Guidance

(Draft) NESO Financial Handbook

Publication date:	11 December 2025
Contact:	Regulatory Finance Policy Development Team
Team:	Regulatory Finance
Email:	RegFinance@ofgem.gov.uk

This is the NESO Financial Handbook, which sets out processes and methodologies National Energy System Operator (NESO) should comply with through its calculation of annual allowed revenues.

This document is issued under licence Condition F5 (Financial model and handbook) in the Electricity System Operator (ESO) Licence and Condition F4 (Financial model and handbook) in the Gas System Planner Licence (GSP) held by NESO.

This is a draft version of the NESO Financial Handbook for consultation. In March 2026, we plan to issue a final version for the NESO Financial Handbook, to take effect from 1 April 2026.

Version History

Version	Summary of the document	Publication date	Release date
1	Introduction of first version of NESO Financial Handbook[1]	12 September 2024	1 October 2024
2 (Draft)	Changes to implement our August 2025 decision on NESO's enduring regulatory framework and to update and clarify the arrangements.	11 December 2025 (for consultation)	1 April 2026 (subject to consultation)

[1] Financial Handbook: National Energy System Operator (NESO) | Ofgem

Contents

1. Introduction

Summary

1.1 National Energy System Operator (NESO) is an independent, public corporation which has key responsibilities across the energy system. NESO has a leading role in driving a secure and cost-effective transition to a clean energy system, and its overarching duties and objectives are unpinned by legislation.[2]

1.2 We[3] regulate NESO, to ensure it is accountable for its performance delivering its duties and to ensure its actions align with consumers' interests. This includes setting requirements on the annual revenues that NESO can recover from energy consumers through industry charges (known as "allowed revenues"). These allowed revenues are established by Condition F1 (Expenditure and allowed revenue) of NESO's Electricity System Operator (ESO) Licence[4] and Condition F1 (Gas revenue calculations and notifications process) of NESO's Gas System Planner (GSP) Licence[5].

1.3 This document is the NESO Financial Handbook. It sets out certain methodologies and processes that NESO must comply with in the calculation of its annual allowed revenues. This includes the processes NESO must follow in relation to the NESO Financial Model - a model maintained by NESO to show its detailed calculation of allowed revenues.

1.4 The NESO Financial Handbook is issued by direction from the Authority under Part B of Condition F5 (Financial model and handbook) of the ESO Licence and Condition F4 (Financial model and handbook) of the GSP Licence. This document may be revised and reissued in accordance with the process in those conditions.

1.5 This document is structured as follows:

- Section 2 sets requirements on NESO in relation to the NESO Financial Model and the annual NESO Financial Model update.
- Sections 3 to 6 provide methodologies for how NESO should calculate certain allowed revenue terms in the ESO Licence (including LEG_t, $ESOI_t$, DPN_t and TAX_t), as well as the price indexation and time value of money methodologies NESO should use; and
- Section 7 sets requirements on NESO in relation to defined benefit pension scheme costs.

[2] See sections 163-165 of the Energy Act 2023 for more details: Energy Act 2023

[3] The Office of Gas and Electricity Markets (Ofgem) supports the Gas and Electricity Markets Authority ('the Authority') in its day-to-day work. In this document, 'we', 'Ofgem', and 'Authority' are often used interchangeably

[4] Electricity licensing (from October 2025) - Publications - Ofgem Public Register

[5] Gas licensing (from October 2025) - Publications - Ofgem Public Register

Compliance

1.6 Where provisions of the NESO Financial Handbook require the compliance of the licensee, the licensee must comply with those provisions as if this document were part of Condition F5 in ESO Licence and Condition F4 of the GSP Licence.

1.7 For the avoidance of doubt, this document is subordinate to the licences. This document does not change any definition or obligations contained within the licences and in the event of any ambiguity over the Financial Handbook, the licences will take precedence.

1.8 The contents of this document do not alter NESO's compliance with its wider obligations under legislation, its licences or industry codes.

2. NESO Financial Model

Introduction and purpose

2.1 The NESO Financial Model is a model that contains the detailed calculation NESO uses to determine the revenues it is allowed to recover under Condition F1 of the ESO Licence and the GSP Licence. This informs the revenues to be recovered each year through industry charges.

