financial statements start on page 132)

- Profit before tax was £375m compared to a loss before tax of £173m in 2018/19.
- Revenue increased from £6.7bn to £8.1bn.
- Operating costs increased from £5.2bn to £5.8bn largely due to increased depreciation, planned increases in maintenance activity agreed as part of the five-year settlement, and higher electricity costs as a result of increased electrification of the network to improve performance and provide greener transport.
- Operating profit was £2.3bn, compared to £1.4bn last year.
- Investment was £5.2bn compared with £7.0bn last year, lower due to the completion of large elements of the CP5 railway upgrade programme in the previous year.
- Net debt increased slightly from £54.1bn to £54.6bn due to increases in the valuation of RPI-linked bonds.

These results show a return to profit before tax this year as planned. All surpluses form part of our overall funding and are re-invested in the railway. The increase in renewal activity targeting improved our service to passengers, through better asset reliability, resilience and longevity. Passengers are also benefiting from recent years' investments with more than 5,000 new services running each week and with more to come.

We now have five regional divisions, which are providing stronger local leadership in our Putting Passengers First programme. This allows us to work more closely with our key stakeholders, drive improved performance, and be more cost-efficient and cost-competitive.

Running one of the safest railways in Europe, we continue to invest strongly to maintain and continue to improve this. Following tragic events, such as Margam, this year, the Safer Trackside Working (STW) programme is designing and developing new protection and warning systems to protect our colleagues. This consists of near-term risk reduction and longer-term solutions aligned to deployment of Digital Railway technologies. As a result we plan to spend over £140m in this control period on improving track worker safety.

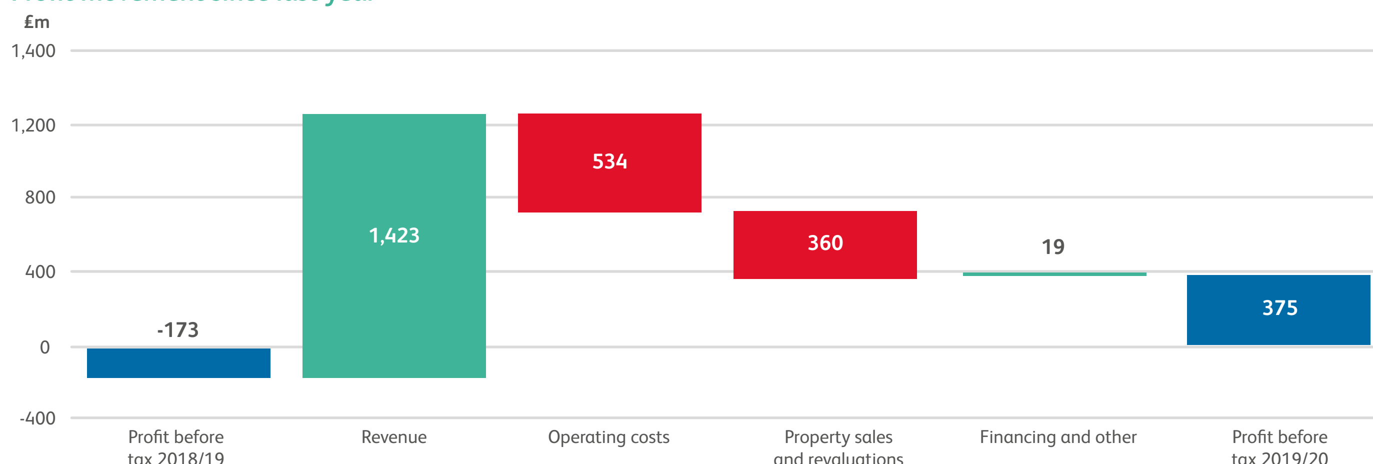
Financial summary

This review will focus on financial performance in 2019/20.

This year we made a profit before tax of £375m (2018/19: loss £173m). This improvement was partially due to the changes in the five-year funding settlement which made

allowance for additional maintenance activities in line with asset management plans and higher depreciation. It also benefited from favourable overall train performance compared to plan, particularly lower costs from disruption. Last year saw the disposal of a large proportion of the commercial property estate and thus income and profits were lower. Finance costs were also lower in the year. After taking into account increases in prospective corporation tax rates from 17 per cent to 19 per cent the deferred tax provision increased, creating a loss after tax of £20m (2018/19 loss of £225m). The variations in costs and revenue are explained in more detail in subsequent sections.

