



NOTICE OF MEETING

CABINET

FRIDAY, 10 AUGUST 2018 AT 4.30PM

THE EXECUTIVE MEETING ROOM - THIRD FLOOR, THE GUILDHALL

Telephone enquiries to Democratic Services Tel 9283 4057

Email: democratic@portsmouthcc.gov.uk

If any member of the public wishing to attend the meeting has access requirements, please notify the contact named above.

Membership

Councillor Gerald Vernon-Jackson CBE (Chair)

Councillor Steve Pitt (Vice-Chair)

Councillor Dave Ashmore

Councillor Ben Dowling

Councillor Suzy Horton

Councillor Darren Sanders

Councillor Jeanette Smith

Councillor Lynne Stagg

Councillor Matthew Winnington

Councillor Rob Wood

(NB This agenda should be retained for future reference with the minutes of this meeting.)

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AGENDA

- 1 Apologies for Absence**
- 2 Declarations of Interests**
- 3 Forward Plan Omission**

The Victory Energy Supply Limited - Expert Review of Business Case report by the Director of Finance was omitted from the Forward Plan covering August 2018 published on 16 July 2018. The Chair of the City Council's Scrutiny Management Panel has been notified and a public notice published.

RECOMMENDED that

- (1) the omission to the Forward Plan for August 2018 be noted and
- (2) that publication of the omission notice be noted

4 Victory Energy Supply Limited - Expert Review of Business Case (Pages 3 - 60)

The report that was to follow was published on 6 August.

Purpose.

To consider the expert reviews and due diligence that has been provided on the Revised Business Case for Victory Energy Supply Limited and consider the options available to the Council.

Recommended that the Cabinet consider the options set out below, taking proper account of the potential risks and rewards, and determine which option should proceed:

Option 1 - To continue the Council's investment into Victory Energy Supply Limited under the current governance arrangements described in the Cabinet Report of the 29 July 2017.

Option 2 - Cease investment into Victory Energy Supply Limited.

Option 3 - Continue the investment into the company, exercising robust oversight and governance with funding for each year subject to the approval by PCC of the company's Business Plan for the forthcoming year.

Option 4 - Seek to enter into a "White Label" agreement with an existing fully licensed energy supplier.

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3 August 2018

Agenda Item 4



Portsmouth
CITY COUNCIL

Title of meeting:	Cabinet
Date of meeting:	10 th August 2018
Subject:	Victory Energy Supply Limited - Expert Review of Business Case
Report by:	Director of Finance & Information Technology (Section 151 Officer)
Wards affected:	All
Key decision:	Yes
Full Council decision:	No

1. Executive Summary

- 1.1 Victory Energy was established primarily to generate substantial income for the Council to support the sustainability of Council services into the future. It had the added objectives of reducing fuel poverty for residents, reducing carbon impact and providing competitively priced energy to business.
- 1.2 The products to be offered by Victory Energy include energy supply to domestic and business users, home energy assessments aimed at reducing consumption, Smart thermostats and connected devices, heating systems installations, servicing and repair and solar PV panels including home battery storage and electric vehicle charging points. A significant development through the "build out" of Victory Energy has been to secure an energy trading partner who can provide 100% renewable energy at market leading costs.
- 1.3 There is a strong financial case for continuing the Council's investment into Victory Energy Supply Limited (VESL) but, as with any commercial opportunity, it is not without risk. If the Council is to continue its investment, it should do so in a measured way ensuring strong governance and oversight and on the basis of the annual approval of the Company's 3 year rolling Business Plan. This is consistent with the advice received from the first Independent Expert Review (undertaken by Baringa) which stated that:

"We would also expect any investor to put in place a stage-gate governance process based on achieving certain operational, customer number and margin targets to determine the release of additional capital..."
- 1.4 To date, the Council has spent £1.5m of the £8.1m investment required¹ before the Company is expected to turn to profit in Year 3. By Year 5, the Business Case forecasts an annual profit by the Company of £5.5m and growing year on year.

¹ As set out in the Victory Energy Revised Business Case (Base Case)

This is the "Base Case" and is predicated on achieving 144,000 customers over the period.

1.5 Seven alternative scenarios have been modelled as part of the VESL Business Case. In addition, "Plan B" represents a scenario that switches the emphasis of customer acquisition to price comparison websites. All but one of the scenarios generated positive financial returns with "Plan B" breaking even by the end of year 5. Once the value of the "Customer Book"² (i.e. a proxy estimate for the Company's sale value) is taken into account, all scenarios provide a positive investment return.

1.6 In relation to "Plan B" specifically and the risks surrounding customer growth projections, Baringa commented as follows:

"The 'Plan B' business case scenario outlined in the final business case does, in our opinion, provide a considered approach to managing these risks and likely impacts on investment returns."

1.7 A second Independent Expert Review conducted by PricewaterhouseCoopers (PwC) has recently concluded. This review focussed on the most material assumptions in the Revised Business Case. The review highlights a number of positive features within the Victory Energy Business Case such as:

- The Business Plan is aligned with the energy markets
- The backing of PCC provides a number of sources of competitive advantage for Victory Energy relative to many competitors
- Victory Energy Supply activities contained in the Business Plan may provide financial upsides to the Council which are not included in the Financial projections for reasons of prudence
- Victory Energy has installed an experienced management team

1.8 The PwC report also advises that the Council should *"fully understand the downside risks and their impacts"*. Accordingly, their report provides 2 alternative Downside Scenarios. The most severe of which is Downside Scenario 2. This is based on lower customer conversion rates and negative impacts from the imposed price caps. It is described by PwC as a "plausible" scenario and in their view, more probable than the Victory Energy Base Case primarily because price caps will be implemented, although the exact impact is unknown and cannot yet be quantified.

1.9 If Downside Scenario 2 were to arise, a much greater level of investment (up to £19.3m in total over 4 years) will be required. At the same point in time, the Downside Scenario 2 forecasts that 126,000 customers would have been acquired with an estimated Customer Book value of £9.8m. Taken together, this implies a risk exposure of £9.5m however, other investment returns would also have been received (see paragraph 1.14) and could further reduce the overall financial

² Customer Book value has been based on a value per customer of £77.50 from an expected range of values from £55 to £100 per customer. This proxy is a function of: (i) Avoided acquisition costs and (ii) an additional premium for the customers being sticky. The estimate assumes that the buyer is an existing supplier looking to grow customer base and would value the stickiness of the customers. It is feasible that the buyer may value customers less for a number of reasons including; not valuing the stickiness of the customers, placing a lower value on avoided acquisition costs and; whether the sale is a distress sale.

exposure to the Council to circa £2.6m. Peak financial exposure for the Council is forecast to be in Year 2 and amounts to £6.5m. Beyond year 4, the Company would start to return annual profits and by year 10 have achieved significant financial returns.

1.10 PwC also comment that:

"..... such a scenario playing out is plausible, albeit, we recognise that there are a number of mitigating actions management could take to reduce the impact."

"Given the nature of these businesses, with high upfront investment costs and an ambition for a long term customer relationship, it is more appropriate to assess the value contribution for longer than 5 years, which would also capture some of the other upsides."

1.11 The underlying message from PwC is that price caps are a reality and therefore it would be wise to consider their potential impact however the returns from the Business Investment should be considered, as is normal, over a longer time frame than 5 years.

1.12 Total investment returns for the Council from the venture are wider than those of just Victory Energy. Total investment returns to the Council over the first 5 years are forecast to range from £24.3m under the Victory Energy Base Case Scenario to £2.5m in the PwC Downside Scenario 2. At either end of the spectrum, positive total returns to the Council are projected within 5 years.

1.13 Taking the Downside Scenario 2 of PwC and their advice to consider investment over 10 years (after repayment of the necessary up-front investment) would return circa £50m, representing both earnings of circa £27m and a Customer Book value of circa £18m.

1.14 Total investment returns include the earnings from Victory Energy plus the estimated value of the Company at Year 5 as well as the income streams to the Council from the following which only arise as a direct consequence of the activities of Victory Energy:

- Leads generated by Victory Energy and passed to the Council's "In House" Energy Management Services team - worth £2.4m over the 5 year period
- Interest on the Loan facility provided to Victory Energy - worth £1.7m over the 5 year period
- Sums set aside by Victory Energy into the Community Investment Fund to be distributed by the Council - worth £4.9m over the 5 year period

1.15 To cease the company at this stage would likely result in a cost (Investment Loss) of between £2.5m and £3.5m depending on the type of winding-up adopted.

1.16 An alternative method of entering the energy market is through a "White Label" arrangement. This is a simplified and quick route to market. It carries lower

financial risk but also very low financial returns. A switch to this approach would also result in ceasing the company and result in a cost (Investment Loss) of between £2.5m and £3.5m depending on the type of winding-up adopted.

- 1.17 There are 4 main options for the Council to consider. They are summarised below and quantify the financial risks and rewards associated with the Base Case and potential Downside Scenarios. Potential upsides associated with the wider services offering of Victory Energy are excluded for prudence purposes.

Option 1 - Continue the Council's investment into Victory Energy Supply Limited under the current governance arrangements

- ❖ Lower energy costs to residents
- ❖ 100% renewable energy to residents and business
- ❖ Base Case total investment return (5 Years) £24.3m
- ❖ Downside Scenario 2 total investment return (5 Years) £2.5m
- ❖ Downside Scenario 2 total investment return (10 Years) Circa. £50m
- ❖ Potential upsides from other Energy Services
- ❖ Other energy services products to residents

Option 2 - Cease investment into Victory Energy Supply Limited

- ❖ Investment loss - best case £2.5m
- ❖ Investment loss - worst case £3.5m
- ❖ Reputational damage

Option 3 - Continue the investment into the company, exercising robust oversight and governance with funding for each year subject to the approval by PCC of the company's Business Plan for the forthcoming year.

- ❖ Lower energy costs to residents
- ❖ 100% renewable energy to residents and business
- ❖ Base Case total investment return (5 Years) £24.3m
- ❖ Downside Scenario 2 total investment return (5 Years) £2.5m
- ❖ Downside Scenario 2 total investment return (10 Years) Circa. £50m
- ❖ Potential upsides from other Energy Services
- ❖ Other energy services products to residents
- ❖ *Stage-gate approach to future funding*

Option 4 - Seek to enter into a "White Label" agreement with an existing fully licensed energy supplier

- ❖ Investment loss - best case £2.5m
- ❖ Investment loss - worst case £3.5m
- ❖ Reputational damage
- ❖ Low financial returns in the future

1.18 The success or otherwise of the Company will be dependent on:

- Strong governance (at Board and operational levels)
- A talented Senior Management Team
- An agile Business Plan
- A robust risk management framework

1.19 It is planned that the Board will include both Executive and Non-Executive Directors. Non-executive Directors will comprise "heavyweight" industry professionals alongside the Council's most senior officers and ideally Members from across the political parties.

1.20 The Senior Management Team are experienced industry professionals with proven track records. The independent expert review commented as follows:

"One of the key drivers for success in the GB energy supply market is the ability to find skilled and experienced individuals to lead and manage these businesses and navigate the various market complexities.

Both the key individuals bring an overall understanding of the commercial and operational fundamentals of the energy supply market. Jo Butlin in particular brings experience of running a non-domestic energy supply business and experience of advising other new entrants in the market" - Baringa November 2017

1.21 The Business Case and all of its iterations have been developed by experienced industry professionals alongside PCC Officers. They include the modelling of 8 alternative Scenarios and include "fall back" plans in the event that the financial projections do not run to plan. Additionally, PwC has also provided two further Downside Scenarios. Baringa, in particular commented as follows:

"In our view, based on the information provided, there is a reasonable expectation that the proposed business would generate returns to PCC that would be attractive to private investors, and it therefore sets out a good case for investment by PCC" - Baringa November 2017

1.22 In addition to robust risk management policies and processes set out in the Business Case, it is also recognised that skilled and experienced staff are essential for success. In this regard PwC have commented as follows:

"VESL has installed an experienced management team and we understand that robust procedures they are putting in place should act as a source of risk mitigation for VESL" - PwC July 2018

1.23 The general approach to the Business Case has been one of prudence. The Business Case and all of its iterations have been developed by experienced industry professionals alongside PCC Officers. Additionally, the Council has now undertaken two separate Independent Expert reviews of Victory Energy's Business Case. CMS is also providing ongoing legal advice as to the governance structure and contractual arrangements in order to provide assurance on the governance protocol and operating model for VESL.

1.24 Importantly, the overall financial forecasts within the Business Case are based solely on the energy supply part of the business. This is for two key reasons:

- i) As a prudent measure to ensure that the Company could generate profits on an energy supply basis only
- ii) The wider product offering is largely based on energy supply being the "enabler" or introduction to conversations regarding wider energy services products aimed at reducing customer bills (e.g. boiler installations, solar PV and battery storage, smart meters etc.)

This means that, as well as Downside Scenarios, there are also upside scenarios within the Business Case which a talented management team could exploit. PwC comment:

"Expansion of VESL's energy services activities may provide upside, particularly in the medium to longer term, but these activities are not reflected in the RBC" - (PwC July 2018)

1.25 Overall the opportunity can be summarised as:

- ❖ Lower energy costs to residents
- ❖ An option for 100% renewable energy to residents and business
- ❖ A Base Case (5 Years) total investment return of £24m
- ❖ A Downside Scenario (10 Years) total investment return of £50m (including the Customer Book value and therefore the sale of VESL at the end of year 10)
- ❖ The value of the Customer Book significantly de-risks the Council's financial exposure; the Downside forecast being an exposure of £6.5m at its peak (after taking account of the Customer Book value and other investment returns to PCC)
- ❖ The alternative of not proceeding is a cost to the Council of between £2.5m to £3.5m but with no further risk or reward

2. Purpose of report

- 2.1 To consider the expert reviews and due diligence that has been provided on the Revised Business Case for Victory Energy Supply Limited and consider the options available to the Council.