2.2 NESO's allowed revenues consist of the following main parts:

- ESO Allowed Revenue ($ESOAR_t$) under the ESO Licence, which in turn has three main subcomponents: Internal Expenditure (INT_t), External Expenditure (EXT_t) and RAV Returns (RTN_t); and
- The gas revenue provision term ($ARGSP_t$) under the GSP Licence, which represents revenues NESO can recover through gas charges to reflect gas-related expenditure.

2.3 The NESO Financial Model calculates values of INT_t and RTN_t using forecast variable values which are directly used in the charge setting process. The NESO Financial Model output of EXT_t is not used for charge setting (which instead uses a separate forecast published at the time of charge setting) and the model is therefore only populated when a year is complete. The $ARGSP_t$ term is calculated in accordance with the GSP Licence and its output in the NESO Financial Model is charged on National Gas Transmission Plc to recover through gas transmission charges. NESO must allocate its costs between $ESOAR_t$ and $ARGSP_t$ in accordance with the Total Cost Allocation Methodology (TCAM) established in Part B of Condition F1 of the ESO Licence and GSP Licence.

2.4 Part A of Condition F5 of the ESO Licence and Part A of Condition F4 of the GSP Licence requires NESO to maintain, update, consult on and publish the NESO Financial Model, in line with the processes and requirements of this NESO Financial Handbook. This chapter describes the information that NESO must include within the NESO Financial Model and supporting reports, as well as the processes NESO must follow to maintain the model and populate it each year to determine allowed revenues.

Information required within the NESO Financial Model

2.5 For each Regulatory Year, NESO must ensure the NESO Financial Model enables it to accurately calculate $ESOAR_t$ and $ARGSP_t$ in line with the latest version of its ESO and GSP licences.

2.6 Unless otherwise agreed with Ofgem, NESO must include within the NESO Financial Model all the specific calculations and revenue terms contained within Condition F1 of the ESO and GSP licences. It should also include any key supporting calculations specified within the NESO Financial Handbook, including price indexation calculations. The NESO Financial Model should include both fixed values and input cells for variable values. NESO must be able to calculate its allowed revenues for each Regulatory Year using the fixed values, the variable values, and the functions embedded in the NESO Financial Model.

2.7 Values within the NESO Financial Model should be shown in £ millions to one decimal place.

NESO Financial Model supporting information

2.8 Either within the Financial Model workbook, or in a separate supporting workbook or document, NESO must include following information:

- A single tab containing a summary of all the main inputs used to calculate revenues under the Financial Model, with appropriate references to the corresponding rows and tabs within the NESO Financial Model where applicable;
- A breakdown of NESO's costs to show how costs are allocated between $ESOAR_t$ and $ARGSP_t$ in accordance with the TCAM;
- Data on any instances of Permanent Tax Differences that will impact the calculation of allowed revenue (in accordance with the tax methodology in chapter 6);
- Details on the expenditure on individual innovation projects being taken forward under the Network Innovation Allowance and Strategic Innovation Fund;
- A reconciliation of the actual costs from NESO's statutory accounts with its actual reported annual licence expenditure;
- A summary of the RAV position, with an overview of the depreciation schedule and RAV return income; and
- Any other information NESO considers or Ofgem determines is necessary to support the Financial Model, provide transparency on how NESO will derive its allowed revenues, or achieve profit neutrality.

2.9 This information must be submitted by NESO with an accompanying commentary alongside the annual Financial Model submission to Ofgem by 15th November.

2.10 A separate Legacy Closeout Model was developed to calculate the value of LEG_t within NESO's allowed revenue and feed into the NESO Financial Model (as described in more detail in Chapter 3). NESO must use the Legacy Closeout Model to inform the calculation of LEG_t until the point at which closeout is complete and a value of LEG_t no longer needs to be used, derived or updated. The Legacy Closeout Model must be updated, submitted and published under the same governance arrangements that apply to the NESO Financial Model, until the point it is no longer needed to calculate NESO's allowed revenue.

Maintenance of the NESO Financial Model

2.11 NESO is responsible for maintaining and updating the NESO Financial Model in line with the requirements in its licences and this NESO Financial Handbook.