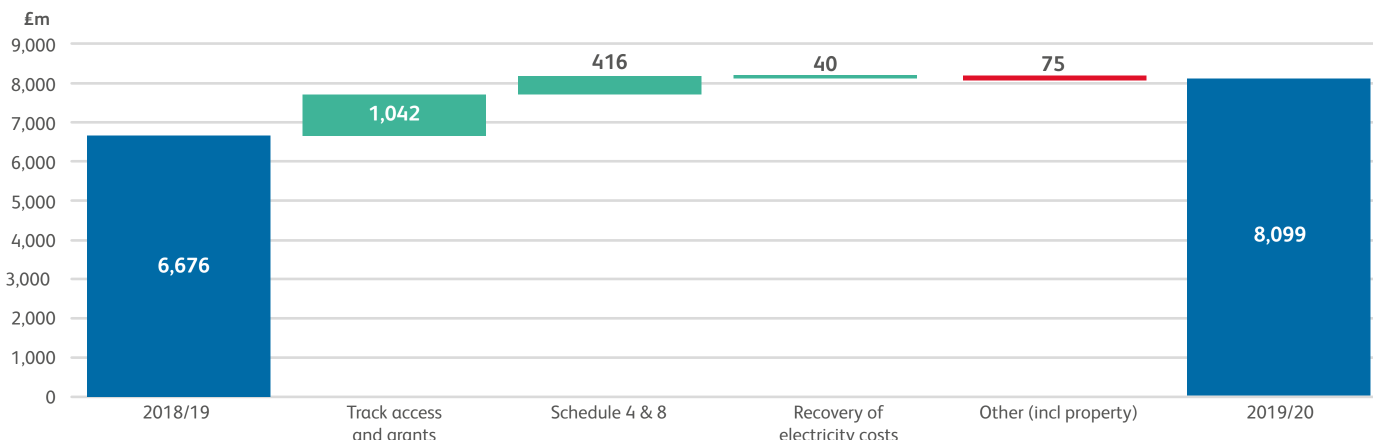
Profit movement since last year



Revenue

Revenue increased in the year to £8,099m, an increase of £1,423m (2018/19: £6,676m).

Revenue movements compared to last year (£m)



Track access and grants rose (£1,042m) in line with the rail regulator's determination of charges including £74m more variable income as a result of increased traffic and an additional £40m for electricity for traction (EC4T), in part a result of increased electrification of the railway. Schedule 4 and 8 performance and access regime costs decreased in the year by £416m; of the improvement, £153m was from reduced compensation for engineering works, as less disruptive possessions were required than in the previous year due to lower investment levels. Stronger train performance with fewer severe weather events, more reliable infrastructure and better response to incidents, alongside a change in calibration of costs for Control Period 6 (CP6) drove further financial benefits. Our other income decreased by £75m as a result of the sale of the commercial estate in the previous year.

Operating costs

Net operating costs this year were £5,777m. This has increased by £534m from last year's expenditure of £5,243m, net of efficiencies. This increase in expenditure is in part driven by extra investment that has increased depreciation by £212m.

Operating costs before depreciation rose by £347m from £3,577m to £3,924m.

This is driven by increases in pension costs (£22m), joint industry cost increases including EC4T (£46m) largely

Chief financial officer's review continued

recovered through track access charges, additional maintenance costs (£240m). This was part of a planned increase in maintenance activity agreed as part of the regulatory settlement to respond more quickly to incidents, to maintain new electrification assets and some other smaller increases at rates lower than prevailing inflation.

Employee costs

Staff costs increased by £154m due to increase in pension costs (£22m), an increase in the average number of employees in the year (£108m) supporting additional activity, and average pay increases (£24m).

Average headcount for the year was 42,099. This is an increase from 2018/19, when the headcount average for the year totalled 40,268. This was due to recruitment in the last year in the routes to fill maintenance and works delivery vacancies and reduce overtime costs, to respond faster to incidents and to support new assets.

Tax

Network Rail has significant brought forward tax losses, not recognised as a tax asset in the accounts. As it continues to invest heavily in the railway network it, therefore, pays relatively small amounts of corporation tax. The tax expense comprises deferred tax and was £395m (2018/19: £52m). This is due to the increase in prospective corporation tax rates from 17 per cent to 19 per cent. This rate change has increased the deferred tax liability to £3.6bn (2018/2019: £3.0bn).

Financing costs

Finance costs for the year were £2,170m. This is broadly in line with last year's charge of £2,200m. In this control period, two significant changes impacted finance costs. Firstly, Network Rail no longer pays a fee for the financial indemnity mechanism that our bondholders continue to benefit from (£266m). As Network Rail receives grants for investment rather than borrowing, there is no interest capitalised to capital additions (£183m). Other than this, interest expense and debt levels were relatively stable across the year.

Investment

Over the previous five years, Network Rail has delivered a huge rail investment programme that is in the process of being translated into new services for passengers. Over 5,300 new services per week have been introduced so far and that will increase by a further 6,000 by 2025.

This year Network Rail delivered £5.2bn of railway investment (2018/19: £7.0bn).

