CHIEF FINANCIAL OFFICER'S REVIEW 2020/21

This financial year was the second year of Network Rail's five-year spending plan, covering the period from 1 April 2019 – 31 March 2024.This review will look back over the last year where the pandemic reduced overall passenger levels by around two-thirds. The Government has supported our industry throughout the pandemic so that our direct customers, the passenger and freight operating companies, have continued to pay amounts owed to Network Rail as they fall due. In addition, Network Rail has been able to use the risk funds available in the five-year spending plan to mitigate increased Covid 19- related costs. As a result, there has been no material change to our delivery plan.

Network Rail has also been able to take actions to offset lower station retail income and additional Covid-19-related costs. As a result, we've made a profit this year that is broadly in line with our plans. Every penny of this profit is used to fund our railway investment programme.

We're ahead on our efficiency plans and have targeted a further £500m of savings to augment our original £3.5bn five-year efficiency programme. This will offset the headwinds caused by the pandemic. This year we delivered around £700m towards our updated £4bn target by reducing our activity-adjusted annual cost-base in operations, maintenance and renewals. This means that over £1bn of the £4bn target has been achieved in the first two years of this control period. This is reflected in our Financial Performance Measures (FPM).

This year saw unprecedented measures put in place to minimise the spread of the coronavirus. The response to the pandemic has changed the way of life for our passengers, suppliers and employees, impacting our operations, ways of working and project delivery. We've kept the infrastructure running and the businesses in our supply chain in a position to return to normal service levels as soon as it was advisable to do so. Keeping infrastructure running supported the economy and provided services for passengers and particularly key workers. We remain on a firm financial footing and the actions taken by the Department for Transport (DfT) and Transport Scotland (TS) to support services for passengers has secured the financial position of our key customers.

Key financial highlights

(The financial statements start on page 149)

- Profit before tax was £1.6bn (2019/20: £375m). The profit is used to fund our railway investment programme.
- Our funding mechanism ensures we receive income via grant to pay for renewals which also keeps our debt levels level. In previous control periods renewals were largely funded through further borrowing.
- Revenue increased from £8.1bn to £9.6bn. This was mainly to fund planned increases in maintenance and renewals. Decreases in retail income through the pandemic was offset by improved train performance, partially as a result of less congestion on the network.
- Operating costs increased from £5.8bn to £6.4bn largely due to planned increases in maintenance activity agreed as part of the five-year CP6 settlement, and additional costs as a result of the pandemic.
- Operating profit was £3.2bn, compared to £2.3bn last year.
- Investment was £5.9bn compared with £5.2bn last year due to an increase in infrastructure renewals in line with our business plans.
- Net debt increased slightly to £54.7bn from £54.6bn due to increases in the valuation of RPI-linked bonds.

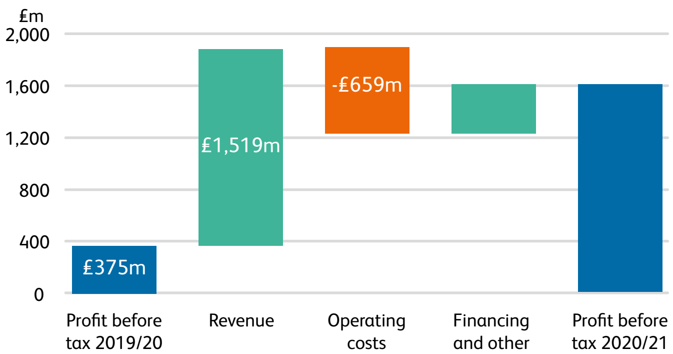
During the year we strengthened our five regions, which are providing stronger local leadership in our Putting Passengers First programme, allowing us to work more closely with our key stakeholders, drive improved performance, and be more cost-efficient and cost competitive.

Financial summary

This review will focus on financial performance in 2020/21.

This year we made a profit before tax of £1.6bn (2019/20: £375m). This improvement was mainly due to the changes in the five-year funding settlement which made allowance for additional renewals activity which we successfully delivered, together with much improved train performance. Set against this, variable track income and retail revenues at stations reduced by £0.2bn as a result of measures taken to curb the pandemic. Maintenance and operating costs showed net increases as new ways of working were put in place to increase Covid-19-security measures and renewals also saw cost increases. We sought to offset these effects by exercising restraint in wage settlements and in making decisions to significantly reduce the previous year's performance-related pay to offset the impact of the pandemic.

