

# Community Investment Fund

A Proposal to Enable Communities to  
Invest in Large-scale Renewable Energy  
Projects

Summary Discussion Paper

October 2011



4D Energy Ltd



SQW



Supported by the Big Lottery Fund Investing in Ideas



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## Foreword

This discussion paper was commissioned by the community-owned Islay Energy Trust (IET) to begin to explore a way in which local communities and their members could become investors in large-scale renewable energy projects. The seas around Islay contain significant tidal, wave and offshore wind energy resources, and IET wishes to participate with project developers in exploiting these resources so as to maximise socio-economic benefits to the local community. The underlying premise is that by enabling local communities – individual members and collectively - to take a financial stake in such projects, if structured appropriately, there is the potential to add value for all stakeholders: investors (community and corporate) will make a return; for communities, “dividends” from projects have the potential to yield socio-economic benefits; for developers, shareholder value is maintained, even enhanced; and for all, a sense of “ownership” and/or participation increases local support, and thereby facilitates the consenting process. The ideas presented, if feasible and implemented, could make a significant contribution to socio-economic sustainability, locally and nationally.

Both the UK and Scottish Government support the participation of local communities in renewable energy projects. The Scottish Government’s consultation document ‘Securing the Benefits of Scotland’s Next Energy Revolution’ states: *“Local communities would be empowered to take a real stake in the low carbon energy opportunities on their doorsteps and to invest the benefits from such opportunities in their future. This could enhance the future for some of the most remote and isolated communities..... Developers would benefit from working in an environment where local communities and businesses actively support and wish to be part of low carbon energy projects.”*<sup>1</sup>

The UK Renewable Energy Strategy states that: *“Developers of large-scale projects will be encouraged to share the benefits of those developments with local communities.....”*<sup>2</sup> In addition, a recent study from the University of Strathclyde, The Importance of Revenue Sharing for the Local Economic Impacts of a Renewable Energy Project, concluded that *“compared with (other) community benefit models.....local ownership (of renewable energy projects) confers the greatest economic impacts for the local community by a substantial margin”*<sup>3</sup>.

A number of options which would enable communities to invest in their own right were studied but are not presented here. This discussion paper summarises a lease and toll model which could be used as a basis for individual and community “investment” without eroding owners’ rights. The intention is not to seek alternatives to existing, successful examples of community ownership of assets and cooperatives, which tend to be appropriate for small or medium-sized projects. Rather, it is an attempt to “scale-up” local involvement in larger scale projects (for example, onshore wind projects greater than 50MW, and offshore projects greater than 10MW). This has been a small study with limited resources and therefore the extent to which all relevant issues, e.g. risk sharing, portfolio diversification, legislative and regulatory constraints, etc., are analysed is inevitably limited, but it is hoped that this paper

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<sup>1</sup> Scottish Government (2010) Securing the Benefits of Scotland’s Next Energy Revolution

<sup>2</sup> Department of Energy and Climate Change (2009) Renewable Energy Strategy

<sup>3</sup> Scottish Government (2010) Securing the Benefits of Scotland’s Next Energy Revolution



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will act as a catalyst for more in-depth research, analysis and discussion, and the eventual establishment of such an investment model.

For the avoidance of doubt this paper is not purporting to offer financial advice.

The Board of Trustees of IET is grateful to the Big Lottery's Investing in Ideas programme, which provided financial support for this study.



Philip Maxwell, Chairman, Islay Energy Trust

October 2011

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## Executive Summary

1. The reason for exploring the option to establish a Community Investment Fund (CIF) is that local engagement with large-scale renewable energy projects is potentially enhanced if local people and their communities have a financial stake in the ventures, and the process may yield outcomes that can benefit developers, investors, communities and consenting authorities. A number of options have been studied. The one which is presented here is a CIF which leases from the operator part of the renewable energy resource (e.g. the wind) accessed by the project asset (e.g. the wind turbines) and pays a toll for the electricity produced. The CIF is then able to sell the electricity to generate funds. In summary the structure is as follows:
  - The community investment fund (CIF) vehicle is a standard Limited Liability Company (LLC) that satisfies the requirements for community interest and qualifies for Enterprise Investment Scheme (EIS) relief.
  - CIF funds are obtained from members of the community – “investors” – who each purchase shares in the CIF, and apply for tax relief due under EIS rules.
  - These funds (created by the tax relief) are used to pay for the lease fee and toll for the energy source and infrastructure which yields electricity as a saleable product. The lease fees and toll tariffs payable are calculated to give the project operators or capacity/asset owners a positive return.
  - Profitable sale of electricity and associated Renewable Obligation Certificates (ROCs), Climate Change Levy Exemption Certificates (LECs) etc. creates revenue for the CIF which can be used to benefit the community, and for CIF investors to make a return on their investment.
2. Resources available for this study were limited, and many issues related to this model need further examination and discussion. For example:
  - *Who are the “investors” - individuals, organisations, match funders? Who or what is the “community”? The more proximate the community is to the renewable energy project, the greater the sense of local engagement, cohesion etc. How are the community that can invest and the community that can benefit defined? What is the “project” being invested in? There is a recognised area of risk around the EIS tax incentive (as there would be with any tax driven incentive) in terms of eligibility and whether this will change in the near future. The main commercial issues to be negotiated between the CIF and project owners/operators include leasing terms and tariff, power purchase/sales agreement (if applicable), entitlement to ROCs, LECs etc. How is the electricity output marketed? An assessment of costs of governance and fund management for the CIF.*



