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BSC Audit

Consultation on the future options for the audit

ELEXON

Confidential

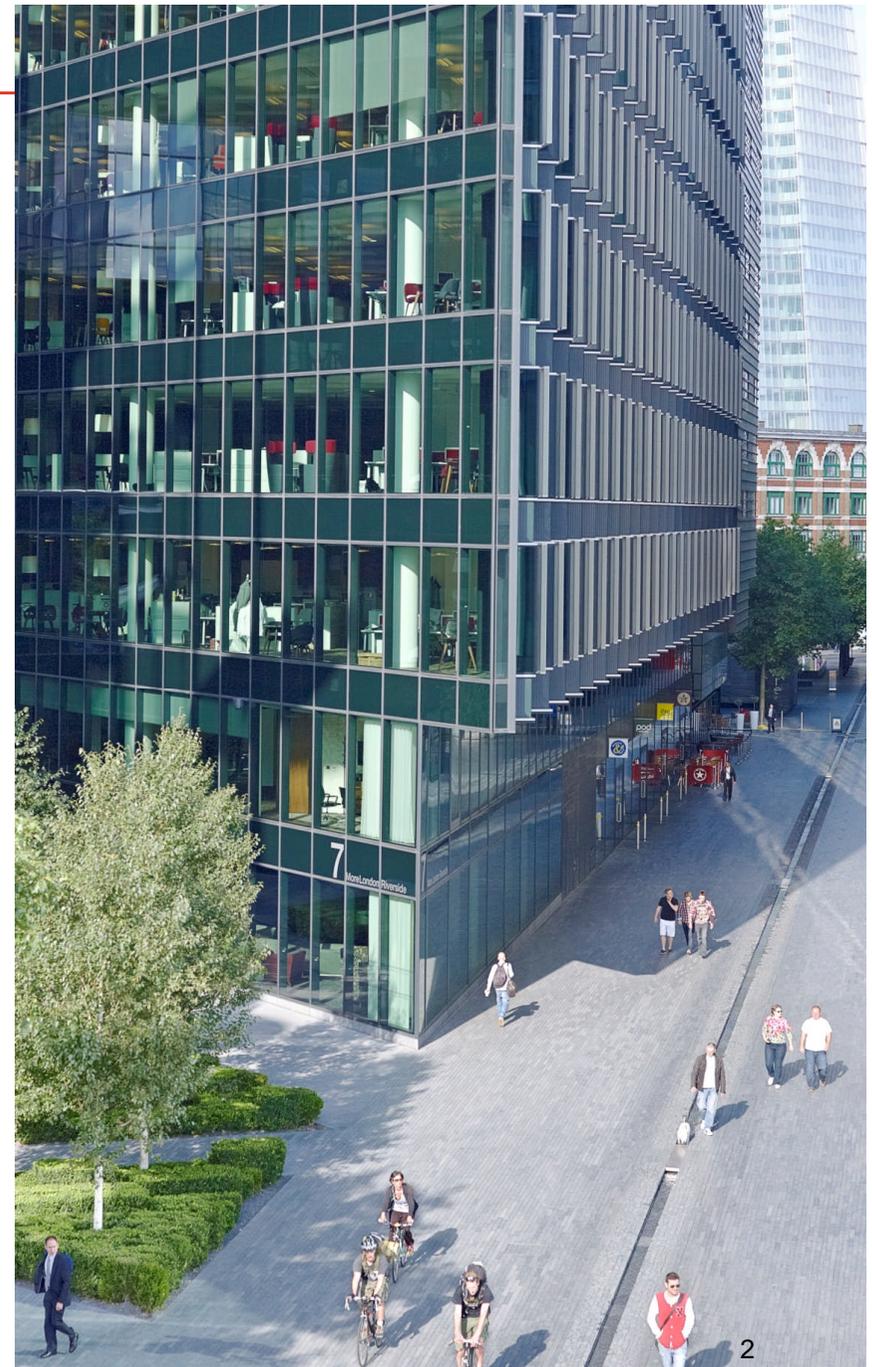
September 2017



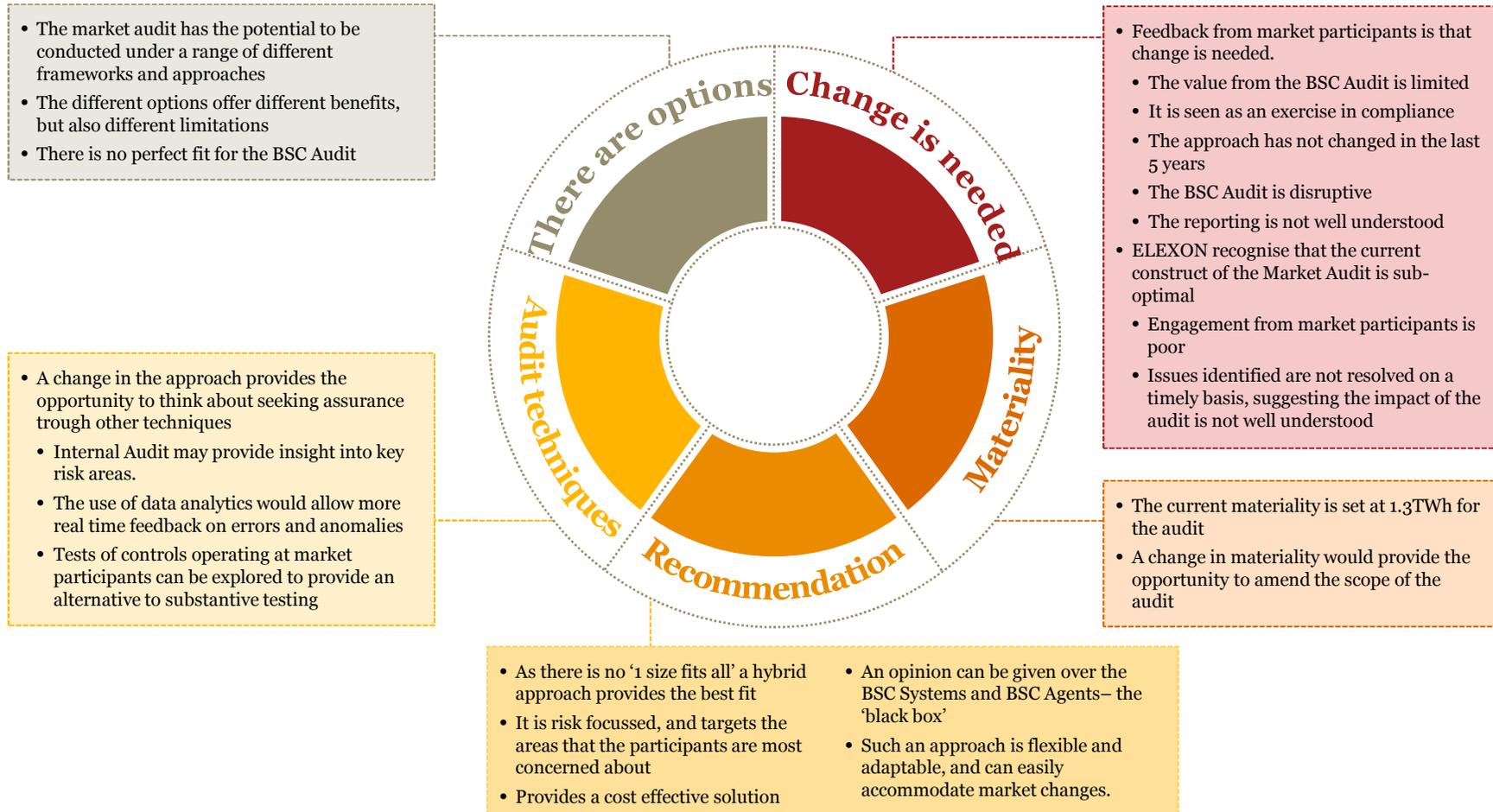
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1. Summary of key findings and our recommendation



2. Background and what you asked PwC to do

Background – the BSC Audit:

The Balancing and Settlement Code ('BSC') Audit is one of a number of Performance Assurance Techniques ('PATs') within the Performance Assurance Framework ('PAF'). The PAF supports the operation of the UK power market, providing confidence to the numerous stakeholders through a range of PATs covering a range of areas, and underpins the calculation and transfer of £billions in charges across the market.

The BSC Audit has been in place since the implementation of the BSC and remains largely unchanged in its scope, approach and outputs. Its key output is a reasonable assurance report under ISAE 3000 (Revised) on the compliance of Supplier Volume Allocation ('SVA') and Central Volume Allocation ('CVA') participants with the BSC. This, in turn, supports a view on whether key BSC calculations and outputs are likely to be free from material error. Materiality is currently defined at 1.3TWh.

Background – this review:

Whilst the BSC Audit has played a part in building market confidence over more than two decades, it receives mixed stakeholder feedback – centred on the following aspects:

1. Its relevance to the current market and the ability to quickly adapt to changes in that market;
2. The scope and coverage of the BSC Audit - is it focused on the key risk areas?;
3. The ability to close out issues and drive change; and
4. The value to market participants versus its cost, and the disruption that the audit causes to participants.

As part of a wider review of the interplay of the PATs and the overall PAF, ELEXON wishes to understand how the BSC Audit could be further developed to address these feedback areas and, consequently, provide greater value to stakeholders.