3. Recommendations

- 3.1 It is recommended that Cabinet consider the options set out below, taking proper account of the potential risks and rewards, and determine which option should proceed:

Option 1 - To continue the Council's investment into Victory Energy Supply Limited under the current governance arrangements described in the Cabinet Report of the 29th July 2017

Option 2 - Cease investment into Victory Energy Supply Limited

Option 3 - Continue the investment into the company, exercising robust oversight and governance with funding for each year subject to the approval by PCC of the company's Business Plan for the forthcoming year.

Option 4 - Seek to enter into a "White Label" agreement with an existing fully licensed energy supplier

4. Background

- 4.1 The Energy market in the UK is heavily regulated by the OFGEM with policy set through the Department for Business, Energy and Industrial Strategy (BEIS). There are currently over 70 domestic energy suppliers in the market place and whilst the market is undergoing rapid change it is still dominated by the Big Six Energy suppliers which hold just over 80% of the market share³.

- 4.2 The domestic energy supply market is currently characterised by:

- Distrust of the Big 6
- Rising real terms prices for consumers;
- Low levels of customer satisfaction;
- Increased scrutiny of Energy Suppliers pricing activities;
- Increasing number of customer switches (2.7 million switches in 2018 for the year to date, 53% of which were from Big 6 to smaller suppliers⁴);
- A significant interest nationally from local authorities seeking to enter the market as Municipal Energy suppliers (usually on a "White Label" basis).

³ Source: OFGEM- State of the Market Report 2017

⁴ Source: OFGEM & Energy UK

- 4.3 At present, just 2 Local Authorities have established their own fully licensed energy supply company, Nottingham City Council (2013) and Bristol City Council (2015) although others exist as a "White Label"⁵ but are not fully licensed.
- 4.4 Wider Government policy on Energy as a whole is centred around the following 3 key objectives:
- Affordability for the customer;
 - Carbon reduction (Energy efficiency); and
 - Security of supply.
- 4.5 Increasingly, Government are looking to more local models to achieve these objectives, through "disrupting the market" with new competition but also recognising that prescriptive national policy cannot effectively address the energy needs of every locality.
- 4.6 On the 29th July 2017, the Cabinet approved the Outline Business Case to enter into a Joint Venture Energy Supply company (ESCo), now known as Victory Energy.
- 4.7 The motivation for the establishment of the company was primarily to generate substantial income for the Council as an "avoidance to cuts" measure which could then help to support the sustainability of Council services into the future. It was to be a key feature of the Medium Term Financial Strategy in meeting the £12m forecast budget deficit over the next 3 years. The motivations were described in that report as follows:
- Improve energy efficiency and enabling more affordable energy to residents as a mechanism to reduce fuel poverty and raise prosperity in the City more generally;
 - Support carbon reduction and air quality improvement through the stimulation of investment into renewable energy sources and energy efficient installations;
 - Enable provision of competitively priced energy to Business as a means to improve growth and productivity; and
 - Provide an income stream to the City Council to re-invest in public services
- 4.8 Given the Council's lack of institutional knowledge of the Energy Market, its operation and regulation, the method of delivery for the Energy Company was by way of a joint venture (JV). The joint venture sought to bring together the JV partner's industry knowledge, regulatory background, expertise, skilled resources and industry contacts together with the Council's ambition, financial resources, creditworthiness and marketing channels to create a successful partnership.

⁵ A simplified and quick route to market. A fully licenced supplier offers a white label offering to another partner. The partner develops its marketing proposition and sells direct to its target customers, whilst the licenced supplier provides all the market related services, billing and customer service

- 4.9 The services to be offered by Victory Energy include (amongst others) the following:
- An option for 100% renewable energy to domestic users
 - An option for 100% renewable energy to business users from year 2
 - Free home energy assessments and advice over how to save money
 - Smart thermostats and connected devices
 - Heating systems installations, servicing and repair
 - Solar PV panels including in home battery storage
 - Electric Vehicle charging points
- 4.10 To be of sufficient scale to operate viably, Victory Energy will operate nationally but will have an initial target market for the first 3 years broadly covering Hampshire, West Sussex and Surrey.
- 4.11 On the basis of the expected financial return (investment payback within 4 years) and the risk mitigation measures set out within the Outline Business Case, the Cabinet resolved to progress the "build out" of the company (including Controlled Market Entry⁶ and Full Market Entry⁷) subject to an Independent Expert Review of the Business Case.

5. Progress to Date

- 5.1 Baringa, a market leading international consultancy focussing on energy and utilities, conducted the first Independent Expert Review which was focussed on the commerciality of the Business Case. It was undertaken to provide assurance to the Council about the reasonableness of the Business Case itself and also to demonstrate "State Aid" compliance. It was not a full due diligence review. The review concluded in November 2017.
- 5.2 Baringa have a long history working across the energy industry with utilities, investors and regulators including the "Big 6", Independent Energy Suppliers, the National Grid and Ofgem. Baringa have previously developed a number of business cases for companies considering entry into the GB energy supply market and successfully supported a number of suppliers through the entry process and early operations.
- 5.3 Baringa's report is attached at Appendix 1. It concludes with the following statements:

"We have reviewed the JV business plan. Subject to review of the final terms of the JV investment structure, we consider that the business case presented (i) has

⁶Controlled Market Entry (CME) is a regulatory hurdle that needs to be met prior to full business launch. A finite number of customers (typically 'friends and family') are recruited to demonstrate that the business can effectively operate defined industry processes through its system architecture and operational processes. CME usually lasts between 2 and 4 months and can only be exited once regulatory approval has been given

⁷ Full Market Entry (FME) is the term used for full business launch. Until CME is complete, the business is not permitted to proactively market itself externally.

been developed with an appropriate level of due diligence which would be expected of a commercial investor; (ii) is based on reasonable assumptions; (iii) provides a considered assessment of the market opportunities and risks to the proposed business; and (iv) puts forward reasonable and well-founded financial projections"

"In our view, based on the information provided, there is a reasonable expectation that the proposed business would generate returns to PCC that would be attractive to private investors, and it therefore sets out a good case for investment by PCC. The base case and alternative scenarios modelled in the business case present a reasonable range of likely outcomes for the business investment. Even if some of the risks outlined above materialised and the investor payback period increased to beyond 5 years with low to mid-teen IRR, this would still be consistent with what we have seen for other new energy supply business that have gained investment from private investors"

"We therefore conclude that private investors in current market circumstances would be sufficiently motivated to invest in the proposed business, and that PCC investment can be justified on commercial grounds. It would be reasonable for PCC to target the base case set out in the business case and hold the JV management team and JV partners to account against these targets"

5.4 Following the first Independent Expert Review, the Business Case was amended to incorporate all of their recommendations and as a consequence Final Business Case approval was granted. Since that time, VESL has almost been fully "built out" and is now on the verge of "Controlled Market Entry". This has involved the following:

- Employment of the Senior Management Team and operational staff (18 full time staff, 10 offers pending and 34 vacancies)
- Design and development of the brand;
- Design and development of define core service offering with associated marketing material;
- Design and development of the end to end customer experience and associated processes;
- Procurement, implementation and testing of IT systems functionality;
- Design and development of key business policies and controls, including risk management, cash management, delegated financial authorities;
- Procurement of metering partners;
- Procurement of energy trading partner;
- Development of energy trading strategy;
- Execution of contracts with the supply chain and industry bodies (35 contracts)
- Specification and fit out of office premises;
- Development of Sales and Marketing plan for launch; and
- Development of specific policies and procedures to meet OFGEM regulatory licence conditions and GDPR obligations

- 5.5 Similarly, the Council engaged a national leading legal firm (CMS) to advise generally and specifically in relation to compliance with the statutory regime governing the electricity and gas markets ("Sectoral Regulations") and public procurement and state aid requirements. CMS have also advised Victory Energy (and continue to do so) in a number of contracts with suppliers.
- 5.6 Given the proximity to Controlled Market Entry (CME) and the greater certainty of contract prices and wholesale energy prices as well as the development of plans for launch (e.g. Sales and Marketing), Victory Energy has revised its Financial Plan which is now described as the "Revised Business Case". This Business Case has been the subject of a further Expert Review by PricewaterhouseCoopers (PwC), one of the four largest Accountancy and Consulting firms in the world.
- 5.7 The headlines of the Revised Business Case are set out below:

Customer Growth:

- ❖ 144,000 Customers over 5 Years (6 customers per Sales Agent/Day)
- ❖ Market Share - Initial Target Market (17%) / National Market (less than 0.5%)
- ❖ Break-even Number of Customers - 44,000 per annum

Financial Performance:

- | | |
|--|--------|
| ❖ Cumulative losses Pre-live to Year 2 | -£8.1m |
| ❖ Cumulative surplus by Year 5 (after payback of £8.1m investment) | £4.2m |
| ❖ Year 5 Annual Net Surplus | £5.5m |

Investment:

- | | |
|--|-----------|
| ❖ Peak investment requirement | £8.1m |
| ❖ Payback Period | 55 months |
| ❖ Estimated Customer Book Value (Year 5) | £11.2m |

NB. All amounts assume the contingency of £1.5m is fully spent

- 5.8 To date, the Council has provided funding of £1.5m to "build out" the company to this stage, this represents a current underspend compared to the Full Business Case of £0.6m, realised from savings negotiated from the supply chain during the "build out" phase.
- 5.9 The programme to launch the company into CME in September 2018 remains on track and within budget.

6. Revised Business Case Expert Review (PwC Review)

- 6.1 PwC have recently concluded a more limited review than Baringa and have focussed on the most material assumptions in the Revised Business Case. The Executive Report is attached at Appendix 2 and a summary of their "Key Messages" are reproduced in full below:

Based on our review of VESL's revised business plan and supporting documentation, we make the following observations:

- *While the market for supplying electricity and gas in the UK has seen many new entrants, including local authority backed suppliers, levels of switching remain at an all-time high.*
- *While VESL's core proposition, around local engagement is unique and directionally aligned with energy markets becoming more decentralised, some features of the sales and marketing plan are untested.*
- *Having the backing of PCC provides a number of sources of competitive advantage for VESL relative to many competitors. These include strong financial backing via working capital facility and provision of PCGs to support low cost hedging of power and gas.*
- *The Market has evolved in a number of material aspects since the FBC was approved in autumn 2017, particularly with regard to more clarity on extended price caps.*
- *Review of the business plan and value drivers found a number of specific areas where we note the following challenges:*
 - *Delivering VESL's customer growth numbers appears achievable over the 5 year plan period based on market benchmarks. We have seen some suppliers grow their customer numbers in this way, reflected in more recent growth in telesales and face-to-face sales activity by other suppliers. However, most suppliers have typically used price comparison websites to drive acquisitions, although we note that this attracts customers with a greater propensity to churn*
 - *There is a risk that VESL will not deliver the required level of acquisitions, particularly within year 1, with the current proposition and untested sales and marketing plan to target unengaged customers through face to face sales*
 - *Delivering the required level of acquisitions may require VESL to adapt its sales and marketing plan and use more proven sales channels. VESL should be well positioned to adapt quickly to a new approach, however, this may result in VESL's acquisition costs increasing and put downward pressure on margins*
 - *VESL's net margin forecasts look high relative to other independent suppliers, particularly given that its costs to serve are comparable with other independent suppliers*
- *VESL's business plan is exposed to regulatory changes. Sensitivity analysis indicates that the introduction of a price cap could materially affect financial performance and peak funding requirements.*
- *Expansion of VESL's energy services activities may provide upside, particularly in the medium to longer term, but these activities are not reflected in the RBC.*
- *Given the nature of these businesses, with high upfront investment costs and an ambition for a long term customer relationship, it is more appropriate to assess the value contribution for longer than 5 years, which would also capture some of the other upsides.*
- *VESL has installed an experienced management team and we understand that robust procedures they are putting in place should act as a source of risk mitigation for VESL. Furthermore the RBC includes a contingency of £1.5m over the business plan period (including pre-live activity).*
- *Once established, energy retail businesses have value to 3rd parties either for their customer book or as a platform for further growth. The larger the customer book and strength of platform, the greater the expected value of the business.*

6.2 The scope of the commission by the Council was for a risks based report only and PwC's key observations in this regard relate to:

- Customer Growth projections
- The introduction of price caps for pre-payment meters (implemented) and Standard Variable Tariffs (SVT's) which is currently out to consultation and due to come into effect by the end of 2018.

Consequently, PwC suggest that the Council should be aware of two alternative "plausible" downside scenarios as described below but go on to state:

"..... such a scenario playing out is plausible, albeit, we recognise that there are a number mitigating actions management could take to reduce the impact"

The two suggested downside scenarios are:

i) Downside Scenario 1 - Reduced Customer Acquisition Rates

- Revising year 1 total customer acquisition assumptions down by 50%
- Pushing year 1 growth targets back to month 18 by reducing the sales conversion rate to 2.5 sales per agent per day and uplifting the required number of sales agents accordingly, to enable year 5 target customer numbers to be achieved. This is reflective of a revised sales and marketing plan driven by door-to-door cold call sales and assumes that VESL's total cost base changes in response to changes in the configuration of its sales teams.

ii) Downside Scenario 2 - Reduced Customer Acquisition Rates and the Impact of the Price Cap

- As Downside Scenario 1 (above), plus
- Reducing SVT customers' annual bills by c. £100 and reducing Fixed tariff customers' annual bills by c. £50 to reflect the introduction of the SVT cap and virtual ceiling price on all tariffs.

