Portsmouth CITY COUNCIL

Title of meeting:	Cabinet
Date of meeting:	27th November 2018
Subject:	Victory Energy Supply Limited - Expert Review of Business Case (re-consideration)
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 The Council has received two independent expert reviews of the Victory Energy Supply Limited (VESL) Business Case from Baringa (Nov. 2017) and PricewaterhouseCoopers (July 2018 and Nov. 2018). The latest version of the Business Case (known as the Price Cap Business Case or PCBC) has been updated to reflect the previous advice from PricewaterhouseCoopers (PWC) to reduce customer acquisition targets in Year 1, reduce the rate at which customers can be acquired, incorporate the effect of the recently announced Energy Price Cap and to extend the financial model over 10 years in order to see the value of the Council's investment over an appropriate period.

1.2 Both independent expert reviews have concluded that there is a positive business case for investment into VESL but, as with any commercial opportunity, it is not without risk. The latest review by PWC, now provided as an Addendum to their report of 31st July 2018, concluded that:

> ***"In our view, the PCBC, provides a reasonable representation of the key risks and results in the supply business continuing to be profitable over the first five years of operation"***

1.3 Substantial additional information is now also available relating to the following:

- Revised risk and reward expectations based on the announcement of the price cap and other updates
- The cost and affordability of the Warm Homes Discount (WHD)
- Social Impact Assessment
- Tariff
- Relationship with the Council's In House Energy Services Team
- The cost of disposal
- Clarification of the status of the Governance arrangements
- The risks and rewards of a White Label proposition

1.4 The core proposition of VESL is now as follows:

- Low cost energy to residents
- 100% renewable electricity to residents and business
- Assistance to reduce energy consumption and energy bills with help from "Green Deal" trained Energy Advisors
- A wider energy services offering such as boiler installations, boiler servicing, solar installations, battery storage and digitally connected appliances
- Local Customer Services
- Locally employed staff

1.5 The financial case related to VESL can be summarised in the following terms:

- Year 10 Investment Return (excl. WHD) of £63m (previously estimated at £50m)
- Year 5 Investment Return (excl. WHD) of £22m (previously estimated at £2.5m)
- Peak Investment (risk) in Year 2 at £4.5m (previously estimated at £6.5m)
- Warm Homes Discount is affordable at a cost of £11.3m over 10 years (£3.9m over 5 years)
- Risk exposure can be managed annually through a "stage-gate" governance process of awarding funding annually based on past performance and future prospects
- Overall governance arrangements are still open for the Cabinet to decide
- Cost of disposal ranges between £1.7m and £4m (previously £2.5m and £3.5m)

1.6 Other key considerations include:

- The assessment of Social Impact is greatest in relation to the use of the Community Investment Fund and reduced tariffs
- The VESL tariff is lower than the equivalent tariffs of the Big 6 (Big 6 hold 75% of the market) and in the top 20 equivalent tariffs*****
- The VESL tariff is cheaper than the White Label alternative (e.g. £57 on a like for like comparison)
- A White Label arrangement:
  - Provides WHD with objectives to reduce fuel poverty
  - Provides financial returns over 5 years of circa £0.3m
  - Carries minimal financial risk but higher reputational risk
  - Involves the disposal of VESL costing between £1.7m and £4m

***** **Dual Fuel 13 Month Tariff - no exit fees**

1.7 The alternative options available to the Cabinet offer a range of financial, economic and social benefits with each option carrying different levels of financial and reputational risk. Continued investment into VESL offers the greatest level of financial, economic and social benefits but also carries the greatest financial risk. A White Label alternative offers strong social benefits with minimal future financial risk, low financial returns and involves the cost to dispose of VESL.

1.8 In summary, since the last consideration by Cabinet in August, the following has been confirmed:

SUMMARY

- **5 Year investment return is up from £2.5m to £22m**
- **10 Year Investment return is up from £50m to £63m**
- **Peak investment requirement is down from £6.5m to £4.5m (Year 2)**
- **VESL is able to fund the WHD and return a profit**
- **VESL has a lower tariff than private and municipal alternatives**
- **100% renewable electricity to residents and businesses**

2. Purpose of report

2.1 To re-consider the case for investing in Victory Energy Supply Limited (VESL) following the decision by the Scrutiny Management Panel on 21st September 2018.

2.2 The report will focus on all new information that is now available as well as providing clarification to the specific matters raised (i.e. grounds) within the "Call In" of the Victory Energy report considered by the Scrutiny Management Panel on 21st September 2018.

2.3 The report also responds to requests that have been made for additional information including a Social Impact Assessment and the financial impact of voluntarily adopting the Warm Homes Discount in advance of reaching the regulatory threshold (150,000 customers).

2.4 Specifically this report will consider the following:

i) The "Addendum to final business case review" that PWC have provided to the their original report of 31 July 2018; this relates to the new information that is now available relating to the Energy Price Cap that was a significant uncertainty at the time the original report from PWC (dated 31st July 2018) was considered.

ii) The overall risks and rewards to the Council, now incorporating the Addendum above, plus all other income streams and value receivable by the Council which is directly associated with any decision to proceed with continued investment into VESL

iii) A Social Impact Assessment

iv) Further information and clarification to those grounds contained within the "Call In" where the original decision may have been taken based on inadequate information. Those grounds are summarised below:

a) Customer Acquisition

b) Marketing Approach

c) Investment / Risk Exposure

d) The 4 success factors as per the Section 151 Officer's report

e) The risk to public money which could be spent more wisely

f) Maximising income for when it is required

g) Target Customers and Tariffs - vulnerable and low income customers

h) Energy Price caps excluded from the Revised Business Case (RBC)

i) The impact on Portsmouth City Council's future budgets

v) An overall evaluation of the risks and rewards associated with continuing to invest in VESL

vi) The financial impact of voluntarily adopting the Warm Homes Discount in advance of reaching the regulatory threshold

vii) Governance arrangements for VESL and the options open to the Council

viii) New information relating to the risks and rewards associated with entering into a "White Label" agreement with an existing fully licensed energy supplier

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(s) 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 29th July 2017

Option 2 - Cease investment into Victory Energy Supply Limited and seek to dispose of the Council's interest at the best possible value for the Council and delegate authority to the S.151 Officer and City Solicitor to conclude all of the necessary agreements to facilitate a sale

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 and cease investment into Victory Energy Supply Limited under the terms described in Option 2

3.2 It is recommended that the Cabinet consider implementing either or both of the following options which are capable of being implemented in conjunction with either of the Options 1 to 4 above:

Option 5 - The Council develops a comprehensive campaign for tackling fuel poverty and looks to resume the promotion of PCC's energy saving website

Option 6 - An Outline Business Case be brought forward by the Council's In-House Energy Savings Team to re-evaluate commercial opportunities (previously approved by Cabinet 8th December 2016)

4. Background

4.1 On 21st September 2018, the Scrutiny Management Panel considered a "Call In" of the decision taken by the Cabinet on 10 August 2018 in respect of item 4 on that agenda, "Victory Energy Supply Limited - Expert Review of Business Case". The "Call In" procedure was invoked by Councillors Donna Jones, Luke Stubbs, Simon Bosher, Judith Smyth and George Fielding on the basis that they believe that the decision may have been taken based on inaccurate, incorrect or inadequate information.

4.2 During the course of the meeting, the Leader of the Council stated that the Cabinet would be content to reconsider the decision at a future meeting and welcomed any further information that was available to also be presented as part of a re-consideration. The Scrutiny Management Panel subsequently resolved that Cabinet should re-consider their decision on the basis that the decision was taken without adequate information.

4.3 The original report considered by Cabinet on 10 August 2018, "Victory Energy Supply Limited - Expert Review of Business Case" is attached at Appendix 2.

5. New Information

5.1 As part of the report considered by Cabinet on 10 August 2018, PWC provided an independent expert review entitled "Victory Energy Supply Limited - Review of Final Business Case" (31st July 2018). This was a risk based review focussing on the key drivers of financial return and risks to achieving any modelled financial returns (or retained earnings).

5.2 The review by PWC did not (and was not commissioned to) consider the following which are also material to the consideration of risk and return and which are directly associated with the continuation of VESL:

- The annual income that the Council would receive from providing a loan facility
- The value of the Community Investment Fund passed over to the Council to be allocated for community initiatives
- The additional income to Housing and Property Services from leads generated by VESL working in tandem to provide Solar PV and other energy services to residents
- The Customer Book value (a proxy for the Sale Value) of the Company over the period of the investment

5.3 At the time that report was received, one of the key uncertainties that could affect VESL's financial return was the forthcoming Energy Price Cap. However, Government had yet to formally consult or determine the level of that Energy Price Cap.

5.4 PWC noted in their report that the VESL Revised Business Case (RBC) had not explicitly included the effect of a Price Cap although the RBC did include a level of contingency and there were other alternative mitigating actions that any Energy Supplier would be able to implement in order to maintain profit levels (e.g. increase the price of Fixed Tariffs to offset any constraints on Standard Variable Tariffs (SVT)). Additionally, previous iterations of VESL's financial model had included 8 alternative scenarios, including the likely effect of a Price Cap.

5.5 In the absence of any known Price Cap level, PWC (based on previous announcements by Government) assumed that the Price Cap would deliver a

typical dual fuel customer paying by direct debit a saving of £100 per annum. Their report factored this into a Sensitivity Scenario entitled "Downside Scenario 2" which included the following:

i) Reducing SVT customers' annual bills by c. £100

ii) Reducing Fixed tariff customers' annual bills by c. £50

iii) Revising year 1 total customer acquisitions down by 50%

iv) Halving the customer acquisition rates to 3 sales per agent per day

5.6 The Price Cap has now been announced at £1,137 which is estimated by Ofgem to deliver a saving of around £75 to a typical dual fuel customer paying by direct debit.

5.7 VESL have now updated their financial model to take account of the Price Cap as well as incorporated the customer acquisition elements of PWC's "Downside Scenario 2" described above into a "Price Cap Business Case (PCBC). Additionally, based on the advice previously received by PWC, the financial model has been extended to a 10 year period. The PCBC now forms the current Business Case and financial model for VESL.

5.8 PWC have reviewed VESL's PCBC and provided an "Addendum to the final business case review (July 2018)" which is attached at Appendix 1. The review concludes that:

> ***"In our view, the PCBC provides a reasonable representation of the key risks and results in the supply business continuing to be profitable over the first five years of operation"***

5.9 The Executive Summary of the Addendum is reproduced in full below:

Our July 2018 report noted that VESL's business plan is subject to a number of downside risks, which management have captured in the PCBC. These include; the impact of the price cap, lower year one customer acquisitions and lower acquisition rates. In our view, the PCBC, provides a reasonable representation of the key risks and results in the supply business continuing to be profitable over the first five years of operation.

Employing a flexible target operating model is essential to VESL delivering a low cost operating base, navigating uncertainty within the market, and delivering the PCBC. VESL have put in place an experienced management team, who have focussed on flexibility and governance in the set-up of the business. In addition, PCC have sought comfort from a separate review of the operating model conducted by Baringa between September 2017 and October 2017. We have not reviewed VESL's operating model as part of our review, therefore PCC should reconfirm that Baringa's review gives them sufficient confidence in the ability of management to deliver the plan.

Further to our view above, we make the following observations:

- ☐ *VESL's revised business case incorporates feedback made in our July 2018 report and reflects; the impact the default tariff cap, updated costs of sales and operating costs, a reduction in acquisition rates (sales per agent per day) and subsequent increase in sales resource, removal of the contingency on the basis that cash flows have been risk-adjusted, and revised smart meter roll-out assumptions based on management's latest view of market conditions.*
- ☐ *While our review has focussed on the first 5 years, where the price cap is in place, we note that the business plan has been extended out to 10 years and captures the value of cash flows beyond the initial 5 year period – VESL forecasts cumulative retained earnings of £33.9m by year 10. The approach taken by VESL to extrapolate cash flows is reasonable and the PCBC now fully reflects the value contribution of the supply business over a 10 year horizon, which we consider an appropriate period.*
- ☐ *VESL's financial performance in the PCBC has been revised downwards due to the price cap and increased acquisition costs. Cumulative retained earnings over the first five years have fallen by £1.7m to £3.1m, reflecting a fall in overall net margins – year 5 net margins have fallen from 5.1% to 4.5%.*
- ☐ *Even after factoring in the impact of the cap, VESL is able to achieve higher margins, than the implied margin in the default tariff cap (2.8%). Higher relative margins are explained by a number of factors:*
  - *VESL not incurring, but being able to recover full policy costs through the tariff, in line with a fully obligated supplier – The PCBC assumes that VESL will be partially obligated under the Energy Company Obligation (ECO). Whether VESL voluntarily participates in the Warm Home Discount (WHD) scheme, is a decision for the Council.*
  - *VESL's ability to outperform Ofgem's operating cost benchmarks based on the Big 6 and four medium sized suppliers, in effect becoming one of the most efficient suppliers within three years.*
  - *A reduction in the fixed tariff discount to SVTs – As a result of higher modelled costs, the price differential between fixed tariffs and SVTs reduces from £100 in the RBC to around £20 to £30 in the PCBC.*
- ☐ *We are comfortable that VESL is able to realise some margin benefit through policy costs, given that it will not be fully obligated during the first years of operation for ECO, and will not incur WHD costs.*
- ☐ *The ability of VESL to consistently outperform Ofgem's operating cost benchmark and become one of the most efficient suppliers within three years, is a key driver of margin. While it is possible for VESL to have a higher cost base and earn a positive return, the business would be unlikely to consistently earn an EBIT* margin in excess of 2.8% in these circumstances. If the cost base is not adequately managed, it is also possible that VESL could make a loss.*
- ☐ *We have gained some comfort in VESL's ability to operate competitively through analysis of their cost base, which is to a large extent (>60%) contracted or dependent on customer numbers. However, we note that consistently delivering operating costs 10% below the default tariff cap, and in line with the most efficient suppliers, will be challenging.*
- ☐ *We have gained comfort in the ability of VESL to deliver the increase in target acquisitions from year 2 onwards, particularly given that VESL has revised down its acquisition assumptions to c3.0 sales per agent per day, and given evidence of other suppliers acquiring customers through face to face sales in the absence of significant price competition.*
- ☐ *We note that there is still a risk to financial performance of lower acquisitions or margin in response to the lower price differential between fixed tariffs and SVTs – this is a market-wide risk.*

* **EBIT is a standard measure of underlying earnings but before interest and taxation**

5.10 As described throughout this report, the PWC review focusses on the modelled financial returns and risks to those returns of VESL alone, it does not cover the other income streams that would be received by the Council or the Customer Book Value, both of which are material to the consideration of the overall risks and return to the Council.