Enhancements that will increase the capacity of the network have amounted to £2.3bn (2018/19 £3.8bn). Major schemes included improvements on the Midland Main Line between London and Corby, Trans-Pennine improvements, substantial completion of the Great Western Electrification programme and Thameslink, East Coast Main Line improvements, and in Scotland improvements relating to Inverness to Aberdeen and Edinburgh to Glasgow lines.

We have also invested £2.9bn (2018/19: £3.1bn) on renewals this year. This included £0.9bn of track renewals which delivered circa 1,100 km of new track and replaced circa 700 switches and crossings. In addition £0.5bn was spent on signalling renewals, £0.5bn on structures (including around 50,000 square metres of underbridges, and 11,000 square metres of tunnels), £0.3bn on electrification assets, £0.3bn on buildings and property (including circa £0.2bn on improving stations for passengers) and £0.6bn on other renewals including telecoms, IT, plant and equipment, drainage, intelligent infrastructure and faster electrical isolation equipment.

In the year, Network Rail met 133 per cent of its seven key renewal volumes (2018/19: 124 per cent), and 85 per cent of its Delivery Plan and Enhancement milestones (2018/19: 91 per cent).

Financial performance measure and efficiencies drive

Network Rail's key performance indicator regarding efficiency is its financial performance measure (FPM), which measures our performance against the regulatory determination and our in-year targets. Network Rail is constantly working to reduce the cost of the work that we deliver. We continue to make good progress in our commercial efficiencies, productivity, and more efficient access to carry out work and through the leverage of new technologies.

Overall Network Rail finished £20m positive to plan (2018/19 £213m behind targets). This was achieved by surpassing FPM targets for profit and loss by £140m and offset by some underperformance in renewals by £34m and enhancements by £85m.

Profit and loss FPM for the year is £140m ahead of target, due in part to lower train delay costs, reduced weather effects and lower performance related pay from the prior year. Performance has been better than planned in nine out of 13 periods in the year augmented by extra track access income from running additional passenger and freight services. Operating cost efficiencies were also ahead of target.

Renewals underperformance of £34m on expenditure of circa £3bn, was mainly due to contractor and delivery issues and programme elongation. This includes £16m in signalling as the length of some works were extended, allowing them to align with other major projects, and changes to original designs. Track was £13m adverse due to increased costs following development of designs and increased materials rates.

The £3.5bn five-year efficiency programme for operations, maintenance and renewals (OMR) reflected in our overall financial performance got off to a good start, delivering £385m of benefits in the first year of the control period. The majority of these savings are expected to recur and support the increased rate of efficiencies to be delivered

in future years. Key elements of this programme are commercial savings, early supplier engagement benefits, improved access, and productivity related gains from new technologies.

The underperformance in enhancements (£85m) is due to increased costs closing out Control Period 5 (CP5) projects such as the Great Western Electrification programme (£54m) after it was extended, and there were disputed costs, and Crossrail (£77m) due to scope increases and higher costs on the Western Stations programme.

Whilst the financial impact of the global pandemic on 2019/20 was relatively minor we saw the start of reductions in revenue, particularly volume related track access income following reduced timetables and retail income at major stations due to extremely low footfall. Work volumes were also initially impacted by social distancing requirements until appropriate arrangements could be introduced to protect staff.

Financial framework

The railway network that we own and have a licence to operate is included in the accounts at a value that represents what a third-party purchaser would pay for it. The basis of this valuation is set out in a note to the accounts (page 150) and comes from an assessment of the cash flows that are forecast to arise from the asset. Cash flows arise from the asset as it amortises.

The starting point for this valuation is the regulatory asset base (RAB). Subject to certain criteria established by the Office of Rail and Road (ORR), each year capital expenditure is added to the RAB and amortisation is deducted.

Amortisation is used by the ORR to calculate the regulatory income requirement and used to calculate charges to customers or grants from governments. The increased level of RAB amortisation and lower investments are the key reasons that the valuation of the railway network decreased by £272m (2018/19: increase £2,632m). After taking into account the changes in valuation, depreciation, additions and disposals the year-end valuation of the railway network was £71,809m (2018/19: £71,467m)

In March 2020 the Core Valley Lines were transferred to Transport for Wales, at book value, for £470m. See Note 12 (page 151) for further details.

Borrowing

Since becoming a public sector body in September 2014, Network Rail has borrowed directly from Government and no longer issues debt on the capital markets. From this year, investments are funded by grant and fresh borrowing is used for refinancing maturing loans.

The regulatory settlement provides strong security for future income and the Department for Transport loan agreement provides a robust loan refinancing platform.