2.12 As set out in Part A of Condition F5 of the ESO Licence and Condition F4 of the GSP Licence, Ofgem has the ability to direct an amendment to the NESO Financial Model where considered necessary. This could include a direction to change either the NESO Financial Model or the values NESO has populated within the model.

2.13 NESO must publish on its website up to date versions of NESO Financial Model, Legacy Closeout Model (if necessary to support the NESO Financial Model), the supporting submission/template for the information outlined in paragraph 2.8, and any supporting commentary (as outlined in paragraphs 2.9 and 2.19). A history must be kept of previous published versions with a clear naming convention.

2.14 Where the NESO Financial Model requires modifications to accurately calculate allowed revenues for an upcoming Regulatory Year, NESO must notify the Authority and must publish a consultation on its website containing:

- 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.

2.15 Any consultation should be undertaken with sufficient lead times to ensure the annual deadlines outlined in the section below are met.

2.16 Where certain information is considered by NESO to be commercially sensitive, NESO can redact the commercially sensitive information before the NESO Financial Model and any supporting information is published. NESO must notify Ofgem if it intends to redact data. Ofgem reserves the right to direct NESO to remove redactions where considered necessary, using its powers under Condition F5 of the ESO Licence and F4 of the GSO Licence.

Financial Model annual process

2.17 To finalise the values of $ESOAR_t$ and $ARGSP_t$ for each Regulatory Year, NESO must ensure that in Regulatory Year t-1 it has[6]:

- By 31 October: made any updates to the NESO Financial Model that are needed to accurately calculate allowed revenues for upcoming Regulatory Year, and published the updated NESO Financial Model on its website (after following the consultation steps in the section above, where required);
- By 15 November: sent the NESO Financial Model with populated variable values, as well as the supporting information outlined in paragraph 2.8, to Ofgem.
- By 30 November: published the final populated NESO Financial Model and supporting information on its website with the confirmed values of $ESOAR_t$ and $ARGSP_t$ that will be used for tariff setting.

2.18 NESO must meet these timelines unless:

- A different timeline has been agreed with Ofgem; or
- Ofgem has issued NESO with a direction under Condition F5 of the ESO Licence or Condition F4 of the GSP Licence to amend the NESO Financial Model and directed new associated timeframes.

2.19 Alongside the submission to Ofgem by 15 November, NESO must include a commentary explaining any key changes to the NESO Financial Model compared to the version submitted in the previous Regulatory Year, as well as any narrative needed to explain the outputs of the NESO Financial Model, Legacy Closeout Model (where relevant) and the supporting information outlined in paragraph 2.8. NESO must also provide a confirmation that the internal governance process required by paragraph F5.5 of the ESO Licence and paragraph F4.5 of the GSP Licence has been followed.

2.20 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 and otherwise provide its best estimate as a provisional value with the information available at the time. The licensee must, if it is uncertain of the correct way to calculate a variable value, seek advice from Ofgem.

[6] The previous working day should be used if these dates fall on a weekend or bank holiday.

3. Closeout Methodology (LEG_t)

Introduction and purpose

3.1 NESO was introduced on 1 October 2024 ('Day 1'), replacing the previous National Grid Electricity System Operator plc (NGESO). As part of its transition from NGESO, NESO received new licences and a new financial regulatory framework. With this transition occurring part way through a Regulatory Year, a methodology was established to 'closeout' the previous regulatory regime and ensure consumers were not unduly disadvantaged by NESO's recalculated allowed revenues.

3.2 Condition F1 of NESO's licences contains a revenue term to allow adjustments to NESO's allowed revenues to account for Legacy Revenues from before Day 1 (LEG_t). This section describes the process and methodology for carrying out the closeout and calculating the necessary adjustment to allowed revenues via LEG_t.

3.3 Whilst the requirements in this section are mostly relevant to the calculations made by NESO for the 2024/25 Regulatory Year (when the transition from NGESO to NESO occurred), we have maintained this section in the Financial Handbook to provide transparency on the approach taken, and to account for final updates and reconciliations that may be needed in relation to LEG_t.

