

# **Delivering ecosystem regeneration and integrated water management**

## **A Co-operative Approach to blending public and private funding to deliver more with less.**

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### **Summary**

The UK is faced with the challenge of regenerating our ecosystems to sequester carbon, as part of achieving net zero, to rebuild our biodiversity and create more resilient catchments reducing flood and pollution risks and increasing water resilience. Nature Based Solutions (NBSs) are seen as a key part of the solution delivering multiple benefits. To-date policy has focussed on creating nature offset markets based on contract law to incentivise private investment, but this model does not clearly fit the challenges of long-term funding needed for catchment systems improvement with their locational specific complexity and uncertainty. This paper argues that local codesigned multi-party cooperative governance is much better placed to draw in funding from a range of ecosystem beneficiaries and underpin the delivery of collaborative outcome focussed projects based on sharing risks and rewards which can adapt as circumstances, policies and science inevitably change over the long-term. It also sets out a broad process for co-designing such cooperatives.

### **Introduction**

The UK faces major challenges in improving the quality of our water catchment systems to increase water resilience, reduce water pollution, particularly from sewage, and reduce flood risk. This challenge is only going to increase as the climate changes with more intense rainfall events and increased risks of droughts. Nature based solutions (NBSs) are seen as a major element of addressing these challenges and evidence is being developed so their effectiveness is better understood, particularly in terms of water resource resilience. However there remains the question as to how funding and governance can be designed to ensure optimum funding from recognising all the simultaneous and often uncertain benefits from NBSs.

To date the main focus on funding NBSs has been through the development of national nature markets to provide revenue to fund private finance, based on the individual commodification of environmental outputs or outcomes e.g. carbon sequestered or biodiversity units created. Delivering catchment water system enhancement doesn't fit neatly into a private finance and nature market model. The location of these NBSs is crucial

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as they are designed to replace or enhance person-made solutions to deliver benefits to specific communities. Furthermore the benefits rely on a change in catchment systems and may involve a whole range of NBSs based on complex modelling of water flows and geology in catchments. The outcomes can also be very uncertain without long-term monitoring. Hence these types of benefits of NBSs cannot clearly be individually commodified as a well-defined product and traded independently of natural systems as required in nature offset markets.

The good news is that these NBSs can potentially deliver multiple benefits, for example changes in land management or use can reduce runoff and recharge aquifers which can increase water resource resilience, and reduce flood risk and water pollution. As a result, there is potential to cross subsidise the delivery of these benefits reducing the costs of delivering the benefits.

To deliver these types of outcomes requires a different policy focus to nature offset markets: The local governance of funding and delivery of systemic NBSs is crucial rather than the national governance of markets as with nature offset markets. The purpose of this governance would be to formalise the collaboration required between those who benefit from these NBSs and will fund them and those who will deliver them, as well as with the wider community who have an interest in their local rural areas and can potentially support NBS delivery by providing citizenship science and community investment.

This approach does not necessarily mean excluding the use of nature offset markets altogether but it does mean using them tactically potentially to lever in wider collaboration to deliver real environmental enhancements. Engaging in such markets can also be integrated into this local governance-based strategy.

## **The need for local cooperative governance**

The purpose of this paper is to set out and provide the rationale for a collaborative approach to providing this governance using cooperative law. This involves bringing together a wide range of collaborators with diverse interests and perspectives around a common purpose of delivering environmental enhancement:

- Farmers and land-owners need to deliver [environmental benefits to gain public funding](#) (public money for public goods) and can gain further funding from delivering benefits that other organisations are looking for but will generally need to work together to deliver local nature system change.
- Water Companies are under increasing pressure to reduce water pollution particularly from sewage overflows. They have been funding farmers and incorporating catchment management for more than a decade to reduce their diffuse pollution as more cost effective than improving their own wastewater and drinking water treatment processes. This approach has been expanded to other land-owners, on the “polluter pays” principle, for whom it is more effective than end of pipe solutions. There is the potential for similar types of action to reduce runoff and increase aquifer recharge resulting in improved water resource resilience potentially reducing the need for new reservoirs and desalination plants as water demand increases and the climate changes.
- The Environment Agency (EA) is looking to scale up [Natural Flood Management \(NFM\) approaches](#) on a catchment basis delivered by land owners to reduce flood risk. At

present the EA is required to incorporate NFM into all Flood and Coastal Risk Management projects.

- Companies are increasingly understanding the need for their supply chains to be more resilient to climate change.