Our terms of reference:

As per our Engagement Letter dated 30th August 2017, you asked us to better understand the current audit construct, through interviews held with key ELEXON staff and review of documentation, and to consider a range of standards under which assurance could be provided. You asked us to establish the relative pros and cons of each. For illustration, such standards and reporting options could include:

1. Reasonable Assurance Report (ISAE 3000 revised);
2. Limited Assurance Report (ISAE 3000 revised);
3. Agreed Upon Procedures (ISRS 4400); and
4. Internal audit, or other advisory review (None, bar general professional standards).

2. Background and what you asked PwC to do

Our terms of reference (continued):

You also asked to us to:

1. Provide consideration as to the approaches taken to market audits in other sectors, such as water, gas, telecoms, financial services and rail;
2. Explore the relationship between the materiality, effort, cost and value associated with assurance opinions;
3. Consider other options that may be available, to what is a mature and established power market; and
4. Develop an initial set of design criteria for an effective market audit.

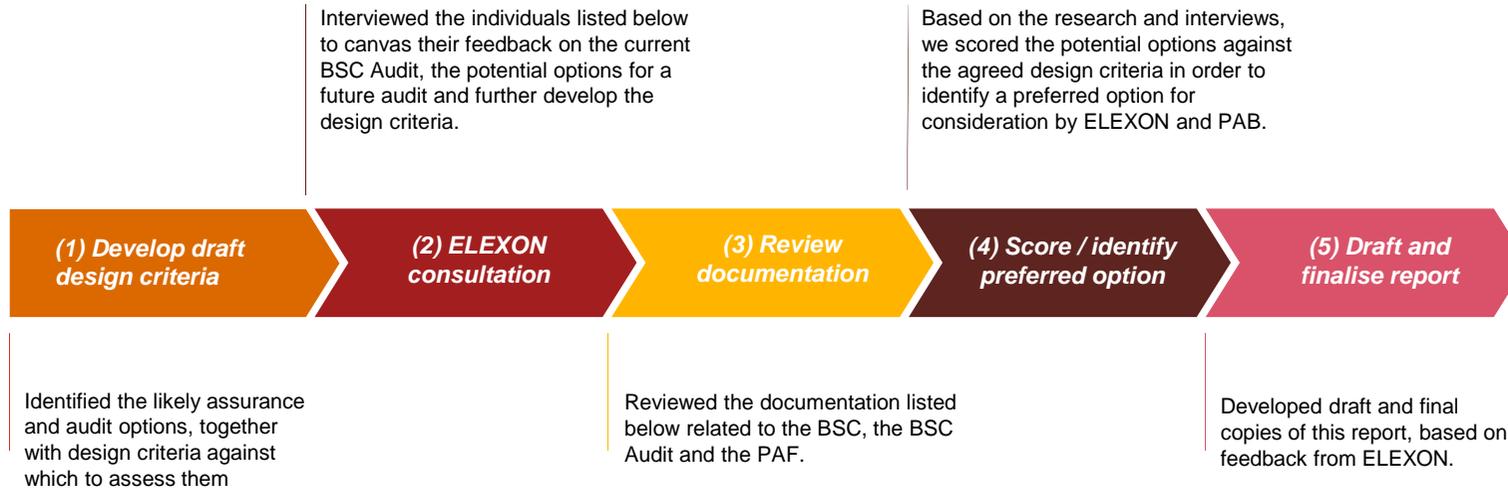
As agreed with you, we have not consulted with individuals outside of ELEXON, or the PAB members.

Purpose of this report:

This report seeks to outline the available options for your consideration, including the relative pros and cons of each of those options and the scoring against the design criteria developed and agreed with you as we have delivered this work. We also include relevant case studies of market audits in other sectors, together with any other relevant information to help answer questions you have posed.

3. The approach we have taken to this review

Based on the Terms of reference agreed with you, we have taken the following approach to conducting this review and consultation with ELEXON.



The individuals we interviewed in (2):

Interviewee	Role
Nigel Perdue	PAF Review Leader
Beth Brown	PAF Review Analyst
Nick Groves	PAF Technical Analyst
Jason Jackson	Compliance Analyst
Kat Higby	Technical Auditor (TAA)
Hanna Pain	Compliance Manager
Beth Procter	Technical Auditor (TAPAP)

The documents we reviewed in (3):

Document reviewed	
BSC Audit Service Description	PAB 197/16 – Proposal to revise BSC Audit scope and assurance arrangements as interim to PAF review
BSC Audit Scope 2017/18	
BSC Audit Approach 2017/18	ELEXON document: BSC Audit findings 2009 Final Findings Report
BSC Audit Summary of Issues 2016/17	ELEXON Guidance document: BSC Audit process
BSC Auditors Report (2017)	ELEXON document: Map of the BSC Audit document interactions
BSC Service Description for BSC Audit: Version 4.0:	ELEXON document: Spot check observations& recommendations
PAB199/05 – Discussion of proposed changes to 1018/19BSC Audit scope	

Consultation relating to options for future BSC Assurance
PwC

4. The potential options for a future ‘audit’ of the BSC

Audit and assurance activity can take a number of forms, with the terminology itself open to considerable differences in interpretation across different stakeholders. For example, the term assurance infers different meaning depending upon the context in which it is used, and care should be taken when referring to audit and assurance. That said, there are a range of frameworks and approaches that an assurance provider can take to build confidence in mechanisms such as the BSC.