6.3 The headlines described in those "Downside Scenarios are set out below:

Downside Scenario 1 - Reduced Customer Acquisition Rate

Customer Growth:

- ❖ 143,000 Customers over 5 Years (2.5 customers per Sales Agent/Day)

Financial Performance:

- | | |
|--|---------|
| ❖ Cumulative losses Pre-live to Year3 | -£14.0m |
| ❖ Cumulative loss by Year 5 | -£6.4m |
| ❖ Year 5 Annual Net Surplus | £5.5m |
| ❖ Cumulative surplus by Year 10 (indicative) | £63.7m |

Investment:

- | | |
|--|--------|
| ❖ Peak investment requirement | £14.0m |
| ❖ Estimated Customer Book Value at Year 5 | £11.1m |
| ❖ Estimated Customer Book Value at Year 10 | £18.1m |

Downside Scenario 2 - Reduced Yr.1 Customer Acquisition Rate and impact of Price Cap

Customer Growth:

- ❖ 143,000 Customers over 5 Years (2.5 customers per Sales Agent/Day)

Financial Performance:

- | | |
|--|---------|
| ❖ Cumulative loss Pre-live to Year4 | -£19.3m |
| ❖ Cumulative loss by Year 5 | -£17.5m |
| ❖ Year 5 Annual Net Surplus | £1.8m |
| ❖ Cumulative surplus by Year 10 (indicative) | £20.8m |

Investment:

- | | |
|---|--------|
| ❖ Peak investment requirement | £19.3m |
| ❖ Estimated Customer Book Value at Year 5 | £11.1m |
| ❖ Estimated Customer Book Value at Year 10 (indicative) | £18.1m |

Note:

Projections to Year 10 are indicative and based on the following assumptions:

- i) Growth in cash flows between years 6 -10 are based on the growth in cash flows between years 4 - 5, this equates to 20% per annum
- ii) Growth in customer numbers between years 6 - 10 are based on the growth in customers between years 4 - 5, this equates to 10% per annum

6.4 In both downside scenarios Victory Energy would enter profit in years 4 and 5, respectively although the up-front investment required is significantly more than the £8.1m described in the Victory Energy Base Case at £14.0m and £19.3m, respectively. Importantly, the Customer Book value by Year 5 amounts to £11.1m which significantly de-risks the financial exposure of the Council. Furthermore, since the Council would not be a "forced seller" as a consequence of cash flow difficulties, it will be better able to determine the optimum point at which to make any necessary sale of the company.

6.5 PwC advice is that:

"Given the nature of these businesses, with high upfront investment costs and an ambition for a long term customer relationship, it is more appropriate to assess the value contribution for longer than 5 years, which would also capture some of the other upsides"

This accords with the advice from the first Independent Expert review from Baringa that stated:

"Even if some of the risks outlined above materialised and the investor payback period increased to beyond 5 years with low to mid-teen IRR⁸, this would still be consistent with what we have seen for other new energy supply business that have gained investment from private investors"

6.6 When viewed over a 10 year period, the indicative projections (based on annual growth rates between years 4 and 5 continuing) are both positive, with the Downside Scenario 2 providing a cumulative surplus of £20.8m plus an estimated customer book value of £18.1m.

7. Risk Mitigation

7.1 Risk mitigation for Victory Energy is described more widely under the "Key Considerations" section of this report. The general Risk Management Framework and scenario modelling that has been undertaken is described in the paragraphs that follow.

7.2 Victory Energy have developed a Risk Management Framework, governed by a Risk Management Committee comprising its senior management and with proper oversight by the Board to cover the following risks:

- Purchase and hedging strategy
- Pricing strategy
- Customer acquisition and retention
- Reputation and customer service
- Settlements performance
- Debt performance
- Key resource
- Systems & Data Risk
- Regulatory Risk

⁸ Internal Rate of Return - an accounting measure of investment return

7.3 The key mitigations common throughout these key risks and embedded within the Business Case include:

- Strong governance
- Key experienced staff
- Strong training for staff
- Use of market leading software
- Robust data capture
- Robust change management processes
- Market leading provider for outsourced industry processes
- Supply contracts backed by robust performance based Service Level Agreements

7.4 In addition to the two PwC Downside Scenarios described previously, the Victory Energy Business Case caters for a further 7 alternative scenarios plus a further scenario entitled "Plan B". The 7 Scenarios modelled the effect of differing levels of customer acquisition, the exclusion of energy sales to business customers and increases in wholesale energy costs without corresponding increases in price. The "Plan B" assumes that only 50% of customers are sourced through the planned Sales and Marketing approach and the remaining 50% via Price Comparison Websites (a more traditional approach).

7.5 In all but one of the scenarios, the Company generated a cumulative net surplus by Year 5 (having taken account of all up-front investment costs). Additionally, "Plan B" had reached break-even by the end of Year 5 (having taken account of all up-front investment costs). Similarly, the company would have a "Customer Book" value which, based on 144,000 customers, could amount to £11.2m.

7.6 Baringa have provided the following comments in relation to the Scenario Modelling:

"The 'Plan B' business case scenario outlined in the final business case does, in our opinion, provide a considered approach to managing these risks and likely impacts on investment returns. This outlines the expectation that the JV would require to switch its acquisition channel mix to be more weighted towards Price Comparison Websites should customer engagement be less than expected through the face-to-face sales channel"

"The base case and alternative scenarios modelled in the business case present a reasonable range of likely outcomes for the business investment."

8. Overall Investment Returns

8.1 The overall financial case for Portsmouth City Council is wider than the financial returns of Victory Energy alone this is broken down into the Revenue Returns (i.e. earnings) and Capital returns (i.e. company value), summarised below:

Revenue Returns:

- i) Victory Energy Retained Earnings (or net profit)
- ii) Additional income to Housing and Property Services from leads generated by Victory Energy and passed to the Council's "In House" Energy Management Services team - worth £2.4m over the 5 year period
- iii) Interest on the Loan facility provided to Victory Energy - worth £1.7m over the 5 year period
- iv) Sums set aside by Victory Energy into the Community Investment Fund to be distributed by the Council - worth £4.9m over the 5 year period

Capital Returns (unrealised):

- i) The value of Victory Energy (where the "Customer Book" value has been used as a proxy for its realisable sale value) - amounting to £11.2m
- 8.2 Set out below is an estimate of total investment returns to PCC taking into account those from Victory Energy, the additional income streams to PCC as well as an estimate of the Company value over the next 5 years. Alongside this are the equivalent total investment returns in the PwC Downside Scenarios (see Appendix 3 for more details).
- 8.3 The Victory Energy Base Case forecasts a total 5 Year Investment Return to the Council amounting to £24.3m, representing total cumulative earnings (after the payback of the initial investment) over the period of £13.1m plus the estimated value of the Company at that point of £11.2m. The peak level of financial risk is expected to occur in the pre-live stage and amounts to £3.5m.
- 8.4 Whilst Downside Scenario 2 forecasts a total cumulative loss in earnings over the 5 year period of £8.6m, by Year 5 the Council is forecast to be making a £3.8m surplus. Additionally, the total 5 Year Investment Return to the Council is forecast to be £2.5m, representing the total cumulative loss of £8.6m but offset by the estimated value of the Company at that point of £11.1m.
- 8.5 An indicative 10 year view of the total investment return in the downside scenarios suggests that the total return could range between £50m to £95m if forecast growth rates between years 4 to 5 continue in later years.

Victory Energy Base Case:

❖ Total Annual Earnings - Year 5	£7.5m
❖ Cumulative Surplus Earnings - Year 5	£13.1m
❖ Total Investment Value at Yr. 5	£24.3m
❖ Peak Financial Exposure (shaded in Appendix 3 tables)	£3.5m (Pre-Live)

Downside Scenario 1 - Reduced Yr.1 Customer Acquisition Rate

❖ Total Annual Earnings - Year 5	£7.5m
❖ Cumulative Surplus Earnings - Year 5	£2.5m
❖ Total Investment Value at Yr. 5	£13.6m
❖ Total Investment Value at Yr. 10 (indicative)	Circa. £95m
❖ Peak Financial Exposure (shaded in Appendix 3 tables)	£5.9m (Yr.1)

Downside Scenario 2 - Reduced Yr.1 Customer Acquisition Rate and impact of Price Cap

❖ Total Annual Earnings - Year 5	£3.8m
❖ Cumulative Loss - Year 5	-£8.6m
❖ Total Investment Value at Yr. 5	£2.5m
❖ Total Investment Value at Yr. 10 (indicative)	Circa. £50m
❖ Peak Financial Exposure (shaded in Appendix 3 tables)	£6.5m (Yr.2)

Note:

Other PCC earnings have been assumed to remain constant through all scenarios for modelling simplicity. Whilst these earnings are likely to be lower in both PwC Downside Scenarios, it is not expected to materially affect the earnings or investment value over the 5 or 10 year period

9. Other Alternative Options

9.1 The alternatives available to the Council in relation to Victory Energy are:

- Option 1 - To continue the Council's investment into Victory Energy Supply Limited under the current governance arrangements described in the Cabinet Report of the 29th July 2017
- Option 2 - Cease investment into Victory Energy Supply Limited
- Option 3 - Continue the investment into the company, exercising robust oversight and governance with funding for each year subject to the approval by PCC of the company's Business Plan for the forthcoming year
- Option 4 - Seek to enter into a "White Label" agreement with an existing fully licensed energy supplier

9.2 The risks and rewards associated with Options 1 and 3 are described fully within the body of the report. Further information regarding Options 2 and 4 are described below.

Option 2 - Cease investment into Victory Energy Supply Limited

i) Voluntary liquidation:

Funding is withdrawn immediately and no further contractual payments are made pursuant to the current executed contracts. It is estimated that the cost to the Council (Investment Loss) would be in the order of £2.5m. A liquidator is appointed to wind up the company and distribute its assets. Whilst default is a normal commercial risk associated with any business, not meeting contractual obligations to both suppliers and staff would also result in reputational damage to the Council and the private sector senior management engaged in the venture.

ii) Managed wind-down:

A managed wind-down would involve honouring of all current purchase orders and contract termination charges and is estimated to cost the Council (Investment Loss) up to £3.5m. Whilst reputational damage to the Council and senior management would still arise, it would be to a lesser extent with business but to a greater extent with residents due to the increased loss.

Option 4 - Seek to enter into a "White Label" agreement with an existing fully licensed energy supplier

A "White Label" arrangement is a simplified and quick route to market. A fully licenced supplier (say a Big 6 Energy Company or an organisation such as Robin Hood Energy) offers a white label offering to another partner (i.e. the Council). The Council develops its marketing proposition and sells direct to its target customers, whilst the licenced supplier provides all the market related services, billing and customer service. In return, the Council receive a small percentage of the tariff price - typically 1% or circa £10 - £12 per customer per annum from which sales and marketing costs must be met. Historically, Local Authorities entering into such arrangements have done so as a mechanism to offer residents lower tariffs rather than to make a commercial return since the overall margins are very low.

The advantages of a "White Label" arrangement (compared to the Victory Energy Business model) are:

- Quick and simple route to market
- Low financial risk

The disadvantages (compared to the Victory Energy Business model) are:

- Low returns
- Limited control of customer service and experience
- No control over hedging and trading and therefore the tariff (tariffs are passed through)
- Limited ability to provide wider Energy Services - e.g. energy assessments to reduce energy bills, heating installations and repairs, solar installations etc.

10. Summary of Options

10.1 A summary of the options available to the Council regarding Victory Energy with some key information are described below:

Option 1 - Continue the Council's investment into Victory Energy Supply Limited under the current governance arrangements

- ❖ Lower energy costs to residents
- ❖ 100% renewable energy to residents and business
- ❖ Base Case total investment return (5 Years) £24.3m
- ❖ Downside Scenario 2 total investment return (5 Years) £2.5m
- ❖ Downside Scenario 2 total investment return (10 Years) Circa. £50m
- ❖ Potential upsides from other Energy Services
- ❖ Other energy services products to residents

Option 2 - Cease investment into Victory Energy Supply Limited

- ❖ Investment loss - best case £2.5m
- ❖ Investment loss - worst case £3.5m
- ❖ Reputational damage

Option 3 - Continue the investment into the company, exercising robust oversight and governance with funding for each year subject to the approval by PCC of the company's Business Plan for the forthcoming year.