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# 1: Introduction

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## Introduction

- 1.1 This study was undertaken by Andris Bankovskis of 4DEnergy with the support of SQW. The summary discussion paper presents the idea of a Community Investment Fund (CIF) that generates financial returns through a lease and toll model to capture the value of the electricity generated by large scale renewable energy infrastructure.

## Brief history of individual and community participation in renewable energy

- 1.2 Until the 1980s, the public ‘owned’ energy utilities through national Government ownership. Sale of publicly owned utilities released cash, and Government control and democratic accountability were replaced by independent regulation.
- 1.3 Since then, there has been significant progress in opening up investment opportunity for community investors to pool resources and become owners of small, ring-fenced developments and/or shareholders.
- 1.4 Large companies use their capital to invest in very large energy generation projects and, if listed, the public and communities can participate through share ownership. Large companies that carry out such developments could benefit from strengthening their ‘license to operate’ through more community involvement and support.
- 1.5 Communities are able to invest in their own energy generation developments by creating and owning limited liability companies or co-operatives<sup>4</sup>.
- 1.6 Communities, through the planning process, have shown that they can often determine whether a technically suitable site for energy developments should proceed or not. Many large corporates have now learned the value of engaging stakeholders in positive ways. Examples include Falck, Energy4All, ScottishPower Renewables.
- 1.7 In the case of large scale offshore wind and marine developments these remain linked to communities through the use of roads and ports, the landing of power cables, the impact of pollution or its avoidance, and the generally shared interest in sustainable energy development.
- 1.8 There remains, however, an obvious gap in community investment models, which is that there are few, if any, examples where communities are able to participate directly in very large renewable energy generation projects. Communities are not likely to have the resources to become the primary investors and would therefore aim to be minority participants in such projects.

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<sup>4</sup> There are now many examples of community co-operatives running their own wind farms, such as Westmill Wind Farm, Baywind, the Co-operative Farms (jointly with Scottish Power), Kilbraur Wind Energy, Boyndie Wind Farm, Torrance Wind Farm (Energy4All)



- 1.9 This paper discusses a possible model whereby communities can pool resources to create a fund to invest in the economic capacity of a large scale energy generation asset.

## Goals of Community Investment Funds

- 1.10 The main goal of the CIF is to allow community investors to invest in the fortunes of specific energy projects as an alternative to the ownership of publicly quoted shares in a renewable power generating company.
- 1.11 For the purposes of this discussion, the goal of the CIF is to move into a new area of direct participation in large project developments.

## Barriers to community investment participation in large scale and/or offshore projects

- 1.12 The barriers to community investments in offshore energy projects include:
- Definition of “community”. Onshore developments define the community as those living within a certain distance from the development; however, offshore developments have initially been seen as “without community”. This limits participation at present and ignores the community link through associated onshore developments and the impacts that may be experienced both onshore and offshore from the development.
  - Large projects are often owned on a balance sheet together with a mix of other assets, so unique investment in the project through shares is impossible because share purchases represent investment in a collection of assets. (This does not apply where the project is owned within a separate legal entity allowing risks and benefits to be uniquely evaluated.)
  - Individual project risks are more significant than portfolio risks for small investors. This is not unique to this model but begs the question of why would community investors choose to invest in this rather than at corporate level. This would need further exploration but may be connected to a sense of ownership and/or control of distribution of funds.

## 2: Community Investment Fund and Lease and Toll Model

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- 2.1 This section presents the concept of the Lease and Toll Model and how it might be applied.