Beyond these parties interested in system change, there is also a range required or willing to fund offsets. They may also be interested in participating in governance as part of ensuring their offsets are reliable and avoiding negative impacts on their reputations:

- Developers need to ensure their developments improve biodiversity, known as [Biodiversity Net Gain](#) (BNG) and in sensitive areas, don't increase nutrients in waterways meeting [Nutrient Neutrality](#) requirements, either by action on their developments or external to them delivered by landowners.
- Infrastructure providers such as energy utilities are also required to offset any biodiversity losses their developments create, while also probably having wider interests in carbon offsets and reduced flooding risks, that can create power failures.
- Businesses with commitments to achieve Net Zero are looking for land management changes to increase carbon sequestration to offset residual emissions that cannot be removed from reductions within operations.

Broadly landowners and farmers are in a position to change their land management and use practices (NBSs) to improve the natural environment (or deliver ecosystem services) and there is a range of public and private organisations that are willing and/or required to fund such improvements, or pay for ecosystem services, on different bases.

There is also a range of organisations, and potentially communities, that would be willing to provide finance if up-front expenditure is required prior to income being received from those seeking to benefit from ecosystem services (beneficiaries). This is particularly the case in markets for carbon and BNG credits, but may be less required where beneficiaries themselves such as water companies and the Environment Agency can provide capital funding.

But how can such a range of different interests and regulatory systems be brought together? This is a time of real uncertainty but also of opportunity for a new and more collaborative approach to managing and improving our natural environment. If all these interests and funding streams can be brought together (or 'blended'), then this presents an important opportunity to drive the acceleration in the natural environment improvement that we so need.

## **The challenges**

This is not a straightforward matter. There are some difficult challenges that need to be addressed to bring these interests together:

- Measurement uncertainty:
  - ◆ Standards for measurement have only been developed for offset markets (such as the Woodland Carbon and Peat Restoration Codes, and the UK biodiversity metric).
  - ◆ Measuring the benefits from large ecosystem change, rather than discrete parcels of land, such as water pollution and flood risk reduction is probably impossible to

standardise for an open market context, as it will always rely on bespoke monitoring and modelling, which can be expensive and time consuming.

- ◆ Ultimately the goal posts could easily move as scientific knowledge (for example, understanding how land use change can deliver improved water resource resilience is still under development) and related policy (e.g. cost benefit frameworks for flood risk management projects) evolve.
- Value uncertainty:
  - ◆ Markets are in their infancy and, with no track record, are therefore not widely trusted. A lack of consistency and knowledge, e.g. around carbon emissions, Biodiversity Net Gain (BNG) units and the causes of water pollution, means funders and investors might be cautious about the impact of their investment. Likewise, farmers and landowners may be reluctant to take investment from a housing developer for Biodiversity Net Gain if their local community is against the development. Some anticipated markets may never develop. Certain environmental benefits from large ecosystem change are very unlikely to see traditional markets emerge due to their complexity and locational specificity, while governmental frameworks may not yet be developed to reasonably recognise their value.
  - ◆ Parties may have different views on the fair valuation of benefits with conflicting perspectives on the appropriate application of beneficiary and polluter pays principles or what costs/income forgone by landowners and farmers should be reasonably compensated for.
  - ◆ Principles for a fair sharing of funding obligations to gain co-benefits have not been developed (e.g. who pays what for woodland that delivers flood risk and water pollution reduction, carbon sequestration and BNG).
- Legal complexity: Ecosystem beneficiaries and investors will require legal formalisation of arrangements to deliver ecosystem benefits by landowners and land managers over the long-term, in order to provide all parties with a level of security. This is particularly challenging as there are:
  - ◆ Such a range and diversity of parties including private, public and statutory interests with different capacities, objectives and responsibilities.
  - ◆ a need to operate at a substantially bigger scale at catchment level which will involve multiple parties as deliverers and beneficiaries.
  - ◆ multiple relationships involved amongst and within the interested parties, and those relationships are likely to be interdependent and interlocking;
  - ◆ the levels of uncertainty in delivery of benefits and the potential for circumstances for individual parties and policies to change substantially over the life of long-term agreements.

These challenges can seem daunting, particularly if we approach the problem as if we need to solve all of them immediately. However clearly any enduringly successful approach, and long-term success is crucial here, will need to effectively engage with all these challenges and probably more over time. This means it must have mechanisms for ongoing adaptation and working to address issues in collaboration at its core. For example:

- **Measurement uncertainty:** the approach will need to use agreed standards for simpler or discrete benefits as they develop, while also securing the required modelling and monitoring capacity to measure system-wide benefits such as water pollution and flood risk reduction. It also need to be able to draw on and respond to the latest, relevant scientific knowledge and public policy assessment frameworks.
- **Value uncertainty:** the approach will need to be able to engage with current emerging markets with integrity and a long-term perspective. It also involves, developing bespoke funding agreements between parties over time as policy frameworks evolve where markets haven't developed and/or are very unlikely to develop as is the case with system wide benefits.
- **Legal complexity:** the approach will need to support and reinforce strong, trusting, collaborative relationships between all the multiple parties around a common purpose so that agreements can be relatively easily adapted by consensus as circumstances and knowledge change, while providing a level of security that the parties need. Flexibility will also be needed to adapt to new projects and programmes, as well as changes in the parties involved.

