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### **NESO Response to the Consultation on the National Energy System Operator Financial Handbook**

Dear Sir/Madam,

Thank you for the opportunity to respond to your consultation on the National Energy System Operator Financial Handbook.

#### **Who we are**

NESO lies at the heart of the energy system as an independent, public corporation responsible for planning Great Britain's electricity and gas networks, operating the electricity system and creating insights and recommendations for the future whole energy system.

At the forefront of our efforts is delivering value for consumers. We work with government, regulators and our customers to create an integrated future-proof system that works for people, communities, businesses and industry, where everyone has access to clean, reliable and affordable energy.

NESO's primary duty is to promote three objectives: enabling the government to deliver net zero, promoting efficient, coordinated and economical systems for electricity and gas and the economy and efficiency of energy businesses and ensuring security of supply for current and future consumers. NESO will take a whole system approach, looking across natural gas, electricity and other forms of energy and will engage participants in all parts of the energy ecosystem to deliver the plans, markets and operations of the energy system of today and the future.

#### **Our key points**

On the Financial Model, we support Ofgem's proposed approach to ownership and development of the Financial Model as it recognises the change in the regulatory framework for the transition from ESO to NESO. Having reviewed the document, we believe that processes as outlined in Chapter 2 are structured to align NESO with other Ofgem regulated sectors and does not fully

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represent the new regulatory framework. NESO's financial regulatory framework, on an actual rather than notional basis, is very different to other sectors and therefore the administrative process should reflect this in a proportionate manner. We therefore propose a simpler process which would retain transparency for stakeholders but be reflective of the new regulatory regime.

For the Closeout Methodology, we agree with Ofgem's proposals which have recognised the value of simplicity in developing policy. We agree that as the electricity system operator licence will calculate a 12-month ESO Allowed Revenue, the  $LEG_t$  term should be defined to adjust NESO revenues to incorporate the pre Day 1 outturn values and adjustments for the transition from the ESO regime to the not for profit NESO regime.

We agree that the approach to Price Indexation methodology outlined in the Handbook carries forward the RII0-2 methodology used by ESO and therefore treats customers consistently. Similarly, the methodology outlined for RTN is fair to the customer as the depreciation profile is largely unchanged. The Tax principles proposed represent a pragmatic approach and balance NESO's various tax requirements whilst recognising its not-for-profit status.

Our view on Pensions is that the proposed defined benefit pension methodology would achieve Ofgem's objective of ensuring neutrality with regard to pension funding costs for consumers. It also appropriately recognises NESO's not-for-profit status and the size of NESO's defined benefit pension liabilities (which will be much smaller than those of other Ofgem regulated entities). In particular, we agree that it is appropriate for all reasonable defined benefit (DB) pension costs (as set out in 8.8) to be captured within NESO controllable expenditure and fully recoverable from consumers. It follows that, as is proposed, adherence to Ofgem's Pension Deficit Allocation Methodology is not relevant or necessary for NESO's pension arrangements. We also note that the proposed approach would link the ongoing operation of the NESO DB scheme to Ofgem's current pension principles, which we agree is appropriate. Should Ofgem's general pension principles be revised in future we would expect to engage with Ofgem on how such changes might affect the methodology applied in respect of the NESO DB scheme.

To aid transparency for the user there are instances where we have suggested slight drafting changes in Appendix 1. There are also some details in the consultation that are incorrect. These are set out in Appendix 2.

### Chapter 2 points

We appreciate that much of Chapter 2 of the consultation has been included in order to mirror the contents of Financial Handbooks for other network companies. However, given that NESO will be part of a separate Ofgem regulated sector (indeed, the only member of that sector), will no longer have a Price Control Financial Model (PCFM) and the requirements in Condition F5 of the Electricity System Operator licence (mirrored in Condition F4 of the Gas System Planner licence) apply, we do not consider that many of the sections covered will be relevant or should be included.

We also do not consider the processes set out to mirror the intent. Broadly speaking, we see the process for 2024 as:

- Ofgem provides the Financial Model template to NESO.

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- NESO populates the Financial Model template by 31 October 2024.
- Ofgem may direct NESO to make changes to the populated Financial Model.
- NESO will notify Ofgem of the finalised Financial Model by 15 November 2024.
- NESO will publish the NESO Financial Model on its website by 30 November 2024.

Overall, we see the process for years from 2025 as:

- NESO will provide regulatory reporting (detail still to be determined) to Ofgem by 31 August.
- NESO will share the proposed Financial Model with populated inputs with Ofgem.
- NESO will hold a functionality change meeting with Ofgem by the end of the first week of September to discuss whether changes should be made to the Financial Model.
- Where NESO considers that the Financial Model needs to have functional changes, NESO will publish the proposed Financial Model for consultation (for at least 14 days).
- NESO should finalise the Financial Model following consultation and publish the Model to be used, revised where appropriate but with no updated inputs, as early as possible but by 31 October.
- NESO should send the populated Financial Model to Ofgem by 15 November.
- Unless Ofgem directs otherwise, NESO should publish the populated model, along with the values of the relevant parts of allowed revenue that are calculated by 30 November.

