

Consultation

NESO Financial Handbook

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We are consulting on the principles and methodologies we will apply for the implementation and operation of the National Energy System Operator (NESO) Financial Handbook and Financial Model. We would like views from people with an interest in the regulation of the NESO. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Contents

NESO Financial Handbook	1
1. Introduction	5
Ofgem’s responsibilities	5
Context and related publications	5
What are we consulting on	6
How to respond	7
2. NESO Financial Model	9
Introduction and purpose	9
The NESO Financial Model	9
Principles.....	10
Price Base	11
Changing the NESO Financial Model	11
Error in the functionality of the NESO Financial Model	11
Availability and updating of the NESO Financial Model.....	12
Calculation of Allowed Revenue	12
Process	13
The NESO Financial Model Working Group.....	15
Terms of reference	15
The Annual Iteration Process (AIP)	16
Submission of NESO Financial Model	17
Dry Runs process	18
Final Run.....	19
3. Financial Model Variable Values	21
NESO Financial Model Variable Values	21
4. Closeout Methodology	23
Introduction and purpose	23
Methodology	25
Overarching methodology for calculating LEG_t	26
Updates to LEG_t value	29
Approach to estimating relevant values	29
5. Price Indexation Methodologies	30
Introduction and Purpose	30
Methodology	31
Network Innovation Allowance (NIA) Expenditure	33
System Owner-Transmission Owner (SO-TO) Commercial Threshold	33
Time Value of Money (TVoM)	34
Recovery of net interest costs.....	34
6. Return (RTN) Calculation	35
Methodology for Calculating DPN_t	37
Methodology for Calculating RAV_t	38

Consultation - NESO Financial Handbook

7. Tax	39
Introduction and purpose	39
Methodology for Calculating TAX _t	39
8. Defined Benefit Pensions	44
Introduction and purpose	44
Methodology	44
General provisions post separation	46
Appendices	48
Index.....	48
Appendix 1 – Privacy notice on consultations	49
Appendix 2 – Consultation questions	51

1. Introduction

Ofgem's responsibilities

- 1.1 Ofgem is Great Britain's independent energy regulator. We work to protect energy consumers, especially vulnerable people, by ensuring they are treated fairly and benefit from a cleaner, greener environment.
- 1.2 We operate in a statutory framework set by Parliament. This establishes our duties and gives us powers to achieve our objectives. We are governed by the Gas and Electricity Markets Authority ('GEMA'), which determines Ofgem's strategy, sets policy priorities and makes decisions on a wide range of regulatory matters.
- 1.3 Our principal duty is to protect the interests of existing and future gas and electricity consumers.
- 1.4 Over the past year there have been important changes that affect our remit. Wider responsibilities are set out in the Energy Act (2023), including in relation to National Energy System Operator (NESO), which has previously been referred to as the Future System Operator¹.

Context and related publications

- 1.5 In March 2024, the Department for Energy Security and Net Zero (DESNZ) and Ofgem jointly published the statutory consultation on NESO licences and other impacted licences².
- 1.6 On 29 August 2024, DESNZ and Ofgem jointly published the response document that set out the joint considerations of the stakeholder responses received to the consultation above³.
- 1.7 A final decision on the granting of licences and making the modifications to impacted licences is to be taken by the Secretary of State (SoS) in sequence with a wider set of decisions to establish NESO.

¹ [ESO announces the name of the forthcoming Future System Operator | ESO](#)

² [National Energy System Operator \(NESO\) licences and other impacted licences: statutory consultation | Ofgem](#)

³ [Response to statutory consultation on National Energy System Operator licences and other impacted licences | Ofgem](#)

Consultation - NESO Financial Handbook

- 1.8 DESNZ and Ofgem are aiming to establish NESO this year. For the purposes of drafting, the date of this transition (i.e. change in ownership and move to a new regime) is referred to as 'Day 1'.
- 1.9 The response document referred to at paragraph 1.6 above also provided the complete proposed NESO licence conditions from 'Day 1' (the date of handover between the two regimes), including those relevant to the financial framework for NESO.
- 1.10 Licence Condition F5 (Financial Model and Handbook) in the proposed Electricity System Operator (ESO) Licence Conditions⁴ and Condition F4 (Financial Model and Handbook) in the proposed Gas System Planner Licence Conditions⁵ establish the NESO Financial Handbook and set out the requirements on NESO in relation to the Financial Model.
- 1.11 In any case of conflict of meaning between these documents, the following order of precedence applies:
- The relevant licence condition(s);
 - NESO Financial Handbook (this handbook);
 - NESO Financial Model Guidance (as defined below in this handbook);and
 - NESO Financial Model.

What are we consulting on

- 1.12 This is our consultation on the principles and methodologies that will underpin the NESO Financial Handbook and will apply in the implementation and operation of the NESO Financial Model.
- 1.13 The details are referred to in the remainder of this document, which is structured as follows:
- Section 2 provides an overview of the NESO Financial Model;
 - Section 3 lists the Variable Values used in the NESO Financial Model; and
 - subsequent sections provide details of how certain NESO Financial Model Variable Values are revised or calculated (along with further details on the NESO Financial Model).

⁴ [ESO Licence Direction and Terms and Conditions Unsigned.pdf \(ofgem.gov.uk\)](#)

⁵ [GSP Licence Terms and Conditions unsigned and subject to SoS decision](#)

How to respond

- 1.14 We want to hear from anyone interested in this consultation. Please send your response to RegFinance@ofgem.gov.uk.
- 1.15 We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.
- 1.16 We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, your data and confidentiality

- 1.17 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.
- 1.18 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.
- 1.19 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 1.
- 1.20 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

How to track the progress of the consultation

- 1.21 You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Choose the notify me button and enter your email address into the pop-up window and submit. [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations)

Notify me +

Would you like to be kept up to date with *Consultation name will appear here*? subscribe to notifications:

Email*

Submit >

- 1.22 Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:
- Upcoming** > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

2. NESO Financial Model

Consultation Questions

- 1a.** Do stakeholders agree with our proposals regarding the NESO Financial Model?
- 1b.** Do stakeholders wish to propose any other alternatives that we have not proposed? If so, please provide evidence for us to consider further?

Introduction and purpose

- 2.1 The NESO Financial Model implements the principles and calculations set out in this NESO Financial Handbook. This indicates the revenues to be recovered from consumers and how that changes following the proposed change of ownership from National Grid Group to HM Government and transition to a new regulatory regime. Ofgem will retain ownership of the NESO Financial Handbook and approve updates to the NESO Financial Model and Legacy Closeout Model, whilst NESO will own and publish those two models. The annual process of updating those models is described further in this section.

The NESO Financial Model

- 2.2 For each Regulatory Year, the NESO Financial Model provides for the calculation of the components (set out in 2.4 below) of ESO Allowed Revenue ($ESOAR_t$) and Gas Revenue Provision ($ARGSP_t$) terms in accordance with Licence Conditions F4 of the proposed Gas System Planner Licence and F5 of the proposed ESO Licence (Financial Model and Handbook).
- 2.3 The NESO Financial Model contains both fixed values and a Variable Values table input area for the licensee. The NESO Allowed Revenue figure for the licensee for each Regulatory Year is calculated using the fixed values, the Variable Values, and the formulae and functions embedded in the NESO Financial Model.
- 2.4 The Allowed Revenue is calculated by the NESO Financial Model, using NESO Financial Model Variable Values and is updated by the licensee in accordance with the relevant licence condition, the NESO Financial Handbook, and the NESO

Consultation - NESO Financial Handbook

Financial Model Guidance⁶. The NESO Allowed Revenue figure calculated by the NESO Financial Model consists of four parts – Internal Expenditure (INT_t), External Expenditure (EXT_t) and Return (RTN_t) for the Electricity System Operator Licence with an additional term for the Gas System Planner Licence ($ARGSP_t$). For the Electricity System Operator Licence, Internal Expenditure and Return are used in tariff setting and so are populated using forecasts to give a value for future years. External Expenditure (EXT_t) is not used for tariff setting and is only populated in the model when a year is complete with no element of forecast.

Principles

- 2.5 The closeout methodology is guided by principles agreed in relation to the transition to the new proposed NESO regime.
- 2.6 Key principles include the following aspects:
- NESO will operate under a not-for-profit regulatory model, with an objective of 'cash neutrality'.
 - The consumer is not intended to be unduly disadvantaged as a result of the transition to the new NESO regime.
 - NESO will be entirely funded by consumers, with all money to be recovered through 'fast money' approach in-year.
 - The financial regulation of NESO will be on an 'actual basis', rather than the current 'notional approach' used for ESO.
 - The approach adopted should be proportionate and recognise the value of simplicity in developing policy, where not otherwise defined in the licences.
 - External Revenue will be set in the same way as required by the Connection and Use of System Code (CUSC), using the same timeline as RIIO-2 ESO, in line with the principles outlined above.
- 2.7 There are occasions where there will be tension between these individual principles. Where this is the case, Ofgem has sought to achieve a suitable balance that best delivers against the overall objectives and we are interested in the views of stakeholders on this balance.

