Guidance

NESO Financial Handbook	
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This is the National Energy System Operator (NESO) Financial Handbook, which forms part of Licence Condition F5 (Financial Model and Handbook) in the Electricity System Operator (ESO) Licence Conditions and Licence Condition F4 (Financial Model and Handbook) in the Gas System Planner Licence Conditions held by NESO.

This document consists of:

a) a description of the NESO Financial Model, including the the requirements on NESO in relation to this;
b) an overview of the variable values used in the NESO Financial Model; and
c) details of how certain variable values are revised or calculated.

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1. Introduction

1.1 Licence Condition F5 (Financial Model and Handbook) in the Electricity System Operator (ESO) Licence Conditions[1] and Licence Condition F4 (Financial Model and Handbook) in the Gas System Planner Licence Conditions[2] establish the NESO Financial Handbook and set out the requirements on NESO in relation to the Financial Model.

1.2 This document is the NESO Financial Handbook and it sets out the principles and methodologies that will apply in the implementation and operation of the NESO Financial Model and the NESO Legacy Closeout Model.

1.3 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.

1.4 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).

[1] ESO_Licence_Direction_and_Terms_and_Conditions_Unsigned.pdf (ofgem.gov.uk)
[2] GSP_Licence_Terms_and_Conditions_unsigned_and_subject_to_SoS_decision

2. NESO Financial Model

Introduction and purpose

2.1 The NESO Financial Model implements the principles and calculations set out in this NESO Financial Handbook. This informs the revenues to be recovered from NESO customers following the 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 review 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.

NESO Financial Model

2.2 For each Regulatory Year, the NESO Financial Model provides for the calculation of the components (set out in 2.5 below) of ESO Allowed Revenue ($ESOAR_t$) and Gas Revenue Provision ($ARGSP_t$) terms in accordance with Licence Conditions F4 of the Gas System Planner Licence and F5 of the 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 functions embedded in the NESO Financial Model.

2.4 The variable values are updated by the licensee in accordance with the relevant licence condition, the NESO Financial Handbook, and the NESO Financial Model Guidance[3].

2.5 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

[3] 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.

populated using forecasts to give a value for future years. The model output of External Expenditure (EXT_t) is not used for tariff setting (which instead uses a separate forecast of the various elements published at the time of tariff setting) and the model is therefore only populated when a year is complete. The $ARGSP_t$ term is calculated in accordance with the Gas System Planner Licence conditions and its output in the NESO Financial Model is charged on National Gas Transmission Plc.

Legacy Closeout Model

2.6 The adjustments required to the NESO regulatory regime to reflect the period of FY24/25 before the transition to Government ownership are set out in Chapter 4. These are amalgamated in the Legacy Closeout Model to calculate and output the LEGt term, which in turn then forms an input to the NESO Financial Model.

Principles

2.7 The closeout methodology is guided by principles agreed in relation to the transition to the new NESO regime.

2.8 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 ‘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.

2.9 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.

Price Base

2.10 The NESO Financial Model and the Legacy Closeout 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.

NESO Financial Handbook and Models Obligations

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

2.12 Ofgem has developed the NESO Financial Model and Legacy Closeout Model and has published initial templates for both models. After Ofgem has published the initial templates, the licensee will issue and amend the NESO Financial Model and Legacy Closeout Model.

2.13 The licensee will publish the NESO Financial Model and the associated Legacy Closeout Model (if necessary to support the NESO Financial Model) on the licensee's website.

2.14 NESO will be the owner of the NESO Financial Model and Legacy Closeout Model. NESO will have the ability to amend the models itself. Ofgem retains the ability to direct an amendment to be made to either model where considered necessary.

2.15 The licensee must ensure that an up to date version of the NESO Financial Model is maintained on the licensee's website, and that a history is kept of previous published versions.

2.16 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.

2.17 The NESO Financial Model will be used for the purpose of determining the value of each relevant component (as set out in 2.5 above) of allowed revenue on an ongoing basis until otherwise specified by the Authority.

Completion obligations

2.18 There must be at least one version of the NESO Financial Model sent to Ofgem by the licensee each year for the purposes of setting $ESOAR_t$ and $ARGSP_t$. The number of submissions needed will depend on the number and timing of variable value updates required for the licensee in any particular Regulatory Year.

2.19 In order to facilitate publication of the relevant components (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$ by 30 November, the following annual cut-off dates will apply unless otherwise agreed with the Authority:

- 31 October in respect of functional changes to the NESO Financial Model, NESO Financial Handbook and NESO Financial Model Guidance; and
- 5 November in respect of information submitted by the licensee in accordance with paragraph 2.21 below.

2.20 Having determined any revisions to variable values, 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 relevant components (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$ for Regulatory Year t for the licensee.