To build the necessary flexibility into the process, we suggest that each of the above dates should allow for Ofgem to agree to another date (to be used where circumstances justify this).

Subject to the above points, we outline below our particular concerns with the proposed drafting and will continue to work jointly with Ofgem on proposing alternative drafting to address these.

- Paragraphs 2.11 and 2.12 talk about publishing the model “before issuing or amending”. The drafting suggests that these paragraphs apply to each change (whenever that change takes place) and also requires a consultation to be carried out every time. As the model is only used on an annual basis, it would be more appropriate to have a streamlined process with an annual publication requirement incorporating all changes made since the previous publication (with associated consultation as required), in a similar way to that outlined in paragraphs 2.52 and 2.53. This process would also include Ofgem who could see (and approve) the proposed list of amendments prior to the consultation being issued with the proposed change log mentioned in paragraph 2.34 as applying in 2024 added to the requirements in subsequent years.
- Taken in isolation, paragraph 2.20 says that “*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.*” This paragraph prevents any other corrections or amendments being made to the model (whether following the process outlined in 2.11 and 2.12 or directed by the Authority in line with 2.14). Therefore we propose that this paragraph is deleted.

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- Paragraph 2.37 says that reporting is required by 31 August each year (after 2024), including both the Legacy Closeout Model and the NESO Financial Model. Paragraph 2.38 covers potential additional reports similar to the current Regulatory Financial Performance Report (RFPR) and the current Regulatory Reporting Pack (RRP). It is likely that the content of these reports will be merged in due course into a single report that it would be sensible to make due on 31 August each year. As the contents of that report will inform model population, it would be inappropriate for the model to also be submitted on 31 August. Given that there will be a significant reduction in the number of submissions required before publication (there will, for example, be no tax trigger) then it would be more appropriate for the model to be first submitted no later than 30 September.
- The section starting at paragraph 2.40 deals with the inception, purposes and procedures for a “NESO Financial Model Working Group”. Under current arrangements, the Price Control Financial Model (PCFM) Working Group forms a useful purpose with the ability for a network company to raise an issue that might affect others and for the sharing of information across multiple users of the same file under similar principles of regulation. In contrast, NESO will be the sole user of the NESO Financial Model and therefore has no other parties to share information with. The usefulness of a Working Group would therefore likely be negligible and, given that there is likely to be ongoing communication between NESO and Ofgem (as provided in the other paragraphs of Chapter 2) the formalisation of a Working Group should not be required. The Authority would still be involved in proposed changes as described above and we propose including wording to formalise the requirement for a meeting in advance of the publication window mentioned above.
- The section starting with paragraph 2.57 outlines the Dry Runs process. As set out above, the requirement for Dry Runs is likely to be significantly reduced such that there would only need to be the initial submission (suggested above as 31 October) followed by the final version.
- Paragraph 2.60 sets out a functional change cut off of 1 June to apply each year. Given that the majority of errors / changes are likely to be found during population of the model, this would preclude required changes being made. The text suggests that Ofgem would “normally” apply this date but since we believe that it should never be applied in practice, we propose that this part be removed.

We look forward to engaging with you further. Should you require further information on any of the points raised in our response please contact Craig Bell, Finance Business Partner, at [craig.bell@nationalgrideso.com](mailto:craig.bell@nationalgrideso.com).

Yours sincerely

Phil Lane

Director of Strategic Finance

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## Appendix 1 – Suggested wording changes

To aid transparency for the user there are instances where we have suggested slight drafting changes. These apply in addition to our more general comments set out above. In each case, amendments to wording are shown in **red**.

### Paragraph 2.1

Given it is not a concept set out in NESO's licences, we suggest that the Legacy Closeout Model should be explained in the Handbook where it is first set out.

### Paragraph 2.4

The last sentence in this paragraph is potentially open to interpretation which might suggest that no element of external expenditure is included within tariffs. To aid clarity, we propose wording as follows:

*The model output of External Expenditure (EXT<sub>t</sub>) 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 ~~in the model~~ when a year is complete with no element of forecast.*

### Paragraph 2.17

To clarify the changes being referred to, we propose an extra clause at the end of this paragraph (and removing an unnecessary comma earlier in the paragraph).

*The licensee must ensure that any modifications of the NESO Financial Model~~;~~ are promptly incorporated into consolidated versions maintained on the licensee's website following the process as described in paragraph 2.12.*

### Paragraph 2.25

This paragraph includes the word "with" when it should say "within".

### Paragraph 2.45

At the moment this paragraph requires "the licensee to give 10 days' notice of a meeting to the licensee". We propose that this is amended to "the licensee to give 10 days' notice of a meeting to the Authority".