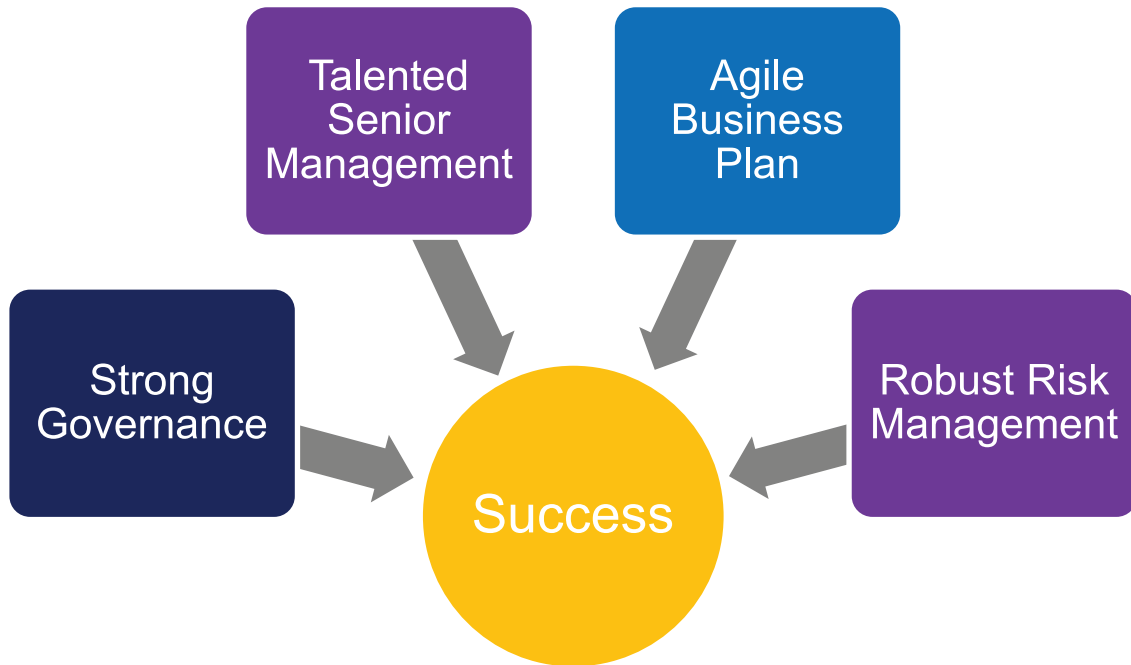
- ❖ Lower energy costs to residents
- ❖ 100% renewable energy to residents and business
- ❖ Base Case total investment return (5 Years) £24.3m
- ❖ Downside Scenario 2 total investment return (5 Years) £2.5m
- ❖ Downside Scenario 2 total investment return (10 Years) Circa. £50m
- ❖ Potential upsides from other Energy Services
- ❖ Other energy services products to residents
- ❖ *Stage-gate approach to future funding*

Option 4 - Seek to enter into a "White Label" agreement with an existing fully licensed energy supplier

- ❖ Investment loss - best case £2.5m
- ❖ Investment loss - worst case £3.5m
- ❖ Reputational damage
- ❖ Low financial returns in the future

11. Key Considerations

11.1 The success or otherwise of the Company will be dependent on the following:



11.2 General Approach:

The general approach to the Business Case has been one of prudence. The Business Case and all of its iterations have been developed by experienced industry professionals alongside PCC Officers. The Council has undertaken two separate Independent Expert reviews of the Company's Business Case alongside a legal review of the Business Case and its governance and contractual arrangements to provide assurance that the Business Case and Operating model for the Company is sound.

Importantly, the overall financial forecasts within the Business Case are based solely on the energy supply part of the business. This was for two key reasons:

- i) As a prudent measure to ensure that the Company could generate profits on an energy supply basis only
- ii) The wider product offering is largely based on energy supply being the "enabler" or introduction to conversations regarding wider energy services products aimed at reducing customer bills (e.g. boiler installations, solar PV and battery storage, smart meters etc.)

Governance

It is planned that the VESL Board will comprise the Chief Executive Officer (CEO), plus non-executive Directors of strong industry reputation and appropriate knowledge, expertise and experience as well as PCC Senior Officers and ideally a cross party selection of Members.

Senior Management

The VESL CEO has over 30 years of experience in the Energy industry through employment with one of the Big 6 energy suppliers, the majority of which has been at a senior leadership level. During this period, he held many diverse roles across the energy market, and included extensive experience establishing new business ventures and taking them to market. Core skills of the individual include leadership, strategy and transformation, underpinned with a demonstrable focus on strong governance and control. Baringa commented:

“Daniel O’Hara in particular demonstrated the drive, passion and determination that will be required to take this Joint Venture through the difficult start-up phases and build it out into a sustainable venture.”

VESL's interim Finance Director has over 25 years of experience in the Energy industry. In addition to twelve years' experience with one of the Big 6 energy suppliers, she has built, led and developed businesses across the market including establishing a new entrant. She is a respected and regular speaker at industry and stakeholder events and brings a broad market perspective as well as specialist expertise in retail, flexibility and regulated markets. She is a member of National Grid's Power Responsive Steering Committee which is leading the development of flexible markets in the UK.

- 11.3 VESL's Trading and Hedging Strategy consultant has had 20 years of experience in the Energy industry with one of the Big 6 energy suppliers. He is a leading expert in the complex traded commodity markets and has held senior Director roles, leading trading and risk management functions. He is highly regarded for his expertise in the UK traded market.
- 11.4 The team also includes an experienced Director of Operations and Director of Sales both of whom have over 25 years' experience in the energy market. The Director of Operations has led teams across all operational functions, has had responsibility for delivering and managing regulatory change; she brings a strong focus on delivering excellent customer experience. The Director of Sales, has previously led face to face sales channel activity in addition to telesales functions. In more recent years he has also led the business development activity for an energy services business.

11.5 In relation to the Senior Management Team, the expert reviews have commented as follows:

"One of the key drivers for success in the GB energy supply market is the ability to find skilled and experienced individuals to lead and manage these businesses and navigate the various market complexities.

Both the key individuals bring an overall understanding of the commercial and operational fundamentals of the energy supply market. Jo Butlin in particular brings experience of running a non-domestic energy supply business and experience of advising other new entrants in the market. However, one area of concern with the key individuals is that it is not clear whether either of these individuals have the detailed level of knowledge specific to the operations and practicalities required to run a domestic energy supply company day to day. We would anticipate the need to recruit an experienced individual who could shape and lead the operations for this JV⁹." - Baringa November 2017

Note that an experienced Director of Operations has now been appointed

"VESL has installed an experienced management team and we understand that robust procedures they are putting in place should act as a source of risk mitigation for VESL" - PwC July 2018

Agile Business Plan

The Business Plan recognises the key risks associated with a highly regulated business and sets out alternative scenarios and fall back arrangements in the event that the individual plans within the Business Plan need to be adapted. It also models, in total, 8 alternative scenarios.

In particular, the expert review by PwC highlighted the key risks within the Business Plan as being the following:

- ❖ Achieving customer growth projections
- ❖ The impact of price caps
- ❖ The hedging approach

Customer Growth Projections:

In relation to customer growth PwC have commented as follows:

"Delivering the required level of acquisitions may require VESL to adapt its sales and marketing plan and use more proven sales channels. VESL should be well positioned to adapt quickly to a new approach, however, this may result in VESL's acquisition costs increasing and put downward pressure on margins."

⁹ Joint Venture

As previously mentioned, the Business Plan includes a "Plan B" that switches the emphasis of customer acquisition to price comparison websites.

The Impact of Price Caps:

Whilst price caps are a risk to the company's margins, it is not expected that they will be implemented in such a way that is contrary to Government Policy. Government will be seeking to protect the consumer from unfair increases in prices and will attempt to do that through price capping but not at a level that acts as a barrier to new entrants to the market or stifles investment and innovation. The Business Plan and its scenario analyses, alongside the Downside Scenarios provided by PwC attempt to model the potential impact of the new regime (as previously described).

In this regard, Baringa commented as follows:

"The base case and alternative scenarios modelled in the business case present a reasonable range of likely outcomes for the business investment."

Should price caps become particularly challenging, the Business Plan with its technical salesforce has the ability to shift its focus towards wider Energy Services products which offer greater margins. Additionally, the strategy would be re-directed to build out energy supply to businesses, which is not price capped.

The Hedging Approach:

With regard to hedging, PwC commented as follows:

"With respect to hedging strategy and collateral, the approach being taken by VESL is in line with what we would expect for a local authority supported retail business"

Robust Risk Management

Risk management has been described in a previous section and relies heavily on strong governance, key experienced staff, training for staff, market leading software robust data capture, robust change management processes and tightly specified contracts.

12. Conclusions

There is a strong financial case for continuing the Council's investment into Victory Energy Supply Limited but, as with any commercial opportunity, it is not without risk. If the Council is to continue its investment therefore, it should do so in a measured way ensuring strong governance and oversight and on the basis of the annual approval of the Company's 3 year rolling Business Plan.

12.1 It presents an opportunity for the Council to:

- ❖ Provide a wide range of Energy Services to residents and businesses aimed at reducing energy cost and energy consumption
- ❖ Provide 100% renewable energy to its customers
- ❖ Make a significant financial return to the Council which will contribute more widely to the "Avoidance of Cuts" strategy and therefore the sustainability of Council services in the future

13. Equality impact assessment

13.1 A preliminary EIA was considered but after proceeding through the process it was assessed that an EIA would not be required in this instance. This proposal relates to a commercial enterprise which will operate externally to the Council and will not impact the equality groups. The decision whether to proceed with the provision of supply to business or retail customers would be based purely on predetermined commercial decisions and would not impact negatively on residents or customers of various protected characteristics across the city.

14. Legal implications

14.1 The Council has the power to enter into Victory Energy Supply Limited pursuant to the general power of competence under Section 1 of the Localism Act 2011. In exercising this power the Council is still subject to its general duties, such as its fiduciary duty, and must exercise the power for a proper purpose.

14.2 Under Sections 1 and 12 of the Local Government Act 2003 the Council may borrow or invest for any purpose relevant to its functions or for the prudent management of its financial affairs. It is proposed that any lending to Victory Energy will be set out within a loan facility agreement structured on market terms and rates and so would not constitute State Aid.

14.3 The interface between the Council as a shareholder, consumer, and a generation asset owner, and Victory Energy, as a separate legal entity fully licensed to trade in the electricity market, will need to be carefully considered at the point of each interface to ensure compliance with the statutory regime governing the electricity and gas markets ("Sectoral Regulations") and public procurement and state aid requirements.

14.4 The corporate governance framework and legal constitutional documents are key in terms of the ongoing scrutiny and deliverables of VESL. Comfort can be provided to the Council by way of a detailed Shareholders Agreement (including PCC reserved matters), articles and scrutiny board. The completion of such documents is key to ensure the specialist nature of the corporate structure is managed effectively by the Council.

15. Director of Finance's comments

15.1 The financial implications associated with the recommendations are contained within the body of the report. The figures within the report are nominal values and do not take into account that future values will not have the same purchasing power as those of today.

.....
Signed by:

Chris Ward
Director of Finance & IT (S151 Officer)

Appendices:

- Appendix 1 - PCC Energy Partnership Review (Baringa November 2017)
- Appendix 2 - Victory Energy Supply Limited "Review of Final Business Case" (PwC July 2018)
- Appendix 3 - Total Investment Returns - Base Case and Downside Scenarios

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Title of document	Location
Final Business Plan FBC.doc	W: Drive/HFS/100 Corp
050718 - FBC to RE-baseline - Base Case.xlsx	W: Drive/HFS/100 Corp
2018.07.31_VESL BP review_Full report_FINAL.pdf	W: Drive/HFS/100 Corp
PCC_Energy Partnership Review - Business Case Reviewv2.0.docx	W: Drive/HFS/100 Corp

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by on

.....
Signed by:

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Energy Retail Supply Joint Venture Business Case Review

CLIENT: Portsmouth City Council

DATE: 16/11/2017

1. Introduction

- 1.1. Baringa Partners LLP ("*Baringa*") are a market-leading management consulting company with a key focus on the GB energy and utilities markets. We advise all of the 'Big 6' energy supply companies and a number of the smaller and mid-sized suppliers. We have previously developed a number of business cases for companies considering entry into the GB energy supply market and successfully supported a number of suppliers through the entry process and early operations.
- 1.2. Baringa have conducted a review of the "*Outline Business Case final Cabinet Report July 2017*" and held interviews with the key individuals (Daniel O'Hare and Jo Butlin) on 25th September 2017. We provided detailed findings of our business case review to Portsmouth City Council ("*PCC*") for consideration. PCC subsequently provided Baringa with an updated business case "*Energy Partnership Final Business Case v0.6*" for review. From these Baringa have developed the following view of the business case for proposed Joint Venture Municipal Energy Supply Company ("*JV*"). We also provide our view on whether the investment by PCC in the JV is in line with the MEIP principle.
- 1.3. The overall business case relies on the key premise that the core proposition will be attractive to local customers who are not solely motivated by price, will be more engaged with the market and motivated to switch through face to face sales channels and will be attractive by a local supplier backed by the PCC. It also relies on the assumption that the combination of this local proposition and the experience and knowhow of the key individuals will allow the energy partnership to operate highly efficiently. The combination of being able to attract sufficient customer without offering low acquisition prices and being able to run the operation efficiently will allow the energy partnership to deliver the attractive returns set out in the business case. In our review of the presented JV business case we have considered whether we believe these key assumptions to be reasonable and whether the key risks associated with the assumptions have been sufficiently considered.

2. The Proposition

- 2.1. The concept of a local municipal energy supplier is not unique in the market with a number of other municipalities (Robin Hood Energy, Bristol Energy, Peterborough Energy, Southend Energy, Leccy, etc.) and housing associations (Places for People, Our Power, etc.) having entered the energy supply market either as a licensed supplier or

through a white label arrangement. The majority of these parties have chosen to enter the market for similar reasons, that is to create new income streams to offset funding cuts, reduce fuel poverty in local areas and reduce carbon emissions. Each of these entrants have had a similar focus on building a customer base initially focused on local residents and also taking advantage of supply to council/housing association owned properties where possible, see Figure 1 below for further details.