### Taking an non-equity interest in large third party projects

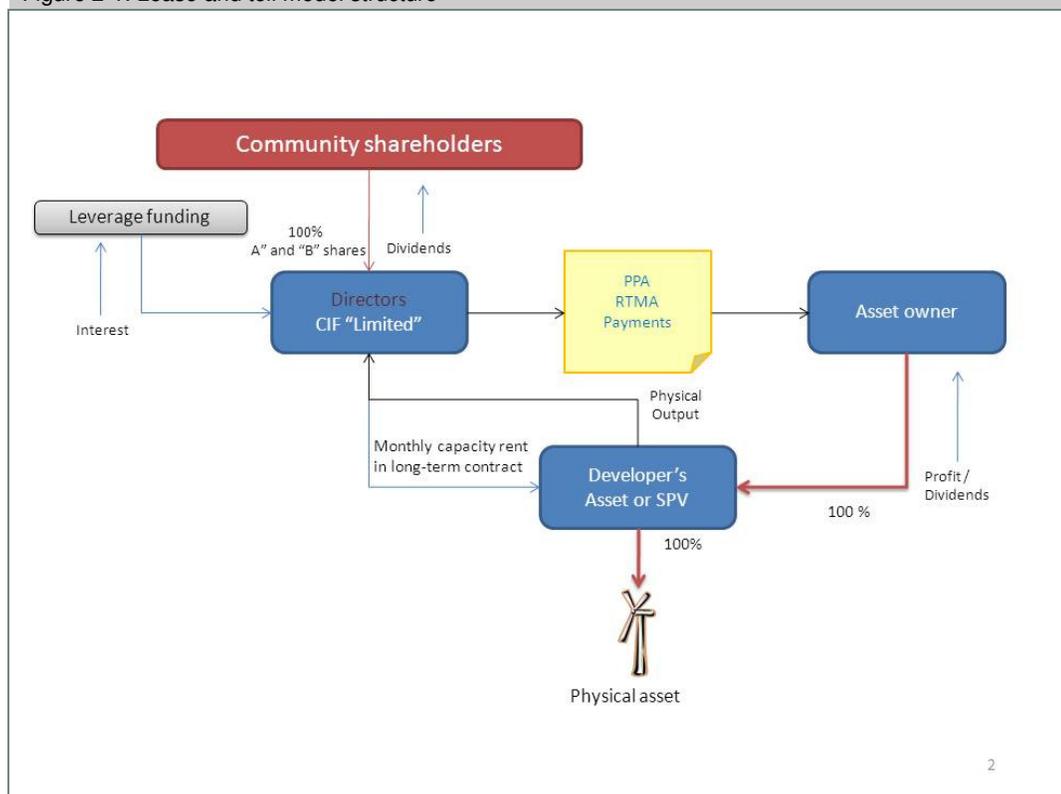
- 2.2 The lease and toll model suggested is an arrangement whereby a “virtual project capacity” can be leased for a fixed period of time. The essence of the deal is that the CIF makes a payment to the project owner to secure a right to the output of part of the asset for the benefit of the CIF. The payments made by the CIF should compensate the owner for the cost of capital invested and both parties should also recognise that income risk has moved from the owner to the CIF. The payment should additionally provide a small incentive payment to the project owner. The electricity generated from the project capacity is paid for at an agreed toll (lower than the price of electricity) and then sold at market rates, providing a profit.
- 2.3 Figure 2-1 illustrates a method to achieve this through a “lease and toll model” which could allow the CIF to invest in a specific project capacity.
- 2.4 Examples of such arrangements can be found in oil and gas industry, “*a tolling contract does not require the converter, processor, or transporter to purchase the input material or to sell the output product.*”<sup>5</sup> A toll processing arrangement is typically defined as follows: “*Type of take-or-pay contract for conversion, processing or transportation (usually through a pipeline) of raw material or finished product.*”
- 2.5 In this case, the definition is adapted and includes the concept of leasing. The concept is that the CIF would pay a sum of money to “lease” a part of the asset for a period of time. The resource (being wind or marine energy) is then processed by the asset to produce energy which becomes the property of the CIF.
- 2.6 This discussion paper does not explore further whether this should involve specified assets (such as three particular wind turbines) or a share of the whole (such as 10% of a whole wind farm) or whether the best option is tolling alone, although the way electricity is metered makes it likely that the simplest method is to reassign a percentage of the whole output to the CIF.
- 2.7 Figure 2-1 shows how the concept of tolling could be applied in the case of a generating asset. The figure shows that community investors provide the CIF with money to invest through the purchase of shares. The CIF would then enter into an agreement with the owner of the asset to “lease” a portion of the asset to the CIF. This means that the CIF, in exchange for a payment, receives the output of the asset in the form of electricity and any green certificates such as ROCs and LECs. The figure also shows a further arrangement with the asset owner whereby the owner purchases the products from the CIF.

<sup>5</sup> <http://www.businessdictionary.com/definition/tolling-contract.html>



