

## > THE CRC ENERGY EFFICIENCY SCHEME

## > KEY ISSUES FOR THE PROPERTY INDUSTRY

The past year has seen extensive political discussion on climate change, with phrases such as “carbon budgets”, “emissions trading” and “carbon accounting” becoming almost everyday parlance in the run up to the passing of the Climate Change Act 2008.

Now one of these carbon initiatives is about to hit home in the form of the Carbon Reduction Commitment, or CRC Energy Efficiency Scheme (CRC), as it has recently been re-badged. But it is much more than a mere ‘commitment’. It is a binding legal obligation that will force large companies and public sector organisations to improve their energy efficiency, starting in April 2010.

It is expected that between 20,000 and 25,000 organisations in the UK will have to provide information about their energy use, with at least 5,000 of those being required to comply with the CRC in full. It will impact on commercial leases and sale and purchase contracts, as well as the administration and operation of multi-let buildings.

### What is the current position?

The Government issued its response to the consultation on the Draft Order to Implement the CRC on 7 October 2009 and the timetable and next steps are as follows:

- > on 9th November 2009 the Environment Agency (EA) published on its website guidance covering how to: assess qualification, identify organisation structure, assess exclusions and exemptions and register (further guidance is anticipated in March 2010);
- > the EA's User Guide is to be updated to reflect the policy changes outlined in the consultation response;
- > the Order to implement the CRC is to be laid before Parliament early this year;
- > revised allocation regulations (setting out details of the Government allowance sales) are to be laid before Parliament in early 2010;
- > the CRC commences in April 2010; and
- > details of the emissions cap are intended to be announced in 2012.

This Briefing has been prepared on the basis of the Draft Order to Implement the CRC and the Government Response and Policy Decisions dated 7th October 2009.

### What is the CRC and how will it work?

The CRC is intended to increase energy efficiency thus reducing carbon emissions by at least 4.4 million tonnes of UK CO<sub>2</sub> emissions per year by 2020, while at the same time delivering reductions in energy costs of around £1 billion per year by 2020. It will require certain public and private sector organisations to

count their greenhouse gas emissions from April 2010 onwards. From 2011 they will then have to purchase, and subsequently surrender, enough “emissions allowances” to cover their annual CO<sub>2</sub> emissions. They will also have to produce an annual report detailing their carbon emissions.

From April 2013, the CRC will become a “cap and trade scheme” – like the EU Emissions Trading Scheme – and a limited number of emissions allowances will be auctioned in advance for each year. These allowances may then be traded between organisations participating in the scheme, on the “secondary market”, so that those with a surplus can sell to those with a deficit.

Funds spent on allowances will be ‘recycled’ back to CRC participants 6 months after the allowances are auctioned, with companies being repaid the amount that they spent on allowances, with either a penalty deducted or a bonus added, depending on their emissions reduction performance compared with that of other participants, as determined by their place on an annual league table. This ‘recycling’ payment means that the scheme is effectively revenue neutral.

However, in the first phase of the CRC (April 2010 – 2013), the rules are slightly different.

#### Year One: April 2010 – March 2011

In the first year of the CRC there is no auction of allowances and organisations must simply calculate their CO<sub>2</sub> emissions from non-transport related use of electricity, gas and any other fossil fuels. For many organisations, however, the reality is that this will not be a simple task.

Although gas and electricity suppliers are now required to provide data for all meters, this does not detract from the difficulties that many organisations are likely to encounter in monitoring their energy use. This includes the initial task of

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locating all gas and electricity meters, and identifying and obtaining details of any purchases of fuel for the purpose of estimating their CO<sub>2</sub> emissions.

#### Year Two: April 2011 – March 2012

The first sale of emissions allowances will take place in April 2011 and firms will have to buy allowances to cover their anticipated emissions for Year Two. Allowances (each being an authorisation to emit one tonne of CO<sub>2</sub>) will be sold at a fixed price of £12 each.

In October 2011 the first ‘recycling’ of funds will take place. This means that firms will be reimbursed for the money that they spent on emissions allowances in April, with either a bonus added or a penalty deducted depending on their energy saving performance, as benchmarked against other CRC organisations in the annual league table.

#### Year Three: April 2012 – March 2013

Emissions allowances will be sold, still at a fixed price of £12, in April 2012 for the year ahead. In October 2012 the funds spent will be ‘recycled’ to firms again.

