

On the citizen dividend in Germany

Review and analysis

1. Background

Between 2012 and 2013, efforts were taken to establish a financial instrument in Germany that would allow local stakeholders (especially citizens) to financially participate in TSOs grid development projects and their broader operations (citizen dividend). The underlying driver was the assumption that a direct financial participation in the power line “on the owners doorstep” would increase acceptance for relevant grid extension projects, similar to what has been observed many times in the development of renewable generation facilities. In early 2013 German TSOs discussed the option of a so-called ‘citizens’ bond’ with the then Minister of Environment Peter Altmaier. After negotiations, a proposed “benchmark paper” was published that set out the criteria of such a bond. Pursuant to these discussions the TSO TenneT decided to launch a product. The TSO 50Hertz also investigated the options but decided that it is not the right point in time to issue such a ‘bond’. This document summarises the experiences gathered and describes some of the challenges in designing and distributing such a ‘citizens’ bond’.

2. The financial instrument developed

In July 2013, the Ministries for Environment and Economic Affairs plus the four German TSOs published the final “benchmark paper”. The bond proposed in the paper contained the following agreed upon characteristics:

- Up to 15% of investment volume to be financed via a proposed tool
- Minimum deposit €1,000
- Privileged access for citizens living within a certain distance to the line
- Rate of return of up to 5% in line with the market
- Long-lasting run time
- Tradable
- Possibility of repurchase by the issuing TSO
- Take-over of additional costs of developing a ‘citizens’ bond’ was to be checked by the ministry

TenneT in parallel designed and launched a financial product for the planned west coast line in Schleswig-Holstein, which was designed to reflect these characteristics. The features were described¹ as follows:

- Minimum deposit €1,000
- Guaranteed minimum subscription for citizens living in the affected district
- Hybrid-character: during permitting phase, the deposit is treated as debt, once construction starts the interest rate increases and the deposit is converted into a hybrid of debt and equity
- Subordinated character of loan to allow for more attractive interest rate in comparison to market interest for conservative investments

¹ http://buengerleitung.tennet.eu/fileadmin/tennet/Downloads/Buergeranleihe_Evaluierung-Nov2013.pdf

- Interest rate premium is oriented at development of the regulated return on equity
- Investment security because of remittance: TenneT Holding is 100% owned by the Dutch government
- No project risks for the investor
- Up to 15% of the required project investment sum are available for the bond scheme

3. Criticisms

The issued “bond” was criticised for a variety of factors, including:

- Not being a stake in the respective power line but actually a credit to the operating company TenneT
- Its subordinated character, implying that in case of pay-back difficulties the citizens would be the last creditors to get back their money
- Its structure which according to the press was hard to understand even for experts
- An interest rate that was described as being too low in relation to the risk of the bond and which could be reduced in case of liquidity bottlenecks
- Not having a fixed lifetime
- Its unclear market value, the risk of lack of actual tradability and
- The risk that the Dutch government could actually sell TenneT, which would undermine the investment security argument

3.1 Challenge of privileged access for affected citizens

One of the main features of the proposed bond, that was strongly backed by the political stakeholders in the negotiations, was that it should be accessible only for a limited group of people – those living within a certain threshold distance from a specific power line project. The idea was to allow these people to invest into this power line, hence benefiting directly from that one *identifiable* specific project.

This is a product characteristic which is challenging to implement for two reasons:

- a) The debt raised would have to be used exclusively for a designated line project. To guarantee this from an accounting perspective requires the founding of a new legal entity which exclusively deals with this project. Investors could then either purchase a share in this legal entity or the legal entity could issue bonds with a guaranteed interest rate. The first option implies that the investor carries the financial risk similar to any other owner, the second leaves the risk to the respective company as it is hard to project the actual costs and return of individual projects into the further future which is a contradiction when providing a guaranteed interest rate (see also section “Challenges of providing an attractive interest rate” for further considerations on the guaranteed interest rate). In addition, from the viewpoint of a TSO, having separate legal entities for each project results in a significant increase of effort when it comes to accounting and other management tasks. All in all, this additional effort would incur significant costs.

- b) Distribution/promotion of the product would have to be limited to a selected audience. Financial products have to be sold to the consumer via a well established/locally trusted distribution channel. Transmission system operators do not have licenses to distribute banking products. For selling the product, they are hence dependent on cooperating with a financial institution. Most financial institutions do not have regionally limited distribution channels, none of them has structures to engage with only a “hand-selected” set of potential clients. A “naturally limited” geographic market can be defined only by the regional German Sparkassen Landesverbände. However, such a channel provides access not only to the very select group of people near the project, but anyone living in a certain district. In addition, these savings banks are not able to deal with complex products which require in-depth advisory services easily. Because of this, TenneT ultimately decided to work with selected media and direct mailings. However, again this was found not to be the best set of channels to sell complex financial products.