6. Social Impact Assessment - VESL

6.1 As previously stated, the Leader of the Council emphasised that the Cabinet would welcome any further information being provided that might help in arriving at a decision regarding the future investment into VESL. A request has been made to include a Social Impact Assessment as part of the Cabinet's re-consideration.

6.2 As described more fully in the original report (attached at Appendix 2), the core proposition of VESL is as follows:

- Low cost energy to residents
- 100% renewable electricity to residents and business
- Assistance to reduce energy consumption and energy bills with help from "Green Deal" trained Energy Advisors
- A wider energy services offering such as boiler installations, boiler servicing, solar installations, battery storage and digitally connected appliances
- Local Customer Services
- Locally employed staff

6.3 A high level Social Impact Assessment has been completed and is attached at Appendix 4. The conclusion of that assessment is reproduced in full below

SOCIAL IMPACT ASSESSMENT - SUMMARY

VESL have identified a number of areas in which social impact could be achieved, although the likelihood and scale of impact is not clear in all cases.

Potential for positive impact is strongest in relation to the Community Investment Fund, targeting of infrequent switchers to reduce energy bills by undercutting the Big 6 and moving people off Standard Variable Tariffs, and the provision of some local employment.

Further opportunities that have been identified but not fully developed or quantified include local generation, supply and storage of energy, procurement of local suppliers of goods and services, and local partnerships to support vulnerable customers.

There is a risk to social impact in combining advice and service provision in the Local Energy Advisor role, particularly in relation to vulnerable customers and partnership working with statutory and voluntary sector services that may be unwilling to engage with an organisation that is not considered to be free and impartial for the customer.

VESL's social impact will depend on their ability to add value, for example by reaching customers who would not otherwise have taken action to reduce their energy use or costs, creating demand for goods and services from local suppliers or leading the market in renewable or local energy services.

7. Clarification of Matters Raised within the "Call In" Considered by the Scrutiny Management Panel

7.1 The key matters raised within the "Call In" procedure and points of clarification are set out below.

i) Customer Acquisition

The VESL Revised Business Case (RBC) assumed that VESL would attract 144,000 customers over a 5 year period and was based on an acquisition rate of 6 customers per day.

PWC commented in their review as follows:

"Delivering VESL's customer growth numbers appears achievable over the 5 year plan period based on market benchmarks"

"There is a risk that VESL will not deliver the required level of acquisitions, particularly within year 1"

"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"

In summary, PWC concluded that the total 144,000 customer numbers were achievable over the 5 year period, attracting the planned first 50,000 customers in year 1 will be challenging but would be made up over the 5 year period and it may cost more to achieve those customer numbers (i.e. require more Sales Advisors). Consequently, the financial impact of this was modelled into their "Downside Scenario 2"

Baringa commented in their review as follows:

"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."

"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"

In summary, Baringa were content that the customer numbers were achievable but also commented that some risks remain and that an investor should consider an alternative scenario also to compliment the face to face channel as described in more detail below.

Both independent experts concluded that the target customer numbers were achievable but advocate the need for a "Plan B".

ii) <u>Sales & Marketing Approach</u>

The sales & marketing approach from VESL is to be delivered through a multi-channel approach with an emphasis on Face to Face sales (not to be confused with "Door to Door"). The approach includes the following:

- Face to Face via Roadshows, Friends and Family, Referrals, Groups and Partners, Cold Calling and Appointments
- Digital marketing
- Events
- Telesales
- Sponsorship

In relation to this approach PWC commented as follows:

"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"

"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"

Baringa commented in their review as follows:

"we can point to the success of Utilita who have gained 3,000-4,000 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"

"… a number of risks remain which would be considered by any investor:

> *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*

In summary, both PWC and Baringa conclude that, in the Energy Supply sector there is limited use and evidence of the success of the Face to Face sales and marketing model although it has been used successfully in some instances. There is much more proven evidence of success using other sales and marketing channels and both independent experts comment that it would be prudent to consider an alternative "Plan B".

iii) Investment / Risk Exposure

Investment exposure is covered in more detail and with current estimates based on the PCBC in Section 8.

The Total Investment Value is the key measure of risk for the Council.

Other financial measures of investment risk exposure have been used throughout both the covering report of 21st August 2018 and the review by PWC of 31st July 2018 which are all valid in the right context. For example, some measures such as "Peak Monthly Financing" and Maximum Cash Contribution" are more appropriate for the Private Sector where access to a credit from a bank or investors is one of the most crucial considerations. In the Council's circumstances however, access to funds does not have the same restrictions and is readily available.

In the Council's circumstances, the Total Investment Value ultimately describes the full financial loss that the Council would experience should VESL fail at a particular point in time, taking account of:

- All loan advances made to VESL
- All repayments of loan interest made to the Council
- All payments from the Community Investment Fund made to the Council
- Any sale value that the Council could achieve for VESL's "Customer Book"

iv) The 4 Success Factors as per the Section 151 officers report

The 4 Success factors required to provide confidence that the Business Case can be achieved are as follows:

- Strong Governance
- Talented Senior Management Team
- Agile Business Plan
- Robust Risk Management

The overall governance arrangements have yet to be finally agreed and are for the Council to determine.

All other success factors have been commented upon positively by the independent experts to the extent that they have been covered by their reviews.

v) The Risk to Public Money which could be spent more wisely

The information provided within the reports to Cabinet for the 10th August 2018 did not make it clear that the proposed investment into VESL would be by way of a loan and that loan funding of this nature is not generally available for other purposes.

It is appropriate for the Council to offer loan funding where there is a strong business case for doing so, it is in the wider public interest and where the overall risk to public funds is proportionate to the Council's overall financial standing.

Loan funding can either be for a revenue or capital purpose but subject to strict criteria (using either Treasury Management powers or Capital Expenditure powers). It is only available where there is a demonstrable and strong likelihood of repayment. It is not available for general spending to supplement the Council's budget for day to day services.

vi) Maximising Income for when it is required

The information provided within the reports to Cabinet for the 10th August 2018 did not make either of the following clear:

i) That there would be an annual income stream that would flow through to the Council from day 1 of VESL trading. This relates to repayments of interest on the loan provided to VESL and the payments into the Community Investment Fund. The estimated annual sums based on the PCBC are described in Section 8 and start at £0.8m in Year 1 (including £0.5m from the Community Investment Fund).

ii) That by proceeding with VESL, it does not deny an alternative investment. Investment funds are readily available to the Council for schemes with strong business cases and funding is generally not rationed.

vii) Target Customers and Tariffs - vulnerable and low income customers

The target market and tariff for VESL is described in more detail in Section 8.

VESL is targeting the non-switchers. Infrequent switchers represent circa 80% of all customers with circa 60% of all customers having never switched. Those customers are likely to be on the highest tariffs (Standard Variable Tariffs (SVTs) and should be more "sticky" and, once switched, will have a longer lifetime value to the company.

At present, 75%[1] of customers are supplied by the Big 6 and 54%[2] of those customers are on SVTs. Additionally, VESL has the stated aim of setting a tariff level that is at the bottom end of the Big 6.

VESL's aim is to reduce fuel bills by engaging with customers on a face to face basis using "Green Deal" trained Energy Advisors from the local area. The Energy Advisors are able to advise both on tariffs as well as reducing energy consumption with products such as energy efficient boilers, solar PV and general good practice.

It is also open to the Council to introduce the Warm Homes Discount and / or use the Community Investment Fund to help those in fuel poverty as well as setting the social and ethical policies of the company.

[1] Source: OFGEM August 2018
[2] Source: OFGEM April 2018

viii) Energy Price Caps excluded from the Revised Business Case (RBC)

When PWC were requested to review the Business Case of VESL, VESL were approaching "Controlled Market Entry" and in the process of updating the Final Business Case (FBC) financial model to move from a Business Case financial model to a "Go Live" Budget; this became known as the Revised Business Case financial model (RBC).

Prior to RBC, VESL were operating with the financial model that had been signed off as part of the Final Business Case, this Business Case had been reviewed by Baringa (the Council's Independent Expert) and it included a total of 8 alternative scenarios including the impact of an energy price cap.

The imperative to quickly undertake a further review of the Business Case (i.e. RBC) and the fact that the energy price cap had not been announced meant that a specific scenario for a particular level of energy price cap had not been developed. However, the overall impact of the price cap was not expected to be a serious impact on Business Case viability for the following reasons:

a) The overall intent by Ofgem of introducing the price cap was not to limit competition and hinder new market entrants

b) The price cap affects those on an SVT and VESL's customers on SVT's were relatively small starting at zero and rising steadily from year 2 and up to 11% by Year 5.

c) Other mitigating actions were open to VESL (and other suppliers) to raise fixed price tariffs to compensate and to provide more emphasis on wider energy services as well as the business market which were not restricted by the price cap

d) A contingency of £1.5m was included within the RBC to guard against any unplanned costs / reductions in income

PWC highlighted the energy price cap as a particular risk and supplied a sensitivity analysis that sought to adjust the RBC for the impact of both the price cap and reductions in customer growth and acquisition rates. This provided a further alternative scenario for the Cabinet to consider.

viii) The Impact on Portsmouth City Council's future budgets including anticipated income, expenditure and capital investments

The report to the Cabinet on 10 August 2018 set out the overall investment return to the Council over the period of both 5 and 10 years. The report focussed on 2 alternative scenarios as follows:

a) The VESL Base Case

b) The PWC Downside Scenario 2

In both alternative scenarios the investment return was positive over 5 years (ranging between £2.5m to £24.3m) and 10 years (estimated at £50m in the PWC Downside Scenario). These values take into account the "Customer Book" value of the company (which would not be realised until sold). The value of the "Customer Book" was the primary reason for reaching an investment return over the 5 year period in the PWC Downside Scenario.

Whilst not the primary measure of risk, the reader of the report could have interpreted the PWC Downside 2 Scenario of retained earnings amounting to a cumulative loss of £17.5m after Year 5 as a significant loss and serious risk. Retained earnings alone is an incomplete measure of risk, it excludes both the Customer Book value and all other income streams that would be receivable by the Council.

As mentioned previously, the report to Cabinet on 10 August 2018 did not clearly set out that VESL would generate income for the Council's Revenue Budget from day 1 (Loan repayment plus Community Investment Fund). Section 8 of this report seeks to clarify both the Annual Revenue Budget impact as well as the Total Investment Value on the basis of PCBC financial model.

8. Summary of the Risks and Rewards associated with Continuing to Invest in VESL

Summary Proposition

8.1 As described more fully in the original report (attached at Appendix 2), the core proposition of VESL is as follows:

- Low cost energy costs to residents
- 100% renewable electricity to residents and business
- Assistance to reduce energy consumption and energy bills with help from "Green Deal" trained Energy Advisors
- A wider energy services offering such as boiler installations, boiler servicing, solar installations, battery storage and digitally connected appliances
- Local Customer Services
- Locally employed staff

Tariff

8.2 VESL's stated strategy is to position their tariffs at least at the bottom end of the Big 6. The modelled fixed rate tariff for a dual fuel customer with typical consumption is £1,107[3]. This positioned VESL cheaper than all of the Big 6 comparable tariffs and in the top 20 of comparable tariffs when compared to the whole market. **(Note: Many suppliers offer cheaper tariffs but with substantial exit fees (e.g. £60-£200), alternative payment methods and different durations. The comparisons provided are like for like, excluding for example tariffs with exit fees)**.

8.3 Fixed rate tariffs (referred to above) are invariably cheaper than SVT's and are the basis upon which energy suppliers promote their prices. It is important to note that Big 6 Energy suppliers, which hold just over 75% of the market share[4], have between 38% (Scottish Power) and 69% (SSE) on SVT's. The average percentage of customers across all of the Big 6 on SVT's is 54%[5].

8.4 The Big 6 and other household name current comparable tariffs are illustrated below:

Dual Fuel Tariff - 13 month, fixed rate, monthly direct debit, no exit fee - 17/11/18

Energy Supplier	Annual Cost £
Bristol Energy	1,069
VESL	**1,107**
Scottish Power	1,155
Robin Hood	1,164
E.ON	1,170
EDF	1,197
SSE	1,202
Npower	1,203
Co-Op Energy	1,208
British Gas	1,218
First Utility	1,232

VESL Financial Returns - Retained Earnings

8.5 As set out previously, PWC have reviewed VESL's PCBC financial model and concluded that it *"provides a reasonable representation of the key risks and results in the supply business".* That conclusion was drawn having taken into account all key assumptions in the financial model relating to customer numbers, the tariff level, energy costs and all other operating costs.

[3] All of the financial modelling (including tariff modelling) has been undertaken at August 2018 prices to be consistent with the Price Cap announced by Ofgem which was also at August 2018 prices.
[4] Source: OFGEM August 2018
[5] Source: OFGEM April 2018

8.6 Whilst VESL will be seeking to achieve better returns through improved customer acquisition rates and therefore lower operating costs, the PCBC has been adopted as the financial model to be considered as the Base Case.

8.7 In this PCBC, it is expected that the Council will need to provide a £9.5m loan to VESL covering the set up phase and the first 2 years of trading. VESL is expected to be profitable from year 3 onwards and by year 5, have repaid the loan to the Council and made an overall return (retained earnings) of £3.1m.

8.8 As described later in this report, the Loan Value does not represent the peak financial exposure of the Council. For example, at the point the loan peaks at £9.5m, the value of the company is expected to be £5.8m and other income received is expected to total £2.3m, leaving a net financial exposure at that point of £1.4m.

8.9 PWC also advised that to appreciate the value of the business given the significant set up costs as systems and operations are built out and the time take to reach scale, it is more appropriate to view the Business Case over a 10 year period. VESL's PCBC has now been extended to cover a 10 year period and is estimated to deliver retained earnings of £33.9m.

8.10 Other income streams will be receivable by the Council in addition the retained earnings and these are set out below.

Other Income Streams - Directly Associated with the Continued Investment into VESL

8.11 The other income streams receivable by the Council will be:

i) Loan Repayment (annual interest):

The Council will provide VESL with a loan facility at commercial rates. That interest will be repaid annually until such time as the loan has been repaid in full. The net surplus to the Council's budget (being the difference between the cost of borrowing and the interest charged on lending) is expected to amount to £1.8m over the first 5 years of operation.

ii) Community Investment Fund (£18 per Customer)

The VESL Business Case and financial model provides for an £18 per customer contribution to a Community Investment Fund. It is estimated that this will amount to circa £1m per annum and £10m over the 10 year period. It will be for the Council to decide how best to utilise and direct this fund. It could for example, be used to support community based initiatives generally, energy efficiency schemes or be more directly targeted towards fuel poverty. Both the contribution level into the fund as well as its use remain open for the Council to determine.

