



Office of Rail Regulation (ORR)
One Kemble St
London
WC2B 4AN

Attention: Carl Hetherington

Our ref: BT/abh

10 June 2013

Dear Sirs,

Audit of CP5 Regulatory Review Model

In accordance with the terms of our agreed proposal of 10 January 2013 setting out our scope of work, we have carried out an independent review of ORR's CP5 Regulatory Review Model ('the Model'). We understand that the Model has been designed to calculate the net revenue requirement for Network Rail over the forecast period to assist the CP5 Determination.

Our work is subject to the assumptions and comments, which we have summarised in Appendix A, and subject to the representations and responses from ORR in respect of our Base Case Findings Reports upon which we have relied. As a result of our review, we confirm that in our opinion, the Model version 'PR13 financial model - draft determination iteration 3a - May 2013_1.xls' (as received on 29 May 2013):

- Is logically constructed, internally consistent and the formulae, algorithms and calculations are materially accurate;
- Is consistent, in all material respects, with the relevant extracts of the Model's User Guide, as provided to us (as listed in Appendix B);
- Functions, in all material respects, in accordance with ORR's policies and policy options, as set out in the documentation as listed in Appendix B and calculates regulatory revenues consistent therewith; and
- Contains the functionality to reflect alternative scenarios through the switches listed in Appendix C.

Our work was limited to the matters set out above and accordingly did not include, for the avoidance of doubt, any form of review of the commercial merits, technical feasibility, or the factual accuracy of the input data; a review of the Model's consistency with UK Generally Accepted Accounting Principles

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or International Financial Reporting Standards; a review of the Model's consistency with current corporate UK tax standards and legislation.

All comments and opinions above are given solely in respect of the Model version 'PR13 financial model - draft determination iteration 3a - May 2013_1.xls' (as received on 29 May 2013) and cease to be valid if there are subsequent changes to the Model.

This letter has been prepared for the information and benefit of the addressees subject to their agreement to the terms and conditions of our engagement and the aggregate limitation of liability set out therein and no other party may place reliance on any matters contained herein.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'BDO LLP'.

For and on behalf of BDO LLP

Appendices:

- A Assumptions and Comments on the Model**
- B Policy Documentation**
- C Alternative Scenarios**

APPENDIX A

ASSUMPTIONS AND COMMENTS ON THE MODEL

Background and Model Assumptions

- 1.1 We understand that ORR, as the independent safety and economic regulator of Britain's railways, determines a regulatory settlement for Network Rail every 5 years (a Control Period) in respect of the forecast revenue requirement and operating, maintenance, renewals and enhancement expenditure, including interest costs, financial indemnity costs and tax.
- 1.2 To support the next regulatory settlement, CP5, which will run from 2014/15 to 2018/19, ORR has developed the Model to forecast Network Rail's revenue requirement and financial position for CP5 to CP11 which covers the period from 2014/15 to 2048/49. The Model is based on the set of inputs and assumptions of revenues and costs including Government grants and FIM fee, ORR's policies and other policy options, to produce Network Rail's ('NR') revenue requirement for CP5.
- 1.3 It should be noted that the Model contains a number of hard coded opening balances for CP5. In accordance with our agreed scope of work we have not reviewed any documentation to support the opening CP5 position, and have accepted such inputs as given.
- 1.4 The Model is designed foremost as a regulatory evaluation tool to measure financial performance under regulatory assumptions. It is not designed as an operational model and thus, while it could be adapted to reflect actual performance by replacing forecasts with actuals, it will not readily allow comparisons of actuals against forecasts.
- 1.5 The Model is calculated in real terms, and additionally there are a number of replicated sections which have been included in nominal terms. Inflation is applied based on 2012/13 inflation rates. The cumulative figures are calculated based on a hard coded inflation profile of 3% per annum in 2013/14, and 2.75% per annum thereafter. It should be noted that, in accordance with our scope of work, we have not agreed these indexation assumptions to any supporting documentation and we have accepted these assumptions as given.

Findings and Comments on the Model

- 1.6 Below are the key comments arising from our review of the Model, excluding those matters which have been resolved with ORR.
- 1.7 The Model has the functionality to apply a revenue smoothing adjustment to smooth the real net revenue requirement across the relevant control period. However we note that the sum of the real revenue smoothing adjustments across each control period does not sum to zero. Although the revenue smoothing adjustment is not currently applied in the Model, when it is, the sum of the revenue smoothing adjustments for each control period is less than 1% of the net revenue requirement for the corresponding period. Users of the Model should be aware of the Model's treatment when the revenue smoothing adjustment is applied.
- 1.8 The Model performs a number of checks throughout the input sheets. However the Model does not summarise these checks in a single location and therefore any errors in these checks are not easily identifiable. We have suggested that ORR may wish to consider, as a future Model development, summarising the checks in a single location and creating a global check to



highlight any potential errors in the Model in order to improve the robustness of the Model. We understand that ORR is considering how best to refine and simplify the Model for future use.

- 1.9 It should be noted that the Model does not include a mechanism to stop the level of debt reducing to below zero. Whilst this does not impact the base case, this may need to be reflected when the Model is switched to alternative scenarios. Should a negative debt position arise this may correspondingly impact the interest cover ratio and interest payable. We understand that ORR may update the Model in this regard prior to final determination.
- 1.10 The User Guide contains a number of sections which are not consistent with the Model and which we understand will be updated including the switch settings in the final determination and the comments regarding the indexation of the two tranches of Non-Guaranteed Debt. We understand from ORR that the User Guide will be updated in due course to reflect the finalised policies, prior to ORR publishing its final determination.



APPENDIX B

POLICY DOCUMENTATION

ORR Policy - PR13 Financial issues for Network Rail in CP5: decisions

- Version 'pr13-financial-issues-decisions-dec12.pdf' as published by ORR in December 2012

User Guide

- Version 'Financial_Model_User_Guide_EDIT_2012_01_21_clean.doc' as received on 25 January 2013

APPENDIX C

ALTERNATIVE SCENARIOS

Switch no.	Switch Name	Switch Options
1	Regional Input Scenario	GB, E&W, SCO, Anglia, Kent, LNE, East Mid, Sussex, Wessex, Western, Wales, LNW
2	Expenditure Scenario	Plan, High, Spot, Low
3	Enhancements	Base Case, Include additional enhancements
4	Annual / semi-annual rates	Semi-annual, Annual
5	Funding approach in CP5	PR08 approach, Adjusted WACC approach, Target AICR
6	Funding approach post-CP5	PR08 approach, Adjusted WACC approach, Target AICR
7	Adjusted WACC option	No risk buffer or accretion, Include risk buffer, Include risk buffer and accretion
8	Amortisation	Steady state renewals, Include enhancements, Actual renewals
9	Capex in AICR	Renewals, Amortisation
10	Indexation in AICR	Include Indexation, Exclude Indexation
11	Revenue smoothing	On, Off
12	Deferred revenue expenditure	Approximation, Amortised
13	Treatment of tax double count	Reduce tax allowance, Reduce RAB
14	FIM fee for unsupported debt	Yes, No

Additional Options	Switch Options
Use of Risk Buffer	Pay Down Debt, Rebate, PAYG Capex
Use of Ring-Fenced Fund	Pay Down Debt, Rebate, PAYG Capex