



## PAPER B

Purpose: For Decision

# Committee report

Committee	<b>EXECUTIVE</b>
Date	<b>12 JANUARY 2017</b>
Title	<b>CONSIDERATION OF INVESTMENT IN A LOCAL ENERGY COMPANY</b>
Report to	<b>EXECUTIVE MEMBER FOR REGENERATION, HOUSING AND HOMELESSNESS, TRANSPORT</b>

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### EXECUTIVE SUMMARY

1. The council has been investigating how it can become involved in the provision of energy services to residents and business. A number of other local authorities have recently established local energy supply companies with a view to securing a financial return, providing cheaper energy and wider community benefits.
2. The council has received a proposal to establish a local energy company as a joint venture. This arrangement allows the council to partner with an organisation that holds gas and electricity supply licences and has the systems in place to comply with the licence requirements.
3. This report considers proposed Heads of Terms for a joint investment with Community Energy Exchange Holdings Ltd in the local energy company (£208,250) and, potentially, a further investment in the Community Energy Exchange (£200,000). The total investment proposal will be subject to full due diligence and the preparation of a business case.
4. This opportunity offers many desirable outcomes, including, but not limited to, increased revenue for the council, a more sustainable energy system and financial benefits for residents.

### BACKGROUND

5. The retail energy market has been going through a period of rapid change with the entry of many new suppliers challenging the dominant position of the “big six” energy retailers (British Gas, EDF, E.ON, SSE, Scottish Power and Npower).
6. A recent report from the University of Leeds (see Background Papers) suggests that local supply arrangements could support local power generation, help to match patterns of generation with demand, increase the take up of energy efficiency programmes and retain energy value within local communities.

7. A number of local authorities have become involved in the retail energy market. The early movers were Cheshire East Council, Peterborough City Council, Nottingham City Council and Bristol City Council. The first two established arrangements to market supplies offered by an existing supplier, while Nottingham and Bristol councils took a more ambitious route, setting up wholly owned companies with their own supply licences.
8. Numerous other public authorities are considering involvement in energy supply including Liverpool and Leeds city councils and the Greater London Authority.
9. To become a supplier of gas and electricity, supply licences must be obtained from Ofgem. These require the licence holder to comply with a detailed and complex set of regulations and codes which protect the customer and ensure the effective operation of the energy markets. The regulations control such things as the buying and selling of energy, customer relations, tariffs and any additional requirements which are imposed through legislation or through the regulator's delegated powers.
10. The gas and electricity market on the Isle of Wight is valued at some £100 million per year. There is an opportunity to retain some of this value in the local area through the delivery of local energy services.
11. The option of holding full supply licences is considered too onerous for the council and other types of arrangements do not offer the potential for the council to gain a return from investing in energy services or for the local community to benefit fully.
12. The council has been approached by Reenergise Ltd (REL) which is establishing the Community Energy Exchange (CX) to serve numerous local energy supply companies. The proposal is for the council to invest jointly in a local energy company (IOWEnergyCo) which will focus initially on the supply of gas and electricity to Island residents and businesses.
13. The Joint Venture partner would be Community Energy Exchange Holdings Ltd (CXH), a Special Purpose Vehicle established by Reenergise Ltd to own and operate the CX.
14. Proposed Heads of Terms for the IOWEnergyCo are attached as confidential Appendix 1 and can be summarised as follows:
  - An investment from the council of £208,250.
  - A shareholding in IOWEnergyCo of 49 per cent.
  - Isle of Wight Council to have two seats on the board of directors out of a total of four. Board approvals with a simple majority.
  - IOWEnergyCo to be an approved agent of CX.
  - IOWEnergyCo or Isle of Wight Council may enter into power purchase agreements (PPAs) with local energy generators to supply energy onto the grid for consumption on the Isle of Wight.
  - When appropriate, to expand its activities possibly to include heat supply, water supply, internet and telephone supply, demand side response services (including time of use tariffs), energy storage, energy efficiency measures, electric vehicle service and other suitable services.