Figure 1 Examples of Local Supply Propositions

Developments in the retail market, combined with specific customer trends, have led to new offerings from local suppliers  **Baringa**
Customer Drivers and Supplier Offerings

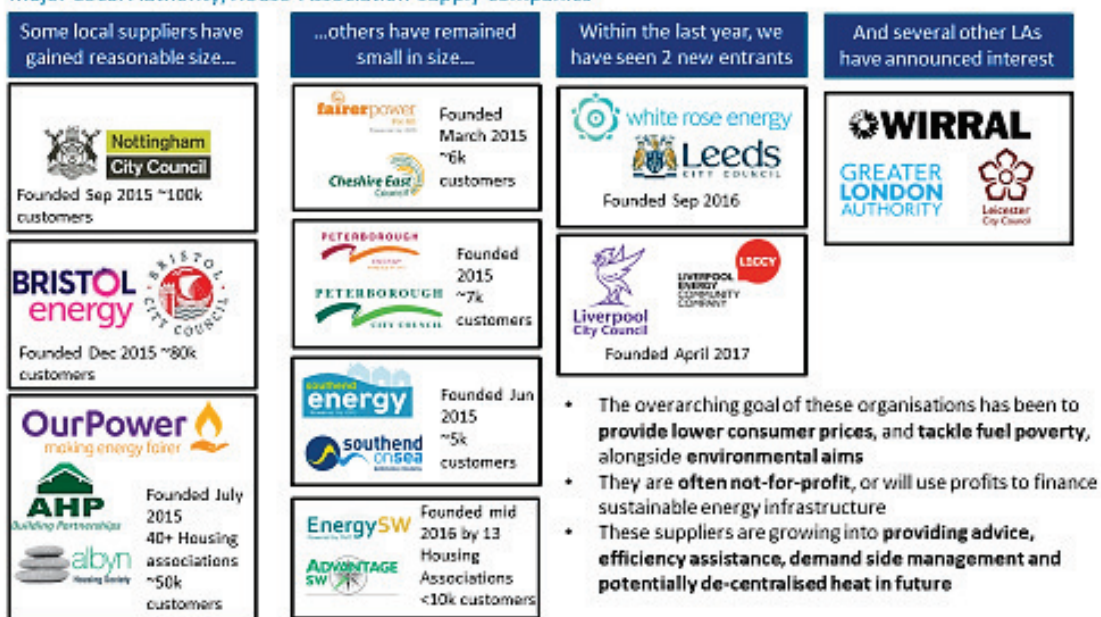


- 2.2. In our opinion, the core proposition is not unique in the market; however, it does have a number of innovative features that could provide a competitive advantage in the supply market allowing the JV to achieve the target customer numbers and margins set out in the business case.
- 2.3. The customer acquisition model with a focus on face-to-face door stop and event selling entirely concentrated in the local region could provide access to a target customer group that have traditionally had low engagement levels with the energy market and are likely to have a higher lifetime value than customers acquired through Price Comparison Websites.
- 2.4. This targeted direct selling approach has proven successful for supply companies such as Utilita. The success of these companies is not based on significantly lower price than other suppliers, but relies mainly on actively engaging the customer through face-to-face sales and providing a proposition that is relevant to the target customer group (in Utilita's case this was a more convenient way to top up the customers pre-payment meter).

2.5. The business case cites the success of Bristol Energy and other municipal suppliers as evidence that this model can work and achieve a scale of 100,000 customers. We have witnessed similar local municipal energy supply companies successfully enter the market since 2015 with both Robin Hood Energy and Bristol Energy already gaining market share in excess of the target 5 year customer numbers for the proposed JV – see examples in Figure 2 below:

Figure 2 Local Authority/Housing Association Supply Companies

Local Authority/Housing Association run supply companies **have been about since 2015 and they continue to increase in number**
Major Local Authority/House Association supply companies



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2.6. Whilst we are not in a position to comment on the what proportion of Bristol Energy’s Customers or others were accessed via a face-to-face sales channel, we can point to the success of Utilita who have gained 3000-4000 customers per week on average over the last 3 years (they now have almost 500k customers) using face-to-face selling of a non-price led proposition as their main sales channel.

2.7. PCC has also conducted research (although we recognise this is limited in nature) demonstrating the willingness for the local community to engage with a local energy supply business.

2.8. These data points provide us with sufficient confidence that this is a viable acquisition channel and can deliver the customer numbers targeted in the business case. However, a number of risks remain which would be considered by any investor:

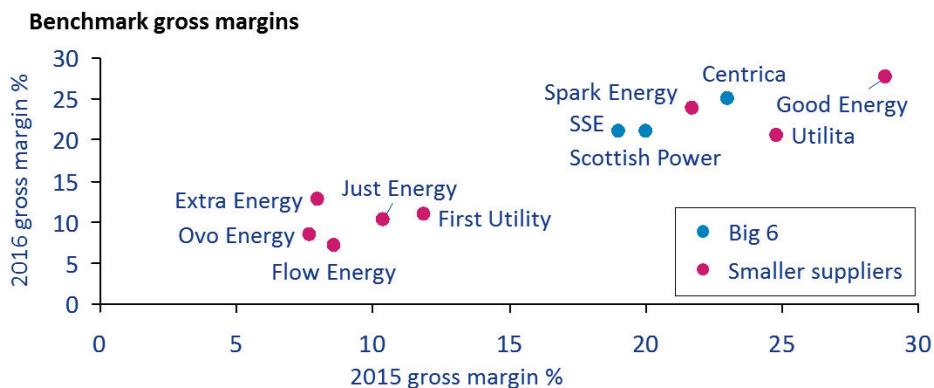
2.8.1. The ability to achieve the stated customer numbers, both total and speed, due to the somewhat unproven nature of the business model within the proposed JV’s target customer catchment area. It would be prudent for any investor to consider an alternative scenario where the JV would need to compliment the

face-to-face acquisition channel with a more traditional price comparison website channel and understand the impact on margins, payback period, and investor returns. This is a realistic scenario evidenced by Bristol Energy, Robin Hood Energy and a number of other new entrants being present on switching sites today.

- 2.8.2. One key difference between the Bristol Energy and Robin Hood Energy propositions and the JV is that the other companies have a 'not for profit' and sole ownership approach. It is unproven as to how important this aspect is in relation to the customer uptake of the propositions during face-to-face selling.
 - 2.8.3. Larger suppliers halted this customer acquisition approach due to issues with mis-selling and fines resulting from this, hence strict control and compliance processes will need to be included in the operating model. Even with strict controls and enhanced training doorstep selling should be considered as a risk either financially through fines or reputational through customer complaints.
- 2.9. The 'Plan B' business case scenario outlined in the final business case does, in our opinion, provide a considered approach to managing these risks and likely impacts on investment returns. This outlines the expectation that the JV would require to switch its acquisition channel mix to be more weighted towards Price Comparison Websites should customer engagement be less than expected through the face-to-face sales channel.
- 2.10. The proposition to provide incentives for new customers that will be directly reinvested in local projects is certainly novel and when combined with locally branded and marketed tariffs linked to a trusted provider (PCC) has a high chance of being attractive to local customers who are not solely motivated by price. However, there is a risk that the quantum of reinvestment available to PCC may be limited, and hence underwhelming to customers, until such a point when the venture reaches scale. The JV business case does allow for a fair degree of flexibility on the approach to execution of this reinvestment scheme, PCC and the JV should ensure that the governance for this scheme is fully defined within the pre-live period and that the risks associated with the scheme are fully considered.
- 2.11. The link to and promotion of the existing PCC energy management capability provides a simple way to expand the customer offer beyond commodities and provides the ability to both diversify the income streams for the JV as well as expanding the market reach of the current commercial service. This is a service most other new entrants and some more established suppliers would struggle to replicate at a local level. However, the size of demand for these services and the ability to cross-sell and up-sell these services is largely unproven and should be considered as a risk factor for any investor. Scenario 7 considered in the business case demonstrates that the investment returns for the JV are not particularly reliant on the margins generated from these services; as such we would consider this a relatively small risk for any investor.

2.12. In terms of the target gross margins set out in the business case we have witnessed that well run and niche focused supply companies such as Good Energy, Spark Energy and Utilita have consistently delivered higher margins than other new entrants. This backs the key assumption that it is possible to deliver sustainable returns (see Figure 3) with a targeted and well executed proposition that is not solely focused on price.

Figure 3 2015/2016 Benchmark Gross Margins



2.13. Whilst these margins are possible in the market, any investor should take into consideration the increased level of competition as well as the regulatory focus on potential customer detriments in the market.

2.14. We believe it is too early to comment on the actual impact of the proposed industry price cap; however, it would be prudent for any investor to consider a business scenario where supply gross margins and EBIT come under significant downward pressure. If the price cap follows the pre-payment price cap methodology then supply EBIT could come under severe pressure as the CMA considers that an EBIT margin of 1.25% allows for a level of profit consistent with competitive pricing by an energy supplier which has reached an efficient scale. We have witnessed the downward pressure on margins at Utilita post the implementation of the pre-payment price cap.

2.15. Our current experience is that the prospect of an industry price cap and increased competition has not been a deterrent to continued investment in new market entry. We would expect the JV management team and board to continue to monitor the potential impacts of the price cap on the JV business case through the pre-live phase as more details of the price cap are released and consulted upon. The 'Plan B' scenario and scenario 6 outlined in the business case provide a reasonable view of the potential impact of downward pressure on margins and should be considered as part of any investment decision.

3. Running an effective and efficient operation

3.1. One of the key drivers for success in the GB energy supply market is the ability to find skilled and experienced individuals to lead and manage these businesses and navigate the various market complexities.

- 3.2. Both the key individuals bring an overall understanding of the commercial and operational fundamentals of the energy supply market. Jo Butlin in particular brings experience of running a non-domestic energy supply business and experience of advising other new entrants in the market. However, one area of concern with the key individuals is that it is not clear whether either of these individuals have the detailed level of knowledge specific to the operations and practicalities required to run a domestic energy supply company day to day. We would anticipate the need to recruit an experienced individual who could shape and lead the operations for this JV.
- 3.3. This risk appears to have been recognised in the business case with the Director of Operations and Change role with industry experience being flagged as one of the first roles to be recruited. We would consider both of the key individuals' standing in the market as beneficial to being able to recruit an appropriate resource into this role.
- 3.4. A key assumption in the business case is that the energy partnership can be run more efficiently than other comparable energy supply businesses due the experience of the key individuals, the quality and experience of key team members to be recruited and the focus on setting up key processes and data correctly before entering the market.
- 3.5. As with all new entrant businesses, there are significant risks that the stated set-up and operating costs in the business case will be higher than forecast resulting in lower EBIT and longer payback periods. Even with the mitigating approach of applying more focus to the correct set-up of key processes and data, any investor should consider the scenario that the operating costs are higher than forecast and the knock on impact on returns. The additional contingency costs factored into the base business case provide a reasonable allowance for mitigating any additional salary costs or additional resources that may be required to run the business effectively.
- 3.6. We would also expect any investor to put in place a stage-gate governance process based on achieving certain operational, customer number and margin targets to determine the release of additional capital and reward of any equity.

4. Investor summary

- 4.1. We have reviewed the JV business plan. Subject to review of the final terms of the JV investment structure, we consider that the business case presented (i) has been developed with an appropriate level of due diligence which would be expected of a commercial investor; (ii) is based on reasonable assumptions; (iii) provides a considered assessment of the market opportunities and risks to the proposed business; and (iv) puts forward reasonable and well-founded financial projections
- 4.2. In our view, based on the information provided, there is a reasonable expectation that the proposed business would generate returns to PCC that would be attractive to private investors, and it therefore sets out a good case for investment by PCC. The base case and alternative scenarios modelled in the business case present a reasonable range of likely outcomes for the business investment. Even if some of the risks outlined above materialised and the investor payback period increased to beyond 5 years with low to mid-teen IRR, this would still be consistent with what we have seen

for other new energy supply business that have gained investment from private investors.

- 4.3. We therefore conclude that private investors in current market circumstances would be sufficiently motivated to invest in the proposed business, and that PCC investment can be justified on commercial grounds. It would be reasonable for PCC to target the base case set out in the business case and hold the JV management team and JV partners to account against these targets.

Version History

Version	Date	Description	Prepared by	Approved by
1.0	11/10/17	DRAFT Issued to Client	HB & RT	HB
2.0	16/11/17	Updated post review with PCC	RT	HB

Contact

Ryan Thomson (ryan.thomson@baringa.com +44 7711 576 595)

Henning Bottger (henning.bottger@baringa.com +44 7739 185931)

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Strategy& - EUR

***Victory Energy Supply
Limited***
Review of Final Business
Case

31 July 2018

Executive report



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Introduction

PricewaterhouseCoopers LLP (“PwC”) have been asked by Portsmouth City Council (“PCC”) to undertake a review of the plans to launch an energy retail business, Victory Energy Supply Limited (“VESL”). Our review has focused on the key commercial assumptions, dated Autumn 2017, underpinning the Final Business Case (“FBC”), which we understood was the basis for the decision to proceed with VESL, and the more recently Revised Business Case (“RBC”), which was provided by VESL management and reflects their latest view of revenue and costs assumptions following further market testing.

Given the limited timeframe to conduct the review, we have focused our assessment on the most material assumptions in the RBC and supporting documentation (see Appendix 1) to assess whether they reflect our view of current market dynamics. Where we consider that assumptions have changed, our expectation is that VESL management will consider reflecting these in revisions to the key performance indicators (KPIs) presented in the RBC. Where our review results in a change to these KPIs, it is for PCC to assess whether VESL still represents an attractive investment opportunity given the other opportunities that they have to deploy capital.

