# Proposal to Change BWCE's Target Member Interest Rate
# Member Briefing 22nd June 2020, presented by the BWCE Board

## 1 Summary of Proposal

**<u>Proposal:</u> To change the annual target for member interest on shares purchased before January 2019, from 7% per year to a variable 3.5% above the [Retail Price Index](), due to reductions in our forecast for project income. This will have no impact on shares bought since February 2019, where the target interest rate will remain 4%.**

All BWCE's existing renewables projects generate income from the [Feed in Tariff]() and from selling electricity exported to the grid. When we raise finance through share issues, we set our long-term forecast for member interest based on predictions of how our income will change over time.

Two important factors, outside our control, that have a significant impact on project income include:

- **<u>Forecast of the wholesale price of electricity over the project life</u>.** We assume that for all electricity exported to the grid (rather than used in a building connected directly to the solar array) we receive either the wholesale price of electricity or the Export Tariff (set as part of the Feed in Tariff), whichever is higher. Since October 2016 the forecast of wholesale electricity prices, as published by industry standard sources, has fallen substantially and now indicates a reduction in income over the life of our project portfolio of £5.2 million. In just the last year our forecast income over the lifetime of our project portfolio has dropped by £2 million.
- **<u>Forecast of the Feed in Tariff over the project life</u>.** The Feed in Tariff (comprising a Generation Tariff and an Export Tariff) provides the basis of our existing project income and will continue to do so even though the scheme has closed for new projects. This income increases each year by the average rate of the [Retail Price Index (RPI)]() over the previous calendar year. Our original intention, as laid out in many of our early share offer documents, was to pay interest at a 3.5% margin on the long-term average RPI. Since June 2012, average RPI has been around 2.5% which means our target return (7%) has been 4.5% over RPI. RPI has dropped to 1.5% in April, with the prospect of falling even further over the short term due to the economic impact of the Covid-19 pandemic, which means that our income will increase more slowly than we originally forecast.

Because of these two factors, our financial forecasts have been significantly impacted and we now believe we need to realign expectations around member interest rates in order to ensure that BWCE remains financially robust enough to maintain our existing projects and to cover their costs as they fall due.

**As a result, we are proposing to members that for shares purchased before January 2019, the target annual interest rate is changed from 7% to a variable 3.5% above RPI, for the foreseeable future.**

**We will keep this under review and we may need to change this margin in the future, depending on the factors outlined below in section 3. If we need to make any further additional changes, we will give members at least one year's notice.**

**For this year, the change to a variable 3.5% margin will result in a target member interest rate of 5.7%[1].** Because RPI tends to range between 0.5% and 1% higher than the [Government's official inflation index - the Consumer Price Index (CPI),]() this return is in fact over 4% above inflation. In May 2020, the Bank of England was forecasting CPI falling to 0.5% and then rising to 2% by 2022[2] which would result in RPI of between 2.5% - 3% and would **provide a target member interest of between 6% - 6.5%.**

The actual interest rates proposed for member approval each year will remain subject to project performance and BWCE's ability to pay, as always. Last year's performance (2019-20) was on target, so we will be able to pay the target member interest indicated above subject to approval at this year's AGM, planned for September 12th.

Interest paid on shares purchased since February 2019 as part of the current share offer to support new projects, will not be affected and will continue to be based on a target annual interest rate of 4%. Bonds will also not be affected.

We understand that this is a significant change to what members might have been expecting and so we are approaching members with 1) a clear explanation of why we are in this situation, as outlined in the rest of this document and 2) what we propose as a way forward.

We want to give members the opportunity to feedback their views prior to this year's AGM, where we will be seeking member approval for our approach. We will be holding two online meetings for BWCE members, both covering the same ground, on **22nd July at 6.30pm [(sign up here)]()** and **29th July at 2.30pm [(sign up here)]()**. Please sign up to attend.

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*[1] The Feed in Tariff increases each year in line with RPI for the previous 12 months, as calculated in the December before the April in which it increases. We propose aligning our approach to setting the target interest rate for each year to this. [RPI in December 2019 was 2.2%]() and so the target interest rate for this year, subject to project performance, as proposed, will be 5.7%.*

*[2] See [Bank of England Monetary Policy Report May 2020](), page 7 Table 1.A*

## 2 Why Is This Proposal Necessary?

We analyse the long-term financial viability of our larger projects that export electricity directly to the grid, using industry standard forecasts of wholesale electricity prices, i.e. what we can sell electricity for.

Over the last three years, as a result of a rapid fall in the price predicted in those long-term forecasts, we are forecasting a reduction of just over 10% in our project income, or over £5 million, over the life of our existing projects. See Figure 1 in the Annex.