VESL - Company Value

8.12 An important consideration of any investment is not just the income return but also the capital value. Energy companies can be valued based on their "Customer Book" and sold on that basis. Customers have a value because there is a cost to acquire through sales and marketing that would be avoided. Equally, if those customers are loyal (or "sticky") they can command a premium because the company will make a profit on those customers for a longer period.

8.13 It was stated in PWC's previous report that:

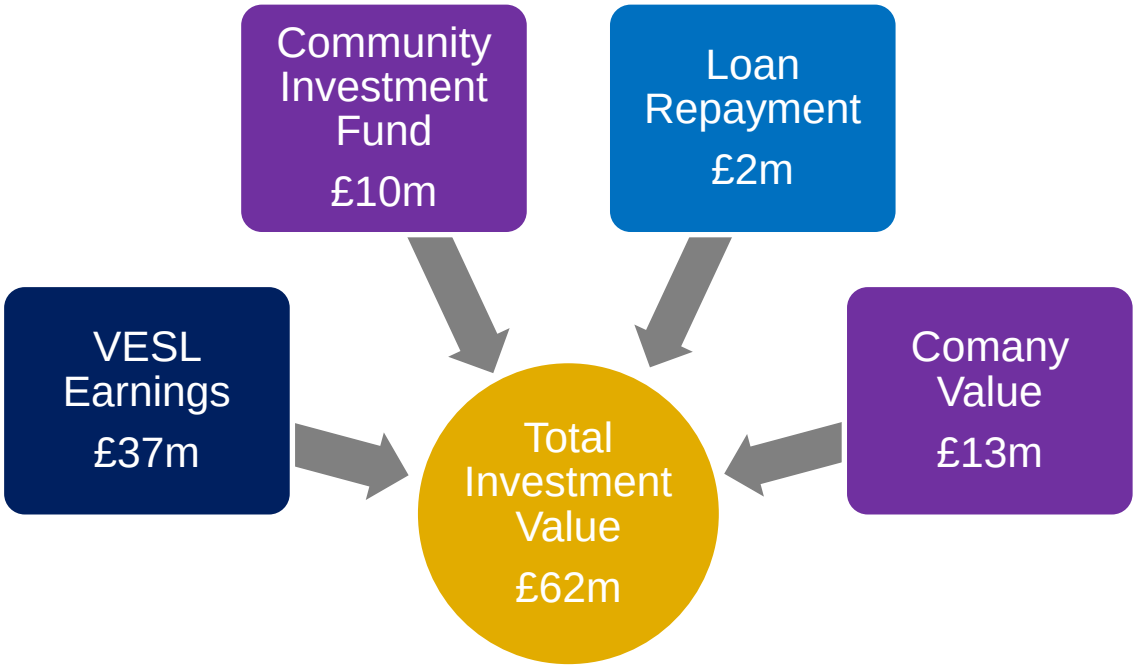
"It would not be unreasonable to assume that VESL could achieve a premium value on its customers, over acquisition costs, based on achieving a premium for them being stickier."

A reasonable estimate of value is £77.50 per customer, which after 10 years equates to a Customer Book value of £14m

Total Investment Value (Retained Earnings, Other PCC Earnings & Company Value)

8.14 Taking all income streams due to the Council and the value of the Company together, the Total Investment Values to the Council of VESL is estimated at £62m after 10 years as set out below.

TOTAL INVESTMENT VALUE AFTER 10 YEARS



Note: The equivalent total investment value after 5 years is £22m

8.15 The full analysis of the Total Investment Value to the Council is set out in the table below:

Total Investment Value - VESL & PCC

Price Cap Base Case (£'m)	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Total Years 1-5	Total Years 6-10	Cumulative Year 1-10
Year End Customer Numbers		25,061	74,731	110,645	136,148	154,348	**154,348**	**176,005**	**176,005**
VESL - Retained Earnings	£3.5	£3.8	£2.2	(£2.0)	(£4.6)	(£5.9)	**(£3.1)**	**(£33.9)**	**(£37.0)**
PCC - Repayment of Loan to PCC	£0.0	(£0.3)	(£0.4)	(£0.5)	(£0.4)	(£0.1)	**(£1.8)**	**(£0.0)**	**(£1.8)**
PCC - Community Fund	£0.0	(£0.5)	(£1.1)	(£1.1)	(£1.1)	(£1.1)	**(£4.9)**	**(£4.9)**	**(£9.7)**
Total VESL & PCC Annual Earnings	£3.5	£2.9	£0.7	(£3.7)	(£6.1)	(£7.2)	**(£9.7)**	**(£38.8)**	**(£48.5)**
Cumulative (Earnings) / Loss	£3.5	£6.5	£7.2	£3.5	(£2.6)	(£9.7)	**(£9.7)**	**(£48.5)**	
Customer Book Value @ £77.50 per Customer	£0.0	(£1.9)	(£5.8)	(£8.6)	(£10.6)	(£12.0)	**(£12.0)**	**(£13.6)**	
Total Investment (Value) / Loss	**£3.5**	**£4.5**	**£1.4**	**(£5.1)**	**(£13.1)**	**(£21.7)**	**(£21.7)**	**(£62.2)**	

8.16 Other important points to note are as follows:

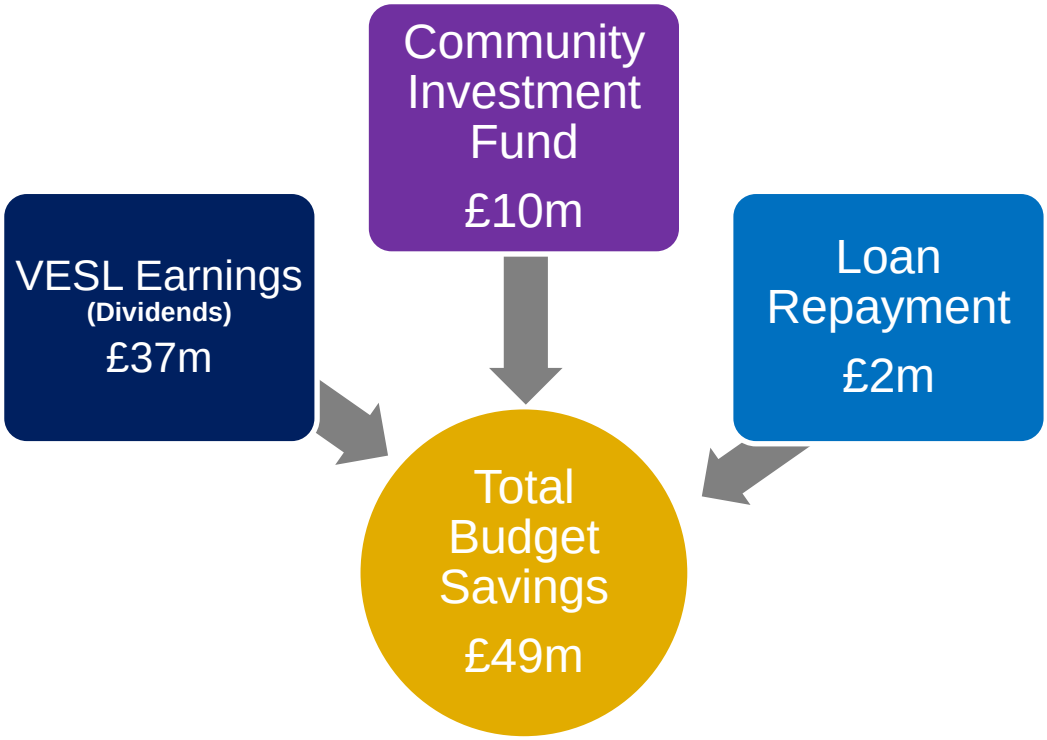
- The key measure of financial risk for the Council is the Total Investment (Value) / Loss
- A Total Investment Return is first realised in Year 3 at £5.1m
- The Total Investment by the Council peaks at £4.5m in Year 1 (shaded in the table above)
- Whilst the Council's loan peaks by the end of Year 2 at £9.5m (shaded in the table above), the investment loss at that point is £1.4m since the loan is largely offset by a Customer Book value of £5.8m

Impact on the Revenue Budget

8.17 Investment value (described above) is different from the impact on the Council's Annual Revenue Budget. Advances of loans do not count as a cost against the budget as ultimately they are expected to be repaid. Only when a loan is in default and needs to be written off (i.e. realised) does it become a charge to the Council's Revenue Budget. Similarly, the Customer Book value also does not feature as an income to the Council and would only do so once sold (i.e. realised).

8.18 The income to the Council's Annual Revenue Budget over the 10 year period is estimated at £49m and is set out below:

IMPACT ON THE REVENUE BUDGET OVER 10 YEARS



Note: The equivalent impact on the Revenue Budget over 5 years is £10m

8.19 The full analysis of the total impact on the Revenue Budget is set out in the table below and key points to note are:

- The Council's revenue budget will realise income in every year, starting at £0.8m in year 1 (**note £0.5m relates to the Community Investment Fund**)
- By Year 5, the Council will start to receive dividends from VESL and annual income starts to accelerate, reaching £4.3m in that year (**note £1.1m relates to the Community Investment Fund)**
- Cumulative income amounts to £9.7m by Year 5, increasing to £48.5m by Year 10

ANNUAL REVENUE BUDGET IMPLICATIONS - VESL PCBC (Without WHD)

Price Cap Base Case (£'m)	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Total Years 1-5	Total Years 6-10	Cumulative Year 1-10
Dividends from retained earnings						(£3.1)	(£3.1)	(£33.9)	(£37.0)
Community Fund		(£0.5)	(£1.1)	(£1.1)	(£1.1)	(£1.1)	(£4.9)	(£4.9)	(£9.7)
Net Interest on Loan Paid from VESL to PCC		(£0.3)	(£0.4)	(£0.5)	(£0.4)	(£0.1)	(£1.8)	(£0.0)	(£1.8)
Total		**(£0.8)**	**(£1.5)**	**(£1.6)**	**(£1.5)**	**(£4.3)**	**(£9.7)**	**(£38.8)**	**(£48.5)**

Risks & Risk Mitigation

8.20 As described in the previous report to Cabinet, and as set out in the PWC Addendum (Executive Summary reproduced in this report and full Addendum attached at Appendix 1), the key risks to the delivery of the financial returns in the PCBC are as follows:

i) Customer Acquisition:

To achieve the returns in the PCBC it is estimated that the following customer numbers will need to be achieved over the period:

Period	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10
Customer Numbers	25,061	74,731	110,645	136,148	154,348	176,005
% Addressable Market	3.7%	9.2%	0.4%	0.5%	0.6%	0.7%

The target market (or addressable market) contained within the Business Case is as follows:

- Year 1 - PO and SO postcodes (672,583 properties)
- Year 2 - PO, SO, RG, BN, SP postcodes (816,639 properties)
- Year 3 Onwards - National market (27m properties)

The Sales & Marketing Strategy has been designed to focus (but not exclusively) on a regional market in the first 2 to 3 years before extending activities to the national market.

It is a multi-channel strategy with an emphasis on face to face sales (not to be confused with "Door to Door" sales) but also incorporating digital marketing, events, referrals and telesales. Whilst none of these channels are unique, this face to face focus and combination of sales and marketing channels has been described by both Baringa and PWC as being "somewhat unproven" and "untested" in the Energy sector. It is recognised however, that customers attracted in this way have "a higher lifetime value"

In recognising the risks associated with the Sales and Marketing Strategy, both Baringa and PWC suggested that VESL should also plan and consider as a "Plan B" adapting to more proven sales channels. PWC in particular commented that:

"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"

Now that the PCBC has been revised to accommodate a sales acquisition rate of circa 3 sales per sales agent per day, the increased cost of acquisition referred to by PWC in their advice has been addressed in the financial returns now forecast.

In the Addendum provided by PWC, they now comment that:

"We have gained comfort in the ability of VESL to deliver the increase in target acquisitions from year 2 onwards, particularly given that VESL has revised down its acquisition assumptions to c3.0 sales per agent per day, and given evidence of other suppliers acquiring customers through face to face sales in the absence of significant price competition."

ii) Sustaining Efficient Operating Costs

PWC comment that a key driver of the returns that VESL is forecast to make are derived from being one of the most efficient suppliers in the market place. This reflects a key pillar of VESL's overall Business Case, seeking to set up and implement lean processes and systems.

Achieving such efficient operations on an ongoing basis is a challenge. PWC have commented similarly but have taken some comfort from analysing VESL's cost base and noting that over 60% is contracted and therefore "locked in" with the majority of the remainder being staffing costs which will only be incurred as and when VESL's customers increase and the business needs to scale up.

iii) Governance Arrangements

As described in the previous report to Cabinet of the 10th August, a talented senior management team, an agile business plan, strong governance arrangements and a robust risk management framework are all crucial in ensuring the delivery of the Business Case. Both Baringa and PWC have commented in positive terms on these aspects to the extent that they were covered by their reviews.

The governance arrangements and the options that remain open to the Council to shape those arrangements are described in further detail later in this report.

iv) Managing Financial Exposure

As mentioned, the key measure of financial risk for the Council can be viewed as the Total Investment Value. This is the only measure that comprehensively takes into account all of the following into a single metric:

- VESL Earnings
- Cash flows (and the timing differences between paying for goods and services and the associated billing and receipt of income related to those goods and services e.g. the purchase of wholesale energy and the tariff income subsequently received for supplying that energy to customers)
- The Loan provided by the Council
- All other income streams receivable by the Council
- The Balance Sheet Net Asset Value of the Company
- The Customer Book Value (realisable on sale)

The Total Investment Value to the Council is described in more detail in Section 8 of this report but is summarised below:

Period	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10
Total Investment Value (Key Measure of Risk)	£3.5m	£4.5m	£1.4m	(£5.1m)	(£13.1m)	(£21.7m)	(£62.2m)

Note: Sums in brackets (Years 3 onwards) represent cumulative gains and sums without brackets represent cumulative losses

Important points to note as previously described in this report and the report to Cabinet on the 10th August 2018:

- ❖ The Total Investment (and therefore peak financial exposure) for the Council is estimated to peak at £4.5m in Year 1, exposure falls thereafter and moves into gain from Year 3 onwards as customer numbers and earnings increase
- ❖ The Council have the opportunity to review VESL's performance prior to the commencement of each financial year and determine whether to continue to invest in VESL. This is described as a "stage gate" approach to investment providing the Council with the opportunity to review previous performance, assess the business plan for the forthcoming year and then decide whether to continue to invest, retain or sell the company.