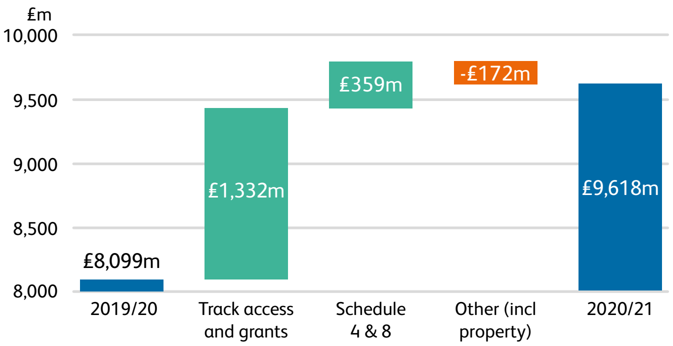
Profit movements since last year



Revenue

Revenue increased in the year to £9,618m (2019/20: £8,099m), an increase of £1,519m.

Revenue movements since last year



Track access and grants rose (£1,332m) in line with the ORR's determination of charges including amounts used to fund planned increases in operating costs and the £1bn increase in renewals delivery. For further details, see Grants recognition policy on page 156. Schedule 4 & 8 performance and access regime costs decreased in the year by £359m. Stronger train performance, a continuation of the previous year's trends, and as a result of less traffic offset the compensation for engineering works. Our Other Income decreased by £172m as a result of a 90 per cent decrease in retail income at stations through the pandemic.

Operating costs

Net operating costs this year were £6,436m. This increased by £659m from last year's expenditure of £5,777m, net of efficiencies.

The year on year movement was driven by: the net impact of Covid (£103m), asset management costs (including research and development) (£118m) and extra maintenance costs (£87m) due to a planned increase in maintenance activity agreed as part of the regulatory settlement.

Employee costs

Staff costs increased by £87m (3 %) largely due to increases to average employee numbers (5 %).

Tax

We have significant brought forward tax losses, not recognised as a tax asset in the accounts. As we continue to invest heavily in the railway network, we therefore pay relatively small amounts of corporation tax. The tax expense of £277m comprises corporation tax at £45m and deferred tax at £232m (2019/20: £395m). The deferred tax liability now stands at £3.4bn (2019/2020: £3.6bn).

Financing costs

Finance costs for the year were £1,741m. This is lower than last year's charge of £2,170m largely because of the impact of lower inflation on RPI-linked bonds and lower prevailing interest rates.

Investment

During 2014-2019 (Control Period 5 (CP5)) Network Rail delivered a major rail investment programme that is now translated into new services for our passengers, ready as Covid-related restrictions ease. This year we delivered £5.9bn of railway investment (2019/20: £5.2bn).

Enhancements that will increase the capacity of the network have amounted to £2.0bn (2019/20 £2.2bn). This included £1.3bn of DfT-funded schemes, £0.2bn funded by Transport Scotland and £0.6bn of other grant-funded projects. Major schemes included improvements on the Midland Mainline between London and Corby, Trans-Pennine improvements, East West Rail, HS2-related projects, East Coast Main Line improvements and in Scotland, improvements relating to the Inverness to Aberdeen and Edinburgh to Glasgow lines.

We have also invested £3.9bn (2019/20: £2.9bn) on renewals this year. This included £1.1bn of track renewals which delivered over 1,200km of new track and replaced over 850 switches and crossings. In addition £0.8bn was spent on signalling renewals, £0.8bn on structures (including around 63,000 square meters of bridges), £0.3bn on electrification assets, £0.3bn on buildings & property, including 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, we delivered 112 per cent of our seven key renewal volumes (2019/20: 133 per cent).

Financial performance measures and efficiency

Network Rail has two methods of measuring efficiencies. Our key performance indicator, the financial performance measure (FPM), which measures our performance against the regulatory determination and our in-year targets. This means our baselines for FPM already include the targeted efficiency savings for the control period.

Meanwhile Efficiency, as required to meet the £3.5bn plus £500m target, is measured against the like-for-like costs at the end of the previous control period.

The financial performance measure is impacted by headwinds. This year there has been a notable impact from Covid headwinds which have resulted in numerous extra costs to keep our staff and the travelling public safe along with the costs of cancelling and re-planning projects at short notice, especially at the start of the pandemic.

Efficiency reporting is focussed on the day-to-day costs of running the railway (opex, maintenance and renewals) whilst the financial performance measure assessment also includes turnover and enhancements.

We're constantly working to reduce the cost of the work that we deliver. We continue to make good progress in our commercial efficiencies, productivity and securing more efficient access to carry out work, and through leveraging new technologies.

Overall, FPM finished £163m behind our original plan (2019/20 £10m ahead of targets). This was due to underperformance in renewals by £258m and enhancements by £26m with profit and loss finishing £122m ahead of target.

Profit and loss FPM was ahead of target due to lower train delay costs as a result of reduced traffic were partially offset by reduced retail and variable track access income and increased maintenance and operating costs. The additional costs and lost income were primarily as a result of pandemic response.

Renewals underperformance of £258m on expenditure of £3.9bn was mainly due to introducing Covid-19-safe and socially distanced work practices in response to the pandemic. This was at a time when many other national infrastructure works had been put on hold entirely.

The underperformance in enhancements (£10m) is due to increased costs closing out CP5 projects and pandemic related changes in working practices to keep our people safe.