- 2.8 The charge for leasing capacity could be determined by an accounting formula and must cover the depreciation of fixed costs plus operating and other costs so that the asset owner is not disadvantaged. The electricity output, which may or may not attract other benefits such as Renewable Obligation Certificates (“ROCs”), Climate Change Levy Exemption Certificates (“LECs”), Renewable Energy Guarantees of Origin (“REGOs”) and other benefits according to the specific terms of any agreement, would belong to the CIF and hence there is a transfer of various risks.
- 2.9 The risks could include: output risk; electricity price risk; credit default risks; ROC revocation risk; ROC recycle risk; LEC invalidity risk; and others. All these risks can be further disaggregated into the more fundamental underlying risks.
- 2.10 A major feature of this model is that it becomes relatively easy to define the periods and amounts which are contracted and to structure these in blocks. It should be possible to acquire any strip or slice of output, and price and risk would vary accordingly. For example, it may be possible to contract for the bottom slice of the output (lowest output risk) across the whole wind farm for a period of one month. Alternatively, it could be possible to acquire all the output over, say, 50MW for the next winter period. The details of any agreement would be down to the CIF to negotiate with the asset owner.
- 2.11 The model is based on the idea that the costs, benefits and risks of owning a generation asset can be synthesised through a contractual arrangement with the owner of such an asset. By entering into such a contractual arrangement, the party contracting with the asset owner has the opportunity to select, subject to the agreement of both parties, from various levels of risk in the output. For example, suppose we are considering the output of a wind farm. The generation from the first 10% of capacity as wind speed rises has completely different risk characteristics from the final 10% of capacity. The former is likely to be available for much longer and will be less variable than the latter. As well as taking horizontal slices of the output (bottom and top slices in the previous example), it would be possible to select vertical slices, such as summer or winter, peak or off-peak, day or night and so on.
- 2.12 One challenge for the CIF is what it should do with its electricity output. One option is to sell the output to the asset owner, who already receives the whole of the metered output. As a result of the tax free contributions and various grants made available to the CIF, and the limited rate of return to shareholders in the CIF, it should be feasible to sell the electricity to the asset owner at a price which on a net basis delivers a small increase in profit to the asset owner and therefore an incentive for the asset owner to participate.

Figure 2-1: Lease and toll model structure



Source: SQW/4DEnergy

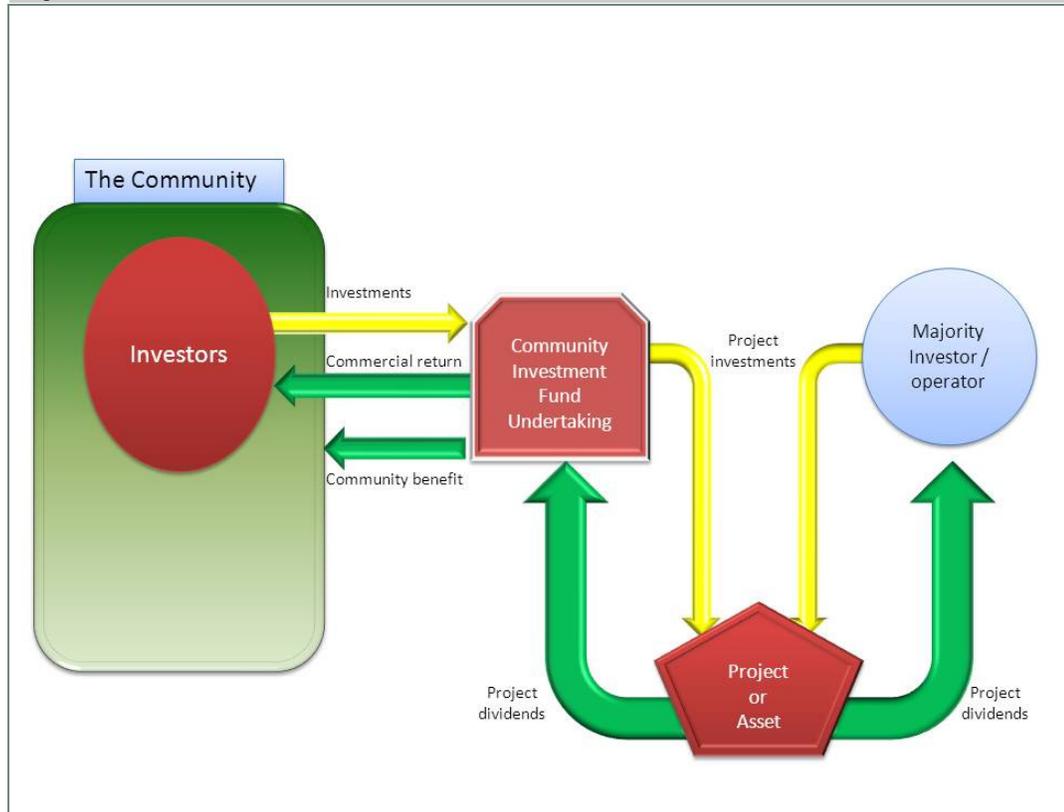
**Note: PPA refers to "Power Purchase Agreement"; RTMA refers to "ROC Trading Master Agreement"**

## Aim to incorporate the CIF as a standard limited company

- 2.13 We further suggest that the CIF could be set up as a standard limited liability company which has a community interest and which qualifies for Enterprise Investment Scheme tax relief (which allows purchasers of shares a 30% tax relief). The tax relief generates extra value that can be divided between: investors in the CIF, the project owner (who would receive the benefit via the fee received from the CIF) and the community (whose membership will include the investors). Since the tax relief is only available if investments are retained for three years, and thereafter the benefit of the tax relief becomes diluted (because the tax relief is received only on the initial investment), the optimum duration of the investment and the company is likely to be three years. Figure 2-2 illustrates how a CIF based on investments from the community might deliver a community benefit as further described below.
- 2.14 Figure 2-2 shows a stylised approach demonstrating how self-selecting members of a community could make investments in return for a financial benefit, while at the same time the community as a whole benefits from the existence of such a scheme.
- 2.15 In this approach, investments are made by investors into the CIF and the CIF then co-invests in a project (or agrees an alternative type of interest for the CIF such as a contractual relationship), along with the major shareholder's contribution. The major shareholder might be the power company which also operates the asset. As the asset generates revenues, net

profits become available to distribute to shareholders or to those with a contractual entitlement to share profit. The CIF takes its share of profit and makes a commercial return to investors, and additional returns are made available to the wider community for communal benefits.