9. Financial Impact of Voluntarily Adopting the Warm Homes Discount in Advance of Reaching the Regulatory Threshold

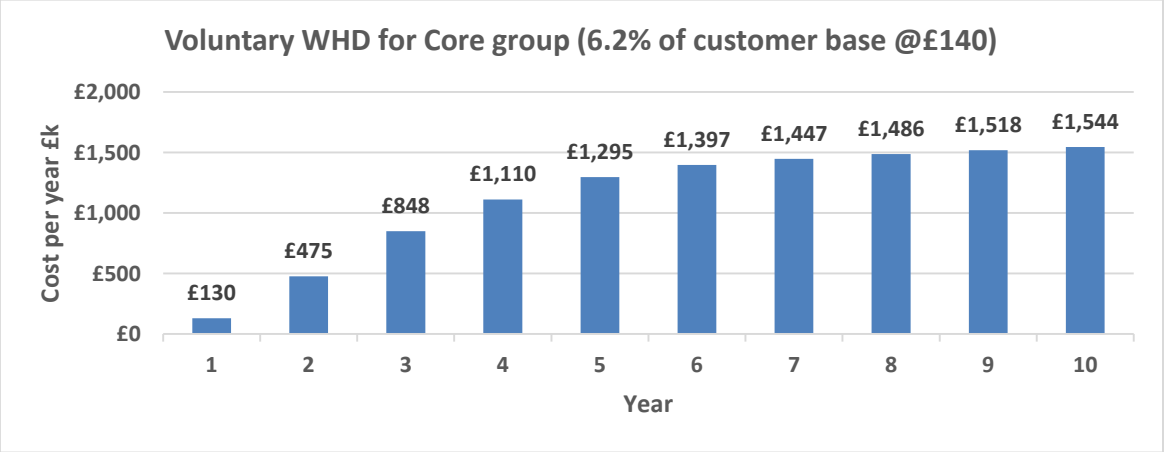
General Background

9.1 The Warm Homes Discount (WHD) is a supplier obligation set annually by Ofgem based on a total amount that they deem should be allocated to the WHD. The current scheme amounts to a "one-off £140 per customer discount to a qualifying persons energy bill.

9.2 VESL is not obligated to become a Warm Home Discount (WHD) provider but can voluntarily opt in to the scheme. For small suppliers, the obligation commences when 250,000 customers has been reached. This threshold will reduce to 150,000 from 2021. It is anticipated that VESL would reach the threshold at the end of year 3 but, as stated, may voluntarily opt in to the scheme at any stage.

Adoption by VESL of WHD - Impact on VESL Financial Returns (excluding Customer Book Value)

9.3 If VESL were to opt to be a WHD provider from Year 1, it is estimated that it would cost the business approximately £1.5m for the first three years to fund the scheme. Assuming that the scheme continues beyond 2020 and it does so in its current structure, in real terms it could amount to a cost of £11.3m over the 10 year period as set out below. Actual amounts will vary depending on scheme design, applicability and customer numbers.



9.4 Since profit margins for VESL amount to circa £25 per customer and the amount of the WHD amounts to circa £140 per customer, the loss of circa £115 per customer represents a cross subsidy which is effectively spread over the rest of the customer base.

9.5 Adoption of the WHD is affordable within the Business Case although it would be wise to consider this in the context of both the Community Investment Fund (which could also be used to meet the social objectives to reduce fuel poverty) and the

overall viability of the Business, at least in the early years before the business has reached scale.

9.6 Described below are the retained earnings from VESL prior to the distribution of funds to the Community Investment Fund alongside the planned costs associated with the Community Investment Fund and the estimated costs of the WHD. This illustrates that:

- Without the WHD and the Community Investment Fund, VESL's retained earnings are £7.9m over the first 5 years (rising to £46.7m over 10 years) - shaded in the table below
- The cost of the WHD over the first 5 years is £3.9m (rising to £11.3m over 10 years) - shaded in the table below
- A balance of £4m would be available to be redistributed between dividends to the Council and the Community Investment Fund over the first 5 years (rising to £35.4m over 10 years) - shaded in the table below
- In addition to the £4m available described above, a further £1.8m will be paid over to the Council from VESL for the repayment of interest on the loan

Option - Total Investment Value - VESL & PCC (incl. WHD and No Community Investment Fund)

Price Cap Base Case (£'m)	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Total Years 1-5	Total Years 6-10	Cumulative Year 1-10
Year End Customer Numbers		25,061	74,731	110,645	136,148	154,348	**154,348**	**176,005**	**176,005**
VESL - Retained Earnings	£3.5	£3.3	£1.1	(£3.1)	(£5.7)	(£7.0)	**(£7.9)**	**(£38.8)**	**(£46.7)**
Voluntary Introduction of Warm Homes Discount		£0.1	£0.5	£0.8	£1.1	£1.3	**£3.9**	**£7.4**	**£11.3**
VESL Retained Earnings (after WHD)	£3.5	£3.4	£1.6	(£2.3)	(£4.6)	(£5.7)	**(£4.1)**	**(£31.4)**	**(£35.4)**
PCC - Repayment of Loan to PCC	£0.0	(£0.3)	(£0.4)	(£0.5)	(£0.4)	(£0.1)	**(£1.8)**	**(£0.0)**	**(£1.8)**
PCC - Reduced Community Fund	£0.0	£0.0	£0.0	£0.0	£0.0	£0.0	**£0.0**	**£0.0**	**£0.0**
Total VESL & PCC Annual Earnings	£3.5	£3.1	£1.2	(£2.8)	(£5.0)	(£5.9)	**(£5.9)**	**(£31.4)**	**(£37.3)**

Notes:

The overall impact on VESL & PCC Earnings is unaffected by the level of contribution to the Community Investment Fund - it has a neutral effect since PCC will receive it via the Community Investment Fund if it is paid; if it is not paid, VESL Retained Earnings will increase by an equivalent amount

Some totals may not add up due to roundings

Adoption by VESL of WHD - Impact on the Revenue Budget over 10 Years

As mentioned, Total Investment Value is different from the impact on the Council's Annual Revenue Budget because both advances of loans, repayments of loans and Customer Book Value is excluded.

Should the Council wish to be a voluntary adopter of the WHD, the impact on the Council's Budget over the 10 year period is set out in the table below. Key points to note are:

- The Council will receive annual budget savings from Year 1 (starting at £0.3m)
- By Year 5, annual budget savings will reach £4.2m as the full investment is repaid and dividends start to be paid to the Council
- The total budget savings over 5 years amount to £5.9m (shaded in the table below) and over 10 years reach £37.3m (shaded in the table below)
- Should the Council elect to make contributions to the Community Investment Fund, this will spread the £5.9m of budget savings more evenly over the first 5 years, with higher savings in the earlier years and lower savings in Year 5.

ANNUAL REVENUE BUDGET IMPLICATIONS - VESL PCBC (Including WHD [incl. in VESL Retained Earnings] and No CIF)

Price Cap Base Case (£'m)	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Total Years 1-5	Total Years 6-10	Cumulative Year 1-10
Dividends from retained earnings						(£4.1)	**(£4.1)**	**(£31.4)**	**(£35.4)**
Community Fund		£0.0	£0.0	£0.0	£0.0	£0.0	**£0.0**	**£0.0**	**£0.0**
Net Interest on Loan Paid from VESL to PCC		(£0.3)	(£0.4)	(£0.5)	(£0.4)	(£0.1)	**(£1.8)**	**(£0.0)**	**(£1.8)**
Total Annual Revenue Cost / (Surplus)		**(£0.3)**	**(£0.4)**	**(£0.5)**	**(£0.4)**	**(£4.2)**	**(£5.9)**	**(£31.4)**	**(£37.3)**

Notes:

The overall impact on VESL & PCC Earnings is unaffected by the level of contribution to the Community Investment Fund - it has a neutral effect since PCC will receive it via the Community Investment Fund if it is paid; if it is not paid, VESL Retained Earnings will increase by an equivalent amount

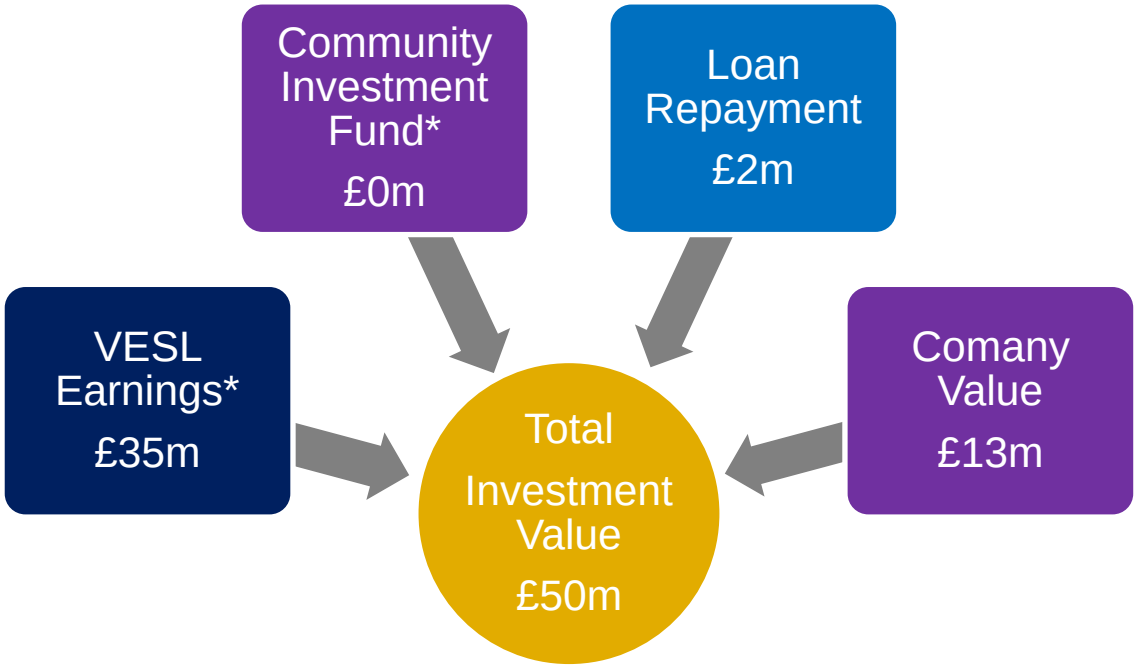
Some totals may not add up due to roundings

Adoption by VESL of WHD - Total Investment Return (including Customer Book Value)

Should the Council wish to be a voluntary adopter of the WHD, taking all income streams due to the Council and the value of the Company together, the Total Investment Value to the Council of VESL is estimated at £50m as set out below.

For illustrative purposes, the Community Investment Fund has been shown at zero however it will be for the Council to decide how much to allocate to the Community Investment Fund from VESL's Retained Earnings. Since any such decision has an equal and opposite effect between Retained Earnings and the Community Investment Fund, the overall impact on the Total Investment Value is neutral.

TOTAL INVESTMENT VALUE AFTER 10 YEARS (Including WHD)



Note: The equivalent total investment value after 5 years is £18m

10. Synergies with the In House Energy Services Team

10.1 VESL's Business Case is focussed on the private sector market providing energy to both the domestic and business sectors. VESL also aims to provide wider energy services such as boiler installations and servicing, solar PV and smart thermostats and connected devices.

10.2 The In House Energy Services team is focused on the Public to Public market, providing project management and advice to other Local Authorities and Public Bodies for schemes such as solar PV installations, LED lighting schemes and general building management systems as well as providing Energy Performance Certificates. The Service has been very successful in attracting Public Sector business and its current strategy seeks to continue along this path.

10.3 Additionally, the team seeks to support the "fuel poor" generally making circa 600 visits per annum to both social and private sector homes based on referrals received from departments of the Council or voluntary sector organisations.

10.4 The In House team also hosts a switching service for which it charges a commission but which has not been actively promoted by the Council.

10.5 VESL and the In House Energy Team are targeting different sectors of the Energy Market and are not in conflict. VESL has been set up with the necessary systems and processes to deal with a large volume of domestic customers including the billing of energy supply, spreading the costs and billing for boilers, solar etc. The In House Energy Services Team does not have the systems and processes to accommodate the provision of similar services to the domestic market.

10.6 Some synergies exist, VESL will be able to refer those customers deemed fuel poor to the In House Energy Services Team. Additionally, VESL will be able to refer any Solar PV installations to the In House team and VESL can arrange any billing requirements through its own systems.

11. Governance

11.1 The overall Governance arrangements are still open for the Council to decide. Documentation containing the following has been drafted but is not finalised:

- Board structure and quantum of Directors (but not appointments)
- Voting arrangements including Reserved Matters (i.e. to shareholders only) and decisions requiring "super majority"
- Delegations for decision making with associated delegations

11.2 VESL also has a suite of Policies which have been approved in readiness for Controlled Market Entry but these policies are able to be amended or new one's introduced (e.g. an ethical policy).

12. New Information Relating to the Risks and Rewards Associated with Entering into a "White Label" Agreement with an Existing Fully Licensed Energy Supplier

Summary Proposition

12.1 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 (based on pence per meter per annum - typically 1% or circa £10 - £15 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.

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:

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

11.2 Since the original report was produced, the Council has further investigated the opportunity of a "White Label" arrangement, to understand the terms under which such an agreement might operate and evaluate the risks and rewards in more detail. Typical terms are described under the headings that follow.

Tariff

All suppliers provide a number of tariffs depending on duration, whether exit fees exist and how a customer wishes to pay. The "White Label" provider provided evidence to illustrate that, over time, they remained in the top 20% of tariffs on the market.

A tariff comparison was recently undertaken on 17th November 2018 for the equivalent of a Dual Fuel Tariff based on a 13 month, fixed rate, monthly direct debit with no exit fee as used in the previous analysis for VESL. The quoted tariff was as follows in comparison to VESL:

Energy Supplier	Annual Cost £
White Label	1,164
VESL	1,107
Additional Cost of White Label	**57**

Social Benefits (incl. WHD)

The "White Label" provider has provided the following information in relation to the Social Benefits of entering into an arrangement with them. This includes:

- Core values centre on tackling fuel poverty

- 100% renewable electricity
- Active engagement with National Energy Action
- £10 contribution to a local fuel bank (emergency top-ups for those in desperate need) for every successful "internal refer a friend"
- Voluntarily opted in for Warm Home Discount payments for the core group.
- Partnerships with groups who offer energy advice and provide practical solutions, along with referral schemes available.
- Working with housing associations and voids to put tenants onto a competitive tariff
- Working alongside social landlords to install Smart meters within properties, to give them the opportunity to become credit customers and cheaper tariffs
- Free 0800 number for anyone to call and ask for advice.
- Sign posting customers to the relevant agencies who can assist customers with energy efficiency
- A specialist team to help with fuel debt who are further trained and supported by Step Change Debt Charity.