During the year ended 31 March 2020, Network Rail borrowed £11.6bn to refinance maturing borrowing. RPI-linked bonds increased in line with index. As a result, net debt rose from £54.1bn to £54.6bn. In the year Network Rail transferred the Core Valley Lines to Transport for Wales for £470m and reduced borrowing (and the size of its borrowing facility with DfT) accordingly.

New financing arrangements

Network Rail is not expected to undertake any new net borrowing during 2019-2024. Instead, its activities are largely funded by grants from the DfT, Transport Scotland and revenue from customers. Network Rail has a loan facility with the DfT for £31.9bn which will be used to refinance maturing government and external debt in the period 2019-2024.

The new loan facility between Network Rail and DfT was signed on 28 March 2019. On 1 April 2019, all borrowings under the previous (July 2014) facility agreement were transferred to the new facility agreement (with their existing interest rates and maturity dates) and the 2014 agreement was terminated. The 2019 facility is sized so that when the legacy bonds fall due for repayment, new money will be provided by borrowing under the 2019 facility (the first such borrowing was not required until June 2020).

The cash required to pay the interest due on borrowings (to DfT or to bondholders) is provided to Network Rail Infrastructure Limited (NRIL) through the financing costs grants.

Grant agreements with Department for Transport and Transport Scotland

Eight separate grants are in place between NRIL and DfT/Transport Scotland, replacing the two grants (England and Wales Network Grant and Scotland Network Grant) that operated throughout CP5. These grants are:

- With DfT: Network Grant; Enhancements Grant; British Transport Police Grant; Financing Costs Grant for DfT interest; Financing Costs Grant for external interest (bonds and swaps); and Corporation Tax Grant.
- With Transport Scotland: Network Grant and Enhancements Grant.

Risk management: Interest rates and currency

Network Rail manages its interest and foreign exchange risk by using derivative financial instruments (hedges). All these arrangements were entered into prior to Network Rail becoming an arm's length public body and will reduce over time as the external debt is retired.

The group measures its hedges for accounting purposes at their market value as required by international financial reporting standards. A market value is determined by comparing the original value of the hedges against the current market rate.

We do not intend to trade these hedges but use them to minimise our financial risks. If the hedges are economically

effective (i.e. they offset changes in the cost of existing and/or future loans), their value at any point in time should not be a key focus when assessing the group's performance.

By qualifying to use hedge accounting rules, we match gains or losses in the market value of hedges to fluctuations in the hedged item (i.e. the loans). The gains on debt and derivative valuations taken through the income statement were £213m (2018/19: £220m). This gain largely represents the reduction of the fair value of interest rate derivatives liabilities through interest paid on swaps (the latter is included in finance costs).

Pensions

Network Rail is party to two defined benefit pension schemes. Costs are shared with pension scheme members on a 60:40 basis. Pensions are measured differently for IFRS than for actuarial funding reports. IFRS is more conservative and discounts expected future liabilities to a present value, using 'risk-free' borrowing rate, and compares this with current asset valuation. Network Rail's accounting deficit at 31 March 2020 decreased to £2,070m (2018/2019: £2,566m) as losses on assets were more than offset by the decrease in inflation assumptions from 3.2 per cent to 2.5 per cent.

On a funding basis, the schemes have seen the value of their assets impacted by the global pandemic but are still substantially fully funded having absorbed the decline in asset values to date. Both the company and members continue to contribute to the schemes.

Post balance sheet events

Network Rail's financial stability benefits from: the certainty provided by the five-year funding settlement and the financial risk buffers therein; the loan facility with DfT and the grant agreements with both DfT and TS; and, from being an arms-length body of Her Majesty's Government.

The Coronavirus pandemic has significantly impacted rail revenues. The financial impact on Network Rail has been mitigated by the steps taken by the DfT and Transport Scotland to change train operator franchises to emergency management contracts. This secured the financial position of our key customers and we continue to be paid as normal. Network Rail immediately moved all its suppliers to immediate payment terms to improve their liquidity during this time of crisis and continues to work closely with our supply chain partners to support them.

Summary

Rail is an increasingly important part of our national infrastructure. More people have been using rail to travel between towns and cities, as the most efficient and environmentally sustainable option and we have been expanding services and investing to support this.

In the 2019/20 financial year, Network Rail delivered a broadly satisfactory outcome on its key financial targets, in particular in making a good start on the £3.5bn efficiency programme for the 2019-24 control period. There is still more we can do and we are extending this to our broader capital delivery programme.

While the Coronavirus pandemic has impacted some of our plans we remain committed to them and are working hard to recover or offset the financial impacts that this has brought.

The current global crisis means that we must be prepared to adapt and change to meet the new requirements of our customers, at a cost that they and the country can afford. There are big challenges ahead, but we are determined to deliver a better, more reliable and cost-effective railway with passengers and freight users at the heart of everything we do.

Jeremy Westlake,
chief financial officer

16 July 2020