## Different approaches

Currently the most developed approach is summarised in the Green Finance Institute's (GFI) [Investment Readiness Toolkit \(IRT\)](#). In simplified terms, its approach/model is akin to standard business development and involves:

1. An organisation seeking a range of landowners/managers who wish to sell ecosystem services and a range of organisations that wishes to buy them; which then seeks finance to cover any requirements for upfront capital to cover timing differences between revenue and expenditure.
2. That organisation develops individual agreements, generally formalised as a number of independent contracts, with all the sellers, buyers and investors.

This approach is based broadly on the mechanism of traditional investment: the provision of funds for use in activities which are anticipated to generate a particular return on capital to investors. A further feature of an investment driven approach is its reliance on contracts as the basis for creating relationships between the parties. Contracts are a well-designed tool for the pursuit of return on capital invested as they help to provide certainty, which is important to secure investor support. But contracts are not so appropriate in the context of significant uncertainty and complexity of relationships. Contracts can be inflexible, unless all of the parties agree to change them; and they are negotiated and agreed at a fixed point in time and particular circumstances that can change (see Annex 1 for further explanation of the problems with contracts).

We are proposing to develop a different approach, for several reasons:

- We believe that cooperatives are uniquely placed to manage current, and inevitable future uncertainty, such as caused by changing science, circumstances or new regulation. Traditional investment dislikes uncertainty and charges a high price for it.
- The range of parties involved and the variety in the nature of their interests give rise to a complex web of relationships; having a multiplicity of separate, private and often interlocking contractual agreements between different parties lacks openness and

transparency, and will not be so conducive to building trust. Furthermore, it will be difficult to modify as inevitable changes impact on the project.

- All of those involved have an interest in making the new arrangements work. Founding the new arrangements on a mechanism designed to prioritise a return for investors may give rise to power dynamics which discourage the building of trust. It seems that a mechanism is needed which can attract investment, whilst also fully respecting the other private, public and statutory interests.

## **A Co-operative Approach**

Our approach is to face these challenges using a cooperative structure, but with a number of different types of interests rather than the single constituency approach which is more familiar (that is to say, consumer, worker or producer cooperatives).

This multi-party approach brings together a number of different parties and interests – farmers, businesses looking to offset, statutory bodies and agencies, developers, communities, investors – in a common and collaborative endeavour which recognises and respects each of their particular interests. These interests need to be balanced and considered collectively, but without intending to provide any special reward to any particular party or interest.

In a cooperative approach, the parties all agree that the ultimate intended beneficiary of the whole collaborative venture is not the private interests of any one party, but the collective benefit of them all and of future generations through achieving the environmental goals.<sup>3</sup> That means striking a balance of fairness and neutrality in all decision-making, because the venture only works if all different interests get what they need out of it, and remain engaged and committed to the ultimate objective.

This alternative approach is designed to cope with uncertainty, and to move the drivers away from return on capital invested (the conventional business approach), and towards meeting the needs of everybody (the common good) which involves striving to meet all needs collectively. It is rooted in traditional cooperative thinking, and requires a willingness to be innovative, and to form long-term trusting relationships.

This does not mean that cooperatives don't or cannot access investment funding. They are clearly able to borrow and can issue shares. They are also particularly well placed to access community investment, which can also help build wider community engagement and buy in. But investors are only one of the interests to be taken into account, rather than taking precedence over all other interests (see Annex 3 for further information).

### ***How does it work?***

This approach works by establishing relationships *through a cooperative*, where those relationships are managed and developed inside the cooperative, between the different

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<sup>3</sup> The underlying aim of policy today is the improvement of the environment for the future. In the 25 Year Environment Plan, it is stated that "Our environment plan sets out our goals for improving the environment within a generation and leaving it in a better state than we found it."

types of members. Those relationships are therefore governed by the rules of the cooperative, which provides flexibility; and not by a fixed contract, agreed at a particular point in time.

This is how it works.

