Chief financial officer’s review of 2017/18

Network Rail is about to enter the final year of its five-year funding period and plans for the subsequent five years are well advanced. To continue to deliver the infrastructure required for a vibrant and growing rail network, we will need to maintain the pace of delivery that we achieved in 2017/18 through 2018/19.

Together, the rail industry is investing to innovate and improve journeys right across the UK. Network Rail is spending £128m every single week on improvements for passengers through our Railway Upgrade Plan. As a result, by 2019 there will be an extra 170,000 seats into major cities across the country every day, with 6,400 extra train services and 5,500 new train carriages; a 30% increase in capacity. Journeys will be quicker, trains will run more frequently and there will be greater comfort on board. This growth provides challenge, not least in providing the growing infrastructure that Britain needs, in a manner that provides value to both the rail user and the taxpayer.

Our key projects for the year have included Crossrail, Thameslink, the Great North Rail Project, the Edinburgh Glasgow Improvement Programme, Great Western Electrification Programme, and the Waterloo and South West upgrade; we are now coming towards the end of these mega-projects with more frequent trains coming into service.

Our efficiencies have faced further challenge this year. The Office of Rail and Road (ORR) and Network Rail agreed ambitious targets at the start of the control period, which have been built into the determination of charges. Efficiencies have been made, but are often offset against cost pressures; including changes to improve workforce safety, challenges in our supply chain such as the collapse of Carillion and fewer opportunities to carry out works as the network becomes busier.

Network Rail needs to reduce costs and raise funds for the final year of our control period. One of the key recommendations of the Hendy Review in 2015 was to dispose of our non-core assets. The reason for this being to help bridge the funding gap for the Railway Upgrade Plan; assisted by additional government funding and generating additional efficiencies. Network Rail has continued to progress this disposal of certain property assets over the year. The anticipated sale of our commercial estate is critical to achieving our plans in 2018/19 and we anticipate that this will take place in the second half of the year.

Devolution continues across the business. This has continued to drive a route-led and customer-driven mindset, allowing us to work more closely with our key stakeholders and further drive improved performance. It has allowed us to be more commercial, and has opened us up to becoming more cost-efficient and competitive.

Finally, in February 2018 we finalised our CP6 Strategic Business Plan; which we believe supports a clear and realistic course for the business through the next 5-6 years.

Financial summary

This review will focus on the financial performance achieved by Network Rail in 2017/18. This year we made a small profit before tax of £48m (2016/17: £483m); every penny of which has been reinvested in delivering the Railway Upgrade Plan. Low and declining profitability is assumed in the CP5 regulatory settlement determination, with a further decrease anticipated next year, the final year of the regulatory control period. This is because income, largely fixed by the regulator, does not increase in line with borrowing costs and depreciation charges, which increase as a result of the accumulated cost of delivering the Railway Upgrade Plan.

Although revenue and operating costs before depreciation increased broadly in line with each other, increased depreciation and finance costs/other gains and losses from delivery of the CP5 investment programme reduced overall profitability to £48m (2017: £483m).
Revenue
Revenue rose in the year, as a company we achieved a turnover of £6,580m. This represents an increase of £321m (2016/17: £6,259m).

Track access and grants rose in line with the rail regulator’s determination of charges, augmented by an additional £21m recovered as a joint industry cost with regard to electricity for traction (EC4T).

Schedule 4 & 8 costs increased as the performance benchmarks tightened in the year. Asset performance was good, but performance in the year continued to be impacted by slower recovery times from incidents, a knock on effect of a more congested network. In addition discrete events such as the snow fall in February and March 2018 impacted the results. As a result, compensation paid to train operators increased by £52m.

Network Rail also generated an additional £19m of property and other revenue, an increase of around 6% with continued growth in income from retail at stations, commercial lettings and increased open access income.

Freight revenue maintained at £53m ending a trend of year-on-year declines as a result of lower volumes transported.

Operating costs
Net operating costs this year were £4,731m. This has increased by £468m from last year’s expenditure of £4,263m. This increase in expenditure is in part driven by extra investment that has increased depreciation by £124m. Operating costs before depreciation rose by £355m from £2,836m to £3,191m.

This is driven by: non-cash increases in pension liabilities (£121m); Joint Industry Cost increases including cumulo (business) rates at £54m and EC4T £21m (recovered through track access charges); additional headcount (£53m) primarily to enable the delivery of maintenance including new electrification assets; additional costs arising from legislation and legal interpretation such as the apprenticeship levy (£10m) and holiday pay rulings (£21m); and by cost inflation (£75m).