### Paragraph 4.18

For consistency in naming terminology, we propose amending the end of this paragraph to:

*... necessary to be recovered for HI ~~FY24/25~~ to be consistent with the licence in force before.*

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**Table 4.1**

To emphasise the impact of component terms of  $LEG_t$  in the model, we propose the following wording changes:

Term	Wording
LEGFPN	... NGESO is unable to recover these costs therefore any expenditure before Day 1 will need to be included as a negative item, as the <del>though</del> proposed NESO licences involve those costs being passed onto the consumer if incurred.
LEGDPN	... Depreciation for <del>the period up to Day 1 HI 24/25</del> is not included in the proposed NESO Financial Model and needs to be included in $LEG_t$ as a positive adjustment reflected under <del><math>LEG_t</math> as depreciation prior to Day 1 has been incorporated in the Day 1 RAV estimate.</del>
LEGRTN	... <del>The real vanilla allowed return on capital for FY24/25 is 5.75%. The return adjustment is included as a positive item in <math>LEG_t</math>.</del>
LEGSOLAR	The NGESO PCFM includes adjustments in 2024/25 for pre-R1102 revenue adjustments. These will need to be included <del>be captured within</del> the $LEG_t$ term as a positive item,; <del>although those values are small.</del>
LEGWCF	... <del>In theory, w</del> Where these costs are not reflected in the proposed NESO Financial Model, they <del>should</del> will need to be added to $LEG_t$ as a positive item.

### Paragraph 5.31 (Footnote 18)

The footnote to this paragraph mentions *RFR*. This should be amended to say *RVR*.

### Paragraph 6.13

This paragraph refers to the Wokingham RAV as being depreciated over a 19-year period. This should be amended to a 20-year period.

### Allowed Revenue

There are numerous instances in the document where Allowed Revenue is mentioned. Allowed Revenue is not a defined term so should not be generally capitalised, and instead the text should refer to allowed revenue. There are instances of this in paragraphs 2.4, 2.18, 2.21, 2.27, 2.33, 2.41, 2.49, 7.24, 7.31, twice in note 7 on page 17 and within the description of LEGADJ in Table 4.1 reproduced above.

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**2018/19 prices**

The document mainly refers to 2018/19 prices where needed. However, there are some instances where the document instead refers to 18/19 rather than using the full term. To ensure consistency we propose that these instances are replaced. This applies to paragraphs 4.24 and 4.25.

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## Appendix 2 – Consultation factual errors

We propose changes in the following areas to accurately reflect the arrangements. Where the points relate to an area in Chapter 2, they should be read in conjunction with the points in our response.

**Table 2.1**

Table 2.1 (in paragraph 2.67) contains the wrong dates for the last column. The table should be:

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 <sub>t</sub> and ARGSP <sub>t</sub> published by	Regulatory year t in which components of ESOAR <sub>t</sub> and ARGSP <sub>t</sub> applies
Nov-2025	31 Aug 25	01 Jun 25	31 Oct 25	15 Nov 25	30 Nov 25	2026/27
Nov-2026	31 Aug 26	01 Jun 26	31 Oct 26	15 Nov 26	30 Nov 26	2027/28
Nov-2027	31 Aug 27	01 Jun 27	31 Oct 27	15 Nov 27	30 Nov 27	2028/29
Nov-2028	31 Aug 28	01 Jun 28	31 Oct 28	15 Nov 28	30 Nov 28	2029/30

The correct dates in the last column are shown in red above.

**Table 3.1**

The entry for Table 3.1 (in paragraph 3.3) for ESOI<sub>t</sub> refers to paragraph F1.19 of the Gas System Planner licence. It should be noted that the GSP licence does not refer to ESOI<sub>t</sub>.

We suggest an addition to this table for Gas Licence Expenditure (GLE<sub>t</sub>) as follows:

VV	Description	Licence Conditions	Cross-reference / Associated Document
GLE <sub>t</sub>	Gas Licence Expenditure	Licence condition F1, paragraph F1.16	NESO GSP Licence

**Table 4.1**

Table 4.1 (in paragraph 4.19) contains inconsistent dates when discussing LEGADJ. For the avoidance of doubt, allowed revenue was set by the publication of the AIP in November 2023 (published 13 December 2023). The allowed revenue for 2024/25 includes an ADJ figure that is calculated using updated inputs for all years up to and including 2023/24. An ADJ for 2024/25 is included in the Financial Model and therefore this need not be included in the Legacy term. We



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have also taken the opportunity to add wording to make this more transparent. When the years and the new wording are combined, we suggest that the paragraph should read as follows:

*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 proposed NESO model will not capture revenues prior to FY24/25. Charges therefore reflect the adjustment term ~~adjustments made, up to and including the~~ relating to all years up to and including FY23/24 AIP. 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 LEG<sub>t</sub> 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 Model. The LEGADJ term would be updated through the Legacy Closeout Model for subsequent iterations.*

Corrected items in this paragraph are also shown in red.

In addition, the definition of LEGEDE that appears in table 4.1 seems to be missing the word “payments” (or similar) from the first sentence. This should therefore read: “There is a cumulative variance between the licensee’s PSED repair *payments* and its historic allowances for PSED repair prior to Day 1.”