- An annual dividend will be payable provided that the payments do not exceed cumulative profit and allow for sufficient cash to be retained in the business to ensure the annual cycle can be covered.
  - Once the business is operating profitably both parties can consider offering a proportion of their shareholding for community investment.
15. The principal activities for the IOWEnergyCo will be the recruitment of customers and the agreement, with CX, on the retail tariffs (within the rules of Ofgem). As the business develops it will need to forecast the number and type of end customers to be supplied over the forward purchase period and to begin to enter into PPAs with local generators.
16. The CX will maintain the gas and electricity supply licences. It will provide a regulated full business services for the delivery of energy supply including demand forecasting, energy trading and settlement, metering, customer billing, collection and debt management and customer management and support. All customer services and interaction will be badged as if coming directly from IOWEnergyCo. The CX will need to exert sufficient control over the operations of IOWEnergyCo to ensure compliance with supply licence regulations and obligations.
17. The CX proposes to help establish a number of local energy supply companies throughout the UK, based on local authority areas or communities of interest. The aggregation of all of these customers allows it to achieve economies of scale and therefore reduce the fees it charges for its services, benefiting all the local companies.
18. It is proposed that the CX infrastructure will be established on the Isle of Wight, providing local employment. This infrastructure will comprise a call centre and support offices which will service all the local energy companies as they are established and, based on conservative estimates of growth, employment in the CX facility will increase from 18 full-time equivalent (FTE) in 2017 to 66 FTE in 2022. This will be new employment for the Island.
19. The arrangement could help the council to achieve numerous objectives, including:
- benefiting from any surpluses generated by the business in order to support ongoing service provision;
  - influence over energy pricing and tariffs offered to customers;
  - support for local renewable energy generation and providing greater local benefits from this generation;
  - job creation;
  - the ability to reduce energy costs for vulnerable groups and 'non-switching' households;
  - the ability to offer reduced prices as a business incentive to encourage inward investment and support small, start-up businesses;
  - providing the infrastructure for more flexible options in the future such as domestic storage of electricity and time-of-use tariffs.

20. As potentially the first area to participate in this model, the Isle of Wight Council has also been offered the opportunity to invest in the CX, benefiting from the wider operation as it expands nationally and becomes more profitable. An investment of £200,000 would secure a five per cent non-controlling stake in the CX.

## STRATEGIC CONTEXT

21. This proposal supports Eco Island, the Isle of Wight Sustainable Community Strategy, in particular the Thriving Island theme. It aims to retain a proportion of the energy spend within the local economy and to reduce the energy costs for residents and businesses. It is also hoped to link directly to local renewable energy generation, ensuring its output benefits local residents.
22. The current Corporate Plan (2015-17) contains, within Priority 1 – “Supporting Growth in the Economy”, the following activity:

*“Continue to investigate the potential for the development of an Isle of Wight energy company to make use of the many sources of renewable energy on the Island and to provide a cheaper alternative supply for Island residents.”*

This proposal is the first step in taking this activity forward.

23. It is anticipated that any investment would provide a return to support future service provision, while also helping to alleviate fuel poverty. These outcomes support the Corporate Plan priority 4 of ensuring that all the resources available to the Island are used in the most effective way in achieving the Island's priorities and that *“income generation maximisation is optimised”*.
24. The Isle of Wight has in excess of 6,000 households in fuel poverty – see <https://www.gov.uk/government/statistics/2013-sub-regional-fuel-poverty-data-low-income-high-costs-indicator>. The local energy company will seek to support those households at greater risk of fuel poverty through a more appropriate range of tariffs (for example, a lower differentiation between those paying by direct debit and through prepayment meters) and through energy efficiency programmes which target the more vulnerable. This will support the preventative health agenda and lead to a reduction in health and social care costs.
25. The national Community Energy Strategy published by the Department for Energy & Climate Change in January 2014 states that *“Government wants to see all authorities showing leadership to help deliver community energy projects. There are a variety of ways local authorities can catalyse and scale up activity that can also help them meet their own goals. Key opportunities include....partnerships and investment...”*

## CONSULTATION

26. The extent of interest in a local energy offer is based on the results of Community Action Isle of Wight's (CAIW) collective switching project, the Big Wight Switch, which took place in 2013. This resulted in the registration of nearly 12,000 Island households expressing an interest in cheaper energy through collective purchasing. A total of 5,185 of these households reported that they had never switched their supplier before. A final report on the project concluded *“Collective switching was a*

*disappointment as energy companies chose not to engage with it in any meaningful way. Greater competition within the energy sector needs to be encouraged to benefit all consumers.”* CAIW has been further consulted on the council’s intent to take forward this agenda and are supportive of the aim to reduce fuel costs for residents. They would like to see the community benefit as broadly as possible from the retained share of the energy market.