3.4 As discussed in Chapter 2, the Legacy Closeout Model developed was issued by Ofgem to NESO in 2024 to support the calculation of LEG_t. For the purposes of calculating $LEG_{t,}$ we expect NESO to maintain the NESO Financial Model and Legacy Closeout Model in line with the descriptions in the chapter, unless otherwise agreed with Ofgem.

Further background and context

3.5 Under the previous regulatory regime, NGESO had a mixture of allowances and pass-through. There was a reconciliation process to ensure that revenues are updated over time as evidence on expenditure was finalised.

3.6 The basis for setting allowed revenues changed following the transition from NGESO to NESO. For simplicity of drafting purposes, we have adopted terminology such that H1 FY24/25 refers to before Day 1 under the previous NGESO licence and H2 FY24/25 refers to after Day 1 under the NESO.

3.7 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).

3.8 The Regulatory Asset Value (RAV) for NGESO was updated to reflect slow money RAV additions, depreciation and inflation indexation prior to Day 1. The value to apply to the RAV for NESO was fixed at that handover point, at Day 1.

3.9 All expenditure for NESO is treated as fast money and no further slow money additions to the RAV are made, although NESO's RAV will continue to be depreciated.

3.10 Allowed revenues are set on an annual basis. The NESO licences maintain the same 12-month period as the NGESO licence, beginning on 1 April and ending on 31 March.

3.11 In the absence of the transition in 2024/25, and the continuing of existing processes for NGESO, an Annual Iteration Process (AIP) would have existed to update revenues based on receiving updated information on expenditure and outturn values of other relevant parameters, e.g. inflation. This would have been delivered through updates to NGESO's Price Control Financial Model (PCFM). NGESO would have continued to make a regulatory submission by end of July in the following financial year with engagement between NGESO and Ofgem leading to an updated PCFM being published at the end of November in the same year. This would then be reflected in industry charges, with a 9-month lag between the announcement of charges and those charges being introduced.

3.12 The process to calculate revenues that would have been allowed for NGESO continues 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. The forecast values for FY24/25, used for the purpose of setting charges in December 2024, have been updated through the regulatory submission on 30 September 2025 to reflect actual values separated between H1 FY24/25 and H2 FY24/25.

Methodology

3.13 The NESO ESO Licence splits the revenue that can be collected via Balancing Services Use of System (BSUoS) charges into 3 components:

$$ESOAR_t = Internal\ Expenditure\ (INT_t) + External\ Expenditure\ (EXT_t) + Return\ on\ RAV\ (RTN_t)$$

3.14 The INT_t term includes a subcomponent to allow the collection of Legacy Revenues (LEG_t).

3.15 The LEG_t term should reflect 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 should adjust the 12-month NESO allowed revenue to incorporate the period before Day 1.

3.16 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.

3.17 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, a full-year value for the parameter should be included the NESO Financial Model, with no adjustment necessary via LEG_t.

3.18 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 LEGt

3.19 The LEG_t term is 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.

3.20 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 contains a full-year of expenditure (both controllable opex and controllable capex). Expenditure in H1 FY24/25 is 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 is 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. 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. LEGTAX shall be calculated within the Legacy Closeout model using the principles under which the NGESO

Term	Item	Description
		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.
LEGFPN	Financial penalties	Financial fines and penalties are separated out for H1 FY24/25 and H2 FY24/25. NGESO was unable to recover these costs, therefore any expenditure before Day 1 is 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 continued to be added to the RAV. RAV depreciation only starts the year after additions are made, so depreciation in FY24/25 is unimpacted by expenditure in FY24/25. The depreciation profile from the November 2023 AIP is retained, with an updated value to reflect FY23/24 additions. 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 was initially forecasted as 5.75% and is 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).

Term	Item	Description
		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 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 LEG_t 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.

Term	Item	Description
		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 are added to LEG_t as a positive item.

3.21 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 concluded as a reputational incentive only for NESO. There is also no ability for Ofgem to disallow Demonstrably Inefficient and Wasteful Expenditure (DIWE), following the change in licence from Day 1.

3.22 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

3.23 NESO used a forecast value for LEG_t in the tariffs set in December 2024. Subsequent data updates will continue with any revised outturn values.

