COMMUNITY WOODLANDS ASSOCIATION

PROPOSAL FOR HYDRO SCHEMES CO-OPERATIVE – OUTLINE OF RECOMMENDED MODEL

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1 BACKGROUND AND SCOPE

1.1 Community Woodlands Association (Scottish charity number: SC038374)("CWA") – are proposing to set up a co-operative to facilitate investment by community woodland groups in renewables projects.

1.2 Burness Paull has been appointed, following upon a tender process, to provide legal support to the project, with the key task at this stage being to guide CWA on the most appropriate legal model for delivering the activities which are envisaged for the co-operative.

1.3 This paper records the outcome of the workshop session – involving Jon Hollingdale of CWA, representatives of community woodland groups, and a representative of Local Energy Scotland – held on 13 November 2015; the workshop was facilitated by Stephen Phillips of Burness Paull.

1.4 It should be noted that there was a very wide-ranging discussion at the workshop, with careful analysis of a number of possible options that were ultimately rejected in favour of the preferred model. This paper does not attempt to capture the full detail of the discussions; instead, it focuses on the legal framework which emerged as the preferred model.

1.5 The intention is that this paper will form a focus for wider consultation – to ensure that all key stakeholders are comfortable in principle with the key features of the recommended model. That in turn should represent a sound basis for the more detailed work that will need to be carried out, to put the preferred model in place.

2 KEY PARAMETERS

2.1 In developing a legal framework in this type of situation, the overriding principle is that form should follow function; that is to say, the type of legal entity, and other features of the legal framework, need to reflect the role which that entity is to play. The initial part of the workshop therefore focused on the role of the new legal entity, and the practicalities of how it would operate.

2.2 Key points emerging from the initial part of the workshop were as follows:

2.2.1 **outline of key activities**:

(a) the new vehicle would provide advisory support to community woodlands groups wanting to progress hydro projects; rather than an individual community group having to employ its own project manager (and/or other technical staff resource) – which is often not non-viable in the context of an individual hydro project – or take on the additional costs associated with sourcing external consultancy support, the new vehicle would have a dedicated staff team which could be called upon by individual groups as required (at a practical level, of course, there may be a need for the new vehicle to access grant funding at the set-up stage to support its initial staff resource until such time as a sufficient income stream from its own activities has been established);

(b) the new vehicle might use collective purchasing power (the ability to point to a potential pipeline of projects from a number of groups, as compared with an individual project) to gain advantageous terms from consultants, hardware suppliers and others – by running procurement processes to set up framework arrangements which member organisations could then use to source services and hardware ie with more advantageous pricing than the member organisations would otherwise have been able to achieve individually (though acknowledging that the fact that groups will be at different stages will make bulk procurement of that kind slightly more challenging than it might otherwise have been);

(c) in a similar way, the new vehicle might engage with prospective lenders, with a view to presenting lenders with the prospect of a flow of future projects, all supported via the advisory services provided by the new vehicle and thus with better assurance for lenders that each project would be investment-ready before they were asked to carry out due diligence; again, this might ease the process for individual organisations in accessing loan funding, as well as driving more attractive loan terms (in the short term, of course, the new vehicle would need to establish credibility with lenders to make that type of approach viable at a practical level);

(d) there may also be the possibility of the new vehicle accessing grants to support initiatives spanning a number of individual member organisations; again, the ability to take forward initiatives at scale may be attractive to certain grant funders;

(e) the new vehicle would seek to spread best practice among member organisations – partly through serving as a resource via its own staff team, but also by encouraging networking and peer-to-peer learning among member organisations;

(f) the new vehicle might engage with key partners (eg Forestry Commission Scotland) to establish agreed templates for lease options and other documentation – thus creating a saving in time and legal costs for member organisations;

(g) the new vehicle might negotiate a power purchase agreement that covered the collective output of the participating member organisations, achieving better terms (via the smoothing of supply and higher volumes) than an individual organisation could achieve.

It was confirmed, for the avoidance of doubt, that:

(i) the new vehicle would not take on ownership of the hydro projects which individual member organisations were developing, but over time it might invest in individual hydro projects (ie as a joint venture partner or passive investor);

(ii) the new vehicle would not act as an intermediate lender, taking on commercial borrowings and lending the money on to individual projects;

(iii) the new vehicle would not itself be the subject of a community share issue.