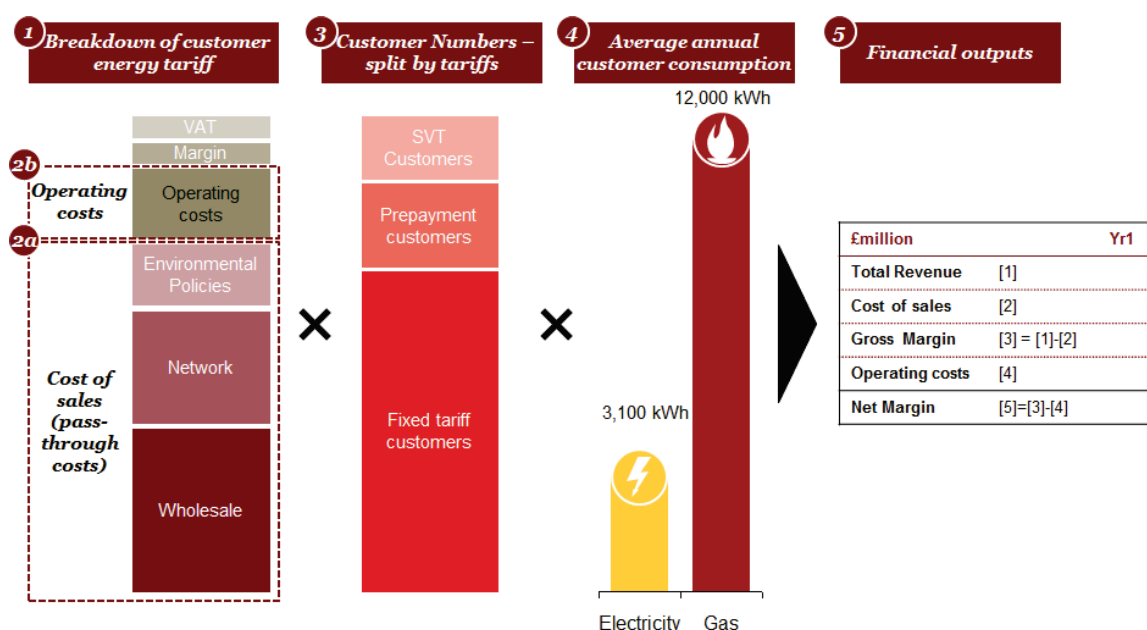
We do comment on the general approach to the choice of KPIs used by PCC and in particular the time horizon that the investment is assessed over. The business case presented is entirely consistent with the direction the energy market is moving in relation to the way energy is sourced, sold and packaged as a wider service beyond solely energy supply. As such, customer value is typically viewed over the medium and longer term, therefore the business model should recognise the potential contribution beyond a 5 year horizon.

Value drivers within energy retail

Our review has focussed on the key drivers of margin and other financial key performance indicators for the energy retail business (VESL). To understand the focus of our analysis, we have broken down the key value drivers of revenue, costs and margins for a supply business and what drives these.

Figure 1 illustrates the main drivers of financial performance, which can be broken down into four primary areas; (i) Customer tariffs charged by energy suppliers, (ii) Costs incurred by suppliers, (iii) Customer numbers and split by tariff types, and (iv) Average annual customer consumption. The product of these elements calculates total revenues, costs (direct and indirect) and margins, which are captured in the financial outputs. We explain the importance of each of these areas below.

Figure 1: Illustrative view of value drivers of the domestic retail market



Source: PwC analysis

1. Customer Energy tariffs

Customer energy tariffs are typically split into two elements; fixed charges, which are calculated on a pence per day basis and are designed to cover a suppliers fixed costs, and variable charges, charged on a pence per kilowatt hour (p/kWh) basis to cover the supplier's variable costs elements. Tariffs are largely determined by the need for suppliers to cover their costs of sales (direct costs) and operating costs (indirect costs) whilst remaining competitive. In addition to competition, suppliers may be 'constrained' in how they charge e.g. the introduction of a price cap in the prepayment meter market restricts the tariff level suppliers are able to charge customers irrespective of their cost bases.

2a. Supplier costs – Cost of sales

A supplier's costs base is split into three main categories, costs of sales, operating costs and margin. Cost of sales are directly related to the sale of each unit of energy and vary with volumes. In the case of energy, there are three cost elements; these are wholesale costs, Network costs and environmental & social policy costs. Wholesale costs cover the cost of the electricity or gas purchased by the supplier on wholesale markets and sold to consumers. In addition to the commodity, wholesale costs include related costs e.g. energy trading fees.

- Wholesale costs are largely dependent on prevailing future market prices (as energy is purchased ahead of delivery) and suppliers are largely price takers albeit a supplier's buying strategy i.e. how much energy is purchased and when, will mean that suppliers will incur different wholesale costs.
- Network costs cover the costs of transmitting power from generators to local distribution zones, and distribution charges from these zones to peoples' homes. Network charges are regulated by Ofgem and therefore for each region, suppliers will all pay the same unit rate charges, albeit different regions incur different charges.
- Environmental & Social charges are recovered by suppliers from their customer base to cover the cost of government policies supporting investment in new low carbon generation and social energy schemes. Suppliers typically incur these costs equally in relation to the size of their customer base, however there are a number of policies where costs may differ across suppliers.

With the exception of wholesale charges, which may vary in response to suppliers' different buying strategies, suppliers have very limited ability to influence these costs. Rather these costs are treated as a 'pass-through'.

2b. Supplier costs – Cost of sales

Operating costs cover all costs associated with the operation of the supplier but which are not directly linked to the sale of the commodity. Operating costs include fixed overheads such as office rental, IT, staff and marketing costs. These costs are often termed as the costs to serve and the ability of suppliers to minimise their fixed cost base will typically determine how competitive their tariffs are and what level of margin the business makes. In addition to costs to serve, operating costs also incorporate variable costs associated with acquiring new customers e.g. the costs of commission payments to sales agents upon signing up a new customer. Like cost to serve, the 'cost to acquire' will in part affect the level of margin that a supplier is able to achieve.

3. Customer numbers (tariffs)

The total revenues and costs for the supplier will depend on how customers are allocated across the different tariffs by suppliers. Tariff levels are typically categorized within three main customer buckets based on payment terms. These are:

- Fixed tariffs, where customers fix their energy tariffs for a fixed period. These tariffs are typically a supplier's lowest priced tariff and used to attract and acquire new customers. These customers will also typically pay for their energy on direct debit.
- Prepayment tariffs, where customers credit their energy meter on a pay as you go basis. Since April 2017 these tariffs have been capped by Ofgem.
- Standard Variable Tariffs (SVTs) under which customers will in effect be on an evergreen contract, where the price they pay will be subject to changes, particularly where wholesale costs increase. These are typically the least competitive tariffs and can be several hundreds of pounds more expensive than the most competitive fixed tariff. These customers are largely unengaged and will form the core target

market for VESL albeit VESL's proposition will be based around re-engaging these customers with more competitively priced fixed rate tariffs.

4. Customer consumption

Understanding the split of a supplier's customer base by the different tariff and the revenues and costs of each of the tariffs is essential to understanding the economic drivers of the business. Furthermore, understanding the different characteristics of these groups is important, particularly with respect to consumption volumes, which vary by customer group and region and which together with the above elements, drive the financial outputs.

What we have reviewed

As agreed with PCC, our review has focussed on key assumptions in the RBC, which reflects VESL management's latest view of the market and incorporates changes to a number of cost and revenue assumptions from those presented in the FBC. In particular, we have concentrated on the key drivers of supply margins and those areas that are largely influenced by VESL. I.e. we haven't typically focussed on cost of sales, which are pass through costs, outside of the control of VESL and not a source of margin. Rather, we have focussed on the more material elements, including:

- Customer numbers and average customer consumption volumes. In particular we have assessed growth in customer numbers, reviewed these against the business plan and comparable benchmarks to determine whether they are reasonable.
- Total revenues and tariff levels. We have not benchmarked these against other suppliers, but have viewed them in comparison with the price caps to determine whether they appear reasonable.
- Wholesale costs. We have reviewed wholesale cost assumptions against current forward market prices as well as how electricity and gas are purchased (hedging strategy), and in turn what this means with respect to PCC's exposure.
- Operating costs and in particular cost to serve and cost to acquire. These are key drivers of VESL's profit margins. We have reviewed these in light of the VESL business plan to understand whether stated levels are consistent. In addition, we have compared these against comparable market benchmarks.
- Financial outputs. We have reviewed a number of key financial metrics including profitability and cash flow and where possible, have compared these against comparable benchmarks.

What we have not reviewed

We have focused our review on the primary commercial assumptions and drivers supporting the FBC and the RBC, as noted above. Appendix 1 details documents reviewed as part of the assessment as well as discussions held with PCC and VESL.

Our review does not cover the following:

- Assessment of state aid risks. These are being covered by CMS, although we have had a number of conversations with CMS, in respect of how state aid could impact on key commercial assumptions.
- A commercial review of key contracts. We assume that the re-baselined business case reflects current contract discussions.
- VESL's governance arrangements, including key policies in relation to risk management, credit risk or market risk policies, or the key management information used to assess business performance post go-live.
- Detailed assessment of each key assumption in the RBC or financial model. Rather, our review has focused on the key areas that in our view, would have greatest impact on VESL's ability to deliver the RBC's KPIs.

- Other investment returns to PCC as part of the proposed Joint Venture arrangement. These include; (i) the Community Investment Fund which would be distributed by PCC and VESL, (ii) work sourced by VESL and passed over to PCC Housing & Property Services (Energy Team) for PV installations etc. and (iii) margin received by PCC for advancing a loan facility to VESL.
- Detailed review of how assumptions and financial indicators stated in the RBC have changed from those detailed in the FBC.
- A risk assurance review of VESL's risk management and governance structure.

Executive Report

Key Messages

Based on our review of VESL's revised business plan and supporting documentation, we make the following observations:

- While the market for supplying electricity and gas in the UK has seen many new entrants, including local authority backed suppliers, levels of switching remain at an all-time high.
- While VESL's core proposition, around local engagement is unique and directionally aligned with energy markets becoming more decentralised, some features of the sales and marketing plan are untested.
- Having the backing of PCC provides a number of sources of competitive advantage for VESL relative to many competitors. These include strong financial backing via working capital facility and provision of PCGs to support low cost hedging of power and gas.
- The Market has evolved in a number of material aspects since the FBC was approved in autumn 2017, particularly with regard to more clarity on extended price caps.
- Review of the business plan and value drivers found a number of specific areas where we note the following challenges:
 - Delivering VESL's customer growth numbers appears achievable over the 5 year plan period based on market benchmarks. We have seen some suppliers grow their customer numbers in this way, reflected in more recent growth in telesales and face-to-face sales activity by other suppliers. However, most suppliers have typically used price comparison websites to drive acquisitions, although we note that this attracts customers with a greater propensity to churn.
 - There is a risk that VESL will not deliver the required level of acquisitions, particularly within year 1, with the current proposition and untested sales and marketing plan to target unengaged customers through face to face sales.
 - Delivering the required level of acquisitions may require VESL to adapt its sales and marketing plan and use more proven sales channels. VESL should be well positioned to adapt quickly to a new approach, however, this may result in VESL's acquisition costs increasing and put downward pressure on margins.
 - VESL's net margin forecasts look high relative to other independent suppliers, particularly given that its costs to serve are comparable with other independent suppliers.
- VESL's business plan is exposed to regulatory changes. Sensitivity analysis indicates that the introduction of a price cap could materially affect financial performance and peak funding requirements.
- Expansion of VESL's energy services activities may provide upside, particularly in the medium to longer term, but these activities are not reflected in the RBC.
- Given the nature of these businesses, with high upfront investment costs and an ambition for a long-term customer relationship, it is more appropriate to assess the value contribution for longer than 5 years, which would also capture some of the other upsides.
- VESL has installed an experienced management team and we understand that robust procedures they are putting in place should act as a source of risk mitigation for VESL. Furthermore the RBC includes a contingency of £1.5m over the business plan period (including pre-live activity).
- Once established, energy retail businesses have value to 3rd parties either for their customer book or as a platform for further growth. The larger the customer book and strength of platform, the greater the expected value of the business.

Key financial metrics

Final Business Case (FBC)

VESL initially informed us that the decision to proceed with the energy supply business was based on a number of KPI's from the FBC. PCC indicated that its primary focus when making the decision was total profit contribution for the supply business; VESL made a cumulative pre-tax surplus of £5.7m over the business plan period, including pre-live activity. In addition, PCC considered a number of other investment returns¹ which cumulatively amount to c. £8.5m over the 5 year period. Table 1 summarises the key financial metrics contained within the VESL financial model, which supported the FBC.

Table 1: Key financial indicators – FBC

VESL financial model	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1-5
Customers on supply ²		50,122	86,639	112,581	131,123	144,466	
Net margin before tax (£m)	-2.29	-3.20	-0.44	2.10	3.88	5.63	-
Net Profit margin (%)		-13.4%	-0.8%	2.5%	3.8%	4.9%	-
Retained earnings (£m)	-2.29	-3.20	-0.44	2.10	3.87	4.51	-
Peak monthly financing (£m)		7.79	10.80	11.99	11.21	8.11	11.99
Max. cash contribution (£m)*	-	-	-	-	-	-	5.93*
IRR (%)	-	-	-	-	-	-	19.83%
Payback period (months)	-	-	-	-	-	-	54

Source: VESL FBC

Note: *Maximum cash contribution calculated as sum of net margin before tax for pre-live, Year 1 and Year 2

Revised Business Case (RBC)

VESL management informed us that the business case and supporting financial model have since been revised to reflect updates to a number of cost assumptions, and inclusion of the updated sales and marketing strategy. Table 2 summarises the key financial metrics from the revised business case and reflects these changes.

