PROPOSAL TO CHANGE BWCE'S MEMBER INTEREST RATE

FAQS

Q1. Why are you doing this and what will the impact on this year's interest rate be?

We are changing how the interest rate is calculated so the target interest rate that was 7% will be changed to 3.5% above the Retail Price Index.

Last year the average figure for the Retail Price Index was 2.2% (as published by ONS in December 2019).

This means that this year, the target interest rate will be 5.7%.

We are doing this because the forecasted income for our projects has been greatly reduced due to changes in the electricity market, with a rapid fall in the long-term wholesale price forecast. If we carry on paying 7% as a target rate, there is a high chance that our projects will over time run out of money and we will not be able to continue paying their costs as they fall due.

Q2. What is the reason for the forecasts for wholesale prices reducing?

Industry experts, who are involved in doing the modelling on which these forecasts are built, tell us that forecasts have reduced significantly over the last few years due to:

- *Far quicker implementation of renewable electricity in the UK and across Europe at much lower prices than expected only a few years ago*
- *The rapid running down of coal fired generation leaving prices heavily influenced by gas, which in turn has been low due to over-supply from international markets, for example US*

Whilst there is an expectation that gas prices will rise over the next decade, this is offset by increased renewable generation on the system.

There is a fundamental problem in how these markets are structured, however. At such low prices it will be difficult to raise investment for the level of new renewables that is required. Wholesale price markets are led by the marginal costs of operation and renewables have very low operating costs, but high capital costs. This is what has been called by some 'the investment gap' and needs to be filled by policy action to ensure that enough funds are invested to continue the transition to net zero.

Q3. Is there an impact on the 4% shares?

No there is no impact on shares taken out since the beginning of 2019 with a target interest rate of 4% per year.

Q4. The briefing refers to 'project life'. How do you calculate what you deem to be 'project life'? Is this a standard figure applied to all projects or is it calculated for each one individually? Does 'project life' imply a termination date for a project or indeed your project portfolio? And, especially in the latter case, does this mean that shares have an end of life too?

The project life is determined usually by the length of lease and planning permission and so varies from project to project. So, for example the life of one of our projects was recently extended from 30 to 40 years following a planning extension and an option to extend the lease.

Most of our projects have either a 25 or 30 year life.

These dates are not termination dates as such. Experience suggests that planning and lease extensions are likely to become more common. So, project life just represents the best current judgement of how long it is reasonable to account for project value.

Shares are taken out in BWCE, not in any of the actual projects that are held in a range of wholly owned subsidiaries. However, we model all the projects on the assumption that shares are repaid over 30 years maximum (from the date of our first projects). The reality is that it is a lot more fluid than that. We are planning new projects and raising new capital, which is also allowing us to more easily repay existing shareholders if they want to exit. We hope this dynamic refreshing of shares will continue as it suggests the organisation is still making an increasing impact.

However, the financial models are intended to give us and our shareholders confidence that if we stopped doing any new work tomorrow, our projects would still continue operating successfully and meet all their costs as they fall due, including repayment of equity.

Q5. The briefing refers to a worst-case scenario that involves RPI being replaced with CPI (and so reducing by up to 1%) as well as further falls in wholesale prices. If this happens you suggest that the 3.5% margin may need to be reduced to 2.75%. Surely if the value of RPI falls, then interest rates will also fall and why does this put pressure on you to reduce the 3.5% margin as well?

It comes down to the difference in actual £s when you take the same % off two very different numbers.

So RPI impacts on our income by increasing the income every year we receive as a result of the Feed in Tariff. Over the life of the portfolio, 0.5% off RPI reduces our income by around £1.2 million. Whereas 0.5% off the interest we pay reduces over time as equity levels fall. Such that over the life of the portfolio we save around £180,000 from a 0.5% fall in RPI.

We can cope with a lower RPI in individual years. But we are talking about reducing the average RPI figure over the life of the portfolio by 0.5-1%. It's also worth remembering that our worst-case scenario also assumes a further fall in wholesale electricity prices, that is mitigated by us being able to revert to the export tariff as part of the FIT, but nevertheless that also has a contributory impact on whether we reduce the margin below 3.5%.