2.2.2 **recycling or distribution of profits**:

(a) the new vehicle is not intended as a means for CWA to generate net income, but it was seen as appropriate that CWA should have some element of financial return;

(b) while it was felt that there should be some financial incentive for member organisations that were contributing to the activities of the new vehicle, it was felt on balance that the idea of profit-distribution - in the sense of sharing in a common pool of surpluses each year - was not appropriate;

(c) for the most part, the new vehicle would be expected to recycle any surpluses - either to further its own activities (eg initiatives for the benefit of all or most of the member organisations) or to provide at-risk support to individual member organisations where that was felt to be appropriate.

2.2.3 **relationship with CWA – practical arrangements**:

(a) it was felt that, from a practical point of view, it would make sense for the new vehicle to accommodate its staff team within CWA's office, and to access back-office services from CWA;

(b) the arrangements outlined above would be reflected in a services contract between the new vehicle and CWA, and with an approach to pricing which allowed CWA a reasonable margin over and above full cost recovery;

2.2.4 **relationship with CWA – formal linkages**:

(a) notwithstanding that CWA is leading the process of exploring options for the new vehicle, it is considered to be inappropriate for the new vehicle to be formed as a wholly-owned subsidiary of CWA;

(b) the new vehicle should be seen to be controlled by the organisations that have a particular interest/involvement in hydro projects (and, as a further point, it is intended that membership of the new vehicle should be open to organisations that are not members of CWA);

(c) nevertheless, CWA should have some degree of formal linkage with the new vehicle, via provisions contained in the new vehicle's constitution – this would comprise (i) an entrenched right to a seat on the board of the new vehicle, and (ii) the ability to veto any future changes to the objects clause; in addition, the constitution should state that any surplus assets on a winding-up should be transferred to CWA.

2.2.5 **relationship with individual member organisations**

(a) an individual member organisation should be entitled to participate in AGMs and other members' meetings, and to vote in elections to the board of the new vehicle;

(b) it is recognised that individual organisations may be at different stages of development in relation to hydro projects at the time when they join the new vehicle, and that the nature and extent of the services and/or other support that they access from the vehicle will be dependent on that and other factors; on that basis, the simplest approach for structuring the interface between member organisations and the new vehicle regarding services and other support would be to adopt a pricing model – with the practical effect that, broadly speaking, the member organisations will be sharing the cost of employing the core advisory team (and other overheads) in line with the extent to which they call on the core team for advisory support;

(c) individual member organisations who have some experience in particular aspects of hydro projects will also be contributing in kind, via peer-to-peer support; again, this will vary over time (eg an organisation might initially be too preoccupied with its own project to spend time helping another group, but well able to release staff to assist another group once its own project has passed through the more critical phases) – so a model under which individual member organisations were given credit for time spent in advising other member groups (with that credit being available to offset fees for support from the core advisory team – see (b) above) would be appropriate;

(d) it should be recognised, of course, that member organisations who seek external funding to support the development of hydro projects will in turn have to satisfy the requirements of those funders regarding the engagement of consultants to provide technical support, and in particular any requirement to follow a procurement process in selecting consultants (eg in relation to CARES funding). The structure outlined in this paper broadly follows EU procurement law principles allowing a procurement process to be dispensed with where there is a jointly-controlled body delivering services to its member organisation – but that does not mean that an individual funder cannot still impose a requirement that consultants be selected only via a procurement process. Having said that, the new vehicle would be able to submit its own bid in the context of any such procurement process, and its bid is likely to be attractive from a pricing point of view as compared with a conventional private sector consultancy. The new vehicle would require to take responsibility for the quality of support provided by member organisations where support from that source formed part of its bid – but that would not necessarily be a major issue.

2.2.6 **overall deal for an individual member organisation**

(a) the overall model would provide an individual member organisation with access to a dedicated technical resource at a cost that will be lower than engaging an external consultant;

(b) there may also be the prospect for an individual member organisation of being able to earn credits to further reduce fees for the support which it accesses for the core team, where that member organisation helps another member organisation via peer-to-peer support;

(c) the work of the new vehicle in negotiating deals with service providers, hardware suppliers, commercial lenders and others would translate into financial savings for an individual member organisation;

(d) the new vehicle would be controlled by the participating organisations, along with CWA, via their powers as members of the new vehicle (including election/re-election of board members); and it should therefore be responsive to the evolving needs and aspirations of the participating organisations.