⁶ The Authority will aim to prepare the NESO Financial Model Guidance document in the future. The purpose of the NESO Financial Model Guidance document will be to provide further clarity on certain Variable Value inputs to the NESO Financial Model as necessary alongside any other guidance as required.

Price Base

2.8 The NESO Financial Model primarily operates on a nominal price basis, with some exceptions still reflecting a 2018/19 price base. See Chapter 5 (Price Indexation Methodologies) for further details.

Changing the NESO Financial Model

2.9 The licensee will issue and amend the NESO Financial Model.

2.10 The licensee will publish the NESO Financial Model on the licensee's website.

2.11 Before issuing or amending the NESO Financial Model, the licensee will publish on the licensee's website:

- the text of the proposed or amended NESO Financial Model;
- the date on which the licensee intends the NESO Financial Model or amended NESO Financial Model to come into effect; and
- a period during which representations may be made on the content of the NESO Financial Model, which must be at least 14 days or as agreed with the Authority.

2.12 After issuing or amending the NESO Financial Model, the licensee must:

- publish the NESO Financial Model on the licensee's website; and
- ensure that any amendments to the NESO Financial Model are promptly incorporated into a consolidated version maintained on the licensee's website.
- The steps required to issue or amend the NESO Financial Model may be satisfied by action taken before, as well as by action taken after, the relevant licences comes into effect.

2.13 The Authority may direct changes it deems necessary to the NESO Financial Model following the same modification procedure outlined in this section.

Error in the functionality of the NESO Financial Model

2.14 If an error of functionality is discovered in the NESO Financial Model, the issue will be considered at the earliest opportunity and a corrective modification will be proposed by Ofgem or the licensee.

Consultation - NESO Financial Handbook

- 2.15 The procedure specified in the NESO Financial Handbook for modifications to the NESO Financial Model will be followed.

Availability and updating of the NESO Financial Model

- 2.16 The licensee must maintain on the licensee's website an up to date copy of the NESO Financial Model for Regulatory Years commencing on or after Day 1.
- 2.17 The licensee must ensure that any modifications of the NESO Financial Model, are promptly incorporated into consolidated versions maintained on the licensee's website.

Calculation of Allowed Revenue

- 2.18 In determining the value of each relevant component (as set out in 2.4 above) of NESO Allowed Revenue, the licensee must use the latest version of the NESO Financial Model published on the licensee's website.
- 2.19 The licensee must update the Financial Model Variable Values table at least annually, in accordance with the NESO Financial Model Guidance.
- 2.20 The licensee must not make any other modifications to the NESO Financial Model beyond the completion or updating of the Variable Values and updating the "Inputs" tab of the NESO Financial Model.
- 2.21 Where a Variable Value is not known at the time of calculating Allowed Revenue, the licensee must determine that value in accordance with the NESO Financial Handbook or the NESO Financial Model Guidance as applicable, and otherwise provide its best estimate using the information available to it at the time.
- 2.22 The licensee must, if it is uncertain of the correct way to calculate a Variable Value, seek advice from Ofgem.
- 2.23 Where any Variable Value relies on a third-party publication that ceases to be published or no longer contains the value or data required for that value, Ofgem will consult on an alternative approach. If the consultation is not completed in time to determine a revised value for the publication of the NESO Financial Model on the licensee's website, Ofgem will agree an interim approach with the licensee (e.g. using the value from the most recently available publication or an alternate input agreed to by Ofgem) to ensure a timely NESO Financial Model publication.

Consultation - NESO Financial Handbook

Any such interim approach for a given Regulatory Year will be revised in the subsequent Regulatory Year.

2.24 No less than 14 days prior to the publication of the NESO Financial Model on the licensee's website the licensee must provide the Authority with:

- a copy of the NESO Financial Model which the licensee intends to publish on its website; and
- a commentary describing any changes since the last submission of the NESO Financial Model to the Authority.

2.25 In the event that the Authority requires the licensee to change the NESO Financial Model following the provision of the NESO Financial Model to the Authority in accordance with paragraph 2.24, the licensee shall not be required to provide the Authority with a further copy with a 14-day notice period.

2.26 The licensee must use the following file naming convention:

NESO FM YYYYMMDD

where:

YYYYMMDD means the year, month, and day the NESO Financial Model was published.

2.27 The NESO Financial Model will be used for the purpose of determining the value of each relevant component (as set out in 2.4 above) of Allowed Revenue on an ongoing basis until otherwise specified by the Authority.

Process

2.28 We discuss how the NESO Financial Model and NESO Financial Handbook will be maintained and updated below, including relevant responsibilities and processes.

Development

2.29 Ofgem will develop the relevant NESO Financial Model and the Legacy Closeout Model and publish initial templates for both models.

Ownership

2.30 Ofgem will retain ownership of the NESO Financial Handbook. Ofgem will consult on changes to the Handbook and this will be published on Ofgem's website. NESO

Consultation - NESO Financial Handbook

may propose changes to the NESO Financial Handbook to Ofgem, though do not have direct responsibility or powers to change the Financial Handbook.

- 2.31 NESO will be the owners of the NESO Financial Model and Legacy Closeout Model. NESO will have the ability to amend the models themselves using the modification process outlined in the section titled "Changing the NESO Financial Model". Ofgem retains the ability to directly amend both models where considered necessary using the modification process outlined in the section titled "Changing the NESO Financial Model".

Timelines

The process for 2024

- 2.32 For the avoidance of doubt, where any of the paragraphs below in this "The process for 2024" section contradict other sections of the NESO Financial Handbook, this "The process for 2024" section takes precedence.
- 2.33 NESO will populate the NESO Financial Model template published on Ofgem's website by 31 October 2024, or by a date as agreed with Ofgem. Ofgem will review the model and associated text. Ofgem may direct NESO to make changes to those two outputs prior to publication. We note this update will be used to derive two components of 2025/26 Allowed Revenue, INT_t and RTN_t . EXT_t will be derived at a later date, in line with the RIIO-2 ESO timelines.
- 2.34 If errors are discovered in the functionality of the NESO Financial Model template published on Ofgem's website, Ofgem and NESO will work together to make amendments to the NESO Financial Model template if deemed necessary by the Authority. For the avoidance of doubt, the licensee will not need to publish an updated NESO Financial Model before the self-publication of the NESO Financial Model by the licensee. Any amendments to the NESO Financial Model can be incorporated in the tariff setting version with any updates detailed in a change log.
- 2.35 NESO will notify Ofgem no less than 14 days prior to the publication of the NESO Financial Model, or by a date as agreed by Ofgem, of the finalised NESO Financial Model, which NESO will then self-publish on their website by 30 November 2024.
- 2.36 If NESO Day 1 has not completed by 30 November 2024, Ofgem will provide a version of the RIIO-2 ESO Price Control Financial Model (PCFM) to use for the annual tariff setting process.

The process after 2024

- 2.37 In years after 2024, NESO will provide regulatory reporting to Ofgem by 31 August in each year. The regulatory reporting will contain at least the:
- Legacy Closeout Model, with associated commentary.
 - NESO Financial Model, with associated commentary.
- 2.38 The Authority will consider additional reporting requirements that may be necessary including reports similar to those of the Regulatory Financial Performance Report (RFPR) and the Regulatory Reporting Pack (RRP).
- 2.39 The calculation of each relevant component (as set out in 2.4 above) of NESO allowed revenues aims to achieve cash neutrality which may not achieve profit neutrality in the short term. NESO will work with Ofgem to agree a suitable approach to demonstrating longer term profit neutrality for annual reporting, noting that timing issues could lead to presentational differences between revenues and costs.

The NESO Financial Model Working Group

- 2.40 The licensee will facilitate an industry expert working group to review issues arising with respect to the form or usage of the NESO Financial Model. The terms of reference for The NESO Financial Model Working Group ('the working group') are set out below.

Terms of reference

Purposes of the working group

- 2.41 The purposes of the working group are:
- to review the ongoing effectiveness of the NESO Financial Model in producing a value for each relevant component (as set out in 2.4 above) of Allowed Revenue and capturing financial performance data for each Regulatory Year;
 - to provide, when requested by the Authority, its views to the Authority on the impact of any proposed modifications on the NESO Financial Model; and
 - to provide such views or recommendations to the Authority with regard to the NESO Financial Model (including as to proposals to modify the NESO Financial Model) as it sees fit.

Consultation - NESO Financial Handbook

Composition

2.42 The composition of the working group will be:

- Licensee (chair);
- Licensee (secretary); and
- one representative of the Authority.

Timing and duration of the working group's work

2.43 The working group will run from Day 1 until otherwise specified by the Authority.

2.44 The working group will meet at least once between 1 January and 1 April during each calendar year, but may meet more frequently if required, in particular in relation to the provision of views on the impact of proposed NESO Financial Model modifications.