Financial Returns

Based on the customer take up forecast by the White Label provider, the Council's experience of voids (which would be transferred to the White Label provider), the commission rates offered and assuming the same level of customer turnover as included in the VESL PCBC, the financial returns to the Council are set out in the table below. Key points to note are:

- There is minimal financial risk to the Council
- The Council will start to receive an income from Year 1
- By Year 5, annual income would be expected to amount to £100,000 per annum and a total of £300,000 will have been earned over the 5 year period
- It is assumed that there will be no additional cost to the use of PCC existing marketing channels and no additional marketing expenditure will be made

Period	Year 1	Year 2	Year 3	Year 4	Year 5
Estimated Annual Commission	£6,200	£41,600	£64,700	£85,000	£102,700
Cumulative Commission	£6,200	£47,800	£112,500	£197,500	£300,200

Risks & Risk Mitigation

There are minimal financial risks to the Council. The main risk to the Council is reputational risk. The Council will have only a minor influence only over the following:

- Tariff - these will be passed through by the White Label provider (past experience demonstrates that these will be in the top 20% of most competitive tariffs)
- Sales and Marketing strategy unless the Council seeks to compliment the activities of the White Label provider at its own cost (but which may improve uptake)
- Customer service and customer journey

13. Disposal of VESL

13.1 Should the Cabinet wish to avoid the financial risk associated with continuing to invest in VESL, it will be either wound up or sold. The cost of both have been further reviewed and updated for the passage of time. The costs would also apply if the Council seeks to enter into a White Label arrangement.

13.2 If VESL is would up, depending on the ability to withdraw from existing contracts, it would be an expected overall cost of between £2.8m to £4.0m

13.3 At this stage, it is not possible to determine a likely value for a sale should it be possible. Taking account of current costs and costs likely to be incurred up to the date of any sale, in total amounting to circa £2.3m, realistically a sale could result in an overall loss to the Council of between £1.7m and 2.3m.

14. Conclusion

14.1 Since the previous report to Cabinet on 10th August 2018, a significant amount of new information is now available in relation to the VESL Business Case which has substantially reduced the financial risk that the Council will be exposed to. Additionally, more information is available relating to the tariff, social impact, synergies with the in house Energy Services Team, governance, alternative models of addressing fuel poverty and the cost of disposal.

14.2 The two independent expert reviews have both concluded that there is a positive business case for continuing the Council's investment into Victory Energy Supply Limited (VESL) but, as with any commercial opportunity, it is not without risk. The latest review by PWC concluded that:

"In our view, the PCBC, provides a reasonable representation of the key risks and results in the supply business continuing to be profitable over the first five years of operation"

14.3 The key measure of financial risk and reward is the estimated "Total Investment Value". That demonstrates the financial risk in the early years with the expected reward realised in the later years. The Total Investment Value based on the PCBC illustrates the following:

- Year 10 Investment Return (excl. WHD) - £63m (previously estimated at £50m)
- Year 5 Investment Return (excl. WHD) - £22m (previously estimated at £2.5m)
- Peak Investment (risk) - Year 2 at £4.5m (previously estimated at £6.5m)

14.4 A tariff model for VESL has now been established that confirms its position as cheaper than equivalent tariffs by all of the Big 6 and within the top 20 comparable tariffs on the market. It is also a cheaper tariff than the White Label supplier.

14.5 The additional cost of the WHD is also now available and is expected to cost £3.9m over 5 years and £11.3m over 10 years. It is now clear that providing the WHD to customers is affordable within the VESL PCBC.

14.6 It is expected that there will be synergies between VESL and the In House Energy Services Team rather than conflicts and the Council will be able to provide a more holistic offer in relation to Energy Services across both public and private markets to residents and businesses.

14.7 A high level Social Impact Assessment has been undertaken and demonstrates that positive impact will be strongest in relation to:

- Reduced energy bills
- Provision of the Community Investment Fund
- Local employment

14.8 Overall governance arrangements are still to be formalised and it is open to the Council to consider the most appropriate Board structure, voting and decision making arrangements alongside new or amended company policies (if required) to provide enhanced safeguards to the interests of customers.

14.9 Adopting a lower risk option and choosing to enter into a White Label arrangement would result in the following:

- ❖ Minimal financial risk
- ❖ Lower cost energy to residents than at present (although higher cost than VESL)
- ❖ Estimated total financial returns of £0.3m over the first 5 years
- ❖ Cost of VESL disposal of between £1.7m and £4.0m

14.10 Should the level of financial risk be acceptable to the Cabinet, continued investment into VESL is expected to provide a long term income stream to the Council, being aligned with the recently approved Income Generation Strategy of the Council and supporting the overall aim protecting and sustaining valuable public services into the future.

15. Equality impact assessment

15.1 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.

16. Legal implications

16.1 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.

16.2 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.

16.3 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.

16.4 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 manged effectively by the Council.

17. Director of Finance's comments

17.1 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 - Victory Energy Supply Limited - Addendum to Final Business Case Review (July 2018)
Appendix 2 - Victory Energy Supply Limited - Expert Review of Business Case (10 August 2018)
Appendix 4 - Social Impact Assessment

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
01 Voluntary WHD impact.xlsx	W: Drive/HFS/100 Corp
Copy of Model - 301018 - Rebaseline Base Case - 10 Year - Scenario 2.xlsx	W: Drive/HFS/100 Corp
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:

APPENDIX 1

Strategy& - EUR

Victory Energy Supply Limited

Addendum to final business case review (July 2018)

15 November 2018

Final report

pwc

Important message to unauthorised readers

This report was prepared for Portsmouth City Council (PCC) under the terms of our engagement letter of 11/06/2018. Only PCC and its affiliates are to have access to this note.

Should any unauthorised person obtain access to and read this report, by reading this report such person accepts and agrees to the following terms:

1. The reader of this report understands that the work performed by PricewaterhouseCoopers LLP was performed in accordance with instructions provided by PCC and was performed exclusively for PCC.
2. The reader of this report acknowledges that this report was prepared at the direction of PCC and may not include all procedures deemed necessary for the purposes of the reader.
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Background

The PwC report on the review of the final business case, dated 31 July 2018, flagged the exposure of the revised business case (RBC) to regulatory changes and the impact on key performance indicators on which the supply business was assessed. Most notably, the RBC did not consider the introduction of a default tariff cap on Standard Variable Tariff (SVT) customers, which was originally announced by government in October 2017. We note however that VESL Management had considered various alternative revenue and cost scenarios in previous iterations of Business Cases.

To assess the potential impact that the introduction of the price cap could have on the RBC, we ran a number of sensitivities in which we tested the impact on key performance indicators (KPIs) of changes in Customer acquisitions, SVT tariff levels, and Fixed tariff levels. Together with our assessment of the RBC, the downside scenario informed the decision made by the PCC Cabinet to not proceed with its investment in Victory Energy Supply Limited (VESL).

In the absence of the default tariff cap level, the sensitivities were based on PwC estimates and the assumption of a £100 discount in VESL's SVT, as was consistent with government announcements. Ofgem published the initial level of the default tariff cap on 06 September 2018, and indicated that the level of the cap for a typical dual fuel customer paying by direct debit from January 2019 would be £1,136 and deliver a saving of around £75 per dual fuel customer.

In September 2018, the decision to cease supporting VESL was called in, and upheld by the PCC Scrutiny Panel on the grounds that the decision was made on the basis of inadequate information. PCC subsequently requested that PwC provide additional analysis on the impact of the price cap and also review the updated Price Cap Business Case (PCBC) produced by VESL, which takes account of the Ofgem default tariff announcement, the PwC downside scenarios and comments made in our July 2018 report.

What we have reviewed

Due to the limited timescales for the review, we have agreed with PCC to perform a high level review of the impact of the price cap on the revised Price Cap Business Case (PCBC) financial model and also the additional financial impact analysis undertaken by VESL outside of the main financial model. In particular, we have focused our assessment on the following:

- Review of VESL's PCBC financial model, which considers the impact on the RBC of; the Ofgem published default tariff price cap, the impact of halving acquisition rates in year 1, and a reduction in the acquisition rates of sales agents from c.6.0 sales per agent per day to c.3.0.
- Financial performance of the supply business over the first five years of operation, where the impact of the SVT price cap is most felt, and where we can make direct comparison to the RBC, on which the decision not to proceed was made. While we recognise that VESL have provided an updated model, we note that years 6 to 10 are not affected by the cap and in effect are derived by extrapolating year 5 financials.
- Assessment of VESL's SVT cost base and revenue assumptions against the default tariff construct, how they compare and where VESL generates its margins on SVT tariffs. In our view, the default tariff provides a publicly available benchmark for assessing VESL's costs, which reflects detailed analysis of suppliers' wholesale, network and policy costs, as well as the costs associated with a relatively efficient steady-state energy supplier. We accept that the operating model of smaller independent suppliers such as VESL, has some specific features which need to be considered when benchmarking VESL's operating costs. NB. We derived VESL's costs stack using top down analysis of the PCBC income statement.
- Indirect impact of the price cap on fixed tariffs and overall financial performance of the supply business.

Our review has not focused on the following:

- Assessment of those areas that have not changed in the PCBC from the RBC and which were reviewed in our July 2018 report. These include, customer acquisition costs, and cost to serve.
- Assessment of the target operating model or governance of the supply business.

Executive Summary

Our July 2018 report noted that VESL's business plan is subject to a number of downside risks, which management have captured in the PCBC. These include; the impact of the price cap, lower year one customer acquisitions and lower acquisition rates. In our view, the PCBC, provides a reasonable representation of the key risks and results in the supply business continuing to be profitable over the first five years of operation.

Employing a flexible target operating model is essential to VESL delivering a low cost operating base, navigating uncertainty within the market, and delivering the PCBC. VESL have put in place an experienced management team, who have focussed on flexibility and governance in the set-up of the business. In addition, PCC have sought comfort from a separate review of the operating model conducted by Baringa between September 2017 and October 2017. We have not reviewed VESL's operating model as part of our review, therefore PCC should reconfirm that Baringa's review gives them sufficient confidence in the ability of management to deliver the plan.

Further to our view above, we make the following observations:

- *VESL's revised business case incorporates feedback made in our July 2018 report and reflects; the impact the default tariff cap, updated costs of sales and operating costs, a reduction in acquisition rates (sales per agent per day) and subsequent increase in sales resource, removal of the contingency on the basis that cash flows have been risk-adjusted, and revised smart meter roll-out assumptions based on management's latest view of market conditions.*
- *While our review has focussed on the first 5 years, where the price cap is in place, we note that the business plan has been extended out to 10 years and captures the value of cash flows beyond the initial 5 year period – VESL forecasts cumulative retained earnings of £33.9m by year 10. The approach taken by VESL to extrapolate cash flows is reasonable and the PCBC now fully reflects the value contribution of the supply business over a 10 year horizon, which we consider an appropriate period.*
- *VESL's financial performance in the PCBC has been revised downwards due to the price cap and increased acquisition costs. Cumulative retained earnings over the first five years have fallen by £1.7m to £3.1m, reflecting a fall in overall net margins – year 5 net margins have fallen from 5.1% to 4.5%.*
- *Even after factoring in the impact of the cap, VESL is able to achieve higher margins, than the implied margin in the default tariff cap (2.8%). Higher relative margins are explained by a number of factors:*
  - *VESL not incurring, but being able to recover full policy costs through the tariff, in line with a fully obligated supplier – The PCBC assumes that VESL will be partially obligated under the Energy Company Obligation (ECO). Whether VESL voluntarily participates in the Warm Home Discount (WHD) scheme, is a decision for the Council.*
  - *VESL's ability to outperform Ofgem's operating cost benchmarks based on the Big 6 and four medium sized suppliers, in effect becoming one of the most efficient suppliers within three years.*
  - *A reduction in the fixed tariff discount to SVTs – As a result of higher modelled costs, the price differential between fixed tariffs and SVTs reduces from £100 in the RBC to around £20 to £30 in the PCBC.*
- *We are comfortable that VESL is able to realise some margin benefit through policy costs, given that it will not be fully obligated during the first years of operation for ECO, and will not incur WHD costs.*
- *The ability of VESL to consistently outperform Ofgem's operating cost benchmark and become one of the most efficient suppliers within three years, is a key driver of margin. While it is possible for VESL to have a higher cost base and earn a positive return, the business would be unlikely to consistently earn an EBIT* margin in excess of 2.8% in these circumstances. If the cost base is not adequately managed, it is also possible that VESL could make a loss.*
- *We have gained some comfort in VESL's ability to operate competitively through analysis of their cost base, which is to a large extent (>60%) contracted or dependent on customer numbers. However, we note that consistently delivering operating costs 10% below the default tariff cap, and in line with the most efficient suppliers, will be challenging.*
- *We have gained comfort in the ability of VESL to deliver the increase in target acquisitions from year 2 onwards, particularly given that VESL has revised down its acquisition assumptions to c3.0 sales per agent per day, and given evidence of other suppliers acquiring customers through face to face sales in the absence of significant price competition.*
- *We note that there is still a risk to financial performance of lower acquisitions or margin in response to the lower price differential between fixed tariffs and SVTs – this is a market-wide risk.*

*EBIT is a standard measures of underlying earnings but before interest and taxation.

Key financial metrics

Following the publication of the default tariff price cap, VESL management have updated the revised business case financial model to reflect:

- The impact of the default tariff price cap, from January 2019 (year 1), on SVT revenues.
- Changes to cost assumptions, including updated wholesale costs in line with commodity trends and contracted operating costs.
- Risks identified in the July 2018 PwC report, including; halving of customer acquisition rates in year 1, the impact of lower acquisition rates (to c.3.0 sales per agent) and an increase in sales agents[1].
- Extension of the model beyond year 5, to 10 years. Cash flows from years 6 to 10 are based on extrapolating year 5 cash flows, which in our view is not an unreasonable approach, given uncertainty beyond year 5.

Given that our initial assessment was based on controlled market entry and the first five years of operation, we have focused primarily on these years. Table 1 summarises the key financial metrics from the price cap business case, and Table 2 summarises the change in these metrics from the RBC.

NB. We refer to the updated business case as the Price cap business case (PCBC).