We have absorbed some of this reduction in income with cost reductions, but mainly through lower actual and forecast community fund payments. For example, we have already reduced our target community fund payment from £75k/yr to £50k/yr, and we are no longer assuming such large increases in fund payments in later years as was originally forecast. All our cash balance (see Figure 1 and 2 in the Annex) will ultimately be distributed as community benefit.

We are also proposing reducing the target fund payment further to £40,000 per year. As a Community Benefit Society required by our rules to maximise community benefit, we do not believe we can lower our community fund on a long-term basis more than this. As with member interest, actual payments each year will be subject to project performance.

However, we cannot withstand the forecast reduction in income outlined above without taking further action to protect our projects, the community benefit that is central to our constitution as a Community Benefit Society and ultimately BWCE itself.

Changing how we set the target member interest from a 7% to a variable 3.5% above RPI will reduce costs by £1 million over the life of our projects, subject to the other assumptions outlined in this document. This is sufficient to put our projects onto a sound footing on a long-term basis.

Figure 1 in the Annex illustrates the impact on our cumulative cash balance of three forecasts outlined below.

| | Wholesale Electricity Price Forecast Date | Target Rate for Member Interest | Target Community Fund Payment | RPI Assumptions | Minimum Cash Balance |
|---|---|---|---|---|---|
| **Forecast 1** | Q3 2016 | 7% | £75k/yr | Long term 2.5% with short term forecast from March 2020, Office of Budget Responsibility | Plus £345k in 2027 |
| **Forecast 2** | Q1 2020 | 7% | £50k/yr | Long term 2.5% with low short term forecast from May 2020, Bank of England | Minus £571k in 2030 |
| **Forecast 3** | Q1 2020 | 3.5% above RPI in previous calendar year | £40k/yr | Long term 2.5% with low short term forecast from May 2020, Bank of England | Plus £172k in 2041 |

Forecast 3, as proposed in this paper, results in member interest of 5.7% this year, and a forecast interest rate of 5%, 5.5% and 6% onwards in the following years. Though if RPI returns to the 3% average of the last 10 years, as opposed to just the average of 2.5% since 2012, then target member interest rates will be up to 6.5%.

Given the level of cash reduction implied by our current project forecasts, we believe the fact that we expect the target member interest rate to reduce by only 1% over the longer term, illustrates the strength of the original financial model.

We will still need to take into account the annual generation performance of our renewables projects. The members target interest rate will continue to be payable only when projects meet their annual generation targets.

The actual return we have paid since 2012 has fallen to a minimum of 6%, due to lower than average project performance in some years. Last year members approved a lower interest rate of 6.25% even though projects performed to target, to allow BWCE to invest the funds retained into project development.

## 3 Longer Term Prospects

We will continue to review the wholesale electricity price market and if long term forecasts increase significantly (for example if an effective carbon pricing policy is implemented or if we are able to secure better value long term power purchase agreements), then we will review this proposed course of action.

Because all our existing projects receive the Feed in Tariff subsidy, which includes a minimum Export Tariff, there is a secure minimum level of export income that can be relied on. As a result, further significant falls in long term wholesale prices will have a material but only relatively limited impact on future project income.

The Government has also recently launched a consultation on reforming how RPI is calculated so that it matches the CPI. Historically CPI is between 0.5% and 1% lower than RPI.

Over time the switch from RPI to CPI would reduce the income projects earn as the value of the Feed in Tariff would not go up as much each year once this has been implemented. **The impact of lower Feed in Tariff income will be far greater in monetary terms than the reduced member interest payments, even though they are attached to the same index.**

We hope these changes don't happen, and if they do, that Government offsets potential lost income through other more positive policy mechanisms. However, if the worst comes to the worst, we may need to reduce the 3.5% margin over RPI used to set the target members' interest rate.

Figure 2 within the Annex, outlines the potential impact of these changes

- Forecast 3: The same as outlined in the table above – what we are proposing to adopt in this paper.
- Forecast 4: **Worst Case Scenario** - The same as Forecast 3 but assumes that RPI rebounds only to 2% as government changes its approach to indexing the Feed in Tariff, from using RPI to using CPI, and wholesale price forecasts fall lower so the Minimum Export Tariff kicks in and prevents income from falling further.
- Forecast 5: As Forecast 4 but with the margin over the index rate reduced from 3.5% to 2.75%.

This analysis suggests that even in the worst-case scenario considered in this paper, member interest will still provide a good return above inflation, as well as enabling BWCE to continue building the appropriate scale of response to the Climate Crisis that we desperately need.