2.21 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.

2.22 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 2.21 the licensee shall not be required to provide the Authority with a further copy within a 14-day notice period.

2.23 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.

What if the annual updates are not completed by 30 November?

2.24 If the licensee does not publish a value for the relevant components (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$ by 30 November prior to any Regulatory Year, then the annual submission will not have been completed and the provisions set out below will apply.

2.25 The licensee will complete the annual update process as soon as is reasonably practicable after 30 November by publishing a value for the relevant components (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$.

2.26 In the intervening period between 30 November and the date the value of the relevant components (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$ is published, the value for the relevant components (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$ will be held to be equal to a value ascertained by:

- taking a copy of the NESO Financial Model in its state following the last completed annual update process
- using the selection facilities on the "Inputs" sheet contained in that copy of the NESO Financial Model to select:

  (1) the Regulatory Year equating to the Regulatory Year t; and

  (2) recording the value of each relevant component (as set out in 2.5 above) of $ESOAR_t$ and $ARGSP_t$ for the licensee that is shown as an output value in the "Live Results" sheet.

Calculation of allowed revenue

2.27 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 most recent consultation. This version of the NESO Financial Model will be the one used in the upcoming annual updates and will be published by the licensee by the functional cut-off dates set out at Table 2.1.

2.28 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 or the NESO Financial Model Guidance as applicable, and otherwise provide its best estimate as a provisional value with the information available at the time.

2.29 The licensee must, if it is uncertain of the correct way to calculate a variable value, seek advice from Ofgem.

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

Process

The process for 2024

2.31 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.

2.32 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 commentary when received. Ofgem may direct NESO to make changes to the output prior to publication. We note this update will be used to derive three components of 2025/26 allowed revenue, INT_t, RTN_t and $ARGSP_t$. EXT_t will be derived at a later date, in line with the RIIO-2 ESO timelines.

2.33 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 first version of the model to be published on NESO's website will be the populated NESO Financial Model. Any amendments to the NESO Financial Model can be incorporated in the version of the model due to be published on 30 November 2024 with any updates detailed in a change log.

2.34 NESO will share a copy of the finalised NESO Financial Model and notify Ofgem no less than 14 days prior to the publication of the NESO Financial Model, or by a date as agreed by Ofgem, which NESO will then self-publish on its website by 30 November 2024.

The enduring process

2.35 In years after 2024, NESO will provide regulatory reporting to Ofgem by 31 August in each year.

2.36 The Authority will consider and consult subsequently on reporting requirements that may be necessary including reports similar to those of the Regulatory Financial Performance Report (RFPR) and the Regulatory Reporting Pack (RRP).

2.37 The calculation of each relevant component (as set out in 2.5 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.

2.38 The licensee will publish on its website a version of the NESO Financial Model that is proposed to be used as the basis for tariff setting.

2.39 Before finalising the NESO Financial Model for use in the annual submission, the licensee will publish on the licensee's website:

- the proposed NESO Financial Model;
- the date on which the licensee intends the 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. If there are no changes since the previous publication then this step need not apply.

2.40 After finalising the NESO Financial Model, the licensee must publish the NESO Financial Model on the licensee’s website.

2.41 In advance of the consultation described above taking place, there must be a joint functionality change meeting between the licensee and Ofgem to discuss the content of the model. Both the licensee and Ofgem can use this opportunity to raise any issues that are required and identify any changes that need to be reflected in the Financial Handbook that Ofgem will consult on in future.

2.42 This meeting must take place no later than the first week of September each year. In advance of the meeting taking place, the licensee must prepare (and share with Ofgem) a version of the Financial Model, updated for the latest Variable Value inputs reported to Ofgem, to support the discussions. At the same time, the supporting Legacy Closeout Model must be submitted (if changed from a version of that model previously used).

2.43 This meeting will be arranged and led by the licensee and must consist of at least one representative from the licensee and one representative from Ofgem. Following the meeting, the licensee must issue formal notes of any discussions. If required, follow up meetings will be arranged.

2.44 Publication of the NESO Financial Model resulting from the consultation should ordinarily take place as early as possible and in any case by 31 October each year. The model must include a change log identifying all changes made to the model since the previous published version.

2.45 The first populated model and associated commentary must be supplied to Ofgem no later than 30 September each year, which has been updated to calculate the INT_t and RTN_t components of $ESOAR_t$ as well as $ARGSP_t$. At the same time, the first populated Legacy Closeout Model and the associated commentary must be submitted.

2.46 The completed model, once populated, must be supplied to Ofgem for review no later than 15 November each year. At the same time, the completed Legacy Closeout Model and the associated commentary on each must be submitted.