Figure 2-2: Illustrative funds flows



Source: SQW/4DEnergy

- 2.16 A quantitative model has been developed to illustrate potential cash flows of this approach, an example of which can be seen in Annex A. In this example, initial investment amounts to £2 million, with £0.6 million tax relief due. The 3-year project, involving leasing 2.32 MW processing capacity for £2.3 million, yields revenues to investors of £111,000 and residual cash of £2.6 million; “donation” to the community of £85,000; and enhanced net present value to the project operator of £72,000.
- 2.17 The return to the CIF of the processing capacity is the price from the sale of electricity. This provides revenue to go into the CIF which is then able to pay revenues to those who own shares in the CIF.

### Other corporate structure options

- 2.18 It is hoped that a standard limited company structure with a community interest would be an adequate vehicle to satisfy HMRC that it should be entitled to the EIS tax relief. If, however, either the EIS tax relief cannot be secured or potential investors feel that the vehicle is too informal for a community purpose, then there are alternative corporate structure options, e.g. Community Interest Company (CIC), co-operative, community benefit society, partnership

etc. depending on the objectives of the community investors, costs of administration, and tax and compliance considerations etc.

- 2.19 For example, a CIC would then have further advantages from an investor perspective (but cost more to administrate) of: mandatory reporting on community benefits; asset lock to protect the assets from disbursement by the Directors in a manner that is not compatible with the community purpose. Distribution of profits to investors is capped at the Bank of England base rate plus 5%. It is also required, amongst other things, to report annually to justify its community benefit and how it has involved its stakeholders.
- 2.20 There are advantages in registering as a CIC compared with their standard equivalents. Although they raise finance in the normal way through shares, loans and debentures, they can also access grants and soft loans from the Community Development Finance Institutions (CDFIs)<sup>6</sup> and private sector businesses.

## SWOT analysis of the Lease and Toll Model

- 2.21 Particular **strengths** of this format are: no interference with share ownership or control over the asset itself; it could preserve or improve the asset owner's business case; and could provide a surplus for community benefits.
- Initial **opportunities to pursue arising from the interface of Strengths and Opportunities** are that contractual agreements between the CIF and the asset owners agreeing: an upfront payment is made in exchange for the risk of future output for a defined period; and / or a defined output and slice entitlement (electricity, green certificates) subject to a specific term.
- 2.22 Some specific **weaknesses** of the model include the potential transfer of physical electricity, ROCs and LECs to the CIF which require specialist management, at risk of contract breach.
- The **weaknesses in relation to opportunities** suggest a number of **areas for improvements** can be made to the model such as: to put in place a standard arrangement for the CIF to sell its electricity to the owner or another third party or a combination of both; and / or to provide for the sale of ROCs and LECs; and / or to minimise exposure to contractual breach by an offset arrangement between leasing charge and failure to deliver electricity.
- 2.23 Two of the most obvious **threats** to the CIF in this model include the insolvency of the Asset Company, and market price volatility in the electricity, ROC or LEC markets as applicable. There is also the threat of the EIS tax incentive being removed in which case the basis of the CIF would have to be reconfigured.
- Taking the **strengths and threats** together indicates the threats that the CIF should seek to eliminate. Specifically, these might include the following: the CIF could seek to strike contracts for sale of power for a time period that corresponds to its commitments to rent capacity; and / or where there is residual market risk that cannot be mitigated through

<sup>6</sup> [www.cdfa.org.uk/members/resultt.php](http://www.cdfa.org.uk/members/resultt.php)



contracts or insurance or other means, then good market information and advice is needed.

- Finally, where the above **threats impinge on the weaknesses** of the model, we have indications as to the risks that must be mitigated or, if possible, avoided altogether. Possible strategies to achieve this include: paying leasing charges in instalments to protect against contractual breach or insolvency; and / or offering a lien on electricity for CIF default; and / or agreeing to waive any margin relating to trading collateral; and / or indexing the leasing fee to market price so that market risk margins do not arise.

## Risk and output management

- 2.24 More generally, given that there is no equity investment, it would be possible to lease part of the asset (or have a pure tolling arrangement) which could be payable in instalments. This is a lower risk position than would be the case where all the capital is fully committed in the equity model. If, for example, the asset suffers a catastrophic failure, or its owner becomes insolvent, the CIF is largely protected because its members will have assessed this possibility and therefore entered into commitments for a short forward period of cash payment at any one time, even if the contract is for a longer term. The asset owner is also protected to a degree from CIF default on payment since it would retain a lien on electricity not yet delivered.