## FINANCIAL / BUDGET IMPLICATIONS

27. A review has been undertaken by the council’s capital accountant of the operating model and financial model for the Community Energy Exchange (CX) including the assumptions on customer numbers, IOWEnergyCo profitability and the proposed structure of the new legal entities for accounting purposes.
28. Analysis of the current proposed operating and financial models suggests that these potential investments could generate significant future returns for the council, as well as supporting the provision of cheaper energy and wider community benefits.
29. However there are significant gaps in the information in the operating model including details of competitive advantage, marketing strategies and the capability of CX to obtain the required licenses; these areas will need to be investigated further during due diligence work.
30. In addition, the financial model requires further scrutiny through due diligence work to confirm the security of the council’s potential investments particularly with concerns over the financial standing of the partnering company, the lack of trading experience of CX, and the uncertainties of the ownership structure of CX.
31. The reasonableness of the customer demand included in the financial model needs to be tested and subjected to sensitivity analysis, in order to validate the potential returns.
32. Should the final proposal be approved by Executive, a capital bid will be submitted for the 2017/18 programme to allow for timely implementation of the scheme. This will be subject to approval by Full Council as part of the annual setting of the capital programme.
33. Further revenue costs will be incurred in-year, including expert support with commercial negotiations, legal structure and financial due diligence for both the IOWEnergyCo and CX investments. The estimated budget requirement is £75,000 and will be sourced from the Economic Development projects’ budget.

## CARBON EMISSIONS

34. The recommendation has no impact on the council’s Carbon Management Plan since it does not impact on council buildings or services.
35. The IOWEnergyCo will aim to include a significant proportion of renewable energy in its electricity supply from both national and local sources. Recent negotiations conducted by Reenergise Ltd indicate that this could be 100 per cent green electricity.

## LEGAL IMPLICATIONS

36. There are a number of legal implications that will need to be fully considered as part of the business case and due diligence which will include specialist legal advice. The implications include consideration of the council's ability to trade in this industry, procurement matters, state aid, competition law and the regulations relating to the power industry. Any subsequent report to the Executive for decision on this matter will include full consideration of all legal implications.

## EQUALITY AND DIVERSITY

37. The council, as a public body, is required to meet its statutory obligations under the Equality Act 2010 to have due regard to eliminate unlawful discrimination, promote equal opportunities between people from different groups and to foster good relations between people who share a protected characteristic and people who do not share it. The protected characteristics are: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation.
38. A full equalities impact assessment (EIA) has been undertaken to assess the potential impact of the establishment of the IOWEnergyCo, based on the proposed Heads of Terms. This has concluded that the proposal will lead to no adverse impacts on any protected groups with potential benefits in terms of reduced fuel costs and alleviation of fuel poverty, particularly for older people and those with disabilities. The EIA will be updated following the business case development and due diligence.

## OPTIONS

39. The options relate to both the establishment of the IOWEnergyCo and investment in the CX:
- Option 1 – do nothing.
  - Option 2 – to undertake a due diligence exercise and the development of a business case into the investment in the local energy company on the proposed terms outlined in this report.
  - Option 3 – to undertake a due diligence exercise and the development of a business case into the investment in the community energy exchange on the proposed terms outlined in this report.
  - Option 4 – negotiate different terms to those outlined in this report.

## RISK MANAGEMENT

40. There are potential financial and legal risks associated with the investment which will be explored fully during the due diligence and business planning phase. A full risk register will be developed and considered prior to financial close to ensure that risks are mitigated and properly apportioned between the parties.
41. The proposed investment partner for the IOWEnergyCo is the Community Energy Exchange (CX), which is a new market entrant. There are some risks associated with this and it will be important to ensure that the CX has systems in place to properly

manage the supply business and meet the supply licence obligations to protect customers.

42. The number of customers recruited is likely to be the critical factor in the long-term success of the venture. For business planning purposes, modelling will be based on the recruitment of 12.5 per cent of Island households after five years. The due diligence process will consider the assumptions on customer numbers.
43. The proposed business model is currently untested and there will be no conclusive proof that this unique model can be executed until CX has an approved licence; therefore, confirmation of award of the supply licences will be a pre-condition for the council investment.
44. It should also be recognised that there are 'do nothing' risks in that a decision to do nothing will forego a potential long-term income stream for the council and wider community benefits. This additional income stream cannot be easily replaced and the aim to reduce fuel poverty and gain the same social and public health benefits may not be easily achieved.