2.45 In convening any meeting of the working group, the licensee will give at least 10 working days' notice of the proposed meeting date to the licensee.

2.46 Representatives may attend meetings in person or through video or telephone conferencing facilities.

2.47 A meeting of the working group will be quorate, for the purpose of expressing a view or recommendation in respect of the NESO Financial Model, when at least one representative from Ofgem, and at least one licensee representative are present.

Resources

2.48 Meeting facilities will be provided or coordinated by Ofgem or the licensee. Ofgem or NESO will keep notes of key points of discussion and views expressed at meetings, and of any recommendations made by the working group with respect to the NESO Financial Model. A copy of the record of each meeting will be provided to the licensee or the Authority as soon as is reasonably practicable and to representatives who attended the meeting, and Ofgem or the licensee will take account of any comments received in finalising the record.

The Annual Iteration Process (AIP)

2.49 The AIP is the process carried out by the licensee and Authority each year in order to calculate two components of the Electricity System Operator Allowed

Consultation - NESO Financial Handbook

Revenue⁷ ($ESOAR_t$ for Regulatory Year t), INT_t and RTN_t , as well as the Gas System Planner revenue, $ARGSP_t$, by updating the variable value inputs to the NESO Financial Model. The EXT_t component of Allowed Revenue will be updated by the licensee independent of the AIP process.

- 2.50 The AIP will be completed by 30 November prior to each Regulatory Year t , or as soon as is reasonably practicable thereafter.
- 2.51 The steps of the AIP are specified below.

Submission of NESO Financial Model

- 2.52 The licensee must use the version of the NESO Financial Model published on the licensee's website and which incorporates any modifications made to it following the NESO Financial Model Working Group as well as any other modifications that have been approved by Ofgem. This version of the NESO Financial Model will be the one used in the upcoming AIP and will be published by the licensee by the functional cut-off dates set out at Table 2.1.
- 2.53 Prior to each Regulatory Year, the licensee must submit to the Authority the NESO Financial Model by the submission date listed in Table 2.1 and with a completed variable values table (covering activity in the prior Regulatory Year and changes to forecast activity⁸), which has been updated to calculate the INT_t and RTN_t components of $ESOAR_t$ and $ARGSP_t$.
- 2.54 This submitted version of the NESO Financial Model may contain provisional values for variable values that are unknown at the time of submission.
- 2.55 Where a variable value is unknown at the time of submission, the licensee must calculate a provisional value using the approach specified within the NESO Financial Handbook (this handbook) or the NESO Financial Model Guidance, as applicable, and otherwise provide its best estimate with the information available at the time.

⁷ Please note references to Allowed Revenue and $ESOAR_t$ in "The Annual Iteration Process (AIP)" chapter should be read as the process of updating INT_t and RTN_t . The EXT_t component of Allowed Revenue will be updated independently of this process.

⁸ Variable values for Regulatory Years later than Regulatory Year t do not feed into the calculation of the term $ESOAR_t$ and $ARGSP_t$. Therefore, calculated values in the NESO Financial Model for Regulatory Years later than Regulatory Year t represent only a forecast. This is without prejudice to the status of the variable values concerned, which may have been decided and/or directed under licence conditions and which may or may not be subject to subsequent revision.

Consultation - NESO Financial Handbook

2.56 Ofgem will review the submitted NESO Financial Model and confirm whether these have been prepared in accordance with the NESO Financial Model Guidance. Where values have not been prepared in accordance with the NESO Financial Model Guidance and NESO Financial Handbook, Ofgem will direct amendments to such variable values, as appropriate and taking into account any decisions it has made in relation to those values.

Dry Runs process

2.57 This process of confirming and amending values will normally take place from 31 August to early November and will be iterative to account for updates to the variable values as they become known.

2.58 There will be one or more dry runs of the NESO Financial Model between the licensee's initial submission of the NESO Financial Model and the final run in early November. The number of dry runs needed will depend on the number and timing of variable value updates required for the licensee in any particular Regulatory Year.

2.59 Where the Authority directs an amendment to a variable value from an earlier licensee submission, either due to a licensee error or to reflect updates to a provisional value, it will notify the licensee and request a resubmission of the NESO Financial Model. Following updates to variable values, the NESO Financial Model should be updated and the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ should be recalculated to reflect the impact of the updated values.

2.60 In order to facilitate publication of the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ by 30 November, Ofgem will normally expect to apply the following annual cut-off dates unless otherwise agreed with the Authority:

- 1 June in respect of functional changes to the NESO Financial Model, NESO Financial Handbook and NESO Financial Model Guidance; and
- 31 October in respect of information submitted by the licensee.⁹

⁹ In applying this cut-off date, Ofgem will, through business correspondence, apprise the licensee of any provisionality it has attached to information submissions, that might involve a restatement of the information by the licensee for the purpose of making a further revision to the variable value(s) concerned for use in a subsequent Annual Iteration Process.

Consultation - NESO Financial Handbook

Final Run

- 2.61 The final run of the NESO Financial Model will take place in early November and will be performed by the licensee.
- 2.62 Having determined any revisions to variable values for the licensee, the licensee will update the NESO Financial Model as follows:
- revised variable values will be entered in the appropriate Regulatory Year columns of the variable values table for the licensee; and
 - the NESO Financial Model will output the the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ for Regulatory Year t for the licensee.
- 2.63 The licensee will give the Authority at least 14 days' notice of the value of the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$, and a copy of the NESO Financial Model used to calculate it (including the licensee's variable values, which may have been revised through the AIP) to allow for any representations.
- 2.64 The licensee will then (by 30 November in Regulatory Year $t-1$, or as soon as is reasonably practicable thereafter) publish the values of the relevant components (as set out in 2.4 above) of $ESOAR_t$, $ARGSP_t$ and a copy of the NESO Financial Model used to calculate it. The values of each component of $ESOAR_t$ and $ARGSP_t$ in the publication will be stated in £ millions to one decimal place.
- 2.65 Where certain information is considered to be commercially sensitive, the licensee may request that this information be redacted before the NESO Financial Model is published. The Authority will consider the request and the licensee will share with the Authority the version of the NESO Financial Model for publication including any redactions as considered necessary with the licensee in advance of the publication.
- 2.66 What if the AIP is not completed by 30 November?
- If the licensee does not publish a value for the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ by 30 November prior to any Regulatory Year, then the Annual Iteration Process will not have been completed and the provisions set out below will apply.
 - The licensee will complete the Annual Iteration Process as soon as is reasonably practicable after 30 November by publishing a value for the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$.
-

Consultation - NESO Financial Handbook

- In the intervening period (between 30 November and the date the value of the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ is published), the value for the relevant components (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ will be held to be equal to a value ascertained by:
 - a) taking a copy of the NESO Financial Model in its state following the last completed Annual Iteration Process
 - b) using the selection facilities on the "Inputs" sheet contained in that copy of the NESO Financial Model to select:
 - i. the Regulatory Year equating to the Regulatory Year t ; and
 - ii. recording the value of each relevant component (as set out in 2.4 above) of $ESOAR_t$ and $ARGSP_t$ for the licensee that is shown as an output value in the "Live Results" sheet.

2.67 Table 2.1 below summarises the timings for the AIP on an ongoing basis.

Table 2.1 - Summary of timings for the Annual Iteration Process¹⁰

AIP Year	Licensee submits populated NESO FM	NESO FM functional change cut-off	Regulatory reporting information cut-off	Notice of proposed variable value revisions by	AIP completed and components of $ESOAR_t$ and $ARGSP_t$ published by	Regulatory Year t in which components of $ESOAR_t$ and $ARGSP_t$ applies
Nov-2025	31 Aug 25	01 Jun 25	31 Oct 25	15 Nov 25	30 Nov 25	2025/26
Nov-2026	31 Aug 26	01 Jun 26	31 Oct 26	15 Nov 26	30 Nov 26	2026/27
Nov-2027	31 Aug 27	01 Jun 27	31 Oct 27	15 Nov 27	30 Nov 27	2027/28
Nov-2028	31 Aug 28	01 Jun 28	31 Oct 28	15 Nov 28	30 Nov 28	2028/29

¹⁰ Use previous working day if these dates fall on a weekend or bank holiday.

3. Financial Model Variable Values

3.1 This section lists all the variable values (including the relevant Licence Conditions and Associated Documents, where relevant, for each).

NESO Financial Model Variable Values

3.2 The variable values included in the NESO Financial Model are set out in Table 3.1 below.

3.3 For each variable value, the table provides a description, cross-references to the relevant Licence Condition(s) (where appropriate), and details of Associated Documents (where relevant). It also identifies the variable values for which further details are provided in subsequent sections of the NESO Financial Handbook.