2.47 Ofgem will review the submitted NESO Financial Model and confirm whether the values it contains have been prepared in accordance with the NESO Financial Model Guidance and NESO Financial Handbook. 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.

2.48 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 must be updated and the relevant components (as set out in 2.5 above) of

$ESOAR_t$ and $ARGSP_t$ must be recalculated to reflect the impact of the updated values.

2.49 In the absence of any direction from Ofgem to amend the output of the model, the final populated version will be published on the licensee's website (by 30 November in Regulatory Year t-1, or as soon as is reasonably practicable thereafter) along with the Legacy Closeout Model that applies for the particular regulatory year. This version of the model will provide the values for the components of allowed revenue described in 2.5 above that will be used in subsequent tariff setting, until those values are updated in the following year.

2.50 The licensee will also publish the values of the relevant components (as set out in 2.5 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 must be stated in £ millions to one decimal place.

2.51 Table **2.1** below summarises the timings for the annual submission on an ongoing basis.

Table 2.1 - Summary of timings for the annual submission[4]

Submission Year	Joint Functionality Change meeting	Licensee submits populated NESO FM	NESO FM functional change cut-off	Regulatory reporting information cut-off	Notice of proposed variable value revisions by	Submission completed and components of ESOARt & ARGSPt published by	Regulatory Year t in which components of ESOARt and ARGSPt apply
Nov-25	1st week Sep 25	30-Sep-25	31-Oct-25	05-Nov-25	15-Nov-25	30-Nov-25	2026/27
Nov-26	1st week Sep 26	30-Sep-26	31-Oct-26	05-Nov-26	15-Nov-26	30-Nov-26	2027/28
Nov-27	1st week Sep 27	30-Sep-27	31-Oct-27	05-Nov-27	15-Nov-27	30-Nov-27	2028/29
Nov-28	1st week Sep 28	30-Sep-28	31-Oct-28	05-Nov-28	15-Nov-28	30-Nov-28	2029/30

[4] 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[5]	Licence Condition F1.23	NESO ESO Licence
$ESOI_t$	Interest Costs	Licence Condition F1.19	NESO ESO Licence
ETE_t	Controllable Expenditure	Licence Condition F1.18	NESO ESO Licence
$FPEN_t$	Fines and Penalties	Licence Condition F1.19	NESO ESO Licence

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

VV	Description	Licence Conditions	Cross-reference / Associated Document
$FSONG_t$	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[6]	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[7]	Licence Condition F1.23	NESO ESO Licence
GLE_t	Gas Licence Expenditure	Licence Condition F1.16	NESO GSP Licence

[6] This will be populated when actual vaues are available for a full year, with no forecast included. This is because this sits with the EXT revenue stream.
[7] This will be populated when actual vaues 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 NESO licences involve a change in policies from the existing NGESO licence. With the 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.

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')[8]. 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 transition from NGESO to NESO. This will be reflected in the 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 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.

[8] With a correction mechanism in place to deal with over- or under-recovery.

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 to occur.

4.9 A methodology is required for closeout, given that there will be a transition between licences within a financial year, with each licence regulating a different form of regulated entity. This section sets out our 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). 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 NESO ESO Licence splits the revenue that can be collected via BSUoS into 3 components[9]:

$ESOAR_t = INT_t + EXT_t + RTN_t$

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 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.

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.

[9] This is shown for the NESO ESO licence in collecting $ESOAR_t$. The NESO GSP licence refers to the collection of $ARGSP_t$.

Overarching methodology for calculating LEG_t

4.18 The LEG_t term is 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 FY24/25 to be consistent with the licence in force before the transition.

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

Table 4.1: Additional terms within LEG_t

Term	Item	Description
LEGETE	Controllable expenditure	The NESO Financial 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. 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).
LEGTAX	Tax	The 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, therefore any expenditure before Day 1 will need to be included as a negative item, as the NESO licences involve those costs being passed onto the consumer if incurred.
LEGDPN	Depreciation	The 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. RAV depreciation only starts the year after additions are made, so depreciation in FY24/25 will be unimpacted by expenditure in FY24/25. The depreciation profile from the November 2023 AIP will be retained, with an updated value to reflect FY23/24 additions.