- Representatives from the key relevant parties work together in a co-design project to develop the core purpose and objects, and an outline of the arrangements needed to meet their aims. After this has been shared with a wider audience of those who will be invited to become members, the arrangements are written as a set of rules for the cooperative.
- All the relevant parties are invited to become members of the cooperative which binds them to achieving the collective benefit, and to follow the rules of the cooperative in how they interact with each other. (The rules of the cooperative are actually a contract between the parties, theoretically enforceable in a court of law. But the whole point is that that will never be needed because the rules provide a mechanism for collective decision-making (governance) and for resolving disputes.)
- The rules set out the scope of what is covered by the cooperative. This may be limited geographically, or by activity. These are the “objects”.
- The rules also set out the essential purpose of the cooperative. This includes the broader collective purpose (reducing environmental impacts, rebuilding biodiversity), but also the particular interests of the individual parties. The nature of cooperation is that unless all parties basic needs are met – or all parties are treated fairly – then compromises have to be made. It means sharing both burdens, and benefits.
- That broader purpose is generally expanded by some values and principles, which articulate both the importance of individual members having a voice and participating in decision-making,
- The mechanism by which decisions are made within the cooperative (governance) are carefully set out in the rules. Some matters require all members to agree them (such as amending the rules themselves); some decisions have to be made by a smaller group which represents all of the key interests – some sort of representative body, so not all members need to be involved. Other decisions can be made by a committee or board comprising people with the right skills and experience, that members trust to make such decisions.
- Cooperatives can also effectively have ‘branches’ ie subgroups of members with a particular interest in say a sub-catchment or particular location, while the overall cooperative can focus on a larger area. This sort of structure can reflect that the beneficiaries may have an interest in one or more catchments or counties, while landowners delivering NBSs may be collaborating as a smaller scale. With this sort of multi-layered structure can reflect the different interests of the parties involved.
- Through these decision-making mechanisms, relevant members can then form agreements on particular matters which will be contained in regulations which are made under the rules. These are visible to all and can be varied from time to time under the mechanism of the rules. For example, this might cover plans as to what land management or use changes are to be made to deliver what ecosystem benefits for which members (such as water companies and the Environment Agency); the principles

for determining payments to land managers and/or owners who are delivering those changes and the basis for sharing the funding requirements by those members benefiting. The relevant parties can agree and set these down in regulations, which sit below the rules and are binding on the members like the rules.

- These plans and agreements can be reviewed and updated under the decision-making rules as circumstances and knowledge changes.
- The reason for having separate regulations is as follows: A cooperative is registered with the Financial Conduct Authority, rather than Companies House. If the members want to change the rules, they must pass a general resolution which must then be approved and registered by the FCA. Much day-to-day business is not relevant to the FCA, and to avoid continually amending the rules and needing FCA approval, provision is made for the members to agree regulations, which can themselves be amended by whatever process the rules then provide. It is this which provides the practical flexibility.
- The rules also need to contain a range of other provisions including who can become a member, whether there is more than one type of member, any eligibility criteria for membership, provisions for exit or removal in extreme circumstances, dispute resolution, the size and composition of any representative body, the committee or board, their roles and responsibilities, how they take or leave office (election, appointment etc.), types of shares/share capital, and a range of other administrative matters.

So a cooperative approach, in summary, seeks to bring the parties together not through a series of binary inter-connected contracts, but through being members together of a collaborative endeavour along the lines set out above. It seeks to replace relationships based on contracts by relationships based on governance. Some contracts with external parties will still be needed; some internal contracts might be needed for transactional purposes between particular parties (employment contracts), but the overarching framework is established by the rules or constitution which the parties agree.

Being members of a cooperative provides a framework for the parties to work together collaboratively. It is not a magic wand – they need to *make* the arrangements work; but if they want to work collaboratively, it provides a mechanism.

### ***How will this approach meet the challenges we have identified?***

This approach provides an adaptable yet secure framework to build enduring collaboration between multiple parties while also engaging effectively with evolving external knowledge, regulations and markets:

- **Measurement uncertainty:** the cooperative can adopt measurement standards as they develop but is not dependant on them. It can also draw on its members' measurement and modelling capabilities, particularly the Environment Agency and water companies, to explore and demonstrate complex system benefits such as reductions in flood risk and water pollution. These members, in turn, can receive 'free' co-benefits from discrete measures to deliver carbon sequestration, BNG and nutrient neutrality, which have to demonstrate 'additionality' ie be fully funded by beneficiaries, if members cooperate to ensure they are strategically located by the right water courses. While members receiving discrete benefits can also demonstrate that they are supporting wider ecosystem understanding. This can allow the cooperative, through pooling



interests, to build its evidence over time on the benefits of the changes in land management and use.

- **Value uncertainty:** the cooperative, as an organisation and/or its members individually, are able to engage with markets as they develop. However it is not dependant on such markets and can manage exposure to changing market prices. It can work to establish core long-term, reliable funding from its member beneficiaries based on principles agreed as fair and reasonable by all its members including factoring in the uncertainty of outcome delivery on a collaborative basis (see Annex 2). Even where markets exist, such as carbon sequestration, BNG and nutrient neutrality, it can engage directly with large beneficiaries outside the market, offering 'premium' benefits compared to the market, based on its secure governance arrangements, its 'brand identity' and the fact that these discrete benefits contribute to wider ecosystem regeneration. In turn, the cooperative can do its own due diligence on these beneficiaries to ensure they are fully committed to environmental goals rather than just greenwashing and/or merely meeting minimum regulatory requirements.
- **Legal complexity:** cooperatives function on the basis of the pursuit of a collective endeavour, and developing ongoing trusting relationships underpinned by fair and transparent decision-making processes including dispute settlement procedures. There is no need to develop long and complicated legal agreements at the outset to cover all possible scenarios that can be imagined. There is no need for endless 'small print'. Instead, the cooperative provides the mechanism for the parties to agree in future how to address issues as they arise. Some arrangements are likely to be multi-party which can be contained in regulations as explained above. As such, they can be updated relatively easily as opposed to situations where there are multiple, interlocking, long and complicated agreements between different parties.