Table 3.1: NESO Financial Variable Values (VV)

VV	Description	Licence Conditions	Cross-reference / Associated Document
BS_t	Balancing Services ¹¹	Licence Condition F1.23	NESO ESO Licence
$ESOI_t$	Interest Costs	Licence Condition F1.19	NESO ESO Licence NESO GSP Licence
ETE_t	Controllable Expenditure	Licence Condition F1.18	NESO ESO Licence
$FPEN_t$	Fines and Penalties	Licence Condition F1.19	NESO ESO Licence

¹¹ This will be populated when actual values are available for a full year, with no forecast included. This is because this sits with the EXT revenue stream.

Consultation - NESO Financial Handbook

FSONG _t	FSO Transition Payments	Licence Condition F1.19 and F10	NESO ESO Licence
LEG _t	Legacy Revenue Adjustments	Licence Condition F1.18	NESO ESO Licence
NIAE _t	Network Innovation Allowance Expenditure	Licence Condition F1.19 and F2	NESO ESO Licence, RIIO-2 NIA Governance Document
OA _t	Other Adjustments	Licence Condition F1.18	NESO ESO Licence
OM _t	User System Agreement Charges ¹²	Licence Condition F1.23	NESO ESO Licence
OR _t	Other Net Revenues	Licence Condition F1.18	NESO ESO Licence
SOBD _t	Bad Debt Allowance	Licence Condition F1.20	NESO ESO Licence
SOTO _t	SO-TO Operational Payments ¹³	Licence Condition F1.23	NESO ESO Licence

¹² This will be populated when actual values are available for a full year, with no forecast included. This is because this sits with the EXT revenue stream.

¹³ This will be populated when actual values are available for a full year, with no forecast included. This is because this sits with the EXT revenue stream.

4. Closeout Methodology

The new proposed NESO licences involve a change in policies from the existing NGESO licence. With the proposed transition occurring part way through a Financial Year, the closeout methodology sets out how revenues will be estimated – initially and on an enduring basis. The mechanism through which this will occur is a legacy adjustment value in the NESO Financial Model. This legacy adjustment value will be estimated within the Legacy Closeout Model. Further details of that approach are set out in this chapter.

Consultation Questions

- 2a.** Do stakeholders agree with our proposals regarding the Closeout methodology?
- 2b.** Do stakeholders wish to propose any other alternatives that we have not proposed? If so, please provide evidence for us to consider further?

Introduction and purpose

- 4.1 Consumers fund the activities undertaken by National Grid Electricity System Operator (NGESO) to a level set out by Ofgem ('allowed revenues')¹⁴. The allowed revenues reflect both fixed values and variable values ('financial variable values').
- 4.2 Under the current regime, NGESO has a mixture of allowances and pass-through. There is a reconciliation process to ensure that revenues are updated over time as evidence on expenditure is finalised.
- 4.3 The basis for setting allowed revenues will change following the proposed transition from NGESO to NESO. This will be reflected in the proposed new licences for NESO, together with any supporting instruments.
- 4.4 The date of the transition is referred to as 'Day 1'. For simplicity of drafting purposes, we have adopted terminology such that H1 FY24/25 will be under the existing NGESO licence and H2 FY24/25 will be under the NESO licences (i.e. referring to the periods before and after Day 1).
- 4.5 Revenues for the NGESO reflected a mixture of 'fast money', i.e. recoverable in the year of expenditure, and 'slow money'. The treatment of slow money utilised

¹⁴ With a correction mechanism in place to deal with over- or under-recovery.

Consultation - NESO Financial Handbook

- a Regulatory Asset Base (RAB) model. An allowed return was provided using a notional cost of capital. Whether expenditure was treated as fast money or slow money was determined by the capitalisation rate (as determined at the RIIO-2 price control).
- 4.6 The Regulatory Asset Value (RAV) is updated to reflect slow money RAV additions, depreciation and inflation indexation prior to Day 1. The value to apply to the RAV will be fixed at that handover point, at Day 1.
- 4.7 All expenditure for NESO (i.e. after Day 1) will be treated as fast money, such that additions to the RAV are only relevant for spend up to the final day prior to Day 1. This RAV will continue to be depreciated, though there will be no slow money additions.
- 4.8 Allowed revenues are set on an annual basis. The NGESO licence denotes year t as a 12-month period beginning on 1 April and ending on 31 March. This notation remains for the NESO licences, but this necessitates separate discussion of how to treat FY24/25 (i.e. 1 April 2024 to 31 March 2025), the period in which the transition is proposed to occur.
- 4.9 A methodology is required for closeout, given that there will be a proposed transition between licences within a financial year, with each licence regulating a different form of regulated entity. This section sets out our proposed process and associated methodologies for undertaking that closeout.
- 4.10 In the absence of a transition and continuing of existing processes, an AIP would exist to update revenues based on receiving updated information on expenditure and outturn values of other relevant parameters, e.g. inflation. This would be delivered through updates to the Price Control Financial Model (PCFM). NGESO would continue to make a regulatory submission by end of July in the following financial year with dry runs and engagement between NGESO and Ofgem leading to an updated PCFM being published at end of November in the same year. This would then be reflected in tariffs, with a 9-month lag between the announcement of charges and those charges being introduced.
- 4.11 The process will continue to be required to reflect values up to Day 1, to ensure that consumers are not subject to losses or gains from incorrect forecast information. At the time of setting charges by end December 2024, values for the FY24/25 will not be finalised. Under the current process, values would not be known until the regulatory submission due on 31 July 2025 (i.e., after Day 1).
-

Consultation - NESO Financial Handbook

Subsequent reconciliations will be required to reflect actual values and reporting to be separated between H1 FY24/25 and H2 FY24/25. This is discussed in more detail in Chapter 2. The NESO Financial Model will initially include forecast values, with subsequent iterations reflecting outturn values once those become available.

Methodology

- 4.12 The proposed NESO ESO Licence splits the revenue that can be collected via BSUoS into 3 components¹⁵:

$$\text{ESOAR}_t = \text{INT}_t + \text{EXT}_t + \text{RTN}_t$$

Internal BSUoS income – this is set out in the NESO licences.

External BSUoS Income – as per the existing approach to BSUoS.

Return on RAV– this will reflect the amount of money collected for the unwinding of RAV which will be returned to NESO.

- 4.13 The INT_t term includes NESO controllable expenditure, pass-through items, other revenues and other costs, together with adjustments for historic values. This last term is denoted as LEG_t .
- 4.14 The LEG_t term reflects true-up adjustments for previous outturn values versus what was known at the time and relevant provisions in the licence and the CUSC, plus adjustments for the transition between one form of regime and another. The term will adjust the 12-month NESO allowed revenue to incorporate the period before Day 1.
- 4.15 In light of the transition, our proposed approach for the closeout is to expand LEG_t in a way that is consistent with values included in FY24/25 in the NESO Financial Model.
- 4.16 The definition of LEG_t intends to minimise the expansion of terms to where a change in policy necessitates a breakdown between H1 and H2 in FY24/25. Where expenditure is treated as pass-through under both NGESO and NESO licences, we include a full-year value for the parameter in the NESO Financial Model, with no adjustment necessary via LEG_t .

¹⁵ This is shown for the NESO ESO licence in collecting ESOAR_t . The NESO GSP licence refers to the collection of ARGSP_t .

Consultation - NESO Financial Handbook

4.17 The limited number of additional sub-values for LEG_t result from a change in policy between values from H1 to H2 (FY24/25), namely a discontinuity. This is discussed further in the following sub-section.

Overarching methodology for calculating LEG_t

4.18 The LEG_t term is proposed to be broken down into additional terms, to adjust the values incorporated in the NESO Financial Model in order to reflect the revenues necessary to be recovered for H1 to be consistent with the licence in force before the transition.