Table 1: Financial indicators - Price cap business case (PCBC)

PwC adjusted metrics	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1-5	Years 6-10[2]
Customers on supply	0	25,061	74,731	110,645	136,148	154,348	154,348	176,005
Net margin before tax (£m)	-3.52	-3.76	-2.22	2.05	4.59	6.69	3.84	42.39
Net Profit margin (%)		-24.9%	-4.0%	2.1%	3.6%	4.5%	4.5%	5.0%
Retained earnings (£m)	-3.52	-3.76	-2.22	2.05	4.59	5.93	3.07	33.91
Maximum cash contribution (£m)	-	-	-	-	-	-	-9.50	-
IRR (%)	-	-	-	-	-	-	33.7%	35.0%

Source: VESL price cap business case

Table 2: Financial indicators – Comparison of price cap business case against revised business case

PwC adjusted metrics	Pre-Live	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1-5	Years 6-10
Customers on supply	0	-25,061	-11,908	-1,936	5,025	9,882	9,882	-
Net margin before tax (£m)	-0.02	0.10	-1.48	-0.49	0.02	-0.20	-2.07	-
Net Profit margin (pp)	0.0pp	-10.8pp	-2.9pp	-0.5pp	-0.3pp	-0.7pp	-0.7pp	-
Retained earnings (£m)	-0.02	0.10	-1.48	-0.49	0.02	0.22	-1.66	-
Maximum cash contribution (£m)	-	-	-	-	-	-	-1.40	-
IRR (pp)	-	-	-	-	-	-	-1.6pp	-

Source: VESL price cap business case & revised business case, PwC analysis
Notes: (1) Negative number indicates a reduction from the RBC, positive number indicates an increase on the RBC. (2) IRRs calculated based on monthly cash flows and incorporate all pre-live cash flows. IRR for years 6-10 reflects 10yr IRR. IRRs include residual cash flows beyond stated period e.g. 5 year IRRs are calculated based on cash flows from years 0 to 5, as well revenues is the first 5 months of year 6.
(3) pp – Percentage Points.

[1] We agreed with management that it would be reasonable to remove contingency from the model, as cash flows have been risk adjusted. [2] Our assessment has not focussed on performance from years 6-10 on the basis that we were asked to specifically assess the impact of the price cap, which we recognise to impact only the first 5 years of operation.

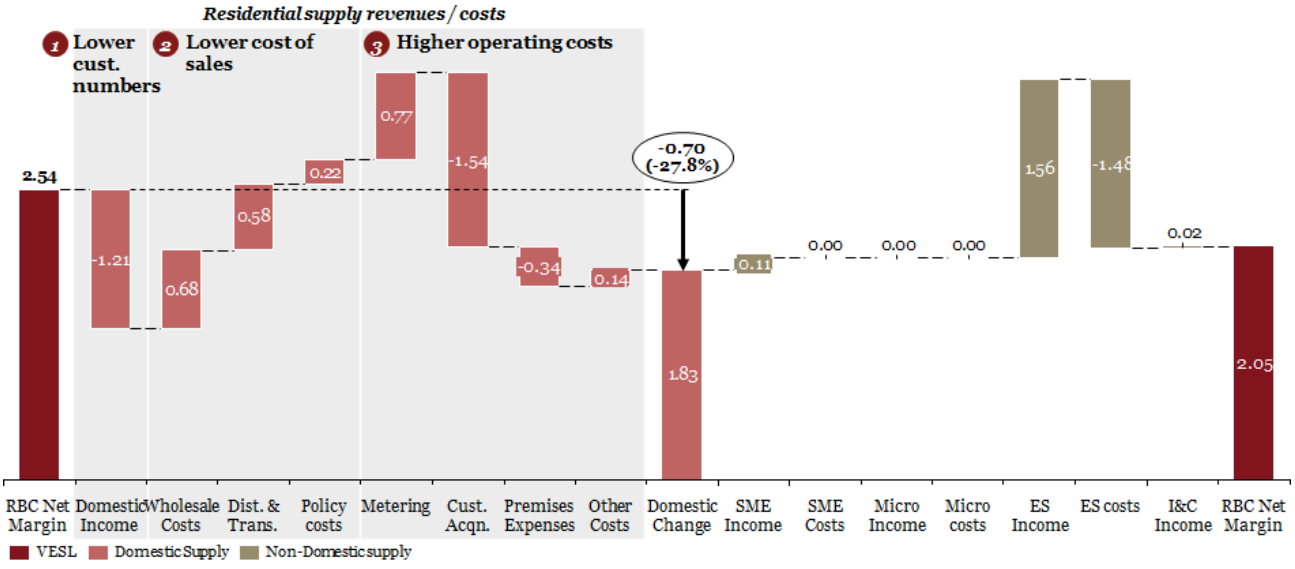
Change in financial performance from RBC to PCBC

Given the updates made to the financial model, we have analysed the key drivers of the change in margin from the RBC to the PCBC. Figure 1 illustrates how net margin before tax (£m) changes from the RBC to the PCBC for year 3. We have chosen year 3 on the basis that this is the point at which VESL's operating cost base realises the benefits of scale.

Our analysis indicates that the update of the financial model results in a £0.5m reduction in reported net margin from £2.54m in the RBC to £2.05m in the PCBC, with the majority of this reduction being driven by changes in the residential supply business forecasts (Figure 1). The £0.7m reduction in residential supply net margin is explained by the following:

1. **Lower customer numbers**: The PCBC now reflects our original view of lower sales in year 1 and therefore a cumulative reduction in total customer numbers to year 3 (from 112.6k to 110.6k). The reduction in customer numbers leads to a £1.2m reduction in energy sales relative to the RBC.
2. **Lower cost of sales**: The reduction in wholesale income is offset by the associated reduction in costs of sales. In addition to this, VESL realises some margin benefit as a result of changes in its cost assumptions.
3. **Higher operating costs**: Despite there being fewer customers on supply in year 3, VESL's operating cost base is forecast to increase. Metering costs are lower as a result of there being fewer customers on supply and VESL revising down its SMART meter roll-out assumptions across its customer base in response to market conditions and a delay in the roll-out smart meters. However, the reduction in these costs, as well as other operating costs, are more than offset by the increase in customer acquisition costs. The increase in acquisition costs is explained by lower acquisition rates for sales agents and a higher number of annual acquisitions (from 54k in RBC to 66k in PCBC) from year 2, to offset acquisition levels in year 1 halving.

Figure 1: Bridged gap between RBC and PCBC net margin for year 3 (£m)



Source: VESL RBC & PCBC, PwC analysis

Primary observations

Our review of the RBC and the supporting financial model identified three main areas where we have comments. These are: Financial performance under the price cap, Operating costs and Customer acquisitions. We summarise the key points below:

Financial performance under the price cap

Although VESL's financial KPIs have been revised downwards as a result of the introduction of the price cap, achieved net margins are above Ofgem's default tariff cap construct based on the average cost base of the Big 6 and the four next largest suppliers.

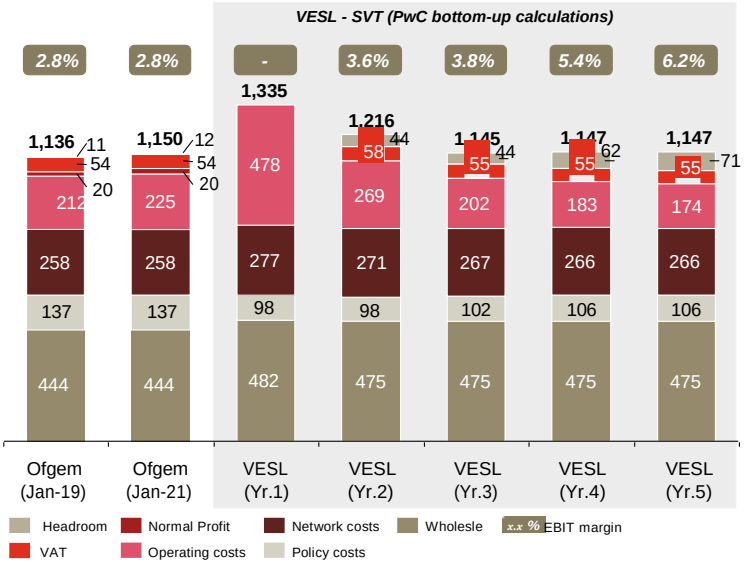
The relative impact of the price cap is lower than the estimates in our July report; that is, rather than delivering a £100 reduction in SVTs relative to the average Big 6 Tariff the default tariff will deliver an estimated £75 reduction on the average SVT tariff across the Big 6 and four next largest energy suppliers (Jan-17 prices)[3]. VESL management have updated their model to account for the latest costs as at Aug-18 and changes in tariffs (both fixed and SVT). VESL has brought its SVT in line with the default tariff annual bill of £1,136 including VAT (Jan-19), by applying a premium over its standard fixed tariff[4].

As a result of the changes, management forecast cumulative retained earnings of £3.1m from years 1 to 5, representing a £1.7m reduction over the RBC. The reduction is largely a result of an overall reduction in net margin over the period – net margin in year 5 falls from 5.1% to 4.5%. This in turn explains why overall retained earnings in year 5 fall, despite an increase in the number of customers on supply. The reduction in margin is driven by a number of factors, including an increase in wholesale, network and policy costs, as well as an increase in customer acquisition costs, reflecting the lower acquisition rate of sales agents in the model. The overall impact on retained earnings resulting directly from the reduction in SVT revenues is relatively small given that only a small proportion of VESL's customers are on, or will be rolled onto SVTs – by year 5 only 23.8k of VESL's 265.8k accounts are on SVT.

Despite falling in the PCBC, net margins of up to 4.5% in the first five years are higher than Ofgem's modelled margin of 2.8% for in the default tariff[5]. We note that the cap directly applies to only a small proportion of VESL's customers, but given that fixed tariffs will be offered at a discount to SVTs, the default tariff cap impacts the achievable margin on all customers, which has been modelled into the PCBC. Furthermore, this indicates that VESL will consistently achieve EBIT margins in excess of 2.8% on its SVT customer base, as illustrated in Figure 2, which compares Ofgem's tariff cap stack for a dual fuel customer with the equivalent SVT stack for VESL calculated from our top down analysis of the Income Statement in the PCBC financial model.

[3] Ofgem press release, 06.09.2018.
[4] The model assumes a premium of 1.6% on the average fixed tariff of £1,107 for SVT customers. Additional ECO costs recovered by VESL are not included in the original fixed tariff of £1,107 but are included separately within the total revenue line in the income statement.
[5] The cap will be reviewed annually from 2021 and depending on the outcome of the reviews, could extend to the end of 2023.

Figure 2: Comparison of PwC calculated, VESL PCBC SVT cost stacks with Ofgem default tariff cost stack



Source: Ofgem, VESL price cap business case, PwC analysis
Notes: (1) VESL bottom up view calculated from reported P&L revenue and costs, total demand in period and average number of customers on supply by fuel. Calculations have been normalised for customer growth. Wholesale, Network and policy costs calculated on a £/MWh basis and waited for TDCVs used in Ofgem consultation. Operating costs calculated based on average cost per dual fuel customer. (2) All stated assuming TDCVs of 3,100kWh/a for electricity and 12,000kWh/a for gas. (3) Ofgem default tariff cap operating costs include payment uplift of £213 (4) Ofgem Jan-21 default cap operating costs have been indexed in line with VESL stated CPI of 3% – operating costs should be indexed in line with CPIH but we assume that in practice there will be no difference in the indexation of these numbers. (5) VESL operating costs include, metering, acquisition, core supply business operations, CIS software, Utiligroup costs, Bad debt, Cash flow financing costs and contingency. (6) Separate 'revenue' allowance for ECO costs has been made in line with VESL modelling approach.

We recognise Ofgem's intention for the cap to not affect the ability of new entrants, particularly those with 'wider' strategies (i.e. offering services outside of energy supply), which is VESL's plan, and the ability of suppliers that aren't fully obligated, to earn margins in excess of the modelled cap level – as in the case of VESL in years 1 and 2[6]. However, given the nature of the tariff construct, which is based on an efficient steady-state supplier and provides allowances for 'normal profit' and a 'headroom', our view is that it would be challenging for suppliers to significantly outperform the cap, unless they have a materially lower operating cost base than used by Ofgem in setting the cap (see below).

Operating costs

The PCBC assumes that VESL will outperform Ofgem's operating costs benchmark and become one of the most efficient suppliers within three years. Our view is that consistently delivering operating costs below the default tariff cap will be challenging and will depend on the ability of management to deliver the target operating model, which we have not reviewed. PCC should therefore reconfirm that Baringa's assessment gives them sufficient confidence in management's ability to deliver the plan.

As noted above, VESL's forecast EBIT margins are higher than the 2.8%[7] margin determined in the price cap. Accounting for any benefit VESL receives for not being fully obligated for all policy costs, analysis of the costs stacks in Figure 2 indicates that operating costs are a key source of margin outperformance for VESL and in part explains VESL's reported margin being above the level in the default tariff cap.

The benchmark is equivalent to operating cost of 'frontier' supplier (i.e. the average of the two lowest cost suppliers in Ofgem's analysis) plus a 15% cost allowance. In particular, we note that from year 3, when the business has scaled up, operating costs are £23 below the Ofgem default tariff cap benchmark, which has been

[6] Some suppliers, including VESL, benefit from not being fully obligated for a number of policy costs, including Energy Company Obligation (ECO) and Warm Home Discount (WHD). As a result of VESL not being obligated for these schemes, its annual policy costs are only £98 vs
£137 for a fully obligated supplier, in the default cap. This £39 saving per customer delivers a c. 3.4% EBIT margin benefit when pricing at the cap of £1,136 as VESL is able to fully recover costs through the supply that it doesn't incur.
[7] Calculated based on 1.9% normal margin and 1.45% headroom. 2.8% is calculated based on the annual bill of £1,136 (inc VAT) for a customer with typical domestic consumption values (TDCV).

calculated by Ofgem doing detailed analysis of existing suppliers' operating cost bases. This would place VESL among the most efficient suppliers in the sector.

We recognise management's view that the benchmarks used by Ofgem are based only on a small sample of suppliers and that it is possible that some suppliers not included within the assessment may have lower operating bases. However, we view Ofgem's benchmark as a relevant and available benchmark, as the suppliers used to inform the analysis have been able to achieve scale and demonstrate sustainable business models.

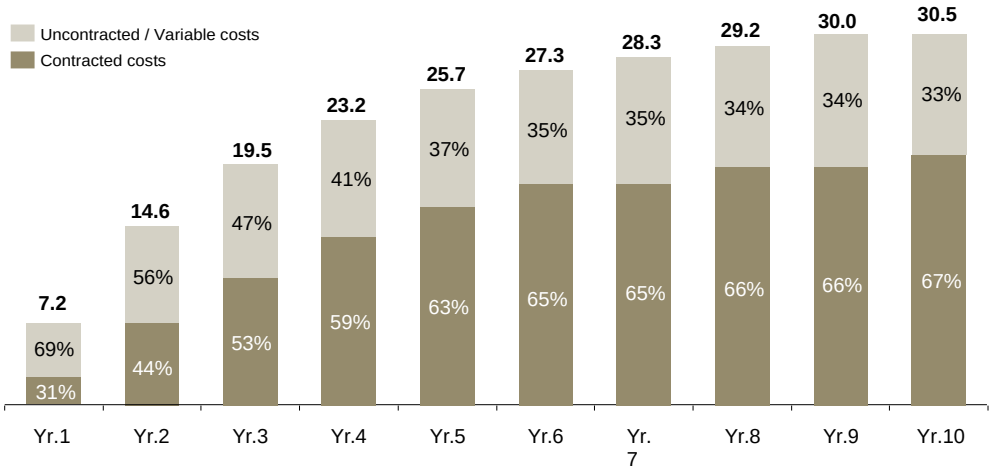
Management's view of their operating cost base is that the supply business is built on an 'efficient model' and assumes that VESL would look to become one of the most efficient suppliers. This is based on some of the features of the operating model, including:

- Portsmouth Council's facilities and cost base;
- PCC's backing to negotiate down contracts;
- Access to lower costs financing through the council; and
- Developing a local proposition delivered using a local workforce.