### ***How can this approach be developed and established?***

The starting point is to bring the relevant parties together and confirm that they collectively agree to work together. This should include those needed to provide funding as participants interested in particular outcomes (water company, for example), as well as representatives of potential external funders interested in financing the pursuit of the environmental outcomes. It is important that they are part of the process to understand the opportunity.

From here, through a process of co-design the different parties and interests can proceed to address the matters described above: purpose and objects, membership criteria and entitlement, and governance arrangements. They also need to develop their ideas on basic values and principles, as well as practical matters such as name, registered office, and website address.

This can be done following a template and needs to take place over a period of weeks. Once the initial intended members have worked through the template and set out their optimal arrangements, these can be confirmed with other potential members and interested external parties, whose acceptance of the arrangements is likely to be needed. Other potential members need the chance to express views before draft rules are finalised as it may affect their willingness to participate.

At some point, a decision is needed to proceed to registration. A minimum of three founder members is needed to register the rules. Once registered other members can be admitted.

Start-up arrangements are commonly agreed in advance, to populate at an early stage any representative body and committee or board.

So the process is one of co-design by those available to be involved – all of the relevant interests having a voice in developing ideas. So, for example, not all farmers need to be involved in the co-design, but once developed, all farmers need to have the chance to comment and decide whether they wish to join.

The process of co-design – a series of meetings bringing the relevant parties together to agree how to take things forwards – is itself the first step in the building of the collaborative relationships.

## **Conclusion**

We believe that a cooperative governance approach can support the delivery of NBSs that deliver real environmental enhancements through substituting natural capital for human-made capital while also tactically benefits from participation in nature offset markets. We are looking to collaborate with a range of parties in different parts of the country to explore this in practice.

## ANNEX 1 - Challenges for Contracts

The usual basis for a commercial relationship is a contract. This legal concept is designed to bring two or more parties together and establish formal and binding obligations between them. Its purpose is to provide a degree of certainty to both over matters on which they depend on each other for performance, and that certainty is created by the ability to enforce the contract in a court of law.

The notion of a contract as the basis for a relationship can pose some issues, which relate directly to some of the challenges identified in the ambition to create viable arrangements for delivering ecosystem services.

- A contract is agreed at a particular point in time and in a particular context. Circumstances may continue to be similar for a long time to come, but if they change, the terms agreed may no longer be so suitable. Contracts can be varied – but only if the parties all agree.
- Recognising the risk that circumstances may change and external events might intervene, the parties can agree and provide in advance for such eventualities. This increases the length and complexity of contracts as parties seek to cover possible risks; but it still doesn't provide a complete solution because the terms are limited by what the parties can foresee. Where circumstances alter substantially, or regulations are changed, a contract may need renegotiating.

Both of these points indicate a degree of brittleness about a contract. It is only as good as the words on the page; and those words only as good as the parties' ability to see the future at the point of signature. In our case, it is known that circumstances, policies and regulation will change over the months and years ahead, and facing the future requires adaptability, as science, regulation and attitudes develop.

- Where there is a substantial network of interlocking contracts, a substantial change in government policy may give rise to the need to renegotiate multiple contracts. This gives rise to further complexity, with a number of inter-locking negotiations taking place at the same time.

The ability to renegotiate a contract at any point is a considerable advantage, but both parties have to agree to any changes. Where there is a complex nexus of contractual relationships, individual parties can hold others to ransom for their own benefit, and changes can be disruptive and distract attention away from the primary business that each party has.

Complexity is an issue.

- It is common in a negotiation for the bargaining position of the parties to be unequal. This may change over time, but a contract agreed at a point in time is likely to reflect the power balance at the time. In a network of separate contracts, one economically powerful party might distort the overall arrangement to the detriment of the less powerful.

The issue here is fairness or neutrality. In the context of land management and ecosystem services, all parties have a legitimate interest which needs to be respected; and those interests all need to be balanced in arriving at a way forwards acceptable to all. Only in that way can the parties build up trust amongst themselves. Contracts are not designed to achieve fairness or neutrality: their objective is certainty, and the negotiation of a series of

binary private arrangements can be expected to favour the most powerful, and less likely to build the trust needed for the future.