4.19 We have set out below the proposed components of the LEG_t term.

Table 4.1: Proposed additional terms within LEG_t

Term	Item	Description
LEGETE	Controllable expenditure	<p>The proposed NESO model will contain a full-year of expenditure (both controllable opex and controllable capex). Expenditure in H1 FY24/25 will be captured in the Day 1 RAV estimate for the proportion of spend that is capitalised (i.e. slow money). The capitalisation rate for FY24/25 is set at 37.60%, as per the NGESO PCFM.</p> <p>The amount provided as fast money that relates to spend added to the RAV before the transition will need to be included as a negative item in LEG_t to avoid a double-count (i.e. being included as both a legacy adjustment allowance and in the RAV).</p>
LEGTAX	Tax	The proposed NESO Financial Model includes tax calculations for H2 FY24/25, therefore LEG_t is required to include an estimate for the tax allowance which would arise during the part of FY24/25 which arises prior to day 1. This is discussed in more detail in Chapter 7.
LEGFPN	Financial penalties	Financial fines and penalties will be separated out for H1 FY24/25 and H2 FY24/25. NGESO is unable to recover these costs, though proposed NESO licences involve those costs being passed onto the consumer if incurred.
LEGDPN	Depreciation	<p>The proposed NESO Financial Model involves 100% fast money for all expenditure after Day 1. For the period in FY24/25 prior to Day 1, slow money will continue to be added to the RAV.</p> <p>RAV depreciation only starts the year after additions are made, so depreciation in FY24/25 will be unimpacted by expenditure in FY24/25.</p>

Consultation - NESO Financial Handbook

		<p>The depreciation profile from the November 2023 AIP will be retained, with an updated value to reflect FY23/24 additions.</p> <p>Depreciation for the period up to Day 1 is not included in the proposed NESO Financial Model and needs to be reflected under LEG_t as depreciation prior to Day 1 has been incorporated in the Day 1 RAV estimate.</p>
LEGRTN	Return	<p>While NESO will not earn an enduring regulatory profit, NGESO's RAV will be wound down to compensate the taxpayer for the cost of providing that capital for a time limited period. NESO will collect a return on RAV reflecting a social discount rate during this period.</p> <p>The return for the period before Day 1 within FY24/25 uses the RAV and a notional cost of capital, as per the NGESO licence.</p> <p>The basis for the notional cost of capital is equivalent to the methodology set out in the proposed NGESO Licence for setting the allowed cost of debt and allowed cost of equity. The real vanilla allowed return on capital for FY24/25 is 5.75%.</p>
LEGADF	Additional funding	<p>NGESO is set a fixed allowance in nominal terms (£4.8m per annum).</p> <p>As NESO is not-for-profit and the concept of allowances is not relevant, no equivalent funding will occur from Day 1.</p> <p>A proportion of additional funding is however required for the period until Day 1. LEGADF will pro-rate the nominal allowance, such that half of the annual amount is included for H1 FY24/25.</p>
LEGEDE	Pension scheme established deficit (PSED) recovery allowances	<p>There is a cumulative variance between the licensee's PSED repair and its historic allowances for PSED repair prior to Day 1.</p> <p>Based on the outcome of the 2023 Reasonableness Review, this is expected to be a negative item.</p> <p>NESO will report on the proposed amount that suitably accounts for this variance (including any timing issues), and this will be included as LEGEDE, subject to Ofgem approval.</p>
LEGADJ	Adjustment for new data	<p>Allowed Revenue for FY23/24 includes true-up amounts for every previous year. The proposed NESO model will not capture revenues prior to FY24/25. Charges reflect the adjustments made, up</p>

Consultation - NESO Financial Handbook

		<p>to and including the FY22/23 AIP. To the extent that allowed revenues subsequently change, that change has to feed in to collected revenues.</p> <p>Updates to allowed revenue need to feed into the LEG_t term of the NESO licences, based on updates on input values.</p> <p>The NGESO PCFM will continue to be iterated to capture values up to FY23/24. The LEGADJ term would be updated through the Legacy Closeout Model for subsequent iterations.</p>
LEGEXT	Interest on BSUoS ('K')	<p>There is an adjustment in the NGESO licence that calculates an interest charge on the balance of over- or under-recovery of BSUoS at a given point in time. The interest rate is as set out in the licence, i.e. SONIA plus a 115bps credit spread.</p> <p>NGESO as of 31 March 2024 had a positive balance (i.e. over-recovery). There will be a negative value for this revenue item to compensate consumers for interest associated with this over-recovery (the over-recovery is addressed separately).</p> <p>This reflects the final calculation of this balance, with no estimate to be made at Day 1 to account for balances in the first half of the year.</p>
LEGSOLAR	Pre-RIIO2 adjustments	<p>The NGESO PCFM includes adjustments for pre-RIIO2 revenue adjustments. These will be captured within the LEG_t term, although those values are small.</p>
LEGWCF	Working Capital Facility costs	<p>The interest costs from the Working Capital Facility are fully recoverable for NGESO. In theory, where these costs are not reflected in the proposed NESO Financial Model, they should be added to LEG_t.</p>

- 4.20 The LEG_t term does not cover all items within NGESO's internal allowances under the RIIO-2 determination. An example is NGESO's incentive performance scheme (ESORI). The value is zero for H1 FY24/25 as the two-year incentives scheme covering the period from April 2023 to March 2025 will conclude as a reputational incentive only for NESO. There will also be no ability for Ofgem to disallow Demonstrably Inefficient and Wasteful Expenditure (DIWE), following the change in licence from Day 1.
- 4.21 The LEG term does not require inputs for values that are shown for a full financial year in the NESO Financial Model and are treated as 100% fast-money. This includes FSO transition costs and Bad Debt.

Updates to LEG_t value

- 4.22 NESO will use a forecast value for LEG_t in the tariffs set in December 2024. NESO will submit its annual regulatory reporting by 31st August 2025. Interim updates may be provided by NESO prior to this date to support the accuracy of the tariff setting process, subject to Ofgem approval. Subsequent data updates will continue with any revised outturn values.

Approach to estimating relevant values

- 4.23 The Legacy Closeout Model will inform calculations of INT_t , which includes LEG_t . This data template will need to be completed by NESO to adjust the NESO Financial Model to give an output that gives equivalence for the period before Day 1 and the period after within FY24/25. This model will include relevant inputs and calculations on both RAV and tax.
- 4.24 The NGESO PCFM includes values in an 18/19 price base for RAV modelling. This will be the basis for the Legacy Closeout Model. This will inform the LEGDPN, LEGRTN and LEGETE items.
- 4.25 There is an established method for converting 18/19 real prices into a nominal equivalent (and vice-versa). This is set out in Chapter 5.
- 4.26 The proposed NESO Financial Model involves most parameters in nominal terms, with some limited exceptions.

5. Price Indexation Methodologies

Consultation Questions

3a. Do stakeholders agree with our proposals regarding the Price Indexation methodologies?

3b. Do stakeholders wish to propose any other alternatives that we have not proposed? If so, please provide evidence for us to consider further?

Introduction and Purpose

- 5.1 When ascertaining Calculated Revenue under the NGESO PCFM, a constant 2018/19 price base has been used, except in respect of some calculations internal to the NGESO PCFM that use nominal prices (e.g. tax, various pass-through costs and legacy calculations).
- 5.2 Following the proposed transition from NGESO, NESO will be entirely funded by consumers with all controllable expenditure to be recovered through a 'fast money' approach in-year.
- 5.3 The move to a 100% fast money approach raises a question surrounding the appropriate price base to be used for the proposed NESO Financial Model and associated inputs (in the absence of an inflation indexed Regulatory Asset Value).
- 5.4 The proposed mid-year transition from NGESO to NESO also necessitates the development of a methodology for the treatment of inflation for expenditure and RAV depreciation in H1 FY2025 and price indexation from Day 1.
- 5.5 The price indexation methodology used in the proposed NESO Financial Model has implications for the calculation of revenues with respect to certain variable values, such as:
- the Network Innovation Allowance (NIA);
 - the SO-TO threshold, and;
 - other monetary values which require price indexation.
- 5.6 This section sets out the price indexation methodologies used in the proposed NESO Financial Model, specifically for the calculation of the maximum Total NIA Expenditure ($NIAD_t$), Total Legacy NIA Expenditure ($LEGNIA_t$) and the SO-TO ($SOTO_t$) threshold. It also includes methodology on the treatment of inflation, particularly related to time value of money (TVoM) adjustments.

Methodology

- 5.7 From Day 1, to reflect the proposed shift to a fast money approach for cost recovery, we propose that the NESO Financial Model primarily operates on a nominal price basis, with some exceptions still reflecting a 2018/19 price base.
- 5.8 Exceptions to the nominal price base are related to RAV calculations, specifically associated RAV additions and depreciation inputs, which would continue using a 2018/19 price base.
- 5.9 The indexation of RAV_t and return calculation methodology is further detailed in Chapter 6.
- 5.10 For the purposes of converting inflation values between nominal and 2018/19 prices, we propose that the methodology remain consistent with the current methodology used under the NGESO PCFM. This has implications for NIA and SOTO expenditure, which are further detailed below.
- 5.11 In line with the methodology used in the NGESO PCFM, we propose the following formula is used:

$$\text{value}_{2018/19\text{prices}} = \text{value}_{\text{nominal}} \times \frac{PI_{2018/19}}{PI_t}$$

Where:

$\text{value}_{2018/19\text{prices}}$	means the deflated/restated value in 2018/19 prices
$\text{value}_{\text{nominal}}$	means the value in a nominal price base or in prices of a Regulatory Year other than 2018/19
PI_t	is the arithmetic average value of each of the twelve monthly values of PI_m from 1 April to 31 March within Regulatory Year t derived in accordance with the following formula:

$$PI_m = PI_{m-1} \times \frac{CPIH_m}{CPIH_{m-1}}$$

Where:

Consultation - NESO Financial Handbook

m	refers to a year and month;
CPIH _m	means the "Consumer Price inflation including owner-occupiers' housing costs" (series L522) published by the ONS for the year and month m. ¹⁶

- 5.12 To account for changes in prior years to the inflation indexation methodology (i.e. prior to 2017/18 under the NGESO PCFM), the proposed NESO Financial Model uses a blended indexation series called "Legacy Combined RPI-CPIH price index (financial year average)". This series is carried over from the NGESO PCFM and is used only for conversion from 2017/18 prices to Regulatory Year t nominal prices.