We have not tested the operating model but Baringa has separately reviewed the operating model and governance structure and found it to be reasonable.

Furthermore, management indicated that the costs in the model were reasonable on the basis that a large proportion of costs had been formally agreed with suppliers. To gain comfort in VESL's operating cost assumptions, we assessed that proportion of operating costs (i.e. total costs excluding, wholesale, network and policy costs) that management confirmed as being contracted. Our analysis is summarised in Figure 3 below.

Figure 3: Breakdown of VESL's domestic cost base by contracted and uncontracted/variable items (£m):



Source: VESL, PwC analysis
Notes. (1) Contracted costs include; metering, premises and Office expenses, IT infrastructure and provision, other infrastructure costs, market costs (Elexon etc.), general and other costs, CIS software, and Utiligroup software and managed services, (2) Uncontracted or variable costs include; Customer acquisition, people, proposition, bad debt, cash flow financing, and contingency.

Based on the analysis, we note that in year 3 just over half of VESL's operating costs are secured but by year 5, this increases to nearly two-thirds. We note also that labour costs, which are a function of customer numbers, account for 30% to 40% of uncontracted or variable costs and that local salaries have been benchmarked by VESL. While this gives us greater comfort in the ability of VESL to achieve its cost benchmarks, we still note that there is a degree of uncertainty and that the overall efficiency of the business can only be determined once VESL has operated for more than a year.

VESL indicated that lean operations could be a source of competitive advantage, however the business will need to consistently deliver a service in line, or lower than the most efficient suppliers assessed by Ofgem to deliver the PCBC. While it is possible for VESL to have a higher cost base than the most efficient suppliers and earn a positive return, the business would be unlikely to consistently earn an EBIT margin in excess of 2.8% in these circumstances. If the cost base is not adequately managed, it is also possible that VESL could make a loss.

Any decision to proceed with the investment should consider the ability of the management team to consistently deliver this level of service. Our initial assessment did not include review of the target operating

model, management's capabilities or governance structure – we understand that this was reviewed separately by Baringa. As such, we have not commented on this.

Ability to acquire customers

Sales agent acquisition rates used by management are reasonable and in line with our July 2018 report. In addition to evidence of other suppliers acquiring customers with similar business models, this gives us greater comfort in VESL's ability to acquire customers in a price cap environment. However we note that there is a risk that the reduction in fixed tariff discount could affect market switching and the level of acquisition and/or margin. It is difficult to quantify this impact as sales conversion will be a function of factors other than price, such as quality of sales agents, VESL brand, perception of local benefits etc.

In response to the analysis set out in our July 2018 report, which questioned the ability of VESL to deliver the level of face to face sales based on its assumed conversion rate of c.6 sales per gent per day, VESL management has revised customer acquisition assumption in the PCBC. VESL management now assume a sales conversion of around 3 sales per agent per day and have updated costs in the model accordingly.

We have reviewed the updated assumptions in the business model and are more comfortable that this more closely reflects other benchmarks we have seen in the market, particularly where there is limited price differentiation in the products being sold by those suppliers.

Further to our initial analysis, we have also considered the impact of the price cap on acquisition rates, particularly in view of the potential impact a reduction in fixed tariff discount to SVTs has on VESL acquisition levels.

Comparison of VESL's tariffs under the price cap scenario indicates that its fixed tariff of £1,107 (inc VAT) will be priced at a discount of £29 to the SVT cap of £1,136. Under the RBC and in a pre-price cap scenario, the differential between VESL's fixed tariff (£1,044) and its SVT (£1,149) was £105. The reduction in the differential is in part explained by the reduction in the SVT to align to the Jan-19 default tariff cap and the increase in cost base in particular, wholesale costs, which results in the fixed tariff increasing.

Management indicated that customer acquisitions will be largely delivered through face to face sales and will be features led. That is, VESL will initially focus on selling a local proposition to customers through face to face sales. Although there is limited evidence of the impact on sales of a lower price differential, we note that there is evidence in the prepayment market of other suppliers growing their customer base through face to face sales and where there is limited price differential.

We take some comfort in VESL management having reduced its acquisition conversion rates. However, we note that the reduction in price differential may pose a risk to the business plan, given that evidence indicates that the propensity of customers to switch is greater when they are able to save in excess of £50 for doing so.

General Observations

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

Inclusion of report feedback

VESL Management have made a number of amendments to the financial model to incorporate feedback from our original report and improve the robustness of the PCBC from the RBC presented in August 2018.

Our July 2018 report made a number of observations in respect of the RBC and identified a number of areas where the model could be improved. These included viewing the business plan on a period of greater than 5 years given that nature of supply business models. Furthermore, our report indicated a number of sensitivities following reservations in respect of acquisition rates and customer growth.

VESL management have taken on board feedback in our report and in response to the two scenarios we originally presented, produced a model that incorporates the impact of the price cap on SVT revenues, and the impact of slower growth and higher acquisition costs.

Management have also revised a number of assumptions; operating costs are now indexed (core contracts by CPI at 3% and employee costs by 2%), bringing VESL's approach in line with the default price cap proposals; the smart metering profile has been amended; customer acquisition rates have been reduced to around 3 sales per agent per day; and the level of annual contingency has been reduced to reflect the inclusion of these risk factors – this is consistent with the approach we applied in our sensitivities in our July 2018 report.

Inclusion of these amendments should bring the model more in line with the default tariff cap market environment. Furthermore, we note that by extending the model out to 10 years, the PCBC now fully reflects the value of an energy supply business.

Policy costs

VESL management have revised their policy costs assumptions to account for changes in the Energy Company Obligation (ECO) mechanism but policy costs remain a source of margin for VESL, particularly as the PCBC assumes no Warm Home Discount (WHD) payments

The RBC presented in August assumed that VESL would not be obligated under ECO or WHD as it was not forecast to reach 250k customers within the first five years of operation, i.e. the customer threshold above which, suppliers become obligated under the two schemes. Publication of the ECO3 consultation response in July 2018 will result in the ECO customer thresholds being reduced under their current levels to 200k from Apr-19 and to 150k from April 2020[8] – Years 2 and 3, respectively in the PCBC.

In response to the announcement, management have updated the model to reflect these assumptions, and expect VESL to become partially obligated under ECO in year 3. While we have not reviewed the level of VESL's ECO costs, we agree with management's decision to reflect ECO costs in the business plan.

As VESL is only partially obligated under ECO, VESL is able to realise some margin benefit, particularly as the business is able to recover the full scheme costs through the default tariff cap despite not incurring costs in line with a fully obligated supplier. The PCBC also indicates that VESL would benefit from not incurring WHD costs but being able to recover costs through its tariffs. Based on Ofgem estimates, the WHD is expected to deliver in the region of £13.40 EBIT benefit per customer[9] to VESL, equivalent to 1.2% EBIT margin.

NB. VESL management have indicated that PCC would be responsible for making any decision to voluntarily participate in the WHD scheme. We note that any decision to participate could potentially result in a loss of margin, particularly if VESL were not to increase its fixed tariffs accordingly.

[8] The Government Response to the ECO3, 2018 to 2022 Consultation, BEIS, July 2018
[9] Default Tariff Cap: Policy Consultation, Appendix 7 - Policy and network costs, Ofgem, June 2018

Appendix 1: Default tariff cap characteristics and differences from RBC assumed cap

Sensitivity analysis in the July 2018 report assumed that the default tariff cap would result in a £100 reduction in VESL's SVT direct debit (DD) tariff – this was consistent with announcements made by government indicating that the cap would on average save dual fuel customers £100 a year. Further to this, our analysis assumed a £50 reduction in VESL's Fixed DD tariff on the basis that in order to win SVT customers and deliver acquisition targets, VESL would have to set its Fixed DD tariff at least £50 below the level of the cap.

Ofgem published the initial level of the default tariff cap on 06 September 2018, and indicated that the level of the cap for a typical dual fuel customer paying by direct debit from January 2019 would be £1,136 and deliver a saving of around £75 per dual fuel customer.

Ofgem's cap is based on a detailed bottom-up assessment. We have highlighted a number of the key characteristics of the cap below:

- Ofgem has calculated the price cap using a bottom-up approach, calculating each cost stack element separately to determine an annual bill amount for the typical user[10]. For each component of the cost stack, Ofgem proposes to provide an allowance for efficient costs, ensuring that customers' bills reflect the underlying efficient cost of supply.
- The SVT cap has been calculated using a 2017 baseline and analysis of suppliers' costs in 2017. In addition to the baseline, Ofgem published a January 2019 cap level (£1,136 for a SVT direct debit customer) setting out the cap level when it comes into force. The January 2019 level reflects changes in wholesale market prices and other cost items.
- The cap will be set with reference to the third lowest operating cost per customer amongst ten representative large and medium suppliers that it analysed, with an additional (£5 per dual fuel account) efficiency factor to sharpen their incentives to reduce their average costs. This results in the operating cost allowance being 15% higher than it would be, if based on Ofgem's frontier supplier.
- The cap level is set based on the assessment of efficient costs and the normal (EBIT) profit level (1.9%) that Ofgem considers an efficient supplier would require to be able to finance its activities on that basis. In addition, a "headroom" allowance of 1.45% would be provided to help suppliers manage additional costs of uncertainty. This allows a supplier to earn a 2.8% EBIT margin on a dual fuel customer with typical annual consumption.

Based on the proposals, Ofgem estimates that the average annual saving for a dual fuel customer with typical electricity and gas consumption under the cap would be around £75, £25 lower than the £100 annual saving originally announced by government. Ofgem expect that the cap will still allow room for competition, both through the provision of headroom and for smaller suppliers who have some cost advantages e.g. through policy cost avoidance.

[10] A dual fuel customer with an annual electricity consumption of 3,100kWh and gas consumption of 12,000kWh.

Portsmouth CITY COUNCIL

APPENDIX 2

Title of meeting:	Cabinet
Date of meeting:	10th 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 required[6] 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

[6] As set out in the Victory Energy Revised Business Case (Base Case)

year. 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"[7] (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 prudency
- 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

[7] 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.

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 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 prudency 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 share[8].

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 suppliers[9]);
- A significant interest nationally from local authorities seeking to enter the market as Municipal Energy suppliers (usually on a "White Label" basis).

[8] Source: OFGEM- State of the Market Report 2017
[9] 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"[10] 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.

[10] 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 Entry[11] and Full Market Entry[12]) 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 been developed with an appropriate level of due diligence which would be expected of a commercial investor; (ii) is based on reasonable assumptions;*

[11] Controlled 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

[12] 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.

(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 IRR[13], 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

[13] 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.

Portsmouth CITY COUNCIL

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.

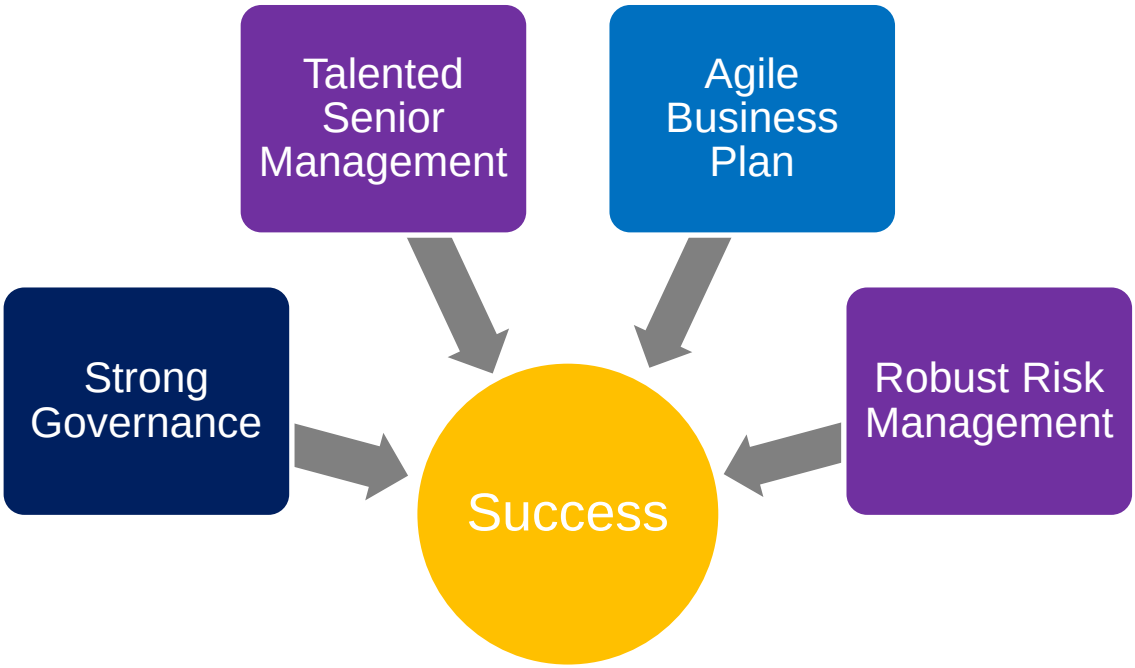
- Lower energy costs to residents
- 100% renewable energy to residents and business
- Base Case total investment return (5 Years) £24.3m
- Downside Scenario 2 total investment return (5 Years) £2.5m
- Downside Scenario 2 total investment return (10 Years) Circa. £50m
  Potential upsides from other Energy 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 JV[14]." - 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."

[14] 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 manged 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:

Portsmouth
CITY COUNCIL

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Appendix 1

Energy Retail Supply Joint Venture Business Case Review

CLIENT: **Portsmouth City Council**
DATE: 16/11/2017

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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 midsized 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 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

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

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 doorstop selling should be considered as a risk either financially through fines or reputational through customer complaints.