## Summary and further research

- 2.25 This discussion paper addresses the question as to how it may be possible for communities to participate more directly in the fortunes of large scale energy production developments. Although there are numerous ways for communities to develop small scale renewable generation projects, and for individuals to acquire shares in listed companies that own generation plant, neither of these approaches works for large scale generation.
- 2.26 Communities cannot afford to develop very large scale projects themselves and listed energy companies generally have a very broad range of operating assets (such as wind, coal, nuclear, energy supply and so on in a number of countries) which means that it is impossible for communities to invest in a particular project though listed shares.
- 2.27 This discussion paper proposes solving this problem as follows. First, we propose that a share of large asset could be, in effect, “leased” to a community by its owner. Secondly, we suggest that funds to incentivise communities to invest and power companies to participate might be available through the income tax relief that can be obtained under the Enterprise Investment Scheme. This would involve setting up a community investment fund (“CIF”) as a standard limited company, which would raise investment capital by offering shares (attracting EIS income tax relief) to members of the community.
- 2.28 The CIF would enter into an agreement to “lease” part of the large energy generation plant for a period of time at a price designed to reward the project owner, and this would entitle the CIF to the benefits of energy and other products (such as valuable green certificates) that the plant generates. One condition that must be fulfilled to obtain the tax relief is that the

company must serve a community purpose. The tax relief would provide funds to enable this too.

- 2.29 Beyond the financial incentive for the power company who owns the “leased” asset is the opportunity to give tangible meaning to claims of community engagement. Communities are defined by commonality of interest amongst their constituent members.
- 2.30 In order to take the idea further, it would be necessary to garner community, corporate and political support. The next stage of development for this innovative idea would be therefore to carry out a policy design and analysis exercise. In outline, this could involve a deeper analysis of the policy issues that arise from community involvement in large energy projects and then designing a scheme that could support those objectives in a sustainable manner.
- 2.31 There is prima facia argument to suggest that this could be a fruitful exercise. Companies can be constituents within communities having complex relationships with and within societal communities. The exploitation of energy resources and their conversion into other forms such as electricity is already an area of interest to companies and increasingly one for societal communities as well.

If a shared vision fosters sustainable relationships within and between communities and companies, it follows that sharing a common vision for energy exploitation and production is a source of community and corporate sustainability and strength. Given the scale of energy development required in the UK over the coming decades and the need for public support and engagement, opening the way to community participation in large scale energy projects is surely a legitimate policy goal.

## **Annex A: Quantitative illustration**

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### Introduction

- A.1 This Annex provides a simplified version of an illustrative quantitative analysis of the incremental economic effect of instituting and running a standard limited liability company (“Company”) based on the principles suggested in this report.
- A.2 A three year project has been chosen for this example because three years is the minimum term for an investment in the Company qualifying for Enterprise Investment Scheme to entitle the investor to a one-off income tax relief based on 30% of the investment made. Each year after the minimum three year period will tend to dilute the effect of this benefit as the one-off sum is spread over an increasing number of years.
- A.3 The analysis modelled the incremental cash flows accruing to all major stakeholders including the investors in the Company, the Company itself, the owner of the asset and the wider community that benefits from a contribution from the Company.
- A.4 As well as the contribution of income tax relief for investors who buy shares in a Company, which qualifies for such relief under the Enterprise Investment Scheme, the other major contributions that are recognised include the benefit of the output of the asset which is leased to the Company. Income tax on dividends paid to investors in the CIF and capital gains taxes of shareholders are not accounted for here.

### Incremental cash flows in outline

- A.5 The outline analysis looks at the arrangement from the perspective of the four main participants: the part of the community that make the investments; the Community Investment Fund; the whole community who receive benefit from the scheme; and the owner of the project assets.
- A.6 The equity raised by the Community Investment Fund is used to pay the lease on the asset. The quantum of the lease is determined by calculating how much must be paid to offset the investment cost of that portion of the asset to the owner together with a reasonable premium in consideration of the owner’s willingness to lease the asset. It is essential that this cost is less than the expected value of the project income stream if the scheme is to work. An important element is how to deal with ROC recycle. In this example, the ROC recycle (essentially a State Aid) is deemed to follow the person entitled to the use of the asset. If this proved to be too controversial, the approach could be reworked, essentially by passing some of the benefits accruing to investors back to the project owner so as to reinstate the ROC recycle benefit.
- A.7 In return for paying the lease, the CIF receives the products of the asset which, in the case of, say, a wind farm, would include electricity, ROCs, LECs and REGOs. These are traded by or on behalf of the Company for value which is then the income stream to the Company.

- A.8 The Company then disburses the income from the sale of products to its investors. It also makes a donation to the relevant community and, at the end of the three year period, any remaining equity is assumed to be returned to the shareholders in full.

### The example in outline

- A.9 The following paragraphs describe a stylised example of the cash flows that might be seen by each of the four main parties involved in the scheme, that is: the part of the community that make the investments (the investors); the Community Investment Fund; the whole community who receive benefit from the scheme (the Community); and the owner of the project assets (the Project Owner).