3 ANALYSIS OF OPTIONS

Use of shares to determine split of profits

3.1 Given the general description given to the new body as a "co-operative", there was fairly extensive discussion at the workshop round the question of what specific co-operative features should be reflected in the constitution of the new body. On the basis of the key parameters set out in section 2, it is clear as a fundamental principle that the new vehicle should be controlled by the member organisations under democratic principles. It was also confirmed that this should apply on a one member/one vote basis – subject to the special rights given to CWA (reflecting CWA's role in establishing the new body) as outlined in paragraph 2.2.4(c).

3.2 The more difficult issues relate to the question of whether a further feature of some (but not all) co-operative structures should be built in to the constitution – that is, the principle that members should share in surplus profits in line with their respective contributions, and with that principle being structured through the holding of different numbers of shares. The concept would be that an organisation which had contributed to the new vehicle would receive an allocation of shares in line with that contribution, and that would be reflected in a certain proportion of the split of profits in future years; a new member joining the vehicle would have to contribute before gaining a significant share allocation; a member which continued to contribute over time would build up a greater holding of shares, and thus a higher profit-share percentage, and so on.

3.3 It is recognised that in this particular context, the contributions are more likely to be in kind (via the provision of peer-to-peer advisory support), rather than cash contributions. There could be significant complications in operating this kind of model in a situation like this one where – unlike, say, an agricultural co-op where it is relatively straightforward to track the year-by-year sales of milk to the co-op by individual co-op members, and allocate annual dividends accordingly – the balance of activities that the new vehicle will be carrying out on a year-by-year basis will change, and potentially a member organisation who makes a very substantial contribution in a given year might find that the surplus available for distribution in respect of that year happens to be very low because the vehicle was involved in a greater volume of non-income generating activities during that year. It also becomes a complex exercise to determine how best to deal with new members, given that issuing shares to new members will inevitably reduce the proportionate share of profits that would be available to existing members; a member who joined and made a reasonable contribution in its first year might find itself participating in a healthy share of profits at the expense of a longstanding member which had perhaps put in substantial contributions at the start but had seen a succession of years pass with little or no profits available for distribution by way of surplus. A further consideration is the possible distortion of the underlying objectives of the new vehicle, if member organisations focus on maximising the surplus profits available for distribution, rather than looking to longer-term benefits for the membership as a whole in taking forward strategic (but possibly non-income generating) activities that will reduce the levels of surplus profits in the short term.

3.4 The position becomes yet more complex if the possibility of negotiating a bulk sale of electricity is taken forward – since there is then a question of whether member organisations that have not shared in the risks associated with that model should benefit from profits generated through that particular initiative.

3.5 In addition, it should be noted that even where there is a co-op structure providing for participation in profits in proportion to the respective members' dealings with the co-op vehicle, that is normally done on the basis of one member: one share, to reduce some of the complications outlined above – with the provisions within the co-op's constitution round distribution of profits making it clear that the proportionate share of profits to which a member is entitled will not vary by reference to number of shares held, but by reference to whatever measure (eg volume of produce sold through the co-op) is appropriate. In certain co-ops (normally with a smaller membership) there is sometimes provision for a member to realise the capital value of its shares through a process by which other members can purchase the outgoing member's shares (or possibly via redemption by the co-op of the outgoing member's shares) – but we could foresee major difficulties in the context of this particular vehicle in assessing the capital value of a member's shares, with the additional problem of whether it is reasonable to expect other members, or the co-op vehicle itself, to have the financial resources to fund the purchase of the outgoing member's shares. If, on the other hand, the concept of gaining a financial return through the capital value of shares is not going to be part of the model for those reasons, it then becomes questionable whether the use of a shares-based model is worthwhile – particularly in light of the additional complications which it introduces.

3.6 Having regard to the above considerations, our recommendation would be that the concept of a share-based approach to distribution of profits be put to one side, in favour of a simpler contractual approach. That would be consistent with the concept of a co-operative, but would be much simpler to operate – and would also represent a more straightforward proposition for prospective members. Essentially, the contributions from a member organisation in the form of peer-to-peer advisory support provided to other member organisations could attract credits towards fees otherwise due by that member organisation to the new vehicle for advisory support provided by the core team. If it was felt that the levels of surplus building up within the new vehicle were greater than what was needed to create appropriate reserves and take forward new initiatives for the benefit of member organisations, adjustments could be made to the pricing arrangements for advisory support from the core team, if necessary. That would also create a dynamic of pursuing the collective interest of the member organisations as a whole, avoiding the potential friction - and focus on individual financial returns - that might arise from addressing on an annual basis how to translate a pool of surplus profits into dividends to individual organisations.