Based on our experience of trusted assurance over similar market mechanisms, we identified the following five audit or assurance options for consideration with the scope of this review. Of these 5 options, we believe that the two System and Organisation Controls (‘SOC’) options are better suited to a more routine outsource service provider arrangement, rather than the more complex combination of market agents and participants that exist within the BSC arrangements*. As such, the two SOC related options have not been considered further. More information on the features of each option is provided in the **Appendix A**.

In addition, we have considered whether a ‘one size fits all’ approach is suitable and believe that a combination of options should be considered in order that the potential benefits from one or more approaches can be leveraged. In particular, we recommend that a hybrid approach of an opinion (e.g. ISAE 3000) and advisory ‘review and recommend’ should be explored. For example, an ISAE 3000 report could be given over the key BSC Systems and Agents (the ‘black box’ calculations), with more flexible and risk-based ‘review and recommend’ work around Performance Assurance parties (such as market participant, suppliers, supplier agents and other roles). This is taken forward as ‘**option 4**’.

#	Option	Overview	Where is this option used?
1	Assurance opinion, e.g. against ISAE3000 (revised)	<ul style="list-style-type: none"> Limited or reasonable assurance opinion over non-financial internal controls or data. 	BSC Audit, National Grid SMPS
2	Agreed-upon-procedures	<ul style="list-style-type: none"> Factual results against agreed programme of testing. International standard ISRS 4400 	Ofgem and Ofwat regulatory reporting
3	Advisory ‘review and recommend’ / internal audit	<ul style="list-style-type: none"> Narrative results and recommendations against an agreed scope of work. General professional standards. 	Widely applicable – many participants will procure advisory work under this mode. Used to provide market feedback on Project Nexus.
4	Hybrid – e.g. 1 and 3	<ul style="list-style-type: none"> For example, an assurance opinion over BSC Parties and BSC Agents, ‘review and recommend’ over Suppliers and their agents. 	MOSL (NHH Water Market)
N/A	SOC1 – not carried forward	<ul style="list-style-type: none"> Assessment of service provider controls, normally over services / processes supporting a user’s financial reporting 	Xoserve gas transportation invoice controls
N/A	SOC2 – not carried forward	<ul style="list-style-type: none"> Assessment of service provider controls over 5 specific principles 	More limited examples of application.

* Note that an ISAE 3402 report (equivalent to ‘SOC1’) is currently used to provide assurance over Xoserve’s gas transportation invoicing in the gas market. In this case, Xoserve is a single agent responsible for allocating and invoicing volumes across gas shippers.

5. The design criteria and our initial assessment (1)

In order to facilitate a balanced assessment, we have developed a series of design criteria against which to assess the identified assurance options. These were developed based on our understanding of the likely success factors for a future BSC Audit, categorized across market outcomes and behaviours, audit process / mechanics and audit outputs.

The design criteria are set out below, together with our understanding of their relative importance to ELEXON. This understanding was developed collaboratively during our discussions with ELEXON staff during the weeks commencing 4th and 11th September 2017. The relative importance ratings are a composite of those ratings provided by ELEXON staff in our meetings.

Category	Design criteria	Relative Importance for ELEXON
Market outcomes and behaviours	• Participants / agents are materially compliant with the BSC	High
	• End-customer centric, promotes good customer experience	Low
	• Facilitates new entrants to the market - there is a level playing field for all	Medium
	• Supports good industry behaviours	Medium
	• Improves data quality and consistency across suppliers and agents	High
	• Supports key industry priorities (e.g. SMIP, faster switching)	High
Audit process / mechanics	• Flexible, risk-based work that is targeted at areas of most market benefit	High
	• The audit is future-proof, easy to incorporate changes and adaptive (e.g. SMIP / faster switching)	High
	• There is an optimal balance of cost, independent challenge, flexibility and likely value to participants	High
Audit outputs	• The outputs need to be easy to use and understandable	High
	• The outputs provide insight into areas of value to the end user	High
	• The outputs support participant financial reporting requirements	Medium
	• The outputs are accessible by all participants / BSC signatories	High
	• The outputs are aligned with the other outputs of the PAF.	Medium

5. The design criteria and our initial assessment (2)

We have assessed each of the 4 selected options against the design criteria in detail, with the scoring and rationale set out in the **Appendix B**. Our assessment has been based on:

- The discussions held with ELEXON and PAB members;
- Our knowledge as experienced assurance practitioners; and
- Our experience of similar market audits and assurance needs, together with what we have seen work well across these markets.