Finally, when powerline projects cross economically weak regions (which tends to be the case in the former East of Germany), the local population may not have the capital to invest in the proposed manner. Meanwhile, large agricultural organisations may have the money and be directly impacted by a powerline, but are not the envisaged target group.

3.2 Challenge of providing an attractive interest rate (target value 5%)

Since autumn 2012 interest rates have declined significantly, consequently the once intended yield of 5% (considering a duration of 20 years) was not achievable for all German TSOs, with a difference in yields of at least 1.25% by July 2013. Rates today have lowered even more, with 20 year rates for the TSOs now below 2.0%. A TSO issuing a financial tool that would guarantee selected investors a 5% interest rate (as was foreseen for the ‘citizens’ bond’) in times of a very low interest rate environment, would face three potential challenges:

- a) according to its mandate of keeping costs to society low, the regulator (BNetzA) cannot simply allow a re-financing of the additional interest via the grid tariffs – the financial risk of a guaranteed 5% interest therefore has to be fully carried by the issuing TSO.
- b) financial markets automatically punish the issuer of a bond for paying more interest on debt than necessary. Specifically, rating agencies will lower the credit rating of the issuer for overpaying on interest and for taking the risk of paying higher interests without being able to claim them back via the grid tariffs – as a consequence, future interest rate requested by the market would increase, reflecting the higher risk premium that comes along with a lower credit rating.
- c) Under the so called equal treatment clause (pari-passus), issuers of debt are legally required to treat different creditors alike, giving the creditors the right to file a court case in case of differing interest rates for different creditors.

3.3 Challenge of designing a citizen-friendly financial product

To be able, nonetheless, to treat different investors differently and potentially provide a 5% interest rate, TenneT issued the hybrid product previously described. Its features are designed in a way that between 3% and 5% interest may be paid on average over the long-term. This was to be achieved by a) converting a share of the debt into equity which is favourably treated on the balance sheet and may obtain a higher interest once the construction phase starts; b) not limiting the duration, hence factoring in that, over time, interest rates may increase again and allow for a higher interest payment on the 'citizens' bond', c) giving the product a subordinate character, which makes it more "risky" but therefore also allows to add a higher risk premium to the interest rate.

This explains why TenneT issued such a complex product, with an unlimited duration, unclear market value and with which a guaranteed interest rate is not provided. Compounding these problems was the fact that TenneT has been held to certain product design restrictions that were stipulated in the Benchmark paper (e.g. the 5% limit). This did not allow TenneT flexibility when trying to re-design or improve the offering.

3.4 Challenge of additional cost recognition

A 'citizens' bond', as a financial product, needs to be designed and distributed. It also requires service support from a financial institution. The financial institution contracted will request remuneration to design the product, develop a legally waterproof product prospect (legally required information document describing the features of the product, such prospects can amount to 75-100 pages) and a provision for distributing the product. These cost items can amount to a significant sum, which may not appear adequate in relation to the targeted market size. By limiting the product to a small number of citizens that only invest a small sum, the costs of the bonds would be far higher than the return gained by the investors over a long period. TSOs have requested a confirmation from the German regulator that these additional costs (administrative and for interest payments) can be spread over all grid users via the grid tariff. This confirmation is outstanding. However, even if obtained, it can be questioned whether this money is "well-spent" from an overall societal perspective, and whether other methods of compensation would be a more effective option.

4. Conclusion/Outlook

Designing a 'citizens' bond' with the desired features is not as easy a solution as was initially hoped for. In an attractive interest rate environment, a bond could still be an attractive product for a rather specific target group. For 50Hertz and TenneT, in order to resolve the criticism of being overly complex and to overcome the challenge of finding the right distribution channel, such a product should be a normal bond, instead of a hybrid product, which allows interested parties to participate in the entire project portfolio of a TSO instead of an individual line. However, market interest rates are currently too low for this in Germany, and far below the terms set out in 2012.

Furthermore, without a clarification with respect to the recognition of additional costs by the regulator, the idea is unlikely to be picked up again by the German TSOs. It should ultimately be considered whether the cost of such a compensation scheme coupled with it's a small scope and low returns produces real value for either participant.