## 4 Impact on New Project Development and Our Current Share Raise

Last year members agreed to waive 0.75% of their interest payment, reducing the interest paid from 7% to 6.25%, so we could appoint Alex Lockton to carry out new renewable energy project development.

This has been going well. We currently have 3.5MW of potential new renewable energy projects under active development. If all this were implemented it would increase our portfolio by nearly 30%.

We do not plan to ask members to waive interest to support project development again this year. We will continue to fund project development from grant funding, consultancy services and from development fees that we will capitalise within the project installation costs when they are built.

We are now raising new share capital, in anticipation for building out these new projects, with a target annual interest rate of 4%. Nearly £490,000 has been raised through this offer, which is still open and accessible via our website.

Because of the removal of the Feed in Tariff for all new projects, we are reliant on selling electricity to building owners or nearby electricity consumers via a direct wire or establishing a long-term agreement to sell electricity via the grid.

We can sell electricity to building owners or nearby consumers on a long-term contract at a price that is higher than the wholesale price, but lower than the price they would have to pay for electricity from the grid – a win-win situation.

It will be difficult to develop new projects that are dependent solely on fluctuating wholesale electricity price, as new projects will not have the Export Tariff to fall back on, unless there is some form of alternative floor price established.

Because the lower interest rate associated with the new shares already takes into account the lower surpluses generated by new projects, our proposal for changing target interest rates on our projects developed pre 2019 will not affect these new shares.

**AS BWCE MEMBERS YOU ARE HELPING US TO TACKLE THE CLIMATE CRISIS TOGETHER**
**THANK YOU FOR YOUR CONTINUED SUPPORT**

If you have any queries or comments that you would like to make on this proposal, please contact,
**Peter Capener, Managing Director, Bath & West Community Energy on pete.capener@bwce.coop** and/or come along to one of our virtual meetings, as described in the Summary of the Proposal section, page 1, above.