Employee costs
Staff costs increased by £259m largely as a result of an increase in pension costs (£121m), an increase in the average number of employees in the year (£53m), the recent rulings on holiday pay (£21m), and the apprenticeship levy (£10m).

Average headcount for the year was 39,370. This is an increase from 2016/17, when the headcount average for the year totalled 38,529. This was due to recruitment in Route Services to fill maintenance vacancies and reduce overtime costs, and to support new electrification assets; and in Infrastructure Projects to deliver record levels of enhancements.

Financing costs
Finance costs for the year were £2,233m. This is an increase from last year’s charge of £1,692m.

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 rail network, it therefore pays relatively small amounts of corporation tax. The tax credit for 2017/18 is £27m. Our deferred tax liability has increased to £2.5bn (2016/17: £2.4bn).

Investment in the rail network
The Railway Upgrade Plan continues to transform the rail network. We have over 15,000 live projects, some of the largest and most complex in the world. These mega-projects include Crossrail, Thameslink, Great Western Electrification and the Edinburgh Glasgow Improvement Programme. Network Rail is delivering nearly a quarter of the entire spend on infrastructure in the UK.
Chief financial officer’s review continued

In order to deliver this level of investment we rely on a strong supply chain. Network Rail has a long-standing commitment to engage positively and collaboratively with its supply chain including a fair payment charter.

During the year the collapse of Carillion, one of our major suppliers, represented a major challenge. By working proactively with Carillion’s administrators we were able to make sure that Carillion’s subcontractors continued to be paid for works delivered on our projects. Furthermore by working with our supply chain we have been able to keep those projects that Carillion was delivering broadly on track.

In the year we continued to deliver historically high levels of investment at £6.6bn in the network (2016/17: £6.8bn).

Enhancements that will increase the capacity of the network have amounted to £4.1bn. This is a record year in terms of delivery; beating last year’s delivery that was valued at £3.9bn.

We have also invested £2.4bn on renewals this year.

In the year, Network Rail hit 100% of its seven key renewal volumes (2016/17: 94.6%), 81% of its delivery plan & enhancement milestones (2016/17: 73%) and seven of its top ten renewals and enhancements milestones (2016/17: eight out of 10).

Financial Performance Measure and Efficiencies Drive Network Rail’s key performance indicator with regard to efficiency is its financial performance measure which measures our performance against the regulatory determination and against our in year targets.

Network Rail is constantly working to reduce the cost of all the vital work that we deliver. We continue to make good progress in our commercial efficiencies and will also seek further efficiency through the leverage of new technologies. Network Rail has suffered through Schedule 8 outflows due to performance issues, an increase in incursions onto the railway and adverse weather during the current year which has meant we have had to mitigate this increase in costs through savings found elsewhere, principally in the reduction of central costs.

In the year we missed targets for turnover by £87m and renewals by £55m. We bettered targets for operating costs by £20m and enhancements by £4m.

Turnover was impacted by worse than targeted train performance from infrastructure failures across a number of routes, exacerbated by severe weather, notably the disruptive snow in February and March.

Renewals performance was impacted by higher electrification costs than targeted, including the cost of implementing the Supervisory Control and Data Acquisition (SCADA) Remote Control System, a scheme that improves our asset stewardship capabilities, and in turn drives more efficient performance in the future, and also additional civils costs. Although performance is worse than targeted, there is a marked improvement on the previous year’s comparatives and some routes (such as Scotland and South East) have been able to deliver outperformance on their portfolio.

Operating costs benefitted from efficiencies made in central costs following devolution and from a real push by our people to make those marginal gains that drive a leaner organisation. Training in lean techniques continued throughout the year and provided a series of benefits from local teams.

Savings on the Rolling Programme of Electrification and Thameslink enabled enhancements to better target.

The CP5 determination of charges frames the funding agreement with Government for CP5, and included very challenging cost reduction assumptions. These were influenced by extrapolations of historic delivery (40% reduction in the previous 10 years which, given the growth in traffic over the period, equated to halving the operating costs per train mile) and influenced by the industry wide efficiency potential suggested by the McNulty report.

Last year we explained that Network Rail needed to reduce costs and raise funds by a cumulative total of £2.3bn in the final two years of the control period in order to remain compliant to the loan limit and we are still on course to do so. We have delivered £1.3bn of the total in the current year and £1.0bn next year, through a combination of asset sales and continued business improvement and efficiencies.