Table 2: Key financial indicators - RBC

PwC adjusted metrics	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1-5
Customers on supply		50,122	86,639	112,581	131,123	144,466	
Net margin before tax (£m)	-3.50	-3.87	-0.74	2.54	4.58	6.89	
Net Profit margin (%)		-14.1%	-1.1%	2.6%	3.8%	5.1%	
Retained earnings (£m)	-3.50	-3.87	-0.74	2.54	4.58	5.71	
Peak monthly financing (£m)		10.36	13.69	14.80	12.90	8.15	14.80
Maximum cash contribution (£m)	-	-	-	-	-	-	8.10
IRR (%)	-	-	-	-	-	-	15.78%
Payback period	-	-	-	-	-	-	55

Source: VESL RBC

Note: *Maximum cash contribution calculated as sum of Net margin before tax for pre-live, Year 1 and Year 2

** The RBC includes £1.35m of contingency from years 1 to 5 (£348k in year 1, £250k per year thereafter) and £250k for pre live operations.

¹ Other investment returns include; (i) The Community Investment Fund which will accrue to PCC, (ii) The work sourced by VESL and passed over to PCC Housing & Property Services (Energy Team) for PV installations etc.), and (iii) the margin that PCC will receive for advancing a loan facility.

² VESL assumes that customers are equivalent to electric accounts and that there are 0.8 gas accounts for every electric account

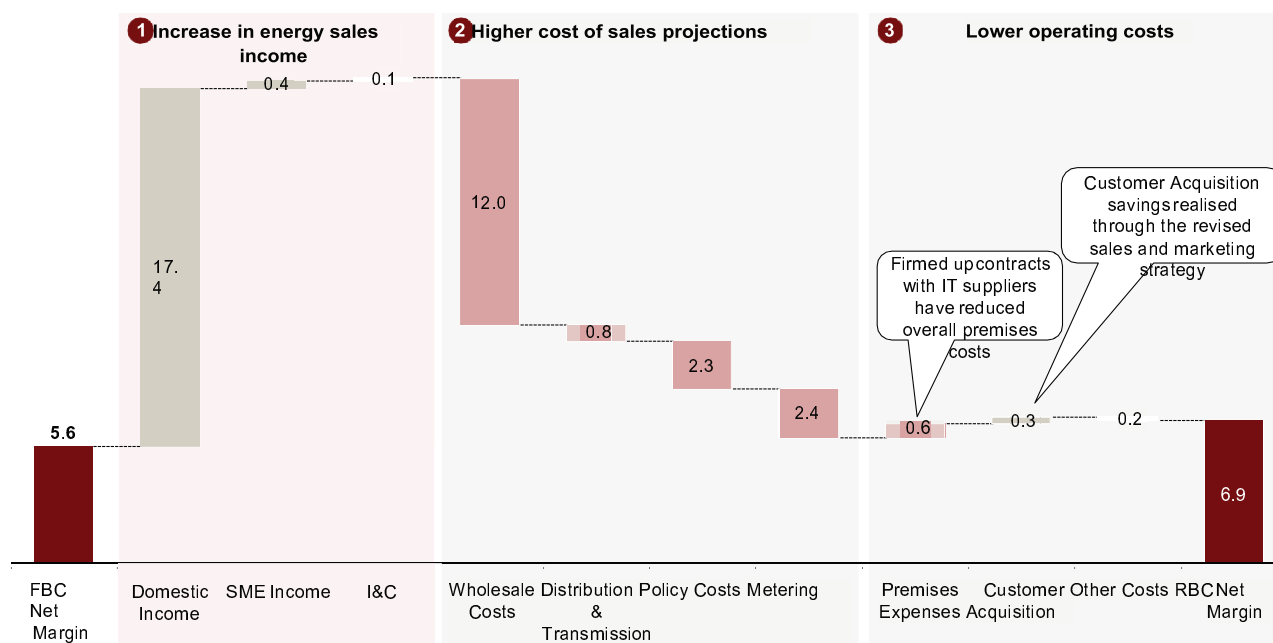
Net margin change from FBC to RBC

Given the updates made to the financial model, we have analysed how net margin projections have changed from the FBC to the RBC, and what has driven these changes. Figure 2 illustrates the net margin bridge for year 5 and summarises how changes in revenue and, most notably, operating cost drivers, have resulted in the net margins reported in the RBC increasing by £1.3m to £6.9m. The increase in net margins is explained by the following factors:

- Increase in energy sales income:** Domestic electricity and gas supply revenues have increased as a result of VESL updating tariffs to reflect higher updated costs projection in the RBC, which are passed through to the end user. The net profit resulting from the increase in revenues for VESL's domestic supply business is therefore largely offset by higher costs.
- Higher costs of sale projections.** Cost assumptions in the RBC have been updated to reflect the latest view of costs. Revised wholesale costs are the primary driver of this increase, accounting for £12.0m of the total £17.9m increase in costs. Average wholesale electricity costs in the RBC have increased by 14% to £55.65/MWh and gas tariffs by 29% to £0.5768/therm, relative to FBC assumptions. Metering costs and policy cost revisions have led to an increase in costs but as noted above, all these costs are passed through and so are net margin neutral.
- Lower operating costs:** The increase in year 5 net margin projections from the FBC to the RBC are largely explained by lower revised operating costs and in particular; (i) a reduction in IT (premises) costs; and (ii) a reduction in customer acquisition costs.

The reduction in IT costs reflects firmed up third party supplier costs for Customer Information Systems (CIS) and other systems, which collectively deliver a £0.6m net margin benefit. The net margin benefit from acquisition costs (£0.3m) stems the reduction in acquisition costs, reflecting VESL's revised sales and marketing approach. We note however that these cost reductions are however partially offset by a £0.2m increase in bad debt (Other costs), which is driven by higher tariff assumptions in the RBC.

Figure 2: Bridged gap between FBC and RBC net margin for Yr5 (£, millions)



Source: VESL FBC & RBC, PwC Analysis.

We have not assessed the changes in net margin or other financial indicators from the FBC to the RBC, as part of our review. Rather, we touch on each of the elements noted above in our review of the RBC.

Primary observations

Our review of the RBC and the supporting financial model identified three key areas, where we have comments. These are; Customer growth, Acquisition costs and Profitability. We summarise the key points below, and provide more detail on each of these areas in the main report.

Customer Growth

1. Delivering customer growth numbers appears achievable over the 5 year plan period based on market benchmarks. However, achieving these targets will be challenging given the distinct nature of the current marketing and sales strategy, and given many features have not been tested.

Five year customer growth numbers appear achievable but will be challenging. The sales and marketing plan has some tried and tested features but is largely different from approaches taken by other fast growing suppliers who have typically led on price and used price comparison websites to drive acquisitions. It is essential therefore, that VESL has a fall back plan to a more proven sales model if customer growth is not delivering to plan (see 3 below).

The updated business plan is dependent on engaging the c.60% of customers that have never switched. Delivery of the face-to-face sales targets is dependent on these customers engaging in response to marketing events and engaging with other customers through non-paid referrals. VESL management view this as one of their key differentiators in the market place. We have seen some evidence of other suppliers successfully growing their customer base in this manner, this is reflected in more recent growth in telesales and face-to-face sales activities by other suppliers.

We question, in particular, whether year 1 growth numbers are achievable, given the need to test systems and processes and the speed with which VESL can create sufficient customer engagement. VESL management informed us that feedback received from suppliers indicated that they would be the first new entrant to have fully tested systems, and that other suppliers had not fully tested known complex industry processes. However, our experience of other suppliers is that even when accounting for known complexities, testing and learning can take up to 12 months.

While customer numbers are an important driver of profit margins, we note that they are not the only driver, particularly given that some operational costs vary with customer numbers. For this reason, our review separately looks at other drivers including cost to acquire, cost to serve and revenues/tariffs.

Acquisition costs

2. As a contingency plan, VESL can deliver the targeted customer growth through adaption of the marketing plan, but this may result in greater acquisition costs being incurred and downward pressure on margins.

Achieving current sales levels may be challenging, and are difficult to test given the unique features of the sales and marketing plan. We have discussed contingency plans with management, which we expect can be achieved by VESL looking to adapt its current face-to-face sales activity. In particular, a fall-back plan involving a move to more focused and direct "cold" door-to-door sales, given that this is a proven sales channel where other suppliers have delivered annual growth levels that are at least consistent with VESL.

In our view, VESL could readily adapt its marketing approach by redeploying its sales force and marketing spend. We note however that established suppliers operating in this field have lower current conversion rates (c. 3 sales per agent per day vs. c.6 in VESL's revised business case). Given that VESL's assumed conversion rate is based on 'warm' leads generated through inbound arranged appointments, VESL management would have to consider revising these assumptions down under a revised sales approach.

Furthermore, average costs per sales agent are also higher in VESL's plan as a means to attract higher skilled, more technical sales agents to maximise conversions. Should VESL need to adapt the marketing model to achieve the growth targets, VESL may incur greater costs, which in turn would increase acquisition costs and put downward pressure on margins. We expect that this would materialise through a greater number of sales agents and we have tested the impact of this in our sensitivity analysis.

Profitability

3. VESL's costs to serve assumptions are in line with the average of other independent suppliers we have looked at and in the range we would expect of a new entrant.

Comparison of VESL's costs to serve (a key measure of efficiency) with other suppliers, indicates that its costs are in line with the average of independent suppliers we have assessed and within the range we would expect of a new entrant. Importantly, VESL's costs are in line with the most competitive of the Big 6 suppliers and below the average of the Big 6 suppliers, from whom, it will target customers. This is in line with our expectations and we note that while the lowest cost suppliers we compared VESL against have typically been in the market longer, PCC's backing of VESL may provide the supply business with a competitive advantage that enables it to deliver lower costs than other new entrants.

VESL's projected cost to serve reduces by 18% from year 2 to year 5. This is consistent with our expectation and reflects the transition from growth phase in the initial period to more of a steady state as net acquisitions slow. The reduction in cost to serve over the first (five) years for a new entrant is typically reflective of continual improvements in operations and processes. Furthermore, the reduction in cost to serve as the supply base grows relative to VESL's fixed costs, indicates that beyond year 5, VESL could deliver costs below the average of other independent suppliers.

4. VESL's financial performance is exposed to regulatory changes and, in our experience, its margins are typically higher than those achieved by other new entrants in the market.

Relative to other suppliers, VESL's projected net margins look relatively high, particularly given regulatory constraints on future tariff levels. Typically, only the Big 6 suppliers have experienced positive net margin growth in line with VESL's projections over the past 5 years and we consider that this was driven by the profitability of their "sticky" SVT customers, soon to be subject to a price cap. Likewise, other new entrants reviewed have typically recorded significant negative net margins in the first two years.

Since the preparation of the FBC, Government have clarified and accelerated their plans to extend the number of customers covered by price caps. The introduction of the prepayment price cap in April 2017 and the SVT price cap before the end of 2018 will result in a relatively large proportion of VESL's customer base being subject to capped prices (22% by year 5). NB. The SVT price cap is currently out to consultation and the financial impact is not yet known.

Even where not covered by caps, tariffs will need to be set by reference to price cap levels given the need to ensure customer bills are cost competitive. As the caps are regulated, based on a target 'normal' net margin of 1.25% for a domestic supply business, only the most efficient suppliers can expect to achieve higher net margins.

There are a number of ways in which VESL could mitigate the risk of delivering returns at or below normal levels. These include; aligning its prepayment and SVT pricing structure and approach to the cap methodology, aligning its hedging strategy to the approach taken in the cap to determine forward wholesale costs for each regulatory period, and driving operational efficiencies. We note that the RBC does not fully consider these mitigating actions and in particular, the impact of the SVT on fixed prices. We have therefore considered the impact of a ceiling price on fixed tariffs in our scenario analysis.

5. The VESL business plan should be viewed on a period greater than 5 years given the business model and heavy level of upfront investment required.

Setting up a new energy services company involves a significant up front cost as systems and operations (staff) are built out. Consequently, business plans are typically viewed over periods of more than 5 years, given these businesses do not typically realise returns for a number of years until their customer bases have reached scale and operations are more efficient.

Furthermore, VESL's proposition is based around a community based energy model – building on a local customer base and using the supply business to deliver a growing services product range including energy

audits, boiler services and solar PV. VESL's plan to work towards a service-led offering is consistent with market trends and the outlook of a more decentralized market, but should be assessed over the medium to longer term to reflect the development of its energy services business and the longer term value of its customer base. Most notably, offering diversified products and services to customers improves lifetime customer value and will potentially reduce the likelihood of customers switching to other suppliers – this can only be viewed over time. In view of this, it would be appropriate for PCC to recognise the potential value contribution beyond year 5 and for VESL management to model cash flows from years 6 to 10.

Risk Mitigation

6. VESL has installed an experienced management team and we understand that robust procedures they are putting in place should act as a source of risk mitigation for VESL.

Our review has not focused on risk assurance and as such, we have not conducted a review of VESL's risk management and governance structure. However, we note that there are a number of areas that should act as a source of risk mitigation for VESL.

Firstly, we note that VESL has recruited a management team with significant experience across the UK energy sector and across different parts of the value chain. In our view, this is a prerequisite for the success of an energy supply business and management's experience should act as a source of risk mitigation for VESL.