A summary of the scoring is shown below. This is an initial assessment that we are happy to engage on and discuss further. Overall, **our assessment shows a clear preference and best fit for the ‘hybrid’ option #4.**

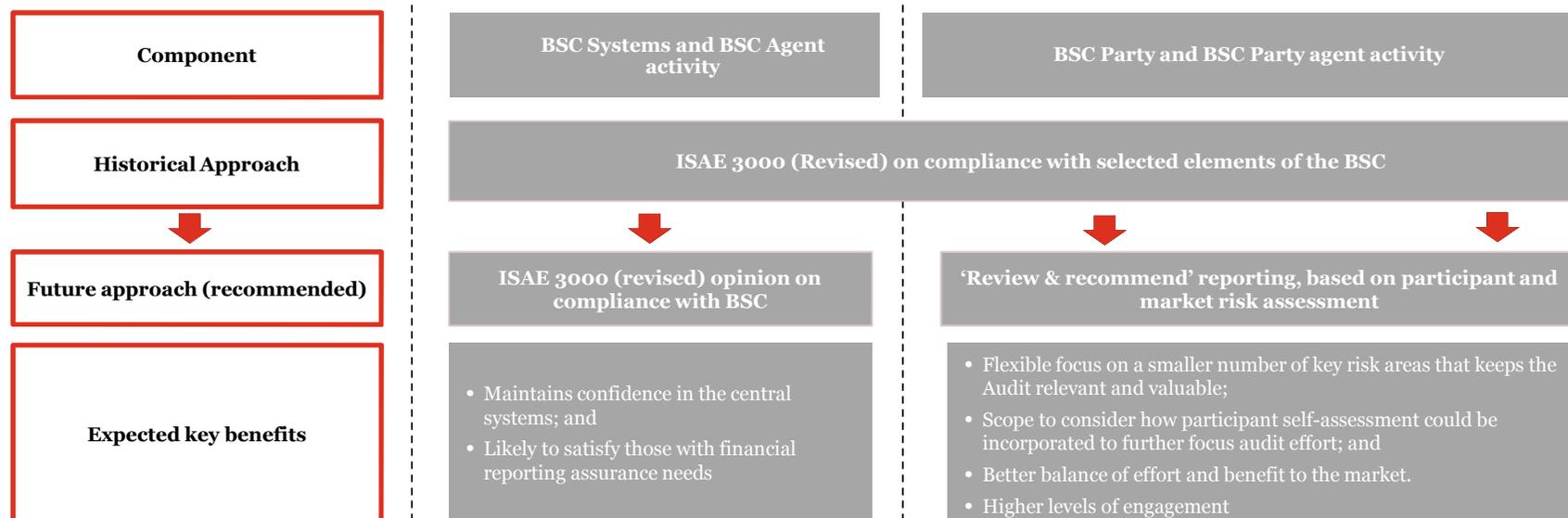
Summary assessment against design criteria						
#	Option	Market outcomes / behaviours	Audit process / mechanics	Audit Outputs	Score	Drivers for scoring
1	Assurance opinion, e.g. against ISAE3000 (revised)	10	4	13	27	<ul style="list-style-type: none"> • Market needs to move beyond pure compliance focus • Limited flexibility • Harder to focus on wider outcomes and value • Most useful for financial reporting
2	Agreed-upon-procedures	17	9	13	39	<ul style="list-style-type: none"> • More flexible to key risks, easier to keep relevant • Can focus on wider outcomes • Outputs likely to require significant review to draw conclusions
3	Advisory ‘review and recommend’ / internal audit	22	11	14	47	<ul style="list-style-type: none"> • More flexible to key risks, easier to keep relevant • Narrative reporting likely to be most user-friendly • No opinion given which participants may require • Least useful for financial reporting
4	Hybrid – e.g. 1 and 3	24	12	16	52	<ul style="list-style-type: none"> • Rigour of an opinion in most useful areas (e.g. over higher risk central BSC System and Agent calculations) • Fully flexible, targeting risks in key areas • Narrative reporting of thematic risks and required actions.

6. Going Forward: the recommended option for the BSC Audit

If ELEXON and PAB were to take forward Option 4 for further engagement and consultation, we believe that an approach similar to that outlined below would achieve the outcomes desired by PAB and market participants, and would address much of the feedback provided by participants.