#### Year Four Onwards/Phase 2: April 2013 – March 2018

From April 2013 there will no longer be a fixed price of £12 for emissions allowances, and a limited number of them will be auctioned instead. In each 5-year “carbon accounting” phase, the limited number of allowances auctioned will decrease to reflect the UK’s carbon budgets. This will tend to push up the price of allowances, meaning that emissions reductions and energy efficiency measures should make even better economic sense for CRC participants.

In 2013, all previous emissions allowances will be cancelled, so that any surplus allowances that have not yet been surrendered do not add to the number auctioned under the cap. However, from this stage on, allowances will be capable of being ‘banked’ for use in future years.

#### Who must comply with the CRC?

All organisations that consumed at least 6,000 megawatt hours (MWh) of electricity through half-hourly meters (HHMs) during the calendar year 2008 – which equates roughly to an annual electricity bill of £400,000 – will have to comply with the CRC. These organisations will have to register online for the CRC between 1st April and 30th September 2010, or face significant penalties. Organisations which register in 2010 must comply with the CRC for the whole of the first phase, up to 2013. Thereafter, organisations subject to the CRC will have to register for the scheme by the last working day of the first year of a subsequent phase.

Organisations which consumed less than 6,000MWh through HHMs in 2008 will have to provide the EA with a list of all of their

HHMs settled on the half-hourly market, as well as details of their total consumption of HHM electricity during that calendar year, by the end of September 2010. All organisations with one or more half-hourly electricity meters settled on the half-hourly market must therefore identify all of their HHMs, and also ascertain the extent of their total electricity consumption through all HHMs for 2008.

The Government has tried to avoid any significant overlap between the CRC and other measures designed to encourage emissions reductions, such as the EU ETS and voluntary industry sectoral Climate Change Agreements (CCAs). There are therefore a number of exclusions and exemptions that may apply to organisations, based on whether they participate in the EU ETS, or have emissions which are subject to CCAs.

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#### Top of the league?

As indicated above, a CRC league table will be published annually by the EA, ranking participants based on their emissions reductions. In the first phase of the scheme, participants will also be able to benefit from taking certain early energy saving measures.

Good performance in the league table will be important for a number of reasons.

Firstly, an organisation’s position in this table will determine whether it will suffer a penalty or receive a bonus when the money it spent on allowances is ‘recycled’ to it. In the first year the penalty or bonus can only amount to a maximum of +/-10%. However, this will rise to as much as +/-50% in 2015. One of a participants’ main priorities will be to ensure at least that so-called ‘recycling’ payments are not lost, which will mean ensuring a reasonable position on the annual league table.

However, there is also another consideration in the context of the league table, and that is corporate image. In pitting companies against one another, rather than against fixed common criteria, such as emissions limits or similar, the Government will hope to harness competition in the free market

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to drive down emissions and increase the uptake of energy saving measures. Without this ‘reputational’ aspect of the scheme, the uptake of such measures would be dictated largely by the price of the allowances and the price of energy, which would be the determining factors in assessing whether any particular measure is cost-effective.

The first league table will be published in October 2011, during the first year of the scheme.

During the first phase of the CRC, there will be three sets of criteria against which performance in the league table is assessed:

1. **Early action** – Participants will score points for taking early measures to become more energy efficient, or to reduce their emissions. For instance, points can be scored for emissions certified under the Carbon Trust Standard or Energy Efficiency Accreditation Scheme, or for voluntarily installing settled HHMs, daily read gas meters, or remotely read meters. In the first year of the scheme, this will be the only criteria for the league table.
2. **Absolute emissions reductions** – Participants absolute emissions reductions will be calculated against historic average emissions over the previous five years. This is the critical league table, in that it is triple weighted in comparison to the remaining tables in calculating a company’s overall performance.
3. **Relative emissions reductions** – Participants emissions reductions are assessed taking into account any growth or decline in turnover. The aim of this is to encourage, and give credit for, low carbon growth.

Following the end of the first phase of the CRC, the early action metric will no longer feature. A participant’s overall performance will be assessed by weighting the individual metrics, with absolute emissions reductions triple weighted, as indicated above.

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There have been some criticisms of the league table aspect of the CRC, alleging that companies that are performing the worst at the moment are likely to benefit the most from the ‘early action’ metric used in the first phase. The argument goes that

these companies will be able to benefit in the table by taking low cost energy saving measures, which have already been implemented by many other participants. The Government’s response to these criticisms is that companies will save more money the more energy efficient they become, due to savings in energy bills. However, with the league table and the recycling payment effectively coupled with one another, this does not really address the concerns of many companies, at least in the initial scheme phase.