Forecasting the Price Index PI_t

- 5.13 At each AIP, NESO will update outturn data for CPIH_m for the period to June of the prior year (e.g. for AIP in November 2025, for Regulatory Year 24/25, the outturn data values will be entered to June 2024).
- 5.14 The NESO Financial Model "Indexation" tab contains a method for forecasting future price indexation values, given calendar year forecast assumptions.
- 5.15 These forecasts will be the Office for Budget Responsibility's (OBR) forecast of CPI from the "economic and fiscal outlook". NESO will update the forecast assumptions from the most recent outlook available as at 31 October in each AIP. The data will be sourced from the following files based on their availability, with preference being given to them in accordance with the order they are listed below:
- The OBR historical official forecasts database¹⁷, "CPI" tab
 - The charts and tables datafile published with the economic and fiscal outlook
 - The economic and fiscal outlook document
- 5.16 The forecast rates will be used to create a forecast of the monthly and yearly index. The OBR growth rate forecasts compare year over year index averages, so the rates are assumed to apply midpoint each year from July to June.

¹⁶ <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l522/mm23>

¹⁷ <https://obr.uk/data/>

Consultation - NESO Financial Handbook

5.17 A long-term CPIH inflation assumption will be used for years included in the proposed NESO Financial Model for which OBR forecasts do not yet exist. This value does not impact on tariffs and is indicative. The proposed NESO Financial Model assumes a 2.0% assumption for dates where the OBR forecasts do not yet exist, based on the Bank of England's 2.0% CPI target.

Network Innovation Allowance (NIA) Expenditure

5.18 As described in the NESO ESO Licence, maximum total NIA Expenditure ($NIAE_t$) is the combined value of $NIAD_t$ and $LEGNIA_t$, where:

- $NIAD_t$ is the value of total NIA expenditure in year t in 2018/19 terms, and
- $LEGNIA_t$ is the value of Total Legacy NIA Expenditure in 2018/19 prices.

5.19 Total allowed NIA Expenditure over the period from 1 April 2021 to 31 March 2026 which can be recovered is subject to a cumulative threshold cap, which has been defined in 2018/19 prices.

5.20 NESO will be required to continue reporting on NIA Expenditure after Day 1. Reported expenditure will be compared to the NIA Expenditure cumulative cap to ensure compliance with the previously defined threshold and the NESO ESO Licence.

5.21 To ensure consistency with previous calculations throughout the above threshold period, the current price indexation approach for calculating maximum total NIA expenditure will be retained.

5.22 For the purposes of calculating maximum total NIA expenditure, this requires deflation from a nominal price base to the 2018/19 price base as per the methodology described in paragraph 5.11 above.

System Owner-Transmission Owner (SO-TO) Commercial Threshold

5.23 Under the proposed NESO Financial Model, $SOTO_t$ refers to recoverable expenditure that is the total costs of payments to Transmission Owners and Offshore Transmission Owners for Outage Changes and Commercial Operational Services. It forms part of the External Expenditure allowed revenue (EXT_t) calculation.

Consultation - NESO Financial Handbook

- 5.24 SOTO_t expenditure under the NGESO Licence has been subject to an annual commercial threshold cap, which has been defined in 2018/19 terms.
- 5.25 As with NIA Expenditure, NESO will be required to continue reporting on SOTO related expenditure for comparison against the reporting threshold, though this will no longer form a cap.
- 5.26 Calculation of SOTO_t expenditure thresholds require the deflation of the annual nominal expenditure figure for each Regulatory Year t to compare against the SOTO Commercial Threshold in 2018/19 prices.
- 5.27 For the purposes of calculating SOTO_t, we propose to use the same methodology described above in paragraph 5.11.

Time Value of Money (TVoM)

- 5.28 Calculations with respect to TVoM will be used to ensure that the right customers bear or receive the correct amount of interest. The TVoM will be applied to non-BSUoS revenue streams (i.e. TNUoS, gas and Assistance for Areas with High Electricity Distribution Costs (AAHEDC)), but none is applied for BSUoS given that interest will be a pass-through item within INT (defined as ESOI).
- 5.29 The TVoM for TNUoS and gas revenue streams is defined as being subject to the Reference Variable Rate (RVR).
- 5.30 The TVoM for AAHEDC is defined in the Energy Act 2004 and will remain unchanged.
- 5.31 The RVR is referred to in the licences and is set equal to the rate paid for the Working Capital Facility (WCF)¹⁸.

Recovery of net interest costs

- 5.32 ESOI_t is equal to the net interest for NESO, as per statutory accounts, once notional interest payments or receipts in relation to TNUoS, gas and AAHDC revenue streams have been subtracted.

¹⁸ In the proposed NESO Financial Model, the RFR has been set as equal to the current Bank of England base rate.

6. Return (RTN) Calculation

Consultation Questions

- 4a.** Do stakeholders agree with our proposals regarding the Return Calculation methodology?
- 4b.** Do stakeholders wish to propose any other alternatives that we have not proposed? If so, please provide evidence for us to consider further?

- 6.1 As discussed in Chapter 4, the proposed NESO ESO Licence splits the revenue that can be collected through BSUoS charges into 3 components:

$$ESOAR_t = INT_t + EXT_t + RTN_t$$

Where:

ESOAR _t	Is the ESO allowed revenue term, derived in accordance with the above formula
INT _t	Reflects internal costs incurred recoverable through BSUoS
EXT _t	Reflects external expenditure incurred, recovered in line with existing approach
RTN _t	Reflects return of RAV to NESO, calculated as per the NESO ESO licence and the proposed approach set out in this chapter

- 6.2 We note that, as set out in the proposed NESO ESO Licence, the calculation of the RTN_t term is equal to:

$$RTN_t = RTNO_t + RTNADJ_t$$

Our proposed approach to the calculation of the RTNO_t term is described below. RTNADJ_t captures any revenue impacts resulting from updates to the RAV balance and updates to forecast inflation rates.

- 6.3 Under the proposed NESO licences, all expenditure from Day 1 will be recovered using a fast money approach. Therefore, the remaining RAV balance (i.e. the Day 1 RAV) will consist entirely of expenditure from the period before Day 1 (i.e. expenditure under the NGESO).
- 6.4 The remaining RAV balance will be recovered by NESO from Day 1, through consumer charges.

Consultation - NESO Financial Handbook

- 6.5 Remuneration of the RAV is reflected in the $RTNO_t$ term and is calculated using the formula below from the proposed NESO ESO Licence:

$$RTNO_t = DPN_t + (RAV_t \times DR_t), \text{ where:}$$

DPN_t	Is the depreciation of the RAV, calculated according to the subsection below
RAV_t	Reflects the RAV value after depreciation, calculated according to the subsection below
DR_t	Per the proposed NESO ESO Licence, is the discount rate equal to 3.5% in real post-tax terms

- 6.6 The subsections below set out the methodologies for calculating the DPN_t and RAV_t terms.
- 6.7 The discount rate (DR_t), referenced above, reflects the rate of return received on the RAV. For NGESO and under the current PCFM, this has been equal to the WACC set out for the price control period. For NESO, DR_t is set out in the proposed NESO ESO Licence as a fixed 3.5% rate.
- 6.8 Given that the proposed transition is expected to occur in FY24/25, the differences in rates of return on the RAV (i.e. WACC for NGESO and DR for NESO) have implications on the calculation of the RTN term in the proposed NESO Financial Model.
- 6.9 Therefore, it is necessary to consider how to calculate the RTN term that reflects remuneration to NESO, in relation to the LEGRTN term that reflects remuneration to the NGESO.
- 6.10 In the proposed NESO Financial Model for the regulatory year in which the proposed transition takes place, the RTN term will be calculated on a partial-year basis, reflecting only the portion of remuneration on the RAV after Day 1 in FY24/25. LEGRTN would then be a positive value, reflecting required remuneration to the NGESO for the period of FY/2425 prior to Day 1 (i.e. the depreciation and RAV return for that period).¹⁹

¹⁹ In the calculation of the RTN_t term, the proposed NESO ESO Licence makes reference to regulatory year t , which assumes a 12-month period. Should RTN be calculated in the

Consultation - NESO Financial Handbook

6.11 The RTN calculation for FY24/25 incorporates a NPV Neutral RAV Return Base, using a blended discount rate to account for changes to the discount rate between H1 2024/25 and H2 2024/25, and maintain consistency across calculations for each period.

Methodology for Calculating DPN_t

6.12 Each year under NGESO, additions to the RAV have been made and captured in the NGESO PCFM in the year following the year in which the expenditure was incurred. These were reported in 2018/19 prices.