In particular, we believe that there is considerable opportunity to better engage market participants in the ‘BSC Party and BSC Party agent’ component. For example, by:

- Proactively involving them in the market risk assessment;
- Asking participants to self-assess how they are mitigating the key risks that are selected for focus in an audit year. We would recommend that any such self-assessment is subject to a central review / moderation and supported by appropriate documentation;
- Targeting participants for further work, based on the review of the self-assessment and evidence provided. This may help to move participants to a rolling programme of work, where timing and scope could be better targeted; and
- Driving out thematic, market-wide reports that look to share both good and poor practices. This would be supported by issuing specific actions to individual parties.



6. Going Forward: additional considerations (1)

Within the construct of the recommended option outlined previously, there are a number of additional considerations that should be included when arriving at the final option, which may support you in addressing the issues identified by the participants. These include the following areas:

A Optimising the use of data analytics

Accurate settlements is reliant upon the sending and receipt of data flows between the participants. In theory, these data flows should provide a ‘complete picture’ of the activities across the industry, and hence it should be possible to build the relevant scripts to identify data anomalies, which in turn would allow the audit work to be focused in areas where the systems, processes and controls may not be working effectively. However, we accept that there are challenges with this approach, for example:

- Information in data flows is not always accurate;
- Some organisations do not send data flows, where those organisations are under common ownership;
- Existing data analytics have been highlighted as being error prone, and hence confidence in this approach may be limited; and
- Data may need to be sourced from a range of organisations in order to fully analyse the consistency of data.

Notwithstanding the above challenges, targeted data analytics using data extracted from the Data Transfer Network (‘DTN’) should be considered.

B. Moving towards greater reliance on controls testing

As discussed previously, the current BSC Audit focuses on compliance with the BSC, with the audit work conducted largely using substantive testing to determine the level of compliance. The majority of market participants will have documented control frameworks, which will describe the controls that have been designed to ensure the complete and accurate transfer of data across the DTN.

Typically, controls based audits are considered to more valuable, in that they identify areas for improvement that will impact significant data volumes, rather than identifying specific instances of potential error from substantive testing. The key challenge is that these control frameworks are not uniform across all market participants, they will not all be documented to the same degree and the controls will be at different levels of maturity.

6. Going Forward: additional considerations (2)

C. Support from, and efficient leverage of, other assurance providers

In delivering their programmes of good governance, many of the market participants will have a range of assurance activities that will support their settlement activities. The obvious example is Internal Audit, but there may be other providers of assurance that could support the BSC Audit.

It is suggested that the BSC Auditor understands, for each market participant, the extent to which they already obtain assurance and in which areas. Whilst it may not be possible to place absolute reliance on the work of these other assurance providers, it is often a useful source of information in support of the risk analysis that should drive a robust audit.

Such an understanding can be gained through the use of some form of self assessment by the participants, which is administered by the BSC Auditor. This also has the benefit of supporting an increase in market participant engagement.

D. Improving the levels of market participant engagement

One of the over-arching themes from the consultation is that the level of engagement from the market participants is low. This lack of engagement results in:

- Audit issues not being addressed, as they're not seen to be important;
- Site visits being considered a 'necessary evil' rather than a value adding exercise; and
- A lack of understanding in the audit process, and hence a lack of interest in the final report as it's not well understood.

We recognise that improving market participant engagement will not be a simple exercise, and may take several audit periods to achieve, but consideration needs to be given as to how to improve the situation otherwise it is unlikely that the feedback received in recent months will materially change in the coming periods.

6. Going Forward: additional considerations (3)

E. Exploring flexibility around materiality

The concept of materiality is already embedded within the BSC Audit, with the materiality currently being set at 1.3TWh. Materiality is defined in International Standard on Auditing ('ISA') 320 as follows:

Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Whilst ISA320 refers explicitly to financial statements, the principle equally applies to non-financial data. The key consideration for the BSC Audit is the level at which materiality should be set, such it is appropriate in the context of the market as a whole. Clearly, the market participants differ in size and hence the materiality set needs to take this into account i.e. what is material to one market participant may be clearly immaterial to another.

Currently, the BSC Auditor states that the '...assessment of what is material is a matter of professional judgement and will be discussed between the BSC Auditor and ELEXON ...' as described in the ELEXON BSC Audit Approach 2017/18.

That said the opportunity exists to reconsider materiality, as this provides a useful level to challenge the extent of the work undertaken in areas of low risk, if considered to be immaterial.