- A contract is a private agreement between two or more parties. Even though it may impact on external third parties, they have no right to seek redress from the court (the so-called doctrine of “privity of contract”). Unless the external impact amounts to something unlawful (contamination of land, harm to people), third parties have no remedy. Even then, enforcement may be beyond their means.
- This leads to a broader point. Contracts are intentionally private agreements entered into by the parties to pursue their own private interest. That’s fine so long as nothing unlawful results. But requiring/waiting for Parliament to make something unlawful to curb the excessive pursuit of private benefit is one of the reasons for our current predicament. Fixing and meeting long term carbon reduction figures requires setting a broader framework within which legitimate private interests need to be accommodated.

The final challenge, which contract law alone is not designed or intended to achieve, is to find a framework within which relationships can be established and maintained, but which recognises and accommodates the private interests in the broader context of achieving environmental goals for future generations. That is what the head-line carbon reduction targets are looking to. But meeting the needs of external or third parties is not one of the functions of contract law.

For these and other reasons, contracts may not be the most appropriate mechanism to use to bind the parties together for present purposes. A cooperative approach is being explored because

- the future uncertainty is clearly recognised, and requires a mechanism for commercial relationships which has good adaptability and flexibility
- achieving the overall objectives in terms of carbon reduction and protecting biodiversity cannot be achieved where the relevant parties are competing with each other for their own private benefit. They need to be collaborating with each other in a joint endeavour to achieve the overall shared objectives for the benefit of all, whilst also seeking to meet their own private needs. This requires the building of trust
- a cooperative provides an overarching arrangement (set of rules) that all parties commit to. These rules
  - describe the area(s) in which the parties agree to collaborate;
  - sets out their shared objectives (overarching targets, the long-term ambitions);
  - describes the decision-making arrangements (governance) which the parties believe are an effective way for them to work together collectively.

## **ANNEX 2 - Ecosystem services: how much to pay and what for? Cooperative trading concept**

A particular challenge in the development of ecosystem services concerns the basis for payment. What is being bought and sold? What is a fair price to pay? Who should bear the risks?

In some cases, standards and related markets have been established or are being developed which seek to answer these questions, but in cases where ecosystem outcomes depend on complex, geographically specific, systemic action, such as natural flood risk and water pollution reduction this may not be practical or possible.

Where markets don't exist, the main options usually considered are payments based on:

1. covering the costs and income forgone related to agreed land management and/or use change, i.e. input costs.
2. Achieving a specific reduction in runoff or pollution into water or air by individual land managers, i.e. output value.
3. Collective ecosystem outcomes delivered such as overall river pollution or flood risk to a major population centre.

The first option is relatively straightforward, and the approach used by Defra for giving grants to farmers to fund environmental action but means that the land managers and owners do not receive any of the added value from their actions, which they may consider to be unfair. By default, all the value and risks go to the beneficiaries or buyers, which they may also consider problematic in terms of determining whether they are getting value for their money.

Basing payments on options two or three can be used to redistribute value and risk but is much less straightforward, as establishing an agreed value for ecosystem services and quantifying risk are both difficult. Value for instance could be either based on the perceived benefit of outcomes or on the savings compared to other options to achieve the same outcomes (e.g. using natural flood management versus concrete flood barriers). The complexity of the systems involved, the effects of climate change and lack of scientific knowledge in many cases (e.g. the impact of wetlands on nutrient pollution) mean that performance risks of land management/use change in terms of delivering ecosystem outcomes or even outputs can be uncertain.

This is a real conundrum when trying to establish contracts between parties; but you need to have clarity, because that's what the contract is meant to record so that the parties know what they are committing to. Furthermore and more widely, the certainty that contracts provide to a business is what they need to attract investment.

Finding the fair price for a transaction partly depends on time: waiting to see how things turn out; allowing time for risks to pass. But that doesn't really suit a transactional approach, which seeks to determine the risk sharing and price at the outset – at the point of signing the contract. Is there another option?

### ***The cooperative innovation***

This was a challenge for the Rochdale Pioneers who established the first cooperative store in 1844. Customers were being over-charged and exploited; but they had no choice – the only option was to pay the price demanded and take a risk on quality and quantity (on both

of which they were further exploited). How could they address that power imbalance between buyer and seller, and replace it with something which would give people access to essential things, but on a fair basis?

They did two things. First, they did away with the binary buyer/seller relationship. By getting together as a group and buying wholesale at the market, they could bring back the goods to their shop, and effectively sell it to themselves. The customers, collectively, were the shop. There was no other party involved, somebody whose only interest was to generate their own income out of the transaction. They were not competing with each other; everyone wanted the same outcome – uncontaminated food at a fair price.

The second innovation was to delay the point at which the price was to be fixed. Customers had to pay for the goods at the counter because no credit was allowed. But the price they paid was only a provisional one, based on the cost of buying the goods wholesale, plus provisions for other estimated costs and overheads which would have to be paid out by the business. The actual fair price could not be worked out yet, so every transaction was recorded in a ledger for each customer.