Q6. What is BWCE's attitude to new projects and the risks associated with them? For example, will the Community Solar 2020 financing for investment in solar PV on roofs expose any of the existing shares (i.e. my shareholdings) to further risk or are they being financed by a separate vehicle?

All new projects will affect existing shareholders as the interest rates paid are blended. However, you might consider investments in new roof top projects as reducing risk because if successful they will have a 20 year power purchase agreement with the site owner at a rate that creates a viable project.

We tend to offer site owners a price for the electricity generated that represents a discount on what they are currently paying their main supplier, but that is also more than the price we would otherwise get from exporting the electricity to the grid.

We are looking at new ground mounted solar arrays that are purely grid connected, but these projects are only likely to be developed if we can set up a 'sleeved' power purchase agreement with a large consumer. See here for more detail on power purchase agreements.

Q7. In case it would have gone the other way around, no-one would pay me more money. Therefore, taking all my investments into account, I need also some highly profitable investments in order not to suffer too hard from those which do go bankrupt. Otherwise investing in renewable energy would not make any sense and would not be sustainable for me. The contract-conditions need to stay in the way they were signed in the past!

If the rationale for changing the policy for member interest is as a result of long term changes in wholesale prices, why does the change need to be made now?

In our early share offer documents, we emphasised that we were targeting around 3.5% above long term RPI and that we would reduce our rates if RPI fell below that figure. We didn't do that, so early investors have had a very good deal to date, that we can no longer afford to continue.

The target interest rate has also always been clearly presented as not guaranteed and dependent on performance. In the risks sections of the share offer documents, we clearly stressed the importance of long term electricity prices and their effect on performance.

So, we are not doing anything that goes against what we have promised investors in the past. This has little to do with investment in renewable energy; most energy investments are struggling now. We believe getting 5.7%, which is what will be paid this year (3.5% plus 2.2% RPI), is a fair return in the current market.

We are in effect acting to protect member interests. If we do not act now, we will be increasing the investment risk going forward. We are taking a prudent approach to protect the organisation and its investors. If we wait for another 5 years before taking any action, there is a high risk that we would have to make even bigger cuts than we are making now.

Q8. If RPI may disappear, why not fix the new rate to CPI plus 4.5% instead of RPI plus 3.5%?

We don't yet know what will happen to RPI. It seems at the moment that its unlikely to disappear, it's more likely that the way it's calculated will change to bring the resulting figure closer to CPI. We don't know when and how this change will happen and what the resulting impact will be, so setting a margin now that prejudges the outcome could be risky.

Q9. Will the RPI plus 3.5% be guaranteed? What happens if RPI goes up and RPI plus 3.5% exceeds 7%, will this still be paid still?

Do we need to publish a target rate, could we just set it each year based on what the organisation can pay?

Can we pay more interest in years where there is very good performance to compensate for poor years?

The target interest rate has never been and will never be guaranteed. It is a target and will depend on the performance of BWCE's projects during the year in question.

If inflation increased significantly and RPI plus 3.5% ended up being much higher than 7% for a couple of years, then we would pay the interest rate that was specified under the proposed policy.

The board always reserves the right to take action to protect the organisation and its investors and would have to review the situation at the time. If this period of high inflation happened at a time when the shareholding in BWCE was still very high, then it might be difficult to sustain such high interest rates for a long time if the increase in income from high RPI was less in monetary terms than the increased interest payable as a result of high interest rates. But that would have to be reviewed at the time.

The principle would however remain that BWCE would honour the agreement for as long as it could safely do so.

We would have to be mindful at all times of the FCA's regulations around setting interest rates. The FCA's guidance on their registration function clearly states the basis on which Community Benefit Societies must look to set their interest rates, see point 6.25 on page 37 of their guidance here, that with reference to interest rates says that:

- *the maximum rate of interest paid on shares is declared in advance of the period for which it is intended to be paid, whether in its rules or elsewhere*
- *the declared maximum rate of interest is the lowest rate sufficient to obtain the necessary funds from members who are committed to furthering the society's objects*
- *in the event the society cannot afford to pay the declared maximum rate of interest, interest payments are reduced, or no interest is paid at all, without compensation in subsequent years*
- *societies can justify a decision to pay interest at a particular rate, and be able to demonstrate the basis for that decision*

Further, point 6.34 in the same document also says that:

- *Any surplus is used to benefit the community by reinvestment in the business, or by application to some external but related community benefit*

So, we have to publish the target rate in advance (so it's not considered a distribution of profits), we can't pay more in future years to compensate for below target interest rates in previous years and we can't profit maximise to the benefit of members. Surplus cash can either be re-invested in the business or distributed via charitable donations for external community benefit.