## Annex

*Figure 1: Cumulative Cash Balance Over Life of BWCE's Project Portfolio*

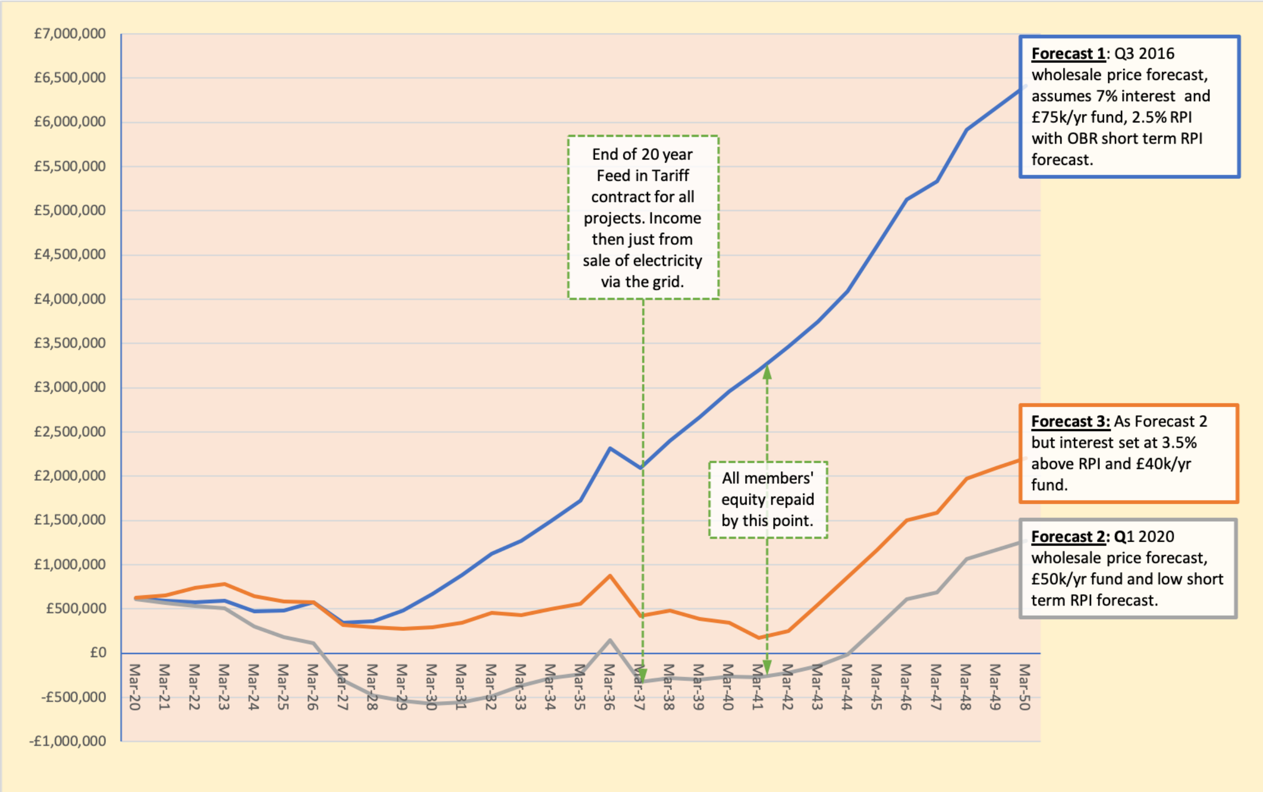
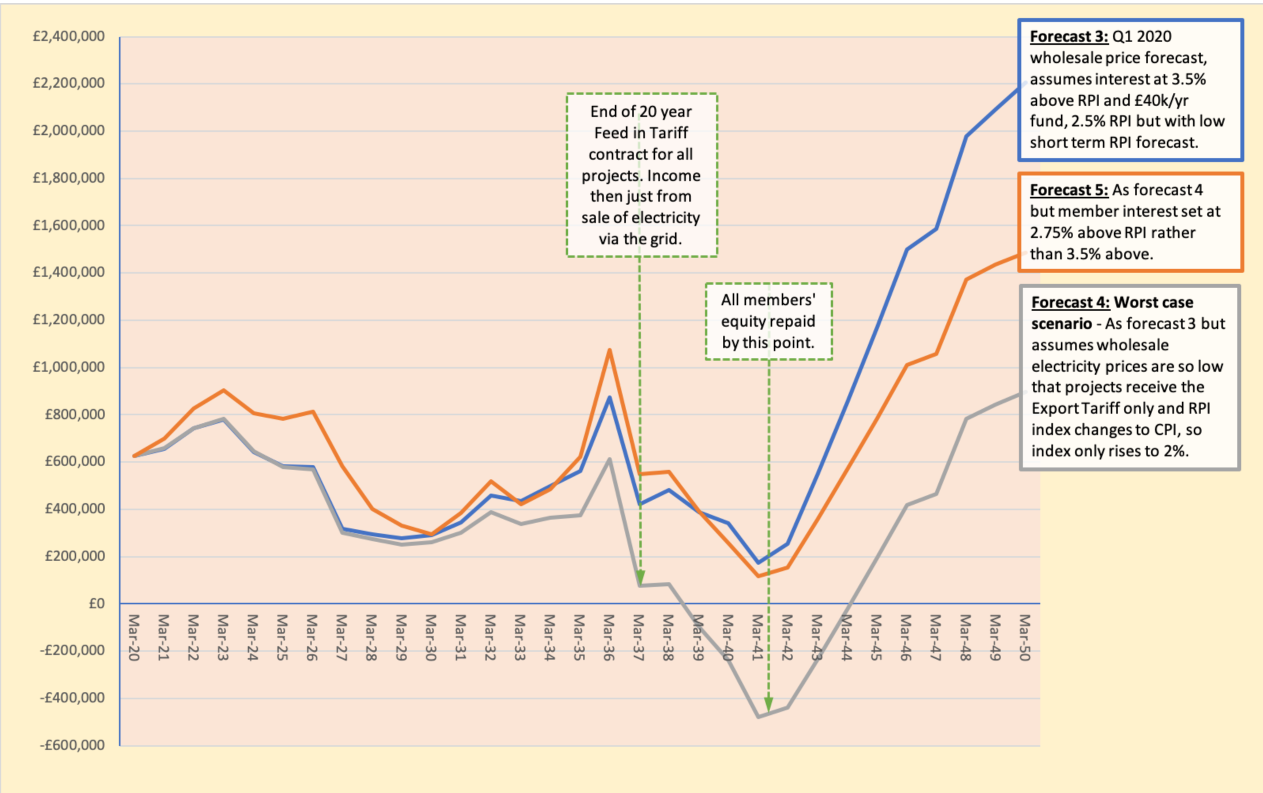



*Figure 2: Impact of Government switching from RPI to CPI to index the Feed in Tariff on Cumulative Cash Balance*




**Notes:**

- The Cumulative Cash Balance is the cash left available to BWCE, after all costs have been incurred. The cash balance goes up or down at the end of each year depending on whether there is more cash incoming than outgoing during the year.
- Figures 1 and 2 have different Y axis scale lengths, to accentuate the difference between scenarios in Figure 2.