4. Price indexation methodologies and interest costs ($ESOI_t$)

Introduction and Purpose

4.1 NESO's allowed revenues under its licences are calculated on a nominal basis. However, certain revenue terms in NESO's licences require a price indexation methodology. For example, NESO's Day 1 RAV must be adjusted for inflation in the calculation of RTN_t, and the maximum values NESO can recover through its Network Innovation Allowance (NIA) also need to be adjusted for inflation. This section sets out the price indexation methodologies NESO must use to calculate allowed revenues where this is required by the ESO and GSP Licences. NESO must use these methodologies for its calculations within the Financial Model.

4.2 This section also provides further guidance on time value of money (TVoM) adjustments used for revenues not collected through BSUoS. This includes the Reference Variable Rate (RVR) which is used in for the purpose of the calculation of Transmission Network Use of System (TNUoS) charges (under Condition F3 of the ESO Licence) and for the gas charges notification process (under Condition F1 of the GSP Licence).

4.3 Condition F1 of the ESO License includes a term to adjust allowed revenues to account for net interest amounts, bank charges or working capital fees incurred by the licensee ($ESOI_t$). This section also provides further guidance on the calculation of $ESOI_t$.

Price indexation methodology

4.4 NESO must use the following methodology where the ESO Licence or GSP Licence refers to a price indexation methodology in the Financial Handbook:

$$value_{restated} = value_{nominal} \times \frac{PI_{other}}{PI_t}$$

Where:

$value_{restated}$	means a value which is deflated/restated in the prices of the different applicable Regulatory Year from Regulatory Year t
$value_{nominal}$	means the value in a nominal price base
other	means the Regulatory Year that is different to Regulatory Year t
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

$value_{restated}$	means a value which is deflated/restated in the prices of the different applicable Regulatory Year from 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.[7]

4.5 This assumes a deflation of values, but the formula can be inversed to inflate values from nominal to future Regulatory Year prices where needed.

4.6 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 originally issued to NESO by Ofgem in 2024 used a blended indexation series called "Legacy Combined RPI-CPIH price index (financial year average)". NESO should continue to use this blended series where it is applicable.

Forecasting the Price Index PI_t

4.7 At each annual Financial Model update, NESO must update outturn data for $CPIH_m$ for the period to June of the prior year (e.g. for the Financial Model update in November 2025, for Regulatory Year 2024/25, the outturn data values were entered to June 2024).

4.8 The NESO Financial Model should contain the method for forecasting future price indexation values, given calendar year forecast assumptions.

4.9 These forecasts should be the Office for Budget Responsibility's (OBR) forecast of CPI from the "economic and fiscal outlook". NESO must update the forecast assumptions from the most recent outlook available as of 30 November in each annual Financial Model update. The data must be sourced from the following files

[7] https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l522/mm23

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[8], "CPI" tab.
- The charts and tables datafile published with the economic and fiscal outlook.
- The economic and fiscal outlook document.

4.10 The forecast rates should 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.

4.11 A long-term CPIH inflation assumption should be used for any years included in the NESO Financial Model for which OBR forecasts do not yet exist.

Time Value of Money (TVoM) adjustments

4.12 Calculations with respect to TVoM are used to ensure that the right customers bear or receive the correct amount of interest. TVoM adjustments are 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 through $ESOI_t$.

4.13 The TVoM for TNUoS and gas revenue streams is defined as being subject to the RVR. The RVR is equal to the rate paid for the Working Capital Facility (WCF)[9].

4.14 The TVoM for AAHEDC is defined in the Energy Act 2004 and will remain unchanged.

Recovery of net interest costs ($ESOI_t$)

4.15 $ESOI_t$ is equal to the net interest for NESO, as per statutory accounts, once notional interest payments or receipts in relation to TNUoS, gas and AAHEDC revenue streams have been subtracted.

[8] https://obr.uk/data/
[9] In the Financial Model first issued to NESO by Ofgem in 2024, the RVR was set as equal to the current Bank of England base rate.