Q10. Would the Board consider reducing the interest rates paid on shares purchased after 2019, especially if the RPI falls to very low rates and RPI plus 3.5% starts to look very like 4%.

The board will keep this under review and carefully consider this point and the scenarios under which this might be required.

Q11. What would happen if RPI went negative?

As long as the RPI plus 3.5% policy was in force, if RPI plus 3.5% remained a positive number then BWCE would continue to pay interest at the specified rate, subject to performance.

For example, if RPI was -1% then BWCE would pay interest at -1% plus 3.5%, so 2.5%, subject to performance.

If RPI went below -3.5% then the interest rate would stay at 0%, regardless of how low it went.

Q12. If the motion to change the target rate was voted down at the AGM, wouldn't the Board still have to consider reducing the interest rate?

If the resolution is not supported at the AGM then because of timescales we would pay out 7% interest this year – but it would need to be reviewed again in subsequent years. By reducing the target now, the Board was aiming to give more certainty over the longer term in response to the fact that we can't continue to pay 7% without introducing more draconian cuts in later years. If the motion is defeated the Board will have to review its approach and bring a new proposal to an EGM during the first half of 2021. This would also involve more consultation with members.

Q13. Will BWCE have any problems in selling all the electricity we generate?

So far, we have had no problems. Electricity is either sold on site or exported to the grid and sold to wholesale suppliers. Our grid connection can be shut down by the network operator when they are working on the grid for safety and there are times when our systems may be shut down due to technical problems. But we assume 99% of the time the systems are connected and generating.

There may be times in the future where the network operators look to shut down large renewable plant at times of very low energy demand. But there are discussions within the industry to secure compensation from generating plant to 'turn down' their output, just in the same way that large consumers (and increasingly small consumers) can securing income for turning down their demand at key times of peak impact on the grid.

Q14. Is there a way to mitigate the impact by shifting to off-peak?

It would make sense to co-locate batteries with our solar arrays so that we can release energy stored during the day to meet demand in the eve/peak period when we could sell at a higher price. Particularly if the solar system is connected directly to a consumer, for example from a roof mounted system, who will increasingly be paying high rates for peak time electricity demand as Time of Use Tariffs become more common. But similar benefits could be accrued for grid connected systems as well.

So, we have been looking at the potential for this approach of co-locating solar and battery storage. But at the moment, these do not seem to be financially viable for our scale of solar arrays. In time the battery price is likely to come down, though there will remain technical issues of retrofitting batteries to old sites.

Q15. Will the proposed changes to the interest rate have any impact on the numbers wishing to redeem their shares?

So far no-one has indicated that they intend to withdraw their shares as a result of these proposals, but it is of course an option. We would be disappointed if members wanted to leave because of this but we would of course understand and do what we can to meet their request.
We do have a share withdrawal policy that requires us to consider withdrawal requests annually. So far have been able to meet all the requests in full in the year that they have been made. In the event of death of a member we aim to meet these requests at the time they are made.

This approach protects the organisation and its remaining members, because of course we invest the funds raised in renewable energy projects, so we do not usually have large amounts of capital free to distribute. If at any time the number or size of requests mean that we cannot meet the demand for withdrawals in any year, we have the option of paying all requests on a pro rata basis and agreeing a repayment schedule with members to cover the shortfall.

Q16. Do we take advantage of all the tax incentives eg EIS, ISAs.

The original share offers were eligible for Enterprise Investment Scheme (EIS) tax relief until December 2015. After that point all renewable energy schemes were no longer eligible for tax relief so our share offers since then have not been eligible for EIS tax relief.

There is a lobby pressing government to allow renewable energy community benefit societies like ours to be eligible for Social Investment Tax Relief (SITR), but unfortunately that has not been successful so far.

The bond issued in 2017 did qualify as an Innovative ISA and so many investors took advantage of that. Unfortunately, shares are not eligible for incorporation within an ISA.