Appendix

Appendix A: The potential options for a future ‘audit’ of the BSC

Below and on the following page, we outline in some further detail below the key potential options that we have summarised in the main body of this report

#	Option	Subject Matter and scope	Key Features	Key Benefits	Potential drawbacks
1	Assurance opinion under ISAE 3000 (revised) Either ‘limited’ or ‘reasonable’ assurance	<ul style="list-style-type: none"> The integrity of non-financial data and controls, such the settlement volumes under the BSC. This can be based on internal controls, compliance with assertions or data testing. 	<ul style="list-style-type: none"> Can be reasonable or limited assurance. Results in an audit opinion. This is the current mode used by the BSC Audit. 	<ul style="list-style-type: none"> Ability to define wide-ranging set of criteria that is in scope (controls or data), therefore simplest standard to align to Code requirements. Assurance opinion – likely to be relied on for financial reporting purposes. 	<ul style="list-style-type: none"> Does not give flexibility to provide recommendations. Relatively high effort for little insight to users.
2	Agreed upon procedures (‘AUP’) under ISRS 4400	<ul style="list-style-type: none"> Specific review and / or testing of a customised scope and procedures against specific needs and scope. 	<ul style="list-style-type: none"> No assurance opinion. Granular procedures and results thereof, but these need to be agreed up front Report includes a description of all testing performed by the auditor. 	<ul style="list-style-type: none"> Potentially more cost effective than opinion-based reporting. Scope, procedures and testing are flexible. Could be relied on for financial reporting, with interpretation and judgement. 	<ul style="list-style-type: none"> No assurance opinion. The procedures must be agreed with third party recipients – challenging when multiple parties with vested interests. Factual findings do not provide further context to underlying issues or recommendations.
3	Advisory ‘review and recommend’	<ul style="list-style-type: none"> Service based on customised scope and procedures for specific user needs. For example, a review of participant practices against a set of risks or specific process areas. 	<ul style="list-style-type: none"> Very flexible report, narrative based. No assurance opinion. Can include a wide range of information, recommendations and insights. Particularly valuable when enhancements are possible. 	<ul style="list-style-type: none"> More cost effective than opinion-based reporting. Scope, procedures and testing are flexible. Detailed recommendations can be provided. Ability to flex response to issues based on risk. 	<ul style="list-style-type: none"> No assurance opinion. Potential challenge from Panel based on Code requirements for assurance. Users mistaking report for “assurance” and therefore increased chance of misuse.

Appendix A: The potential options for a future ‘audit’ of the BSC

Below and on the following page, we outline in some further detail below the key potential options that we have summarised in the main body of this report

#	Option	Subject Matter and scope	Key Features	Key Benefits	Potential drawbacks
4	Hybrid – a blend of the other options				
5	SOC 1 or ISAE 3402	<ul style="list-style-type: none"> Independent review of service organisation controls ('SOC'), relating to internal controls over financial reporting ('ICFR'). 	<ul style="list-style-type: none"> Focuses on services provider's internal controls supporting financial balances and reporting. Generally used by stakeholders' external auditors. Shows details of controls and testing performed. 	<ul style="list-style-type: none"> Focus on internal controls over financial reporting, meaning user entities are likely to leverage for financial audit. Assurance opinion – likely to be relied on for financial reporting purposes. 	<ul style="list-style-type: none"> Unlikely to suit all aspects of the BSC as limited to controls underpinning financial reporting. Better suited to single service providers, rather than the multiple agents in the BSC. Relatively complex reporting.
6	SOC 2	<ul style="list-style-type: none"> Independent review of service organisation controls over five principles: <ol style="list-style-type: none"> 1.Security; 2.Privacy; 3.Confidentiality; 4.Availability; and 5.Processing integrity. 	<ul style="list-style-type: none"> Focuses on one or more of the five principles. Generally used by the customers / stakeholders of the service organisation. Shows details of controls and testing performed. 	<ul style="list-style-type: none"> Focused on operational trust, which is increasingly relevant to user organisations. Able to choose relevant trust principles (i.e. include security, confidentiality, data processing) and omit others. 	<ul style="list-style-type: none"> Relatively complex reporting requirements, where all criteria within trust principle must be included. Unlikely to suit all aspects of the BSC. Potentially high set-up cost. Better suited to single service providers, rather than the multiple agents in the BSC.