Second, VESL management has indicated that it will install a coherent governance process to mitigate risk. As part of this, the business is establishing a risk management committee (RMC) to manage wholesale trading risk, credit risk, financial risk and regulatory compliance. The RMC will be a sub-committee to the board with delegated authority to manage ongoing business risks. Whilst membership is yet to be confirmed as part of pre-live activities, management indicated that the committee would likely include many of the VESL management team.

Finally, we note that the business and proposition has been established in such a manner to reduce risk exposure. E.g. the business is largely focusing on direct and prepayment customers, who will account for around 80% of customers, which should reduce VESL's exposure to bad debt (late and non-payment). Collectively, these areas mitigate VESL's exposure to market risk.

Sensitivity analysis

Our review of the FBC and financial model highlighted a number of areas where the assumptions appear to be challenging. As such, we developed two alternative downside scenarios to test the sensitivity of the business case to changes in a number of key sensitivities that appeared challenging.

Scenario 1 takes account of slower growth and makes the following adjustments to the RBC:

1. Revising year 1 total customer acquisition assumptions down by 50%
2. Pushing year 1 growth targets back to month 18 by reducing the sales conversion rate to 2.5 sales per agent per day and uplifting the required number of sales agents accordingly, to enable year 5 target customer numbers to be achieved. This is reflective of a revised sales and marketing plan driven by door-to-door cold call sales and assumes that VESL's total cost base changes in response to changes in the configuration of its sales teams.

Scenario 2 builds on the two sensitivities in scenario 1, and considers the impact of the price cap:

3. Reducing SVT customers' annual bills by c. £100 and reducing Fixed tariff customers' annual bills by c. £50 to reflect the introduction of the SVT cap and virtual ceiling price on all tariffs.

The results of our analysis are presented in Table 3 (Scenario 1) and Table 4 (Scenario 2).

Table 3: Revised financial KPIs - PwC alternative downside scenario 1

Downside scenario	Pre-live	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1-5
Customers on supply		25,061	69,792	102,876	126,377	143,123	-
Net margin before tax (£m)	-3.50	-5.79	-4.12	-0.65	2.17	5.50	-
Net Profit margin (%)		-44.2%	-8.6%	-0.8%	1.9%	4.2%	-
Retained earnings (£m)	-3.50	-5.79	-4.12	-0.65	2.17	5.50	-
Peak monthly financing (£m)		10.26	17.51	21.12	22.44	19.71	22.44
Max. cash contribution (£m)	-	-	-	-	-	-	13.41
IRR (%)	-	-	-	-	-	-	-15.91%
Payback period (months)	-	-	-	-	-	-	-

Table 4: Revised financial KPIs - PwC alternative downside scenario 2

Downside scenario	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1-5
Customers on supply		25,061	69,792	102,876	126,377	143,123	
Net margin before tax (£m)	-3.50	-6.14	-5.39	-3.06	-1.22	1.78	
Net Profit margin (%)		-48.1%	-11.6%	-3.7%	-1.1%	1.4%	
Retained earnings (£m)	-3.50	-6.14	-5.39	-3.06	-1.22	1.78	
Peak monthly financing (£m)		10.51	18.84	23.84	28.13	28.92	28.92
Max. cash contribution (£m)	-	-	-	-	-	-	15.02
IRR (%)	-	-	-	-	-	-	-56.99%
Payback period (months)		-	-	-	-	-	NA

Source: VESL RBC, PwC analysis

*For the purpose of the alternative downside scenario, we remove contingency from the business plan.

Our view is that scenario 2 reflects a more probable alternative downside case. While the scenario under which VESL needs to adjust its sales and marketing strategy to meet acquisition volumes is plausible, we know that the SVT price cap will come into effect from the end of 2018. It is reasonable to assume that the introduction of the SVT price cap would create a ceiling price for all tariffs not directly regulated by either the SVT or

prepayment cap. Our recent experience of the prepayment cap indicates that this may result in suppliers' profit margins becoming constrained

Under scenario 2, VESL would attract fewer customers and see a marked reduction in net profit and retained earnings over the five year business plan period. Lower revenues in a price cap environment and lower acquisition rates would result in the business incurring cumulative net losses of £19.3m³ over the first four years of operation and not making a net profit until year 5. Furthermore, the lower net profit margin of 1.4% delivered in year five would be significantly lower than values in the RBC, but is consistent with normal levels of profit in a price cap environment. Most notably, VESL's peak funding requirements would more than double to £28.9m.

When viewed over the first five year period, the value of the business's cash flows at today's prices would be c. £-11.1m under the downside scenario. However, VESL's business plans should be viewed over a period of greater than 5 years to reflect the longer-term value of its customers, given its proposition. In the absence of 10 year cash flows, we have extrapolated year 5 cash flows through to year 10 assuming annual growth to reflect contribution from new business areas. We estimate that when taking account of assumed growth in cash flows from years 6 to 10, the total cash contribution of VESL could be in the region of £8.0m⁴ in today's money.

While it is reasonable for VESL management to not include these assumptions within the base case, such a scenario playing out is plausible, albeit, we recognise that there are a number mitigating actions management could take to reduce the impact. Our view therefore, is that PCC should fully understand the downside risks and their impacts when making its decision whether to proceed with the supply business. In particular, PCC should give consideration to the potential level of funding that the business may require under such a scenario.

We note however that the business may have value to third parties, either for their customer book, or as a platform for growth. E.g. It would not be unreasonable to assume that VESL could achieve a premium value on its customers, over acquisition costs, based on achieving a premium for them being stickier.

³ Includes net losses made ahead of launch.

⁴ Net present value of cash flows for years 1 to 5 (£-11.1m) and estimated cash flows from years 6 to 10 (£19.0m). Assumes a 20% year on year growth in year 6 to 10 cash flows and an 8% discount rate.

General Observations

In addition to the primary observations, we note the following additional observations from our review:

1. There are costs in the current model that could be reviewed and removed, while other upsides have not been reflected.

In addition to £250k of annual contingency⁵, the RBC contains a market based cost for working capital funding and a charge for use of PCGs. These costs could be revisited based on legal advice, which suggests that PCC can provide cheap finance to VESL. Furthermore, VESL's management indicated that there are a number of upsides that haven't been included within financial projections. In particular, VESL's management consider that the business model offers a platform for the business to take advantage of a number of market changes such as;

- The ability to offer develop white label propositions – VESL have already been approached by a number of other local authorities;
- the move to a more decentralised energy market, where penetration of electric vehicles creates opportunities for energy companies to expand their customer offering – VESL intends on leveraging PCC's existing roof-top solar (leasing) business, capabilities and pipelines to deliver margin, and at relatively low cost;
- the move to smart connected homes where energy companies can partner and compete with technology and telco's for a greater share of the customer wallet – VESL indicated that it is already in conversation with a number of bluechip companies;
- the ability to further leverage the home services proposition.

As these opportunities have not been quantified in the RBC, we have not assessed this area in detail, however we are aligned with the broad direction of travel for the industry set out above.

2. VESL will require a PPC Parent Company Guarantee (PCG) of up to £20m depending on the level of wholesale market exposure

VESL management indicated that the potential collateral exposure over the 3 year proposed trading agreement could be in the order of £10m - £15m at current market commodity prices⁶. This assumes that VESL pays for the commodity in accordance with standard industry settlement terms, which expose the commodity provider to c.6 weeks risk for commodity delivered but not paid.

In addition, VESL will be exposed to market risk on forward energy sales i.e. the risk that where commodity prices fall and VESL is unable to take the commodity, that the counterparty would be forced to sell the commodity into the market at a lower price than purchased for. Forecasting this exposure requires sophisticated modelling but on the basis that the proposed period extends to 5 years (i.e. beyond the 3 year trading agreement), the size of the PCG could be expected to increase to £15m - £20m.⁷

We note that the probability of a business defaulting is typically the result of worsening financial performance in response of worsening market conditions, e.g. lower sales levels, or the introduction of a price cap, as outlined in our downside scenario. In the case of VESL, the PCG exposure would be triggered if VESL were to default as a result of the council's decision to stop VESL's funding.

We note that such an event where VESL were to default and PCC would be fully liable for the full value of the PCG is low. Furthermore, such an event where the supplier defaults is likely to occur in a rising market with rising wholesale prices. This in itself would reduce the mark to market risk and could potentially result in some upside for PCC, should the value of electricity sold back into the wholesale market by VESL's counterparty exceed the value at the time VESL purchased the energy.

⁵ The RBC includes £1.35m of contingency from years 1 to 5 (£348k in year 1, £250k per year thereafter) and £250k for pre live operations.

⁶ Commodity prices have increased by c.20% since FBC

⁷ Any supply business that fails will have a mark to market position at the point of failure. However this information isn't in the public domain and so we cannot provide a comparison of the level of financial exposure.

3. VESL benefits from preferential commodity trading terms due to its ability to leverage PCC's balance sheet.

With respect to hedging strategy and collateral, the approach being taken by VESL is in line with what we would expect for a local authority supported retail business. VESL does benefit from preferential commodity trading terms due to the ability to leverage PCC's balance sheet through a low cost PCG.

Financial model observations

We have not reviewed the financial model, the integrity of the model or the functionality of the model, but have worked on the basis that it is fit for purpose. Rather, our review has focused on assumptions contained within the financial model, and checking that they are consistent within the business plan. That said we have noted a number of elements that should be considered as part of ongoing updates to the model:

- **Use of time series assumption.** Cost of sale and revenue calculations are largely driven by assumptions that change over time, including wholesale costs and policy costs. However the model uses a single average assumption for many of these elements, which assumes prices remain constant in real terms over the period. Not reflecting changes in these cost items over the modelled period can potentially affect costs, revenues and overall funding requirements. E.g. over the 5 year period to 2017 wholesale electricity costs varied by as much as 20% from their starting point in 2013 and this could in turn have a relative impact on costs and funding requirements which would otherwise be ignored through the use of a single assumption.
- **Split out P&Ls for each business unit and customer segment.** The model presents only a top level P&L for VESL and does not split this by market (domestic, SME, Micro, SME, I&C) or in the case of the domestic market, by tariff (Fixed, SVT, Prepayment). Although we note that a number of calculations are made at the tariff, there is insufficient clarity on how customer numbers are projected to grow or the performance of each of these tariffs.
- **Inconsistent indexation.** We note that a number of assumptions are indexed, by CPI or other indices, while others are not. The model should be reviewed so that users are confident where data are real (typically assumptions) and where they are nominal (typically calculations and financial outputs).
- **IRRs are incorrectly calculated.** IRRs in the model have been calculated using the P&L rather than the cash flow, as is typically the case in financial reporting. In our view the use of Net Margin taken from the P&L results in the IRR being overstated (15.9%). When based on total monthly cash flow we estimate the IRR to be nearer to -2.0% for the duration of the venture and 8.0% when excluding pre-launch cash flows in the RBC.

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TOTAL INVESTMENT RETURNS - BASE CASE AND DOWNSIDE SCENARIOS

BASE CASE - PCC Investment Return	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5
CUSTOMER NUMBERS		50,122	86,639	112,581	131,123	144,466
<u>EARNINGS</u>	£m	£m	£m	£m	£m	£m
VESL Earnings	3.5	3.9	0.7	(2.5)	(4.3)	(5.5)
All Other Earnings	0.0	(1.4)	(1.7)	(1.8)	(1.9)	(2.0)
TOTAL (EARNINGS) / LOSS	3.5	2.4	(1.0)	(4.4)	(6.2)	(7.5)
CUMMULATIVE (EARNINGS) / LOSS	3.5	5.9	5.0	0.6	(5.6)	(13.1)
ESTIMATED SALE VALUE @£77.50 per Customer	0.0	(3.9)	(6.7)	(8.7)	(10.2)	(11.2)
TOTAL INVESTMENT VALUE / (LOSS)	3.5	2.0	(1.8)	(8.1)	(15.8)	(24.3)

PwC Downside Scenario 1 - PCC Investment Return	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5
CUSTOMER NUMBERS		25,061	69,792	102,876	126,377	143,123
<u>EARNINGS</u>	£m	£m	£m	£m	£m	£m
VESL Earnings	3.5	5.8	4.1	0.7	(2.2)	(5.5)
All Other Earnings	0.0	(1.4)	(1.7)	(1.8)	(1.9)	(2.0)
TOTAL (EARNINGS) / LOSS	3.5	4.4	2.4	(1.2)	(4.1)	(7.5)
CUMMULATIVE (EARNINGS) / LOSS	3.5	7.9	10.3	9.1	5.0	(2.5)
ESTIMATED SALE VALUE @£77.50 per Customer	0.0	(1.9)	(5.4)	(8.0)	(9.8)	(11.1)
TOTAL INVESTMENT VALUE / (LOSS)	3.5	5.9	4.9	1.1	(4.8)	(13.6)

PwC Downside Scenario 2 - PCC Investment Return		Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5
CUSTOMER NUMBERS			25,061	69,792	102,876	126,377	143,123
<u>EARNINGS</u>		£m	£m	£m	£m	£m	£m
VESL Earnings		3.5	6.1	5.4	3.1	1.2	(1.8)
All Other Earnings		0.0	(1.4)	(1.7)	(1.8)	(1.9)	(2.0)
TOTAL (EARNINGS) / LOSS		3.5	4.7	3.7	1.2	(0.7)	(3.8)
CUMMULATIVE (EARNINGS) / LOSS		3.5	8.2	11.9	13.1	12.4	8.6
ESTIMATED SALE VALUE @£77.50 per Customer		0.0	(1.9)	(5.4)	(8.0)	(9.8)	(11.1)
TOTAL INVESTMENT VALUE / (LOSS)		3.5	6.3	6.5	5.2	2.6	(2.5)

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