When the quarterly accounts were prepared, the business was able to see what level of surplus it had made (the extent to which income exceeded expenditure). If the surplus was more than that needed to sustain the business, it meant that customers had been charged too much. So they were re-imbursed via a “dividend”, paid in proportion to what they had spent. This dividend wasn’t a profit share: it was a price adjustment to get back to a fair price.

The members decided how to allocate the surplus, and how much to pay back to themselves. Before doing so, they set aside funds for reserves, and made payments to support local causes and needs. The remainder was distributed to members by payment into an account in each member’s name at the store, which they could withdraw at any point in the future. Not only did this provide early high-street banking facilities and a safe place for people to keep their money, it also built up capital for the business.

### ***How does this apply in our situation?***

The collaborative mechanism pioneered in Rochdale replaced the more familiar adversarial or market-based approach. Instead of the risks of quality, quantity and price all falling on the customer, the members agreed to share risks amongst themselves to strive for collective fairness. It meant a certain amount of uncertainty at the point of sale, and a period of time to see how things played out. But the benefit of that was that the parties could get to a fair price.

The approach also differed from the usual business approach because during the period of waiting for the fair outcome, the parties had to trust each other and their collective arrangement. That is the role of the cooperative: to establish a trust-based relationship, where the parties rely on each other and the arrangements (rules) they have signed up to, in order to get the outcome they want. It contrasts with the mistrust-based arrangements of a traditional contract which establishes a basis for the parties to sue each other if something goes wrong.

Our situation is comparably more complex, but the following factors nevertheless apply.

- The parties don't know the fair price to pay at the point of the transaction. That doesn't matter, because through the cooperative they are in a longer-term relationship with each other, through which they can allow time to pass to establish the fair price.
- The parties aren't trying to exploit each other. The starting point for their relationship is a recognition and respect of each other's needs, and the aim to treat all parties fairly.
- The business involves risks, but nobody knows how they will play out. The mechanism of the cooperative allows risk sharing to be worked out over time in a fair way.
- The transactions between the parties through the cooperative are the purpose of the enterprise. There is no ulterior purpose of generating profits to reward investors. Indeed no third party owner is needed: if funding is needed, such funding will entitle the funders to fair compensation for use of their capital; but it will not give them ownership and control of the business or any special reward. (See separate annex on Cooperative Funding).

It takes time and trial-and-error to work out the principles that will underpin fair arrangements. The cooperative provides a safe space within which to try out ideas and principles and arrive at something that parties can be comfortable with. For instance, landowners and managers may initially be paid on the basis of cost and income forgone, on the basis that they receive a share of the value delivered later once it is clearer and based on agreed principles for establishing value.

Initially, the parties are likely to be cautious, getting to know each other, building up trust, learning about each other's needs and priorities, not knowing exactly how particular actions might work out in practice. This will affect the initial attitude to risk-sharing. Over time, it makes sense to develop principles about risk-sharing in relation to payment for different services, but the parties may prefer to start by looking at each transaction separately and on a shorter time-scale.

This process of collaborative development is critical to the long-term success of the cooperative. It is the building of the collaborative relationships which will underpin the future of the cooperative. It must be allowed to evolve over time.

## **ANNEX 3 - Cooperative Finance**

### ***Distinctive Nature of Cooperative Capital***

A cooperative is a legal body which has limited liability, the ability to own property and to enter into contracts, like a company. However, its purpose, ownership and funding arrangements are different.

A company is owned by its shareholders, who provide it with the capital it needs to trade, and the purpose of a company is to provide an economic return to its shareholders on the capital they have invested. It does this by paying dividends out of its profits (income less expenditure). A company exists and carries on business for the private benefit of its shareholders.

A cooperative is owned by its members, who provide it with some of the capital it needs to trade, but its purpose is to provide goods and services to its members and others who need them. Unlike a company which has a private purpose, a cooperative seeks to meet the private needs of its members through its activities, but its trade is carried on for the broader benefit of its membership and the wider community.

A cooperative's trading surplus (or profit) also comprises income less expenditure but included in expenditure is compensation paid to the providers of capital, namely interest. It is generally a low level of interest sufficient to attract capital, but interest cannot be paid as a "reward" as in the case of company dividends.

Any trading surplus is used for a number of things including to build up reserves to strengthen the business, to support other community and local initiatives, and (subject to its rules) to make payments to its members in proportion to their transactions with the society. The principle behind such payments (or "dividends" as they are sometimes confusingly called) is that the existence of a trading surplus, after making all other provisions, means that members have paid too much for what they have bought (in a consumer cooperative) or been paid too little (in a worker or producer cooperative). The payment of a dividend is an ex post facto adjustment, and hence paid in proportion to transactions with the cooperative.