6.13 These annual additions depreciated evenly over a 7-year asset life period. Each year, the total depreciation amount consisted of the depreciating main RAV additions for the 7 previous years. The Wokingham Facility RAV was an exception, and was depreciating evenly over a 19-year asset life period under the PCFM.

6.14 We assume that the Day 1 RAV value is subject to the same depreciation profile as applied in the NGESO PCFM. The exception is for the Wokingham Facility RAV, which will face a new depreciation profile from the start of FY25/26 reflecting a shortened asset life.

6.15 From Day 1, the declining main RAV balance will continue following the existing profile used in the NGESO PCFM. The Wokingham Facility RAV depreciation profile will be brought in line with the main RAV depreciation profile, with effect from 1 April 2025, with the remaining Net Book Value at that point to be recovered evenly over seven years (a 'straight-line' basis). All remaining RAV balances will be fully recovered by 31 March 2032.

6.16 The RAV balances will be shown within the proposed NESO Financial Model in 2018/19 prices. The RAV will be uplifted by outturn inflation using CPIH inflation, as described in Chapter 5.

proposed NESO Financial Model in such a way that is consistent with a full annual period, this would require a full-year calculation of the RAV at a discount rate equal to the fixed 3.5%. LEGRTN would then need to be a negative value that captures the required remuneration to NGESO for the period of FY24/25 prior to Day 1, at the specified rate of return. However, we consider that for the purpose of transparency for stakeholders, an alternative calculation approach could be taken to more clearly delineate between remuneration on the RAV for NGESO and NESO, respectively, for FY24/25.

Methodology for Calculating RAV_t

- 6.17 As per the proposed NESO ESO Licence, RAV_t is equal to the RAV less regulatory depreciation.
- 6.18 Given that there are no net additions from Day 1, this will be calculated in the proposed NESO Financial Model by taking a 12-month average of the RAV balance throughout the regulatory year (i.e. calculating an average RAV using the opening RAV balance and closing RAV balance for each financial year).
- 6.19 The calculated 12-month average will then be uplifted by outturn inflation using the same methodology described in paragraph 6.15 and converted into nominal prices.

7. Tax

Consultation Questions

- 5a.** Do stakeholders agree with our proposals regarding the Tax methodology?
- 5b.** Do stakeholders wish to propose any other alternatives that we have not proposed? If so, please provide evidence for us to consider further.

Introduction and purpose

- 7.1 NESO will remain a UK company limited by shares and as such will remain subject to corporation tax on its taxable profits.
- 7.2 To allow NESO to fully recover the RAV, and the agreed rate of return, a tax allowance will be required to form part of the allowed revenue calculation as noted at section F1.19 in the proposed NESO ESO Licence.
- 7.3 The Tax Liability allowance is guided by principles set out in Chapter 2.

Methodology for Calculating TAX_t

- 7.4 The proposed NESO Financial Model calculates the revenue to be collected in respect of three distinct components, being Internal Expenditure (INT_t), External Expenditure (EXT_t) and the financial return in respect of the unwinding of the RAV (RTN_t).

Tax Allowance in respect of INT_t

- 7.5 This section is to be read noting that TAX_t is itself a component part of the INT_t term and includes a grossing up element to account for the tax on tax.
- 7.6 From Day 1 NESO will receive revenue to recover Internal costs on a 100% fast money basis. Where revenues and costs arise in the same period for accounting and tax purposes it is expected that these will offset and no tax charge will arise. Similarly, all material capital expenditure is expected to arise on items which either directly qualify for First Year Allowances (FYA) at 100% relief, or will be able to be elected into the FYA regime.
- 7.7 From Day 1, no tax allowance will be required in respect of 100% fast money expenditure, except where tax becomes a permanent difference (see section 7.23 below).

Tax Allowance in respect of EXT_t

7.8 Timing differences in respect of certain external costs may arise due to the application of existing accounting standards. These timing differences are not able to be accurately forecasted in advance, and therefore are assumed to reverse for tax purposes within existing loss carry-back and carry-forward rules. These timing differences are therefore not included within the calculation of the tax allowance (consistent with the NGESO PCFM), but will be funded through the NESO working capital facility.

Tax Allowance in respect of RTN_t

7.9 To allow NESO to fully recover the RAV, and the agreed rate of return, a tax allowance will be required to form part of the allowed revenue calculation as noted at section F1.19 of the proposed NESO ESO Licence.

7.10 The proposed NESO Financial Model calculates the licensee's tax liability allowance on a notional basis (i.e. as a stand-alone entity) using, among other inputs, corporation tax rates and capital allowance writing down rates. Where rate changes are announced, these can be reflected in the proposed NESO Financial Model by updating the variable values for these rates at each annual update.

Calculation of TAX_t

7.11 TAX_t shall be calculated as follows:

$$TAX_t = (RTN_t - \text{Total Capital Allowances} + TAXP_t) * \text{Corporation Tax Rate} / (1 - \text{Corporation Tax Rate})$$

For the definition of $TAXP_t$, see section 7.23 below.

7.12 Total Capital Allowances refers to the total writing down allowances / deductions in a Financial Year per the proposed NESO Financial Model see further 7.28.

7.13 Corporation Tax Rate refers to the United Kingdom headline rate of corporation tax for a Financial Year as included within the proposed NESO Financial Model.

Tax Clawback

7.14 The NGESO licence contained provision whereby the tax allowance could be clawed back where the licensee's actual tax deductible net interest exceeded the notional interest in the NGESO PCFM, and the licensee exceeded agreed gearing limits.

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7.15 Post Day 1, NESO will be funded solely through the working capital facility, and therefore a tax clawback will not be required in the proposed NESO Financial Model.

Regulatory tax losses

7.16 In contrast to the previous NGESO PCFM, it will not be possible for NESO to make a regulatory tax loss.

Group tax arrangements

7.17 Post Day 1, NESO will not be part of a group for Corporation Tax purposes.

7.18 For any part of the period of account straddling Day 1, the previous NGESO PCFH section regarding group tax arrangements shall apply.

Tax Trigger Events

7.19 The NGESO PCFM allowed for changes to a licensee's tax liability allowance, through Tax Trigger Events (TTEs), for factors exogenous to the licensee, its owners or controllers that cause a change in its notional tax liabilities for one or more Regulatory Years.

7.20 The proposed NESO Financial Model does not include TTEs, as a tax allowance is only provided for the existing RAV as at 31 March 2024 and tax rates and writing down allowances can be set via variable values in the proposed NESO Financial Model.

Tax review

7.21 The NGESO licence contained Special Condition 4.2, Part I (Tax Allowance Adjustment) which set out that the Authority could require an independent review of the licensee's Actual Corporation Tax Liability, where unexplained differences between the Calculated Tax Allowance and Actual Corporation Tax liability arose.

7.22 The proposed NESO licences do not require a similar provision as there should be no unexplained differences between the actual tax liability of NESO, and the tax allowance.

Tax on permanent differences (TAXP)

7.23 NESO will manage their tax affairs in a way which is consistent with the overarching non-profit making objective. This may include for example, but not be limited to, making various elections to bring expenditure on Intangible Fixed

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Assets into the Plant and Machinery Main Pool to allow 100% FYA's to be claimed. This will then align the 100% fast money revenue with the associated tax relief, consistent with the over-arching principles of the establishment of NESO.

- 7.24 Notwithstanding this, there may be instances where Allowed Revenue and tax relief do not align. Where this occurs, NESO will make use of Loss Carry-back, Loss Carry-forward or any other claims or elections available to it to recover any tax paid or alleviate any tax which would otherwise fall to be paid in a future period.
- 7.25 Due to statutory restrictions on Loss Carry-back and Loss Carry-forwards there may be circumstances where tax relief cannot be claimed and a permanent difference arises. There may be other costs which are not deductible for tax purposes and will therefore give rise to permanent differences.
- 7.26 The proposed NESO Financial Model contains an input line to allow the tax allowance to be adjusted in any individual year for tax which has become a permanent difference. This input is named TAXP.
- 7.27 The licensee shall be responsible for populating this input line. The Authority may direct an amendment to the line if it does not consider that the difference represents a permanent difference.

Capital allowances – Opening pool balances

- 7.28 Tax liability allowance calculations under the AIP make use of regulatory tax pool balance figures held within the proposed NESO Financial Model. The opening balances (as at 1 April 2024) for these tax pools will be taken from the NGESO PCFM. These shall be adjusted as required to reflect the partial period which arises between 1 April 2024 and Day 1.
- 7.29 The NGESO pool balances were set at the start of the RIIO-2 NGESO price control and tied to the CT600 values at that time. Some differences may have arisen in the intervening period between the start of RIIO-2 and Day 1. Bringing the PCFM pool values into the proposed NESO Financial Model ensures that the NESO Tax Allowance is not increased to reflect additional deductions claimed by NGESO in its CT600 in excess of the tax allowance provided in the PCFM. This protects consumers from being unduly disadvantaged, and is consistent with the principle set out in NESO ESO Licence condition F1.15(b).