#### **Investor cash flows**

- A.10 The investor invests £2 million and receives income tax relief of 30%, i.e. £600K. The £600k is assumed to be transferred to the fund, the details of which mechanism are not discussed here.
- A.11 The income to the investor arises in the form of annual dividends and a capital gain at the end of the three year lease period. These are shown in the table below:

Year / (£K)	2012	2013	2014
<b>Share purchases by investors</b>	-2,000		
<b>Income tax relief obtained</b> (assumes 30% average)	600		
<b>Income tax relief contribution to fund</b>	-600		
<b>Dividends paid to CIF shareholders</b>	12	32	32
<b>Capital returned to Shareholders at end of period</b>			2,600
<b>Net shareholder cash flow</b>	-1,988	32	2,632
<b>Net cumulative shareholder cash flow</b>	-1,988	-1,956	<b>676</b>

- A.12 The outcome is a net £676K for shareholders which is represented by a return of the initial capital, the initial tax relief and the dividends paid to shareholders by the CIF.

#### **Community Investment Fund cash flows**

- A.13 The Community Investment Fund company receives the equity investment comprising the investor capital plus tax relief as shown above (along with any other sums that are not accounted for here such as grants and loans, which themselves also constrain the way in which monies can be paid out and which are not added here).

- A.14 The Company then uses its resources to obtain a three year lease of a portion of the asset owner's generation asset, which could be a wind farm, for example. The figure below shows these cash flows in outline which is based on a notional capacity of 2.32 MWe operating at a load factor of 35% and receiving 1.5 ROCs per MWh as well as LECs.

Year / (£K)	2012	2013	2014
<b>Equity received from Share purchases by investors</b>	2,600		
<b>Income received by selling products of generating capacity leased</b>	872	872	872
<b>Cost of lease, set-up cost and fees</b>	-838	-813	-813
<b>Gifts paid to the community</b>	-20	-20	-20
<b>Gross profit of fund</b>	14	39	39
<b>Corporation tax</b>	-3	-8	-8
<b>Net profit of fund</b> <i>(rounding errors)</i>	12	32	32
<b>Dividend paid to CIF shareholders</b>	-12	-32	-32
<b>Net CIF cash flow</b>	2600	0	0
<b>Equity returned to shareholders</b>			2,600
<b>Net cumulative CIF cash flow</b>	2,600	2,600	0

### The Community Cash Flow

- A.15 The cash flow of the community is very simple in that it is represented by the gifts made by the Company as shown in the figure below.

Year / (£K)	2012	2013	2014
<b>Gift paid to community</b>	20	20	20
<b>Net cumulative gift to community</b>	20	40	<b>60</b>

### Project Owner's Cash Flow

- A.16 The final set of cash flows is seen by the project owner. The project owner on the one hand gains the benefit of the lease income, which should be lower risk than project income and therefore be accounted for at a lower discount rate than project income. On the other hand, the owner loses the opportunity to earn from the project. Arguably, this is of benefit to the project

owner because the larger project can be operated at lower financial risk during the period of the lease, while gaining experience on a smaller element of the project. Later, the owner will acquire the entire project once again.

- A.17 The stylised outline cash flows can be seen in the table below and show that, in this example, a positive net return is possible for the owner based on the assumptions in this evaluation. ROC recycle has not been considered a loss as it is state aid relating to an asset that has been leased to another party, who could be regarded as now having the equitable entitlement to the state aid.

Year / (£K)	2012	2013	2014
<b>Income from capacity lease</b>	813	813	813
<b>Lost revenue from relinquished capacity (excluding ROC recycle)</b>	-776	-776	-776
<b>Cost of set up</b>	-25		
<b>Net project incremental cash flow</b>	12	37	37
<b>Net cumulative project incremental cash flow</b>	12	49	<b>86</b>

- A.18 It is instructive to observe that examples can be found where, in essence, the income tax relief obtainable under the Enterprise Investment Scheme, whereby investors can get a one-off income tax relief of 30% of the value of shares purchased in a qualifying community interest company, tend to incentivise the maintaining of the investment for no longer than the minimum three year period for which such qualifying investments must be held. This is because of the dilution effect where the tax relief is spread over a greater number of years. This suggests that creating and unwinding schemes every three years is the best approach to achieve maximum benefit.