Appendix B: Detailed scoring matrix results

Design criteria	ISAE 3000 Revised		AuPs		Advisory		Hybrid ISAE 3000 and advisory	
Participants / agents are materially compliant with the BSC	Yes, this is the key benefit of this approach.	4	Testing could be designed to explore this, but reader would need to reach their own conclusion. No overall assurance opinion is given, but there is a rigorous description of work done.	2	The scope of the review could be designed to consider this, but no overall assurance opinion would be given. Detailed testing results could be incorporated as per AuP option.	2	Optimal blend can be explored - e.g. an opinion over CVA activity and settlement calculations with more flexibility across SVA activity, which would be risk-based testing.	4
End-customer centric, promotes good customer experience	Limited specific focus on this aspect	1	More flexible, testing could be aligned to this aspect.	3	More flexible, testing and scope could be aligned to this aspect. More narrative comments could be added to aid understanding.	4	Use of advisory, risk-based focus in combination with an assurance opinion likely to provide optimal blend.	4
Facilitates new entrants to the market - there is a level playing field for all	Not specifically within scope, though qualification audit explores participant readiness to integrate with the BSC.	1	More flexible, testing could be aligned to this aspect.	3	More flexible, testing and scope could be aligned to this aspect. More narrative comments could be added to aid understanding.	4	Focus on the key risks by participant, so audit is targeted to support all participants.	4
Supports good industry behaviours	Implied through BSC compliance	2	More flexible, testing could be aligned to this aspect.	3	More flexible, testing and scope could be aligned to this aspect. More narrative comments could be added to aid understanding.	4	Flexible nature of the work allows the auditor to consider behavioural elements, as well as substantive elements	4
Improves data quality and consistency across suppliers and agents	Implied, but not specifically examined	2	More flexible, testing could be aligned to this aspect.	3	More flexible, testing and scope could be aligned to this aspect. More narrative comments could be added to aid understanding.	4	A blend of assurance techniques can be deployed, which focus on data quality through different lenses	4
Supports key industry priorities (e.g. SMIP, faster switching)	Would need to be incorporated into the BSC to include within the scope of the Audit.	0	More flexible, testing could be aligned to this aspect.	3	More flexible, testing and scope could be aligned to this aspect. More narrative comments could be added to aid understanding.	4	Flexibility is built into the construct of the approach, allowing audit work to focus on the most important areas.	4

Appendix B: Detailed scoring matrix results

Design criteria	ISAE 3000 Revised	AuPs	Advisory	Hybrid ISAE 3000 and advisory
Flexible, risk-based work that is targeted at areas of most market benefit	All areas of SVA and CVA compliance is in scope. Bound by work required to support the opinion	1 Work can be scoped to focus on key areas of interest and risk.	3 Work can be scoped to focus on key areas of interest and risk, with scope for narrative comment, findings and recommendations.	4 Work can be scoped to focus on key areas of interest and risk, with scope for narrative comment, findings and recommendations.
The audit is future-proof, easy to incorporate changes and adaptive (e.g. SMIP / faster switching)	Less flexible - changes would need to be integrated into the BSC to be brought into scope	2 Work can be scoped to focus on key areas of interest and risk.	Work can be scoped to focus on key areas of interest and risk, with scope for narrative comment, findings and recommendations.	4 Work can be scoped to focus on key areas of interest and risk, with scope for narrative comment, findings and recommendations.
There is an optimal balance of cost, independent challenge, flexibility and likely value to participants	Participant feedback suggests imbalance between cost, effort and value	1 As scope and focus can be varied, then intuitively the value should be greater. This may be tempered by the structure and volume of the reporting.	2 As focus can be flexed, with narrative comment on findings and key recommendations, this is likely to offer best insight and therefore value. However, this option may provide less comfort to those looking for robust assurance across overall BSC compliance.	3 As focus can be flexed, with narrative comment on findings and key recommendations, this is likely to offer best insight and therefore value. And with the ability to offer an opinion in given areas, the value to participants is significant.

Appendix B: Detailed scoring matrix results

Design criteria	ISAE 3000 Revised	AuPs	Advisory	Hybrid ISAE 3000 and advisory
The outputs need to be easy to use and understandable	Whilst short, opinions are not easy for lay person to understand and do not generally contain wider information	2 Likely to be voluminous description of testing executed and therefore difficult to draw concise conclusions	2 Likely to be the easiest and most engaging output to review and understand.	3 The interplay of an assurance opinion (e.g. over CVA activity) and advisory, risk-based reports over SVA activity would need to be carefully explained.
The outputs provide insight into areas of value to the end user	More limited	1 If a reader is prepared to assimilate the testing information, there is likely to be more inherent value.	2 More flexible, testing and scope could be aligned to this aspect. More narrative comments could be added to aid understanding.	4 The risk focus nature of the work ensures that it is targeted in the key areas of concern.
The outputs support participant financial reporting requirements	Yes	4 Partially - participant's external auditors would need to assess the level of work done and the exceptions, rather than relying on an overall assurance conclusion	2 Not likely to provide the level of comfort required by financial auditors.	0 Where an opinion is given this is likely to be the case, but not for those areas where the work is advisory in nature
The outputs are accessible by all participants / BSC signatories	Yes	4 Mechanisms could permit this.	4 Mechanisms could permit this.	4 Mechanisms could permit this.
The outputs are aligned with the other outputs of the PAF.	Opinion and scope makes it harder to flex and align with the potential evolution of the PAF.	2 More flexible and potentially easier to align as PAF evolves.	3 More flexible and potentially easier to align as PAF evolves.	3 More flexible and potentially easier to align as PAF evolves.

This document has been prepared only for ELEXON and solely for the purpose and on the terms agreed with ELEXON in our letter of engagement dated 30 August 2017. We accept no liability (including for negligence) to anyone else in connection with this document, and it may not be provided to anyone else.

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