Methodology for calculating LEGTAX

Consultation - NESO Financial Handbook

- 7.30 Chapter 5 contains details of the Legacy Terms, which adjust the proposed NESO Financial Model for the proportion of the regulatory / statutory accounting year which occurs prior to Day 1.
- 7.31 The proposed NESO Financial Model calculates the tax allowance for the part of FY24/25 that arises after Day 1. The purpose of the LEGTAX value is to ensure that the Allowed Revenue is adjusted to materially reflect the tax allowance which would have arisen in NGESO for the partial period prior to Day 1.
- 7.32 LEGTAX shall be calculated within the Closeout model using the principles under which the NGESO PCFM Tax Allowance calculations have been carried out. These shall allow the notional tax allowance to be apportioned to the partial period up to Day 1.

8. Defined Benefit Pensions

Consultation Questions

6a. Do stakeholders agree with our proposals regarding the Pensions methodology?

6b. Do stakeholders wish to propose any other alternatives that we have not proposed? If so, please provide evidence for us to consider further?

Introduction and purpose

- 8.1 Our minded to position regarding the transfer of pension scheme costs, assets and liabilities and any financial adjustments relating to the proposed formal separation of NGESO from the National Grid plc group are covered in this chapter. This chapter also includes our initial minded to position for general provisions post separation which will be developed at a later date.
- 8.2 The proposed separation and transfer of the pension schemes from NGESO to NESO has been designed to ensure neutrality with regard to pension funding costs for consumers and National Grid Electricity Transmission plc (NGET).

Methodology

- 8.3 NESO defined benefit pension costs during FY24/25 will be in relation to the existing pension scheme, the National Grid Electricity Group of the Electricity Supply Pension Scheme ('NGEG scheme'). NGET are the sponsor of the NGEG scheme.
- 8.4 After FY24/25, there is the expectation that a new defined benefit scheme ('NESO DB scheme') will be set up and that:
- The NESO DB scheme will be fully separate from the NGEG scheme.
 - Current active members employed by NESO will transfer from the NGEG scheme to the NESO DB scheme, as part of an agreed bulk transfer, for the build of new pension benefits (subject to consultation as required).
 - The assets and liabilities of the NGEG scheme that are attributable to active members employed by NESO on or after Day 1 will subsequently be transferred from the NGEG scheme to the NESO DB scheme.

Consultation - NESO Financial Handbook

- Deferred and pensioner members who previously worked in the NGESO (but are not transferring over to the employ of the NESO) will remain members of the NGE scheme.
- The scheme will be closed to any new members, other than in exceptional cases such as a Protected Person²⁰.

8.5 This means that while the costs and risks associated with the deferred and pensioner members who previously worked in the NGESO are currently funded as a pass-through cost through the NGESO price control, those same costs and risks will not be funded through the NESO price control from Day 1. As a result, the Electricity Transmission Licence of NGET has been amended to avoid exposing NGET to the costs and risks associated with the deferred and pensioner members of NGESO who will remain within the NGE scheme after the separation date (NGET's Special Licence Condition 6.1 Pass-through items).

8.6 The date that contributing members employed by NESO transfer from the NGE scheme to the NESO DB scheme for the build of new pension benefits is denoted as the 'pension transfer date'.

8.7 The treatment of the transfer is covered in Special Licence Condition 6.1 (Pass-through items) in the NGET licence, which covers pensions obligations. Assets and liabilities for these members will remain within the NGE scheme, with no subsequent obligations remaining with NESO post-transfer.

8.8 For the NESO DB scheme, the costs of ongoing pension employer contributions, deficit recovery payments and the associated costs of running the scheme will be captured within NESO controllable expenditure. This will be fully recoverable from consumers. Costs of running the scheme recoverable under NESO controllable expenditure include:

- reasonable scheme management and administration costs, including all explicitly charged investment fees and regulatory imposed costs such as Pension Protection Fund and related levies and other non-controllable costs of meeting regulatory requirements of the Pensions Regulator and all relevant statutory requirements;

²⁰ Protected Person has the meaning given to that term in The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (SI 1990/346) or the [Electricity \(Protected Persons\) \(Scotland\) Pension Regulations \(SI 1990/510\)](#) (as applicable).

Consultation - NESO Financial Handbook

- reasonable pension liability management costs including the cost of early retirement, voluntary redundancy, flexible retirement options, transfer and pension increase exchange (PIE) exercises, and
- such project costs reasonably incurred.

8.9 Pension costs recoverable by NESO under controllable expenditure in relation to the NGE scheme (i.e. after Day 1) are expected to match those conditions set out in relation to NGE costs.

General provisions post separation

8.10 This section sets out the intended general provisions following the transfer of pension costs, assets and liabilities from the NGE scheme to the NESO DB scheme.

Pension principles

8.11 The ongoing operation of the NESO DB scheme, should be linked to Ofgem's current pension principles²¹ and in particular the principles regarding stewardship.

Actuarial valuations and Reasonableness Reviews

8.12 On a triennial basis, NESO will provide Ofgem with the following information in respect of the NESO DB scheme: the most recent actuarial valuation report, statement of funding principles, statement of investment principles and any other information reasonably required.

8.13 The first actuarial valuation of the NESO DB scheme is expected to be on 31 March 2025 prior to the pension transfer date and therefore the assets and liabilities will not carry any net asset or liability position.

8.14 The subsequent valuation of the NESO DB scheme is expected to be at 31 March 2028.

8.15 After receiving the information set out in paragraph 8.12, Ofgem will undertake a Reasonableness Review of the way in which NESO has: (a) formulated and justified the costs in respect of the NESO DB scheme (b) engaged with pension scheme trustees and managers to advocate for the interest of consumers (c)

²¹ <https://www.ofgem.gov.uk/decision/decision-ofgems-policy-funding-pension-scheme-established-deficits>

Consultation - NESO Financial Handbook

responded to any recommendations in preceding Reasonableness Reviews (d) otherwise followed good practice, informed by practice in the regulated and broader private sectors, in promoting consumer interests.

- 8.16 The first Reasonableness Review post separation is expected to be during 2026, with subsequent reviews carried out on a triennial basis.

Treatment of Pension Surplus

- 8.17 NESO will be required to consider and report to Ofgem on the extent to which any surplus that emerges in the NESO DB scheme can be used to derive economic benefit for consumers (for example, by way of pension contribution holidays).
- 8.18 Any submitted report of a surplus may be reviewed by Ofgem.
- 8.19 Any surplus released by the NESO DB scheme trustees to NESO should be returned to customers as a negative cost.

Other general provisions

- 8.20 As the associated costs of running the NESO DB scheme will be captured under NESO controllable expenditure no Pension Deficit Allocation Methodology will be required for NESO's pension arrangements.
- 8.21 However, detailed reporting requirements in respect of the NESO DB scheme will be required and separately developed with Ofgem and relevant parties, once more information is available in relation to the set-up of the scheme.

Appendices

Index

Appendix	Name of Appendix	Page No.
1	Privacy notice on consultations	49
2	Consultation questions	51

Appendix 1 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, “Ofgem”). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. With whom we will be sharing your personal data

We will share responses with the Department for Energy Security and Net Zero and National Energy System Operator.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for 12 months after the project has closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
 - access your personal data
-

Consultation - NESO Financial Handbook

- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas**8. Your personal data will not be used for any automated decision making.****9. Your personal data will be stored in a secure government IT system.****10. More information**

For more information on how Ofgem processes your data, click on the link to our "[ofgem privacy promise](#)".

Appendix 2 – Consultation questions

1a. Do stakeholders agree with our proposals regarding the NESO Financial Model?

1b. Do stakeholders wish to propose any other alternatives that we have not proposed?
If so, please provide evidence for us to consider further?

2a. Do stakeholders agree with our proposals regarding the Closeout methodology?

2b. Do stakeholders wish to propose any other alternatives that we have not proposed?
If so, please provide evidence for us to consider further?

3a. Do stakeholders agree with our proposals regarding the Price Indexation methodologies?

3b. Do stakeholders wish to propose any other alternatives that we have not proposed?
If so, please provide evidence for us to consider further?

4a. Do stakeholders agree with our proposals regarding the Return Calculation methodology?

4b. Do stakeholders wish to propose any other alternatives that we have not proposed?
If so, please provide evidence for us to consider further?

5a. Do stakeholders agree with our proposals regarding the Tax methodology?

5b. Do stakeholders wish to propose any other alternatives that we have not proposed?
If so, please provide evidence for us to consider further?

6a. Do stakeholders agree with our proposals regarding the Pensions methodology?

6b. Do stakeholders wish to propose any other alternatives that we have not proposed?
If so, please provide evidence for us to consider further?