## **Annex B: Financial Regulation**

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- B.1 In any of the scenarios discussed, the impact of regulation must be taken into consideration. In the case of a standard limited company, normal FSA rules apply, requiring a prospectus and other rules regarding financial promotions and trading any specified investments in a regulated market.
- B.2 In the case of the CIC, the requirements of the Community Interest Regulator must be taken into account. In reality, in either case, it would be prudent to follow the same processes even where the law does not formally impose regulatory conditions.
- B.3 Further, consultation to date suggests that rules may change to bring all company formats under the same framework as standard companies making financial offerings, and therefore decisions should not be made simply to avoid the burdens of existing financial regulation.
- B.4 Great care needs to be taken regarding the accounting aspects of this approach, although the challenges presented are nothing out of the ordinary, such as the creation of financial leases. For example, it may be suggested that leasing a portion of a wind farm, which results in the CIF acquiring initial ownership of electricity which it then sells to the asset owner, is a fictitious arrangement for accounting purposes because the same physical result could be achieved if the arrangement had never been put in place. The answer to that is that the two situations can be sharply distinguished in a multiplicity of ways: the CIF is free to sell to any party and may do so without the permission of the asset owner; there is absolute evidence of a different chain of title custody; the arrangement exists to serve a separate commercial purpose, which is to generate profit for the community; the outcomes may be different in the event of insolvency.

### ***Financial Services and Markets Act***

- B.5 Financial business is regulated, amongst other legislation, by the Financial Services and Markets Act 2000 (“FSMA”). The most immediately significant aspect of FSMA that is relevant for the CIF is the Section 19 Prohibition, as it is commonly referred to. This requires that any person who is carrying out a regulated activity in the UK must either be authorised by the Financial Services Authority (“FSA”), who is currently the regulatory body overseeing compliance with FSMA, or must seek exemption.
- B.6 Compliance with FSMA is extremely important because a breach of Section 19 is a criminal offence. FMSA is an exceptionally complex area of law and the list of regulated activities is extensive, but it includes dealing in investments as an agent or a principal, managing investments, advising on investments and setting up collective investment schemes, and even agreeing to carry out such activities.
- B.7 The CIFs considered here involve carrying out all these activities as a minimum by way of business (the “business test”). Exemption from FSA authorisation is available for professional firms (meaning solicitors, accountants and actuaries), but only if incidental to their main business, and local authorities. The CIFs suggested are therefore unlikely to qualify for exemption and authorisation will need to be provided for.

- B.8 This note does not attempt to spell out every detail of how FSA Authorisation should be obtained, but it should be pointed out that there are a number of alternatives which include seeking authorisation for the company itself and installing all the procedures and appointments necessary to comply with “Conduct of Business” rules, or it may be possible to contract financially regulated elements to a third party who already has this in place, such as an existing professional fund manager. The costs and benefits of each approach will only be known when a specific fund is being considered.
- B.9 Compliance with FSMA regulations regulates the way that the CIF can deal with its investors and investments within a very strong and well-defined framework. The main intention is to prevent investors from unnecessary financial loss.
- B.10 The practical consequences include a need to identify and classify customers according to their financial sophistication (“Know Your Customer”). This means, for example, that an ordinary individual investor may need to be informed formally in writing regarding the risks involved in investments. On the other hand, a very sophisticated investor, such as a bank (classified as a “Market Counterparty”), would not need to be warned. Further rules exist for “Intermediate Customers” such as regular commercial companies and “High Net Worth Individuals”.
- B.11 FSMA also imposes constraints on the promotion of financial products and services which must be taken into account in the procedures and training of the CIF management. These rules are particularly significant in relation to, for example, offering unlisted shares to private individuals.

### ***Money Laundering Regulations***

- B.12 A second major element of financial regulation that is applicable to the CIF is the Money Laundering Regulations 2007 (“MLR”) which are also regulated by the FSA. This legislation is vital to strangling the routes by which money acquired through illegal means can be given the appearance of legitimacy by interrupting the laundering process of “placement” (introducing illegally gained cash for laundering), “layering” (disguising the source through layers of complexity such as offshore accounts and large numbers of electronic transactions in relation to fictitious deals) and finally “integration” (where the money emerges from a legitimate business with all the appearances of normality).
- B.13 The relevance of MLR to the fight against the drugs trade and terrorism means that falling foul of its procedures is a significant criminal offence as it exposes the UK to serious and possibly life-threatening consequences. The rules include a general legal obligation to report suspicious activities and to desist from tipping off potential suspects.
- B.14 Regulation of Co-operatives and Community Benefit Societies Co-operatives formed according to the Co-operative and Community Benefit Societies and Credit Unions Act 2003 (as renamed by the 2010 Act)
- B.15 Compared with general financial and money laundering regulation, the legislation governing the registration and operation of Co-operatives and Community Benefit Societies is relatively straightforward and accessible, though still with its own nuances and complexities.

- B.16 Community Benefit Societies are not regulated by the FSA, a practical consequence of which is that they do not need to comply with specific FSA codes of practice and they do not need to issue a prospectus when starting up. Nevertheless, Societies are responsible for assessing whether any of the activities they carry out are prohibited by Section 19 of FSMA. If so, the Society must obtain authorisation from the FSA. Also, the FSA is currently liaising with co-operatives to produce a non-binding code.
- B.17 In short, regardless of the format of the CIF, the need to understand and comply with financial regulation is inescapable, and it is anyway good business practice. Financial and money laundering regulation is of the utmost importance to a CIF and there should be no compromise in ensuring that all regulations are complied with.