### Out of the comfort zone – carbon trading

Under the CRC the purchase of allowances from the Government is based on projected emissions for the compliance year ahead, meaning that there will inevitably be discrepancies between projected and actual emissions, which must be balanced prior to allowances being surrendered. The way participants will do this is through the sale and purchase of allowances on the ‘secondary market’ – i.e. between one another. This will take many organisations well out of their comfort zones, as they grapple with predicting and managing their emissions and energy use, and developing trading strategies.

On the last working day in the July following the end of a compliance year, participants must both report their CRC emissions for the year and surrender enough allowances to cover those emissions. There has been some concern that, because of many participants unfamiliarity with allowances trading, there will be a last gasp dash at this point to purchase additional allowances, and offload any surpluses. This would lead to spikes in the price of allowances, and might result in the CRC’s ‘safety valve’ mechanism having to kick in, allowing participants to purchase EU ETS allowances and use those instead of CRC allowances. However, this is intended to be used as a last resort, rather than a regular measure, and entails some additional costs on the participant, such as a deposit and additional administrative costs.

The EA has indicated that it will provide guidance on the mechanics of allowances trading, but will not provide advice on trading strategies, which will be left up to participants. Pilot schemes mirroring the CRC have apparently experienced low volumes of trades, but it remains to be seen how participants adapt and set about trading with one another.

### Particular challenges facing the property industry

The major issue faced by the property industry, and landlords in particular, relates to who is responsible for energy use in a large multi-let building with common parts. Ordinarily, in this situation the landlord pays the bills relating to the common parts, which

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they recover from the tenants through the service charge, while individual tenants are likely to have their own electricity bill for their separate units.

Under the current draft legislation, the CRC makes the counterparty to the electricity supply contract responsible for the energy used under it. In the case of a multi-let building with common parts this could be the landlord, meaning that landlords may find themselves responsible for complying with the CRC in respect of their tenants 'common' energy use. A criticism of the CRC has been that it does not differentiate between sectors with differing abilities to reduce or manage their emissions, and will therefore, some argue, automatically penalise certain types of participant, including commercial landlords.

Landlords will therefore have to consider carefully how they are going to deal with this in the context of new leases or those being renewed, since they will no doubt wish to pass on the cost of complying with the CRC to their tenants wherever possible. They will also have to develop procedures for obtaining information on their tenants anticipated energy consumption, and any changes in such projections, so that they can consider how many allowances they will have to purchase.

A potential way of reducing the administrative burden for a landlord with numerous assets may be to take advantage of the rule in the CRC that enables organisations to exclude, for the purposes of the CRC, up to 10% of their emissions. This might allow some landlords to exclude some small properties, removing the need to ascertain, verify and report emissions from them. On the other hand, landlords will want to be strategic about the way they comply with the CRC, and, given the potential to earn early action points for the league table in the first phase, some may prefer to include all of their emissions but invest in cost-effective reductions at appropriate premises before 2013.

“An issue faced by landlords is that their emissions will go up whenever they purchase new property assets.”

Another issue faced by landlords is that their emissions will automatically go up whenever they purchase new property assets, which will, in turn, affect their performance on the CRC league table. It is understood that the Government is seeking to remedy this before the scheme's implementation. However, it is not clear how it intends to do so. There are numerous issues to take

account of, including, for instance, whether the sale is between two CRC participants or not. In any event, there will be a host of questions to be addressed during any sale to a CRC participant regarding the treatment of the building in the context of the CRC in the past and how it is to be dealt with, as between the buyer and seller, in the future.

Something which may be more of a concern for tenants is to ensure that they benefit from any emissions reductions that they make. They will wish to discuss how different tenants, with different levels of energy efficiency and emissions, should be treated by the landlord. Some landlords have already raised the possibility of running a scheme mirroring that of the CRC, whereby costs and any bonuses or other benefits under the scheme can be recycled back to tenants. Whether or not this is an option will likely depend on the scale of the landlord's operation, and the extent of their commitment to cutting emissions.

“Tenants will want to ensure they benefit from any emissions reductions that they make.”

In relation to the overall effectiveness of the CRC as a means of increasing energy efficiency and reducing emissions, it is worth noting that neither the landlord nor the tenant currently has a strong incentive to invest in energy efficiency measures. The Energy Performance of Buildings Directive sought to introduce a form of 'energy efficiency labelling' for buildings in an effort to enable tenants to differentiate between landlords on the basis of the energy performance of the asset being let, and to stimulate competition between landlords on this basis. However, there are as yet no real indications that this has been successful, and it seems likely that, in the grip of the current financial crisis, the bottom line will remain tenants paramount consideration for some time yet.