Looking at our five-year efficiency programme for operations, maintenance and renewals (OMR) we built on a good start in 2019/20, delivering a further £710m of benefits in the second year of the control period, adding to the £385m achieved in the previous year. So it has now cost more than £1bn less, on a like-for-like basis, to run the railway than the prevailing cost base in 2018/19.

The majority of these savings are expected to recur and thus 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. We have targeted £500m of additional savings in addition to our original £3.5bn five-year efficiency programme.

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. This valuation uses an income approach.

The basis of this valuation is set out in note 12 to the accounts 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 ORR, each year capital expenditure is added to the RAB and amortisation is deducted.

Amortisation is used by ORR to calculate the regulatory income requirement and our 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 £1,812m (2019/20: decrease £272m). After considering the changes in valuation, depreciation, additions and disposals the year-end valuation of the railway network was £71,998m (2019/20: £71,809m).

An alternative valuation method for the railway network, depreciated replacement cost (DRC) is used in DfT group accounts. Applying a DRC valuation to the Railway Network results in a higher carrying value than Network Rail's income-based valuation, as it reflects the replacement cost for the entire network. This includes significant elements funded before the RAB was introduced, such as earthworks, long-life structures, and operational land. Together, they comprise much of the value for DRC purposes and are essential to the operation of the railway network. This cost-based approach therefore measures the significant economic benefits of the entire network to Great Britain, which exceed the monetary returns receivable by the holder of the railway network licence.

That DRC approach is used in Network Rail's accounts solely to derive the weighted average asset life of the railway network.

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. Investments are funded by grant, and from cash generated from operations, and fresh borrowing is used for refinancing maturing loans.

The regulatory settlement for CP6 provides strong security for future income and the DfT loan agreement provides a robust loan refinancing platform.

During the year ended 31 March 2021, we borrowed £10.8bn using the DfT loan facility to refinance maturing borrowing with DfT (£9.8bn) and commercial bonds (£1bn). RPI-linked bonds increased in line with the RPI index. As a result, net debt rose from £54.6bn to £54.7bn.

Financing arrangements

We do not expect to undertake any new net borrowing during 2019-2024. Instead our activities are largely funded by grants from the Department for Transport, Transport Scotland, and revenue from customers. We have a loan facility with the Department for Transport for £31.9bn which will be used to refinance maturing government and external debt in the period 2019-2024.

The 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 in June 2020).

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

Grant agreements with Department for Transport and Transport Scotland

Eight separate grants are in place between NRIL and DfT/TS, 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 TS: network grant and enhancements grant.

Risk management: interest rates and currency

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

We measure our 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 don't 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 our 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 £176m (2019/20: £213m). 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. Our accounting deficit at 31 March 2021 increased to £2,899m (2019/20: £2,070m) as changes in financial assumptions were offset by gains on assets. On a funding basis, the schemes have seen the value of their assets increase in the year and they are still fully funded, meaning that the value of pensions assets is expected to grow to meet pension obligations as they fall due. Both Network Rail and members continue to contribute to the schemes.

Post balance sheet events

The change in corporation tax rates, to 25 % from 19 % (effective from April 2023), was substantively enacted in the Finance Bill 2021 after the balance sheet date. It is estimated that this will increase the deferred tax provision by £1.0bn and will be reflected in next year's accounts.

Summary

The world has changed significantly in the past year and we must adapt too.

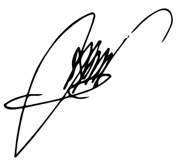
The Williams-Shapps plan for rail resulting from the Williams Rail Review was published in May 2021.The way the rail industry has responded to the pandemic shows what can be achieved when we work together as one industry. For example, the pace at which timetable changes have been implemented. This last year has seen Network Rail adapt to challenges and find solutions quickly, while focussing on putting passengers first and delivering value-for-money for taxpayers.

In the circumstances we delivered a broadly satisfactory outcome on our key financial targets and continued to make reasonable progress on our efficiency programme for the 2019-24 Control Period. Of course, that progress excludes the additional costs of the pandemic response and the lost income in the rail industry from lower passenger numbers. So, we recognise we need to focus on the efficiency programme further and have increased our 2019-2024 target from £3.5bn to £4bn of savings.

The next year will require continued ingenuity and focus from the committed, caring and hard-working people that make up the rail industry, whilst also focussing on cost efficiencies and delivering our plans to build back better.

Looking beyond the pandemic recovery period, rail will be an increasingly important part of our national infrastructure. It remains the most efficient and environmentally sustainable option both for passengers wishing to travel between towns and cities, and freight distribution.

The rail industry and we as a company are committed to providing the infrastructure for building a greener and lower carbon society that delivers a better, more reliable and cost-effective railway that continues to put passengers and freight users at the heart of everything we do.



Jeremy Westlake,
chief financial officer
15 July 2021