3.7 A bulk sale package for electricity generated by a grouping of member organisations will be complex in itself – and it would be much easier to deal with any additional financial returns to members participating in that arrangement through the contractual provisions associated with that specific project, as that would enable a tighter focus on the specifics of what was appropriate in that context.

Type of legal entity

3.8 If, therefore, we proceed on the assumption that any "surplus profits" will be dealt with:

3.8.1 in the case of surpluses arising under any bulk electricity sale arrangement, via provisions in the contract to which participating organisations are party, allowing for additional financial returns to be paid over to them on a contractual basis;

3.8.2 in the case of surpluses arising from fees generated by advisory work, via downwards adjustments in the pricing model for the subsequent financial year and/or through initiatives that provide other (non-income generating) support to member organisations; or

3.8.3 to the extent of a reasonable margin above the fees for accommodating the staff team and providing back-office support, by way of payments to CWA under the services contract,

we then have a situation where the co-op vehicle could fall within the category of a non-profit distributing organisation.

3.9 On that basis, the potential legal entities for the new vehicle would be:

3.9.1 a registered society[1], formed as a co-operative (rather than as a society for the benefit of the community - "BenCom");

3.9.2 (if charitable status was available) a Scottish charitable incorporated organisation ("SCIO");

[1] The term "industrial and provident society" used to be applied to this type of legal entity; under legislation passed in 2014, the correct term is now "registered society"

3.9.3 a company limited by guarantee, with three possible variants – with charitable status, with community interest company ("CIC") status, or with no special status.

3.10 The process of setting up a registered society which does not closely match established model rules is significantly more expensive than setting up a SCIO or a company, given that the Financial Conduct Authority (which fulfils the role that Companies House takes in relation to companies, in formally incorporating the legal entity) charges fees in proportion to the number of departures from the model rules (so in this instance, a likely fee for FCA of £850, in addition to the fees payable to the legal advisers). Also, the concept of enhanced voting rights – in this particular case, the suggestion is that CWA should be able to veto future alterations to the objects clause – is likely to fall foul of the FCA's normal rule-of-thumb that voting in a co-op should be on the basis of one member: one vote. While we would consider that there is a reasonable prospect of persuading the FCA to accept CWA's right of veto and other enhanced rights, we would anticipate quite a lengthy engagement with FCA in arguing for that position – and we would be unable to guarantee a successful outcome.

3.11 The workshop gave careful consideration to the possibility of achieving charitable status for the new vehicle. From one point of view, the activities of the new vehicle in providing support to third sector organisations seeking to engage in renewables projects are similar to those of Community Energy Scotland, for whom we successfully achieved charitable status a few years ago – but in the case of this vehicle, we would anticipate difficulties in persuading OSCR (the Scottish charities regulator) that the wider public benefit outweighed the benefits to individual member-organisations. The essential nature of a co-op – as something which, in terms of fundamental principles, must operate primarily for the benefit of its own members – is as a general rule seen as incompatible with fulfilling the public benefit test associated with charitable status. The counter-argument in this case would be that while the new vehicle did operate primarily for the benefit of its members, it would have an open membership policy – so any third sector group with an interest in renewables projects could access benefit from the new vehicle's activities. All in all, we would regard the prospects of obtaining charitable status as broadly equating to a 50% likelihood of success – so unless charitable status is seen as very significant, we would suggest that it should not be pursued. In saying that, careful consideration should be given to the possibility that certain funding sources (eg particular charitable foundations) may be unable to support the new vehicle if it does not have charitable status; also any surpluses earned by the new vehicle might be exposed to tax, though (a) there should be scope for managing pricing so as to minimise surpluses and (b) there could be the possibility of making gift aid payments to charitable bodies operating in this sector (who could in turn use those funds to advance projects that were aligned with the new vehicle's aims) so as to minimise tax leakage.

3.12 If charitable status will not be pursued, the option of using a SCIO will not be available – as the SCIO model can only be adopted by a charity.