Term	Item	Description
		Depreciation for H1 FY24/25 is not included in the NESO Financial Model and needs to be included in LEG_t as a positive adjustment.
LEGRTN	Return	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. 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. The basis for the notional cost of capital is equivalent to the methodology set out in the NESO Licence for setting the allowed cost of debt and allowed cost of equity. The real vanilla allowed return on capital for FY24/25 is currently forecasted as 5.75% and will be updated per the NGESO licence as actual data becomes available. The return adjustment is included as a positive item in LEG_t.
LEGADF	Additional funding	NGESO is set a fixed allowance in nominal terms (£4.8m per annum). As NESO is not-for-profit and the concept of allowances is not relevant, no equivalent funding will occur from Day 1. 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.
LEGEDE	Pension scheme established deficit (PSED) recovery allowances	There is a cumulative variance between the licensee's PSED repair payments and its historic allowances for PSED repair prior to Day 1. Based on the outcome of the 2023 Reasonableness Review, this is expected to be a negative item. 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.
LEGADJ	Adjustment for new data	Allowed revenue for FY24/25 includes an ADJ value that trues-up amounts for every previous year as they were seen at the time of that AIP. The NESO Financial Model will not capture revenues prior to FY24/25. Charges therefore reflect the adjustment term relating to all years up to and including

Term	Item	Description
		FY23/24. To the extent that allowed revenues subsequently change, that change has to feed in to collected revenues. Updates to allowed revenue in respect of years prior to FY24/25 need to feed into the LEGt term of the NESO licences, based on updates on input values. Therefore, the NGESO PCFM as published in December 2023 will continue to be iterated to capture values up to FY23/24 that would otherwise not be included in the NESO Financial Model. The LEGADJ term would be updated through the Legacy Closeout Model for subsequent iterations.
LEGEXT	Interest on BSUoS (‘K’)	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. 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). 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.
LEGSOLAR	Pre-RIIO2 adjustments	The NGESO PCFM includes adjustments in FY24/25 for pre-RIIO2 revenue adjustments. These will need to be included in the LEG_t term as a positive item.
LEGWCF	Working Capital Facility costs	The interest costs from the Working Capital Facility are fully recoverable for NGESO. Where these costs are not reflected in the NESO Financial Model, they will need to be added to LEG_t as a positive item.

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 a 2018/19 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 2018/19 real prices into a nominal equivalent (and vice-versa). This is set out in Chapter 5.

4.26 The NESO Financial Model involves most parameters in nominal terms, with some limited exceptions.

5. Price Indexation Methodologies

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 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 NESO Financial Model and associated inputs (in the absence of an inflation indexed Regulatory Asset Value).

5.4 The 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 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 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 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:

$$value_{2018/19prices} = value_{nominal} \times \frac{PI_{2018/19}}{PI_t}$$

Where:

$value_{2018/19prices}$	means the deflated/restated value in 2018/19 prices
$value_{nominal}$	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:

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.[10]

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 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 database[11], "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.

[10] https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l522/mm23
[11] https://obr.uk/data/

5.17 A long-term CPIH inflation assumption will be used for years included in the NESO Financial Model for which OBR forecasts do not yet exist. This value does not impact on tariffs and is indicative. The 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 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.

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 SO-TO 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)[12].

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.

[12] In the NESO Financial Model, the RVR has been set as equal to the current Bank of England base rate.

6. Return (RTN) Calculation

6.1 As discussed in Chapter 4, the 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 approach set out in this chapter

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

$$RTN_t = RTNO_t + RTNADJ_t$$

Our 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 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.

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

$RTNO_t = DPN_t + (RAV_t \times DR_t)$, 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 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 NESO ESO Licence as a fixed 3.5% rate.

6.8 Given that the 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 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 NESO Financial Model for the regulatory year in which the 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 FY24/25 prior to Day 1 (i.e. the depreciation and RAV return for that period).[13]

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

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

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 20-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 NESO Financial Model in 2018/19 prices. The RAV will be uplifted by outturn inflation using CPIH inflation, as described in Chapter 5.

Methodology for Calculating RAV_t

6.17 As per the 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 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

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 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 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 NESO ESO Licence.

7.10 The 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 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:

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

For the definition of TAXP, see section 7.23 below.

7.12 Total Capital Allowances refers to the total writing down allowances / deductions in a Financial Year per the 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 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.

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 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 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 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 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 over-arching non-profit making objective. This may include for example, but not be limited to, making various elections to bring expenditure on Intangible Fixed 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 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 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 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

7.30 Chapter 5 contains details of the Legacy Terms, which adjust the NESO Financial Model for the proportion of the regulatory / statutory accounting year which occurs prior to Day 1.

7.31 The 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

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 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 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.
- 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 NGEG scheme.

- The scheme will be closed to any new members, other than in exceptional cases such as a Protected Person[14].

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 NGEG 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 NGEG 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 NGEG 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;
- 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.

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[14] 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).

8.9 Pension costs recoverable by NESO under controllable expenditure in relation to the NGEG scheme (i.e. after Day 1) are expected to match those conditions set out in relation to NGESO 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 NGEG 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 principles[15] 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) 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.

[15] https://www.ofgem.gov.uk/decision/decision-ofgems-policy-funding-pension-scheme-established-deficits

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.