The purpose of a cooperative is to provide goods and services on a basis which treats everybody fairly and doesn't seek to provide a special reward to anybody. This has a number of consequences.

1. Co-operative share capital is significantly different from share capital in a company. First, unlike company share capital, it can usually be withdrawn by a member, though subject to restrictions in the rules. Second, members (who are the holders of shares) have one vote per member, rather than one vote per share. Third, the "return" or compensation on share capital is a modest fixed percentage, paid at discretion (i.e. not guaranteed like debt). Finally, rules of cooperatives generally provide that on a solvent winding up, members are entitled to be repaid their capital, but they do not share in any increase in value of the cooperative. Instead, this capital surplus is retained for future members and the sustainability of the society for their benefit.
2. Although cooperatives are established for people or businesses which wish to trade with the cooperative, in the UK it is possible to have "non-user investor members", namely persons who contribute share capital without expecting to have any other



trading relationship with the cooperative. The interest on such capital is similarly limited.

3. In summary, cooperative share capital is entitled to be paid a modest level of compensation for the use of that capital, but unlike a company it has no right to the financial benefits of the trade as a reward.
4. Cooperative capital is also unlike company share capital (which is fixed capital) in that it is generally withdrawable (variable capital) – that is to say a member can withdraw their capital if they wish to do so. The ability to withdraw is generally limited by the rules and also by the ability of the society to meet demands.
5. Withdrawable share capital is not subject to the same financial services regulations as company share capital. In practice this means that where a company would need to publish a prospectus to raise capital from the public, a cooperative does not. Consequently community share offers are an option available to a cooperative (see further below).
6. It is possible to have non-withdrawable capital in a cooperative, but transfer of such capital has to be approved by the board which means that it does not provide a mechanism for having a market in cooperative shares. Indeed the concept of such a market is generally not compatible with registration as a cooperative.
7. Care needs to be taken in using the term “investment” in relation to a cooperative. Investment is commonly understood to imply placing your money somewhere to obtain a maximum financial return, with consequential assumptions about the rights of “investors” (ownership and control) and the purpose of the venture (profit maximising). Those assumptions do not apply to cooperatives for the reasons set out above.
8. A cooperative can borrow (subject to its rules) just like a company. However it could not use debt-funding as a mechanism to distribute profits, to get around the restrictions on share capital.

The limitations on what a cooperative can do with its surpluses is closely linked to its nature as a cooperative. It is that nature which makes it distinctive and focussed on wider benefit.

## **Forms of Community Finance through Co-operatives**

This increasingly common approach means some or all of the capital for a project being raised by investment from the community served by the project (or by supporters of that community). This is normally achieved by some form of public crowdfunding campaign or renewable share offer, but the monies raised are a form of repayable finance, not grants or donations.

**Community shares** are non-transferable, withdrawable shares in an independent society that is owned and democratically controlled by the community it serves.

Members have the right to withdraw their share capital, subject to the terms and conditions stated in the society’s rules and share offer document. But they cannot sell or transfer their shares or liquidate the business in order to achieve a capital gain.

“Investing” in community shares engages communities in a virtuous circle where it is in their interests as members and investors to also be active as customers, supporters, and volunteers. Community shares rely heavily on community engagement; the involvement of people in the life of the enterprise. Community shares can provide an enterprise with a

competitive advantage by engaging stakeholders in new responses to the causes of market or policy failure.

**A community bond** is a form of loan. It is a legal agreement between the issuer of the bond and the purchaser which usually states the amount of interest to be paid on set dates on the loan and when the loan will be repaid in full. The traditional bond is an instrument usually fixed term and fixed interest rate which is tradeable. However, if the bond is tradeable then ownership of the bond could easily end up in the hands of people who have no interest in the Society's business.

A key issue to consider about any bond is that it is a fixed term loan. Whilst interest rate payments during the term of the loan may be low (especially in times of low interest rates) there is still a bullet repayment at the end of the term. So, if you have issued £100k of bonds for 5 years, at the end of the 5 years you may have to repay that money in one tranche. Either there need to be sufficient profits generated to make this payment or there must be a defined refinancing plan.

**Loan stock or loan notes** are fixed term (usually 3 – to 5 years) non-tradeable loans where annual interest only is paid until the loan comes to the end of its term. Loan stock or loan notes are simply a means of doing this in a way which breaks up the borrowing requirement into smaller chunks that small community supporters can afford.

Again a key issue to consider is that loan stock or a loan note is a fixed term loan. Whilst interest rate payments during the term of the loan may be low (especially in times of low interest rates) there is still a bullet repayment at the end of the term

Community shares provide ownership rights in the Society; bonds; loan stock and loan notes do not - they give no right of ownership; no right to vote in the Society and no share of the Society's assets.