5. Return calculation (DPN_t and RAV_t)

Introduction and purpose

5.1 Condition F1 of the ESO Licence allows NESO to recover a time-limited annual return which is passed on to NESO's shareholder.[10] This involves the full deprecation of the RAV balance that NESO acquired at Day 1, and a return on return on capital which is equal to 3.5% of the remaining annual RAV balance (in real terms).

5.2 This return is calculated in practice through the RAV Returns ($RTNO_t$) term in Condition F1 of NESO's ESO Licence. It is calculated using the formula below:

$$RTNO_t = DPN_t + (RAV_t \times DR_t)$$

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	is the discount rate and is equal to 3.5% in real post-tax terms

5.3 The subsections below set out the methodologies for calculating the DPN_t and RAV_t terms.

5.4 For the FY24/25 financial year in which the transition from NGESO to NESO took place, the RTN term should be calculated on a partial-year basis, reflecting only the portion of remuneration on the RAV after Day 1 in FY24/25. This has implications for the calculation of $LEGRTN_t$ in Chapter 3, which should reflect the required remuneration under NGESO's financial framework for the period of FY24/25 prior to Day 1 (i.e. the depreciation and RAV return for that period).

5.5 The RTN calculation for FY24/25 must incorporate 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.

[10] Please see Section 3.1 of the Statutory consultation on National Energy System Operator licences and other impacted licence for more information of this policy: statutory-consultation-on-national-energy-system-operator-licences-and-other-impacted-licences.pdf

Methodology for Calculating DPN_t

5.6 Under NGESO's financial framework, additions to the RAV were 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.

5.7 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.

5.8 For NESO's Day 1 RAV value, NESO must use the same depreciation profile as applied to the depreciation of NGESO's RAV in the NGESO PCFM. The exception is for the Wokingham Facility RAV, which from the start of FY25/26 must align with the main RAV balance depreciation profile. From 1 April 2025, the remaining Net Book Value of the Wokingham Facility RAV must also be recovered evenly over seven years (a 'straight-line' basis). This means that all remaining RAV balances should be fully recovered by 31 March 2032.

5.9 The RAV balances included within the NESO Financial Model issued to NESO in 2024 were in 2018/19 prices. NESO must uplift the value of the RAV according to inflation using the CPIH price indexation methodology described in Chapter 4.

Methodology for Calculating RAV_t

5.10 As per the NESO ESO Licence, RAV_t is equal to the RAV less regulatory depreciation.

5.11 NESO should calculate this 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).

5.12 The calculated 12-month average must then be uplifted by outturn inflation using the indexation methodology described in section 4 and converted into nominal prices.

6. Tax (TAX_t)

Introduction and purpose

6.1 NESO is a UK company limited by shares and as such is subject to corporation tax on its taxable profits.

6.2 Condition F1 of the ESO Licence includes a revenue adjustment term to account for corporation tax (TAXt).

6.3 To allow NESO to fully recover the RAV, and the agreed rate of return, a tax allowance is required, and which should be recovered through TAXt.

6.4 The calculations undertaken to implement the methodologies in this section and calculate TAXt should be included within the Financial Model.

Methodology for Calculating TAX_t

6.5 NESO's allowed revenue has 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

6.6 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.

6.7 NESO receives 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 to the FYA regime.

6.8 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 6.15 below).

Tax Allowance in respect of EXT_t

6.9 Timing differences in respect of certain external costs may arise due to the application of existing accounting standards. These timing differences cannot 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 but will be funded through the NESO working capital facility.

Tax Allowance in respect of RTN_t

6.10 To allow NESO to fully recover the RAV, and the agreed rate of return, a tax allowance is required to be recovered through TAX_t.

6.11 The NESO Financial Model should calculate 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

6.12 TAX_t shall be calculated as follows:

$$TAX_t = (RTN_t - Total\ Capital\ Allowances + TAXP_t) \times \frac{Corporation\ Tax\ Rate}{(1 - Corporation\ Tax\ Rate)}$$

For the definition of TAXP, see the relevant section below.

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

6.14 Corporation Tax Rate refers to the United Kingdom headline rate of corporation tax for a Financial Year.

Tax on permanent differences ($TAXP_t$)

6.15 NESO must manage its tax affairs in a way which is consistent with an over-arching non-profit making objective, and as set out in NESO ESO Licence condition F1.15.