## EVALUATION

45. An initial appraisal suggests that the IOWEnergyCo could provide a revenue stream to the council of over £300,000 per year from year five onwards. This figure relates only to energy sales and does not include the many income streams that can be derived from providing a wider range of energy services, particularly the opportunities that are starting to arise for grid balancing services. A separate investment in the CX opens up the possibility of an additional long-term income stream through dividend payments.
46. **Option 1** – there is the option to do nothing should the council not wish to be involved in energy services as described in this report. The council may also choose to wait to see if any arrangements are developed by local authorities across the Solent area and join in with these. At present Southampton City Council is investigating the opportunity to implement a risk phased approach to setting up an energy supply company; however, the final approach has yet to be confirmed and approved. The model being proposed in this report allows local areas to set up their own energy supply arrangements with some autonomy over tariffs, while providing wider benefits to all communities through reduced CX fees as customer numbers increase nationally. Therefore, there is the possibility of the CX model being utilised by others in the Solent area.
47. **Option 2** – the proposal has the potential to provide a long-term income stream to support general service provision while at the same time supporting a broader agenda, from reducing fuel poverty to local renewable energy generation and job creation. In providing a customer base it also allows the council to become more actively involved in future innovations such as time-of-use tariffs and energy storage which create a more resilient electricity network and improve the Island's energy security. It is believed that cheaper energy can be provided for the majority, especially those that have not previously switched supplier.

Establishing the IOWEnergyCo provides greater benefits than basic promotion of an existing supplier's product, but does not require the investment or risk involved in securing supply licences. Under this proposal it is the CX that is required to ensure compliance with supply codes and regulations at all times. The licences themselves ensure customer protection to the same levels that are required across the industry from the "big six" to new market entrants. The CX will also provide all the back office functions necessary for the operation of the company and will be the interface with customers.

Further investigation of the proposal requires officers, with external expert support, to conduct commercial negotiations along with the development of a full business case and legal and financial due diligence. This will be based on the proposed Heads of Terms provided (paragraph 14) and the results will be brought back to Executive for further consideration. The total cost of the proposed work will be less than £75,000 and will be accommodated within the existing Economic Development budget.

48. **Option 3** – should it decide to invest in the establishment of IOWEnergyCo, the council will have the opportunity to make an additional investment in the CX on preferential terms, as outlined in paragraph 20. This recognises the role of the Isle of Wight as the first community and allows the council to benefit as the CX grows. As with the IOWEnergyCo investment, the proposal requires due diligence which, because of the interrelated nature of the investments, is best carried out in parallel with the work on the IOWEnergyCo investment. The proposed work will be included in the £75,000 budget mentioned above (paragraph 47).
49. **Option 4** – the proposed Heads of Terms summarised in paragraph 14 and provided in confidential Appendix 1 provide the basis for the joint investment with CX. They state the objectives of the investment, along with the level of council shareholding and associated investment and are believed at this stage to provide the best balance of risk and reward. Heads of Terms are a set of agreed principles which are expected to be reflected in the final contract; however, they may be altered through commercial negotiation, only becoming binding on financial close. Executive may request alterations to any of the proposed terms as the starting point for further investigations, bearing in mind that the final terms will be subject to approval at a later date should the case for investment be established.
50. In conclusion, establishing the IOWEnergyCo has the potential to offer significant rewards to residents, businesses and the council. The involvement of the council to ensure a social benefit ethos for the business is considered to be a key factor in attracting and keeping customers, as is the ability to demonstrate local benefits. A final decision on whether to go ahead with the investment will only be made once the commercial and governance arrangements are determined through the detailed business case to be prepared and checked.



## RECOMMENDATION

51. Option 2 - To undertake a due diligence exercise and the development of a business case into the investment in the local energy company on the proposed terms outlined in this report.
52. Option 3 - To undertake a due diligence exercise and the development of a business case into the investment in the community energy exchange on the proposed terms outlined in this report.

## APPENDICES ATTACHED

53. Appendix 1 – Proposed Heads of Terms for a joint venture to create an Isle of Wight Energy Company. *Confidential due to commercial sensitivity at this stage – This appendix is exempt from disclosure by virtue of paragraph 3 of part 1 of Schedule 12A of the Local Government Act 1972 (as amended) as it, “relates to financial or business affairs of any particular person”, (including the authority holding that information). The public interest in maintaining confidentiality is outweighed by the public interest in disclosing it. Disclosing the information could place the Council at risk of legal challenge from individuals or other bodies identified in the report.*
54. [Appendix 2](#) - Stage 1 Equality Impact Assessment – Initial Screening

## BACKGROUND PAPERS

55. “Local Electricity Supply: Opportunities, archetypes and outcomes”, Dr. Stephen Hall & Dr. Katy Roelich, University of Leeds, March 2015. Available at: [https://research.ncl.ac.uk/ibuild/outputs/reports/local\\_electricity\\_supply\\_report\\_WEB.pdf](https://research.ncl.ac.uk/ibuild/outputs/reports/local_electricity_supply_report_WEB.pdf)

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