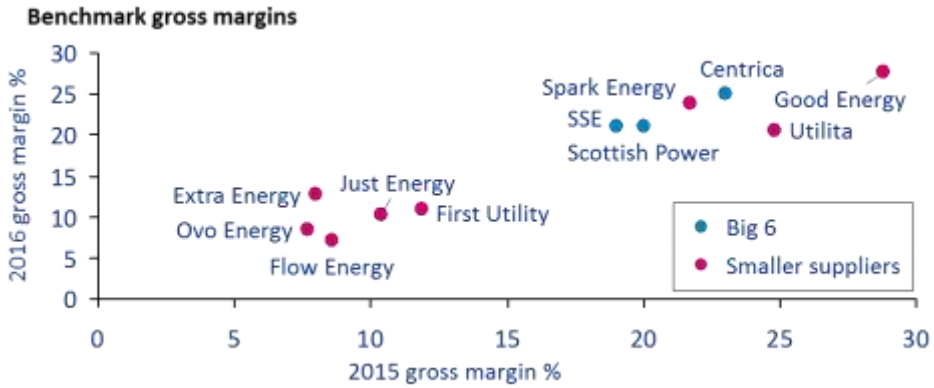
2.9. The 'Plan B' business case scenario outlined in the final business case does, in our opinion, provide a considered approach to managing these risks and likely impacts on investment returns. This outlines the expectation that the JV would require to switch its acquisition channel mix to be more weighted 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

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Appendix 2

Strategy& - EUR

Victory Energy Supply Limited
Review of Final Business Case

31 July 2018

Executive report

pwc

Important message to unauthorised readers

This report was prepared for Portsmouth City Council (PCC) under the terms of our engagement letter of 11/06/2018. Only PCC and its affiliates are to have access to this note.

Should any unauthorised person obtain access to and read this report, by reading this report such person accepts and agrees to the following terms:

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2. The reader of this report acknowledges that this report was prepared at the direction of PCC and may not include all procedures deemed necessary for the purposes of the reader.
3. The reader agrees that PricewaterhouseCoopers LLP, its partners, principals, employees and agents neither owe nor accept any duty or responsibility to it, whether in contract or in tort (including without limitation, negligence and breach of statutory duty), and shall not be liable in respect of any loss, damage or expense of whatsoever nature which is caused by any use the reader may choose to make of this note, or which is otherwise consequent upon the gaining of access to the note by the reader. Further, the reader agrees that this note is not to be referred to or quoted, in whole or in part, in any prospectus, registration statement, offering circular, public filing, loan, other agreement or document and not to distribute the note without PricewaterhouseCoopers LLP's prior written consent.

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.

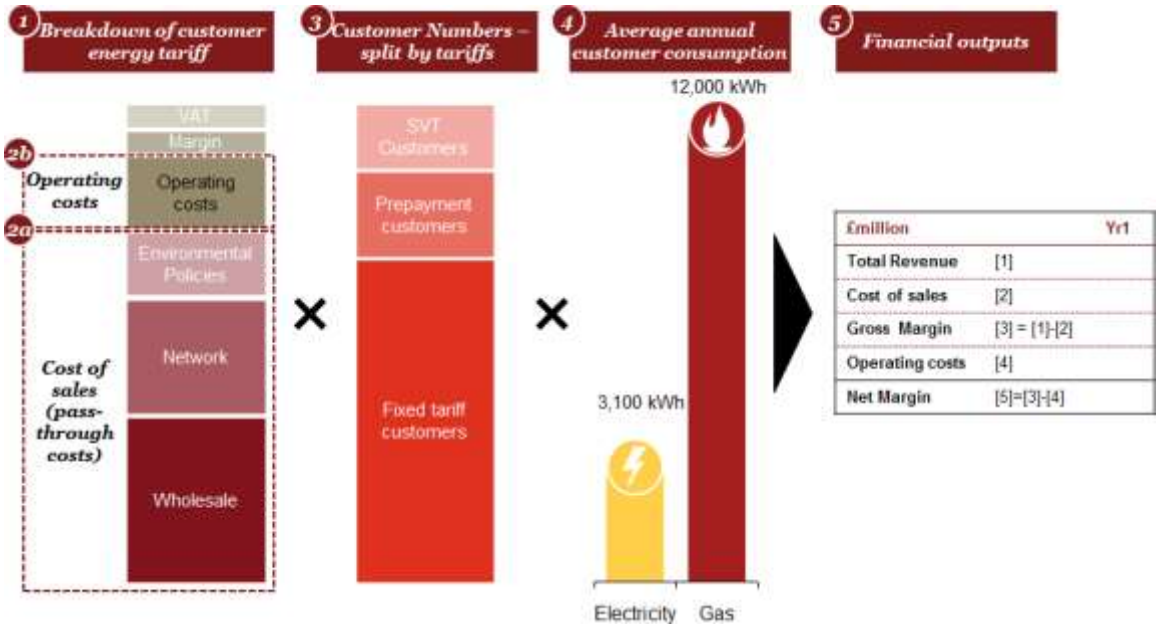
We do comment on the general approach to the choice of KPIs used by PCC and in particular the time horizon that the investment is assessed over. The business case presented is entirely consistent with the direction the energy market is moving in relation to the way energy is sourced, sold and packaged 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 returns[1] 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 form 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:

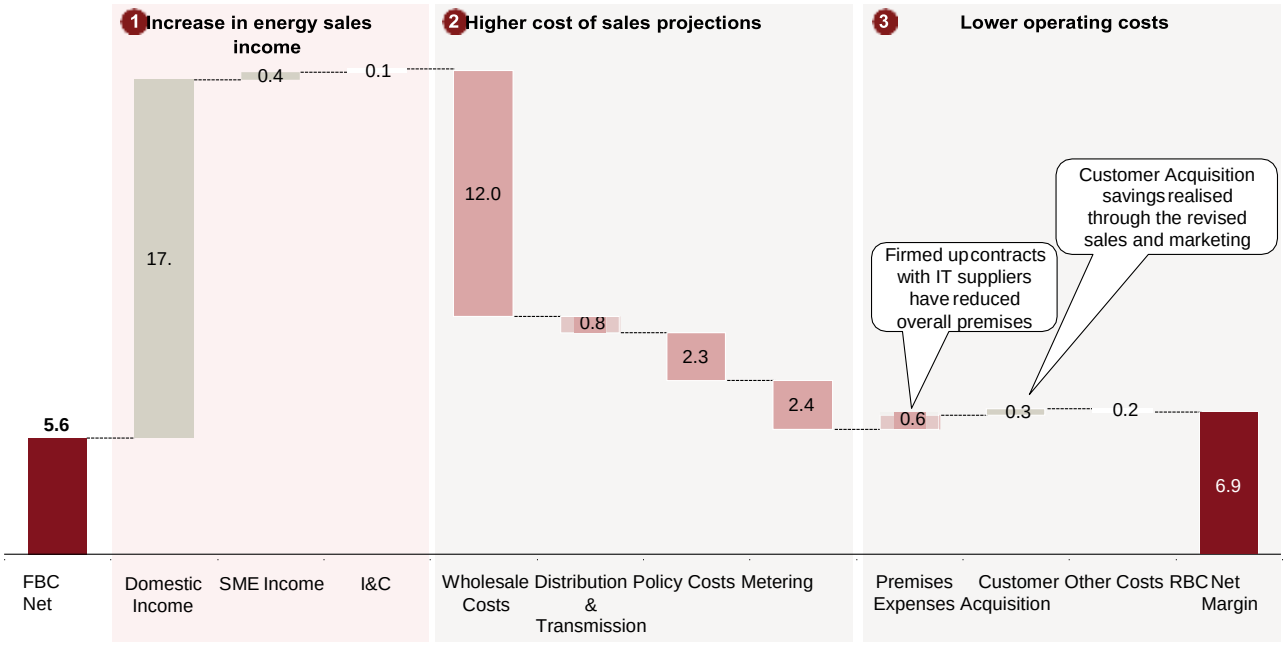
1. **Increase in energy sales income**: Domestic electricity and gas supply revenues have increased as a result of VESL updating tariffs to reflect higher updated costs projection in the RBC, which are passed through to the end user. The net profit resulting from the increase in revenues for VESL's domestic supply business is therefore largely offset by higher costs.

2. **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.

3. **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 form 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 £19.3m[3] 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 £8.0m[4] 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 contingency[5], 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 prices[6]. 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 affects 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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Appendix 3

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
EARNINGS	**£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
EARNINGS	**£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
EARNINGS	**£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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APPENDIX 4

Social Impact Assessment: Victory Energy

This is a high level assessment of the social impact in Portsmouth of the Victory Energy Supply Limited (VESL) business plan, as laid out in the report to Cabinet (10th August 2018), the Acquisition Opportunity document (October 2018), the Options presentation (August 2018), the Energy Governance Board Recommendation for Community Investment Scheme (16th November 2017), and additional information provided by VESL.

14.5% of households in Portsmouth (n = 12,815) are in fuel poverty, so there is significant need for services to tackle fuel poverty by reducing energy costs, improving energy efficiency and increasing household income.

Renewable electricity and clean air

Procuring 100% renewable electricity will reduce emissions from energy generation, a positive social impact, but this will not directly impact on air quality in Portsmouth, because the carbon-based electricity used in Portsmouth is not generated in the city.

Replacing old boilers with more efficient boilers reduces local emissions, but the business case does not identify the expected level of impact in this area.

VESL will initially concentrate on domestic energy supply, but aims in future to develop products and services related to the local generation, supply and storage of energy to reduce costs and emissions, and support the growth of electric vehicle usage, but outline plans are not currently available.

Community Investment Fund

VESL is committed to contributing to a Community Investment Fund (CIF), and has forecast a total of £4.9m over five years, based on contributing an amount equivalent to a price comparison website commission for each new customer. The Fund objectives are: investment in the local area to improve the lives of residents; demonstrating commitment through investment, fundraising and volunteering; building the VESL brand. VESL intend to work with the council to distribute the fund.

In 2017, Hampshire and Isle of Wight Community Foundation distributed funding (including the Portsmouth City Community Fund) worth £319,156 to 130 community-based projects in Portsmouth, while the Keep Warm Keep Well scheme provided energy grants worth £13,030 to 224 households in fuel poverty. A CIF of almost £1m a year would therefore be a significant addition to existing community funding streams.

Voluntary member of Warm Home Discount (WHD) Scheme

Because 39 energy companies (Big 6 and other larger firms) are currently participating in WHD, VESL will only achieve additional social impact if customers who qualify for the Core group in WHD (based on age and income criteria) transfer from one of around 30 energy

companies that are not currently offering WHD. Until VESL joins the WHD scheme, anyone eligible for WHD transferring from one of the 39 participating energy companies will lose their £140 annual discount.

Home energy assessments, advice and other customer engagement activity

PCC currently partners with Agility Eco to provide free and impartial home energy visits for anyone within a broad range of vulnerability criteria at risk of fuel poverty, under the Local Energy Advice Partnership (LEAP). Referrals are increasing, both from partner agencies and self-referrals, and 600 energy visits are expected to be provided in the next 12 months, with a total value of £150,000, resourced by Ofgem's Industry Initiatives Fund. There is currently no capacity limit; Agility Eco can increase the number of visits conducted to meet demand.

The estimated lifetime value of energy savings from a LEAP home visit is £875, with significant additional savings in health and wellbeing and reduced demand for social care. LEAP also identify need and refer in to PCC-managed schemes for emergency boiler replacement (estimated average lifetime saving £12,500), first-time gas central heating (saving £17,200) and other home energy efficiency provision (saving £6,000).

VESL's Local Energy Advisors (LEA) could refer in to this existing provision, providing an additional referral pathway. VESL LEAs advice on energy saving measures could help to reduce energy use and costs, particularly among the able-to-pay market, but there is currently no projection of the number of people who will be assisted or level of impact. As a combined advice and service provider, VESL may find it difficult to develop referral pathways with services working with vulnerable people, because the service is not completely free and impartial.

Energy efficiency

Measures such as smart thermostats increase efficiency, reducing energy use and cost to the consumer. Social impact will depend on whether VESL solely provides these measures to informed consumers who would be likely to find another provider if VESL was not available, or if they can develop a market of customers that are able to pay for VESL products and services but would not otherwise take action.

Savings for customers

VESL aim to be in the top quartile on affordability compared to competitors, and will target the 80% of customers who are not frequent switchers. Savings for customers will depend on supporting people to switch who would not otherwise have switched, being cheaper than providers that customers would otherwise have switched to, and ensuring that customers renew their fixed term contracts (either fixed price or market tracker) and do not default onto the higher Standard Variable Tariff (SVT). VESL anticipate a maximum of 5-10% of customers will be on SVT, compared to the 54% of Big 6 customers on SVT. A price comparison by VESL on a 13 month fixed rate dual fuel contract showed they were cheaper than all of the Big 6; 10.0% cheaper than British Gas and 8.6% cheaper than

SSE, two of the most common providers in this area. Customers on SVT with the Big 6 are likely to save more by switching to VESL.

Employment

VESL forecast their employment headcount to be 120 in Year 5. Portsmouth has a resident employment rate of 74.8% (n = 106,300), equal to the UK average, but well below the Hampshire rate of 82.5%. However, Portsmouth has a net in-flow of commuters of 13,000 and better-paid jobs in Portsmouth are often taken by people living outside the city; average workplace wages are 4% higher than average resident wages.

VESL intend to attract and retain local employees, including office-based support and management staff and skilled energy advisers, offering a training and development plan, with pay rates benchmarked against standards in the energy industry and locally.

Giving preference to local suppliers

Some energy services are likely to be delivered by local suppliers in most cases, such as servicing, repair and installation of lower value items, due to the cost and availability of trained engineers. Increasing activity from current levels would therefore have a positive social impact. Locally procuring higher value energy services and energy efficiency measures would support the local energy industry supply chain, but it is not possible to quantify that impact at this stage.

Local knowledge and partnerships

VESL aim to proactively identify fuel poor consumers and link in support from third party organisations, and to organise and attend community events to share energy advice. VESL suggest they could offer a personalised service to local customers, such as face to face support when needed, which could help customers experiencing debt or other issues.

Conclusion

VESL have identified a number of areas in which social impact could be achieved, although the likelihood and scale of impact is not clear in all cases. Potential for positive impact is strongest in relation to the Community Investment Fund, targeting of infrequent switchers to reduce energy bills by undercutting the Big 6 and moving people off Standard Variable Tariffs, and the provision of some local employment.

Further opportunities that have been identified but not fully developed or quantified include local generation, supply and storage of energy, procurement of local suppliers of goods and services, and local partnerships to support vulnerable customers.

There is a risk to social impact in combining advice and service provision in the Local Energy Advisor role, particularly in relation to vulnerable customers and partnership working with statutory and voluntary sector services that may be unwilling to engage with an organisation that is not considered to be free and impartial for the customer.

VESL's social impact will depend on their ability to add value, for example by reaching customers who would not otherwise have taken action to reduce their energy use or costs, creating demand for goods and services from local suppliers or leading the market in renewable or local energy services.