Financial framework The rail 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 underpins our financial framework.

The basis of this valuation is set out in a note to the accounts and comes from an assessment of the cash flows that are forecast to arise from the asset. 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. The ORR can make deductions from the RAB in the event that we do not achieve our required outputs; for example not meeting required train performance, breaching a licence condition, or where the ORR wishes to make a retrospective funding adjustment.

As the valuation of the rail network is based on projected cash flows, we have considered the potential for underperformance in CP5; both in terms of the financial settlement and the required outputs. This therefore reflects the gap between the trajectory of costs assumed in the CP5 determination and our forecasts.

As a result, the valuation of the rail network was increased by £675m (2016/17: decrease £1,075m). This is because we forecast to spend more per activity than the settlement allowed.

Borrowing

Since becoming a public sector body in September 2014, Network Rail borrows directly from government and no longer issues debt on the capital markets. This applies to both the borrowing required for new investment and refinancing of existing debt.
Chief financial officer’s review continued

The regulatory settlement provides strong security for future income and the Department for Transport (DFT) loan agreement provides a robust platform to refinance and borrow to invest in the rail network. Network Rail is in line to live within the funding envelope established at the time of agreeing the DFT loan facility.

During the year ended 31 March 2018, Network Rail borrowed £6.7bn from the DFT. Part of this new debt was used to pay back existing bonds, whilst the remainder was used to invest in the railway infrastructure. As a result net debt rose from £46.3bn to £51.3bn. See page 118 for movement in net borrowing.

Network Rail plans to borrow significantly over the final year of the control period to finance the investment programme. We plan to draw down a further £6.4bn from the agreed DFT loan facility to finance and to refinance maturing debt.

In addition to the DFT loan facility, Network Rail has plans to sell certain assets, increase efficiencies, and find other ways to attract commercial partners in order to deliver more capital investment that will help increase the capacity of the rail network.

Looking forward to Control Period 6 (2019-2024) Network Rail and the DFT have agreed that future funding will not require additional borrowing from government, but will be made available by grants.

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 prior to Network Rail becoming a public body and will over time reduce in significance, as we expect to have no requirement to enter into new hedging programmes in the future.

The group measures its hedges for accounting purposes at their market value as required by International Financial Reporting Standards (IFRS). 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. As long as 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 £234m (2016/17: loss of £211m). 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). In addition, £29m (2016/17: loss of £116m) of gains in the value of interest rate swaps, used to control the cost of future borrowings was posted to the hedge reserve as statistically effective cash flow hedges.

Pensions

Network Rail is party to two shared-cost 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 discounts expected future liabilities to a present value, using ‘risk-free’ borrowing rate, and compares with current asset valuation.

Network Rail’s accounting deficit at 31 March 2018 remained at £2,311m (2017: £2,311m) as gains on assets matched the decrease in discount rate from 2.5 % to 2.4 %.

On a funding basis the schemes are not considered to be in a significantly different position than at last year end. Assets held by the schemes increased by £226m in the year and the latest actuarial valuation indicates the schemes are more than 100 % funded.

Post balance sheet events

Except as disclosed above, there have not been any significant post balance sheet events, whether adjusting or non-adjusting.

Summary

Network Rail has continued to deliver another huge part of the Railway Upgrade Plan; delivering the highest level of enhancements to the rail network it has ever recorded. These enhancements are designed to improve performance and increase network capacity to assist in meeting the increasing demand for rail travel. To maintain this momentum in the investment programme, Network Rail plans to continue additional funding through the sale of non-core assets and continues to look for additional funding from third parties and internally by delivering further cost efficiencies.

In 2018/19 alongside the delivery of the Railway Upgrade Plan and the final year of CP5, stands the challenge, shared with our industry partners, of managing the implementation of the new capacity we have developed. By 2019 there will be an extra 170,000 seats into major cities across the country every day, with 6,400 extra train services and 5,500 new train carriages; a 30% increase in capacity. Whilst this presents rail industry-wide challenges to implement, once in place this will be transformational for our customers both now and into the future.

Our CP6 plans are now finalised; a bottom-up plan, highlighting how Network Rail will efficiently spend the funds the government has committed. It is arguably our best plan ever created.

All of which will assist the rail network to drive better connectivity, a precursor to economic growth and build a better railway for a better Britain.

Jeremy Westlake, chief financial officer

27 June 2018