For landlords, however, the CRC may well be the measure required to drive investment in energy efficiency, at least where any bonuses earned under the scheme are not being passed on to the tenant.

#### Audit and Enforcement

The EA is responsible for the day to day administration of the CRC. However the local administrators (i.e. the EA, SEPA and NIEA) are responsible for enforcement, monitoring, auditing and charging of participants in their respective jurisdictions.

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Participants should expect to be audited at some point every 5 years. Accordingly, robust and secure information management and storage systems will require to be put in place by participants. Given the self-certification basis of the CRC, the Government's view is that strong penalties are required to deter abuse and secure compliance. The penalties are predominantly civil with fines and publication of non-compliance being the most common, although in certain cases the administrators will have power to block trading accounts.

## Interaction with Renewables Obligation

There has been much criticism of the interaction of the CRC with the Renewables Obligation and the new feed-in tariffs proposed to support renewable electricity generation. The Renewables Obligation enables those generating renewable energy to earn ROCs (Renewables Obligation Certificates), which can then be sold on the open market. The scope to earn ROCs has been a significant driving factor in the installation of renewable generating capacities by a number of companies not ordinarily concerned with generation. The Government recently undertook to introduce feed-in tariffs to provide a guaranteed price for electricity generated from renewable sources, in order to remove some of the risks involved in developing renewable electricity generation.

However, the Government has confirmed that companies will not be able to report emissions savings from on-site renewables under the CRC unless they forego their ROCs entitlement. The rationale is that this would potentially enable them to benefit from a double subsidy, as they would earn money for selling their ROCs, and could also earn a bonus under the CRC for their resulting improved emissions performance.

This has led to warnings that this could stifle investment in renewables projects, with companies saying that investment in on-site renewables is only attractive where it is financially viable (in the sense of being subsidised by money from the sale of ROCs earned, or from the guaranteed price supplied by feed-in tariffs) and the resulting carbon savings can be reported. It seems that in the environmental context the importance of corporate image cannot be underestimated.

While the Department of Energy & Climate Change (DECC) has confirmed that the CRC, focused on energy efficiency rather than renewables, will not provide an additional incentive for renewable generation, it has conceded to publish a table showing the increase in onsite renewable generation by organisations, together with any energy efficiency savings, alongside the CRC league table. This should enable organisations to benefit from improved corporate image resulting from their renewables investment, without effectively resulting in a double subsidy by Government.

Despite some calls for the CRC to be postponed for a year in light of the recession, the Government looks set to press ahead with its

implementation. If it continues, final legislation will only be published a couple of months prior to the start of the scheme in April 2010. Businesses should start planning now to ensure they are prepared, and to avoid significant penalty payments for late registration and submission of information.

**Geographical note: The CRC applies on a UK-wide basis, having been developed by the UK Government and the devolved administrations. Accordingly, certain aspects of the scheme will be administered by the Environment Agency, which also acts as the regulator for England and Wales. The other regulators are the Scottish Environment Protection Agency and the Northern Ireland Environment Agency.**

## Practical tips

- ▶ Start collating the information required for registration or information disclosure. Ascertain where all of your HHMs are (and those of any subsidiaries or franchisees), and send the EA a list of these, along with (for group companies or franchisors) a single contact address for the qualification pack to be sent to;
- ▶ Complete the qualification pack when received;
- ▶ If your organisation used more than 6,000MWh of electricity through HHMs in 2008, register for the CRC online between 1 April 2010 and 30th September 2010;
- ▶ If your organisation does not qualify for the CRC, make an information disclosure online by September 2010;
- ▶ Between April 2010 and April 2011, monitor and manage energy use and emissions and consider the number of allowances you will require to purchase, factoring in any changes to your company structure or assets;
- ▶ Landlords and tenants should be reviewing their existing contracts and any being currently or prospectively negotiated should have CRC built into the “heads of terms” discussion; and
- ▶ Consider whether you can take advantage of the early action metric by becoming accredited by the Carbon Trust Standard, or by voluntarily installing automated meters.

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The legal regulations surrounding waste and renewables are a severe headache, with very significant commercial ramifications which are buried deep in complex EU and UK laws which are still in a state of frustrating transition and uncertainty.

Industry needs to be aware not only of the law affecting liability but also practical advice on what they should be doing.

Semple Fraser's specialist Waste, Renewables & Energy team handles the maze of EU and domestic climate change legislation, dealing with energy security, resource efficiency, and carbon cutting. It's a fraught agenda – how to do more with less (be energy efficient, create less waste, put what waste there is to good use, emit less carbon, and develop renewable forms of energy), yet stop the lights going out.

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