6.16 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.

6.17 Notwithstanding this, there may be instances where allowed revenue and tax relief do not align. Where this occurs, NESO must 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.

6.18 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.

6.19 NESO must contain within the Financial Model an input line to allow the tax allowance (recovered through TAX_t) to be adjusted in any individual year for tax which has become a permanent difference. This input should be named $TAXP_t$.

6.20 The Authority may use its powers under Condition F5 to direct an amendment to the relevant line of the Financial Model if it does not consider that the difference represents a permanent difference.

Capital allowances – Opening pool balances

6.21 Tax liability allowance calculations under the annual Financial Model update must make use of regulatory tax pool balance figures that must be contained within the NESO Financial Model. The opening balances (as at 1 April 2024) for these tax pools must be taken from the NGESO PCFM. These must be adjusted as required to reflect the partial period which arises between 1 April 2024 and Day 1.

6.22 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. NESO should bring the NGESO PCFM pool values into the NESO Financial Model to ensure 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).

7. Defined Benefit Pensions

Introduction and purpose

7.1 In line with Part B of Condition F5 of the ESO licence, the Financial Handbook may include provisions or impose requirements on NESO in relation to defined benefit pension cost recovery and reporting.

7.2 This section sets out the background to the transfer of pension scheme costs, assets and liabilities and any financial adjustments relating to the separation of NESO from the National Grid plc group.

7.3 Following its separation from the National Grid plc group, NESO has a standalone defined benefit pension scheme (the 'NESO DB scheme). Costs associated with the NESO DB scheme can be recovered as part of its Internal Expenditure through the revenue term ETE_t in Condition F1 of the ESO License, in line with the requirements in this section.

Further background and context

7.4 The separation and transfer of the pension schemes from NGESO to NESO has been designed to ensure neutrality regarding pension funding costs for consumers and National Grid Electricity Transmission plc (NGET).

7.5 NESO defined benefit pension costs during FY24/25 were 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.

7.6 After FY24/25, a new defined benefit scheme ('NESO DB scheme') has been set up and:

- The NESO DB scheme will be fully separate from the NGEG scheme.
- Current active members employed by NESO transferred from the NGEG scheme to the NESO DB scheme, as part of an agreed bulk transfer, for the build of new pension benefits.
- The assets and liabilities of the NGEG scheme that were attributable to active members employed by NESO on or after Day 1 subsequently 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) 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[11].

7.7 This means that while the costs and risks associated with the deferred and pensioner members who previously worked in the NGESO were 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 remain within the NGEG scheme after the separation date (NGET's Special Licence Condition 6.1 Pass-through items).

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

7.9 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.

Cost recovery requirements

NESO DB scheme costs

7.10 For the NESO DB scheme, the costs of ongoing pension employer contributions, deficit recovery payments and the associated costs of running the scheme are recovered through the ETE_t revenue term in NESO's licence. 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.

[11] 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).

7.11 Pension costs recoverable by NESO under ETE_t in relation to the NGEG scheme (i.e. after Day 1) must match those conditions set out in relation to NGESO costs.

Treatment of Pension Surplus

7.12 NESO will be required to consider 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).

7.13 Any surplus released by the NESO DB scheme trustees to NESO should be returned to customers as a negative cost in ETE_t and shown clearly within the Financial Model supporting information.

General provisions on NESO pension schemes

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

Pension principles

7.15 The ongoing operation of the NESO DB scheme should be linked to Ofgem's current pension principles[12] and in particular the principles regarding stewardship.

Actuarial valuations and reasonableness reviews

7.16 On a triennial basis, NESO must 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.

7.17 The first actuarial valuation of the NESO DB scheme was 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.

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

7.19 After receiving the information set out in paragraph 7.16, 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

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

(d) otherwise followed good practice, informed by practice in the regulated and broader private sectors, in promoting consumer interests.

7.20 The first reasonableness review post separation is expected to be during 2026, with subsequent reviews carried out on a triennial basis.

Reporting

7.21 NESO should provide transparency on the recovery of pensions scheme related costs through the annual Financial Model process as outlined in 7.10 and 7.13.