



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

Attention: Carl Hetherington

Our ref: BT/sd

30 October 2013

Dear Sirs,

Audit of CP5 Regulatory Review Model

In accordance with the terms of our agreed proposal of 9 August 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 opinion 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 FD model - final iteration - 25 10 2013 - sent to BDO.xls' (as saved at 16:46 on 25 October 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 FD model - final iteration - 25 10 2013 - sent to BDO.xls' (as saved at 16:46 on 25 October 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 3.1% per annum in 2013/14, 2.9% in 2014/15 and 2015/16, 3% in 2016/17, 3.4% in 2017/18, 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 them 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 applied, 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 all of these checks in a single location (although the majority of checks are captured in one summary sheet) and therefore any errors in the checks that are not included in

the summary sheet are not easily identifiable. User of the Model should be aware of these checks, and should ensure that all input checks are “OK” when they switch the Model between different scenarios

- 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 note that this treatment does not affect the treatment in the base case position of the Model.
- 1.10 Further to the above, we note that the Model contains embedded and flexible debt. The Model includes embedded debt repayment assumptions for CP5 only. As a result, when running certain alternative scenarios the Model, for years after CP5, may forecast outstanding embedded debt, and a negative balance on the flexible debt. We note that this treatment does not affect the treatment in the base case Model.
- 1.11 It should be noted that whilst the Model has the functionality to calculate Network Rail’s revenue requirement and financial position after CP5, the Model has not been fully populated with data to run such scenarios, with the regional inputs being populated for CP5 only. Similarly the Model includes functionality to include ‘high’ and ‘low’ input information, however, such inputs have not been populated with data, and therefore activating the ‘high’ and ‘low’ switches does not give a meaningful output. For the avoidance of doubt our review has focused on the Determination position highlighted within the user guide.

APPENDIX B

POLICY DOCUMENTATION

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

- Version '<http://www.rail-reg.gov.uk/pr13/PDF/pr13-draft-determination.pdf>' as published by ORR in June 2013, Sections 12, 13 and 14

User Guide

- Version 'Financial_Model_User_Guide_EDIT_2012_01_21_clean.doc' as received on 24 October 2013

APPENDIX C

ALTERNATIVE SCENARIOS

Switch name	Setting in final determination	Switch Options
Regional Input Scenario	All used for producing final determination	GB; E&W; SCO; Anglia; Kent; LNE; LNW; East Mid; Sussex; Wessex; Western; Wales
Expenditure Scenario Switch	Spot	Spot; Plan; High; Low
Enhancements choice	Include additional enhancements	Base case; Include additional enhancements
Annual / semi-annual rates	Semi-annual	Semi-annual; annual
Funding approach in CP5	Adjusted WACC approach	PR08 approach; Adjusted WACC approach; Target AICR
Funding approach post-CP5	Adjusted WACC approach	PR08 approach; Adjusted WACC approach; Target AICR
Adjusted WACC option	No risk buffer or accretion	No risk buffer or accretion; Include risk buffer; Include risk buffer and accretion
Amortisation	1.1 Steady state + sustainability adjustments	Steady state renewals; Actual renewals; Steady state + sustainability adjustments
CAPEX in AICR	Amortisation	Renewals; Amortisation
Indexation in AICR	Exclude indexation	Include indexation; Exclude indexation
Revenue Smoothing	Off	Off; On
Deferred revenue expenditure	Amortised	Amortised ; Approximation
Treatment of tax double count	Reduce tax allowance	Reduce tax allowance; Reduce RAB
FIM fee for unsupported debt	No	Yes; No
Calculation of network grant	Market body test and investment test	Investment test only; Market body test and investment test
Market body test	Excluding financing costs	Including financing costs; Excluding financing costs