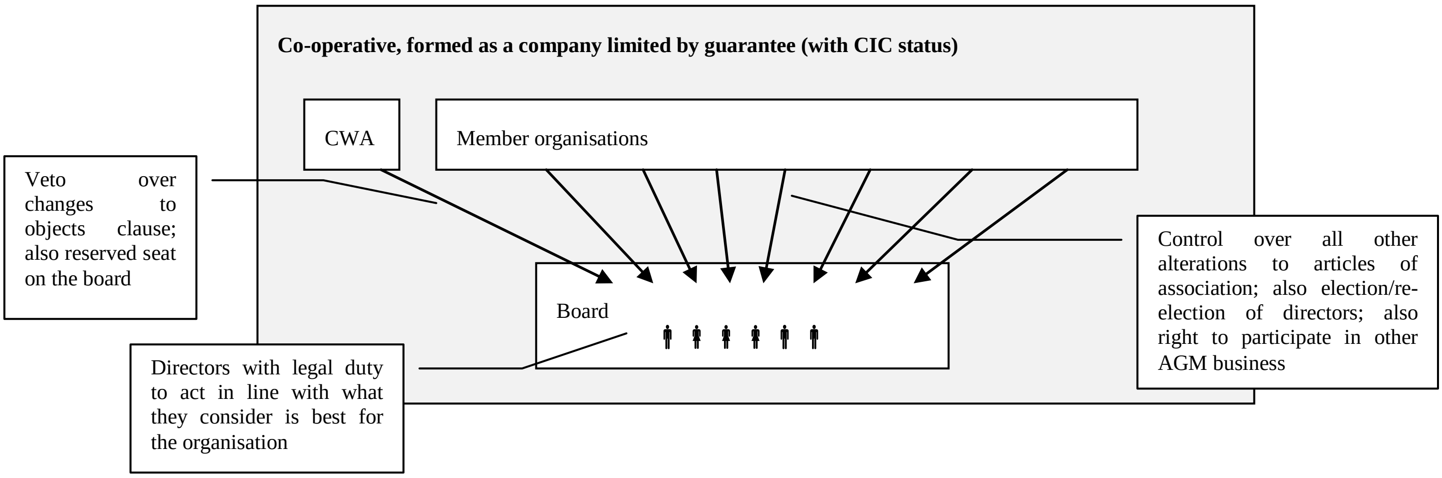
3.13 Having regard to the considerations set out above, the company limited by guarantee model would, in our opinion, be the most appropriate type of legal entity for this initiative. It provides the benefit of limited liability for its members and a clear contracting party (so that contractual risks and liabilities sit within the joint vehicle); it readily reflects the principle of non-profit distribution; and it can easily be fine-tuned to reflect what is proposed with regard to democratic member control, balanced with CWA's special rights as the founder organisation. The majority of the member organisations are likely to be companies limited by guarantee, and will therefore be familiar with the model.

3.14 We can confirm, for the avoidance of doubt, that the label "co-operative" can readily be applied to a company limited by guarantee whose constitution and values reflect co-op principles. We have prepared a number of template articles of association using the company limited by guarantee model, to assist Co-operatives Development Scotland in its work within the co-op sector; and these have been widely adopted across Scotland.

3.15 As regards the question of whether the company limited by guarantee should have CIC status, the advantages associated with CIC status are not particularly significant in this context. Certainly, it would help to reinforce, for those dealing with the company, the message that it existed for public benefit rather than being a purely commercial organisation. There are, however, no tax benefits currently attaching to CIC status that would be relevant in the context of the activities proposed for the new vehicle. CIC status could, however, be helpful in the context of certain potential funding sources, as it makes it clear that the vehicle sits firmly within the third sector. We should say, for the avoidance of doubt, that the fact that the company will operate primarily for the benefit of its members should not be a bar to CIC status, given the wider public benefits implicit in its aims; we regard it as very likely that the CIC Regulator would allow CIC status in this instance, but it will be appreciated that the CIC Regulator has wide discretion, so that cannot be guaranteed. On balance, our recommendation would be that application be made for the company to be registered as a CIC for the reasons outlined above.

4 RECOMMENDED MODEL

4.1 The recommended model can be illustrated in diagrammatic form as follows:



4.2 As regards the contractual and financial relationships, these can be illustrated as follows: