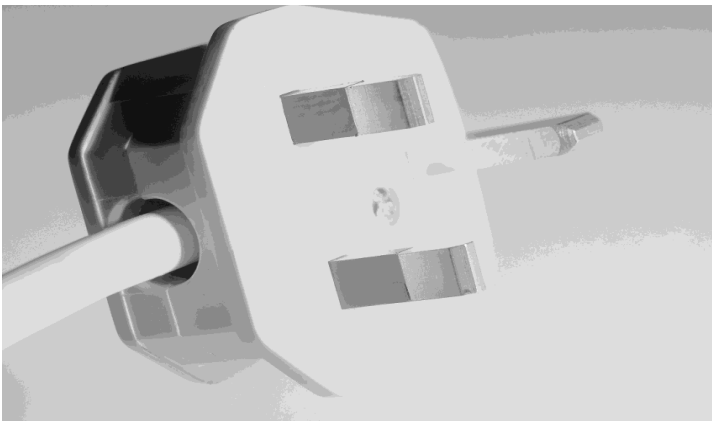


CRC Energy Efficiency Scheme: A Primer



Time is quickly running out for companies to prepare for the UK's CRC Energy Efficiency Scheme with the scheme's first registration deadline approaching on 30 June 2010. This briefing explains the initial steps that companies should be taking and includes a summary of how the CRC works with a timeline of obligations.

The new UK emissions trading mechanism, the CRC Energy Efficiency Scheme (CRC), came into force on 1 April 2010. Around 4000 to 5000 private and public sector organisations will be obliged to participate in the CRC including banks, retailers, hotels, property and other funds, professional firms, and other office-based corporations. CRC groups together certain entities (e.g. groups of companies) to comply with the scheme as a single participant.

CRC will involve ongoing action to monitor and report energy use as well as the buying of allowances from the government to cover participants' energy use. Monies collected by the government will be recycled back to participants favouring those who are most successful in reducing their energy use. This will encourage continuing action to improve energy efficiency. Whilst the obligations to buy allowances only begin in April 2011, the monitoring and reporting elements of the scheme are already in force as from April 2010.

The first major deadline under the scheme is the obligation for potential participants to register for the scheme. There is a possibility for participants to carve out larger subsidiary groups (called Significant Group Undertakings) to participate in the scheme on their own. If they wish to do this, it is important to note that the deadline for registration is **30 June 2010** which leaves very little time to prepare. If they do not wish to do so, the deadline is 30 September 2010.

Affected companies should already be some way through the process of preparing for CRC, but if you have not already done so, you should:

- Analyse which entities within your organisation should form part of a CRC Participant and complete registration of single or multiple CRC Participants

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prior to expiry of the registration period on 30 September 2010 (or by 30 June 2010 if disaggregating Significant Group Undertakings, or SGUs)

- Identify the energy sources for which your organisation is responsible and whether your organisation therefore qualifies for CRC or has related disclosure obligations based on its electricity consumption
- Consider your strategy for disaggregating SGUs
- Choose a UK representative for any CRC Participant whose parent is overseas
- Put in place a compliance function for each CRC Participant and reporting lines through the organisation to ensure ongoing compliance and consider whether environmental advisers are required to assist with this
- Prepare for and commence registration – beyond collating necessary information, the process of inputting data and navigating the online registry application may take some time for larger organisations and includes a potential 2 week period during the registration whilst the scheme regulator performs checks on relevant participant contacts
- Consider your strategy for reducing energy use in your organisation
- Consider how CRC will affect any future property or company acquisitions or disposals or lending transactions and what sort of due diligence and contractual protection might be needed e.g. landlords should be considering whether changes need to be incorporated into their standard lease terms to deal with CRC impacts

Appendix 1 sets out a timeline showing a CRC Participant's principal obligations during the early stages of the scheme and in particular demonstrates the overlapping requirements between the first and second phases. Appendix 2 to this briefing sets out a summary of how the CRC scheme works.

Clifford Chance Environment Group

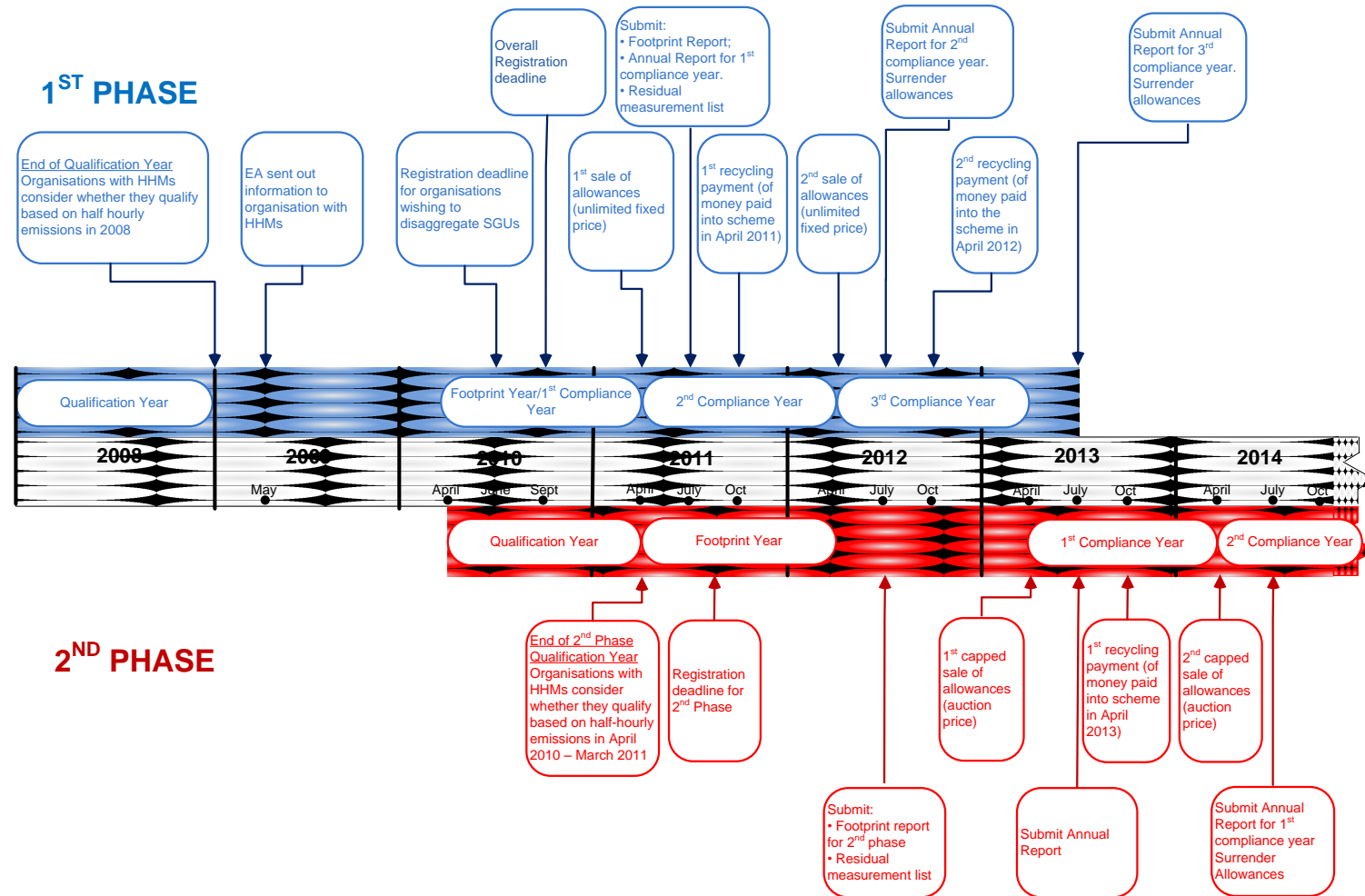
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APPENDIX 1 – CRC ENERGY EFFICIENCY SCHEME TIMELINE



APPENDIX 2 - SUMMARY OF THE CRC ENERGY EFFICIENCY SCHEME – PRINCIPAL ELEMENTS

Introduction

The CRC Energy Efficiency Scheme (CRC) is a new mandatory emissions trading scheme for non-energy intensive large public and private sector organisations. It is intended to contribute towards the government's targets in the Climate Change Act 2008 to reduce carbon dioxide (CO₂) emissions by 80% by 2050. The CRC is a revenue neutral scheme as far as the government is concerned. On this basis, monies obtained from the scheme will be recycled to participants, favouring those who are able to reduce their emissions most effectively. The scheme will operate in successive phases. There will be an 'introductory phase' running from April 2010 to April 2013 and then successive 5 year 'capped' phases beginning in April 2013. The scheme is intended to run until 2043. The Environment Agency will be the regulator for the scheme in England & Wales.

Qualifying for CRC

Qualification for the scheme – grouping entities together

The CRC scheme groups together certain entities who are required to form a single "CRC Participant" for the purposes of determining initial qualification for the scheme and for ongoing participation in it. See further below (Group participation and Disaggregation of Significant Group Undertakings).

Qualification for the scheme - threshold electricity consumption test

Once it is understood which organisations must be grouped in this way, qualification for the CRC scheme is based on a test applied once before each scheme phase. Under this test, the electricity consumption for which the potential CRC Participant is responsible must be added up. The potential CRC Participant will only qualify for the scheme if the organisation, during the qualification year:

- Has at least one Half-Hourly Meter (HHM) settled on the half hourly market;
- Has aggregated UK electricity consumption of over at least 6,000MWh (representing an electricity bill of around £500,000 - £750,000)¹. For the first phase of the scheme, 2008 was the qualification year for measuring that consumption.

There are a number of additional rules to follow, principally:

- Electricity consumption would only be calculated from certain forms of HHM;
- Supplies used for the purposes of transport or domestic accommodation are not counted and there are also some exemptions related to minor energy use.

If the organisation including all grouped entities and electricity usage as determined above does not qualify for CRC for the introductory phase, then it may qualify at a future date, but only at the beginning of a subsequent capped phase.

"Application of the tests may also result in funds (e.g. private equity and infrastructure) being grouped together with their portfolio companies"

Group participation and Disaggregation of Significant Group Undertakings

In brief, the draft CRC Order uses Section 1161 Companies Act 2006 to determine whether undertakings are part of a group and must participate in CRC together. On this basis, where a shareholder has more than a 50% equity share in a company (e.g. in a joint venture vehicle), that company will be regarded as part of the CRC Participant. Where no shareholder has more than 50%, the company will stand alone for CRC purposes: the qualification tests and subsequent compliance obligations would apply to it as a standalone entity. Application of the tests may also result in funds (e.g. private equity and infrastructure) being grouped together with their portfolio companies.

Overseas subsidiaries of a group are included in the CRC Participant, although only UK emissions are covered by the scheme for reporting and allowance purchase purposes. In general, the parent UK entity will manage the group's compliance with the CRC. However, if the parent is non UK-based, then it will need to nominate a UK representative (either a group company or an agent) for this purpose.

¹ Even if an organisation does not reach the 6,000 MWh threshold, it will have disclosure requirements if it has at least one HHM settled on the half hourly market; and there are more extensive obligations if the organisation reaches a 3,000 MWh threshold in the qualification year.

Significant Group Undertakings

In order to encourage maximum incentives for companies to perform well in the CRC, the scheme allows "Significant Group Undertakings" (SGUs) within a CRC Participant to take part in the scheme on a standalone basis. SGUs are groupings of subsidiaries that would qualify for the scheme on their own, if it were not for the fact that they are part of a larger group.

A CRC Participant can be "disaggregated" into a combination of SGUs as long as, among other criteria, the SGUs and remaining part of the CRC Participant each have qualifying emissions (i.e. over 6000 MWh). Advantageously, where a SGU is disaggregated, the remaining entities in the CRC Participant will no longer be jointly and severally liable for that SGU's compliance and will not need to report on its emissions.

Disaggregation of SGUs can be done as part of the registration process, at the beginning of subsequent phases or when an SGU is acquired by an existing CRC Participant.

In order to disaggregate for the first phase, the wider organisation must register by 30 June 2010 and will need to elect to disaggregate any SGUs at that time. This is so that the SGUs can themselves register separately by the overall registration deadline of 30 September 2010.

Responsibility for Energy Supplies under CRC

General rule

An organisation A will be responsible for a particular supply of electricity and gas² for CRC purposes if:

- it is party to a supply agreement with an energy supplier;
- the energy is supplied to A, and charged for, by reference to a meter; or
- A uses some or all of the energy for itself (if A on-supplies some or all the energy to a third party B, B will be responsible for the energy on-supplied).

"Where a landlord receives a supply and provides part of that supply to its tenant (e.g. in a multi-let building), the landlord will be responsible for that supply"

Government guidance provides that facilities management organisations or others that contract for energy supplies on behalf of an end user will not be responsible for CRC purposes. However, this is a difficult area and there is a lack of clarity, for example, as to how this will apply to PFI structures where there may be complex contractual and practical arrangements between public authority, project and facilities management companies as to how energy is provided and used.

Landlord & Tenant relationships

A significant exception to this rule is the position of landlord and tenants. Where a landlord receives a supply and provides part of that supply to its tenant (e.g. in a multi-let building), the landlord will be responsible for that supply³. Conversely, where the tenant is responsible for the energy supply (i.e. it has a direct agreement with the energy supplier, CRC liability for energy use will be allocated to the CRC Participant to which the tenant belongs, if any. It may therefore be the case that, in respect of the same building, the landlord may be responsible for certain energy supplies (e.g. common parts) and tenants may be responsible for others (direct supplies to the tenant's leased space).

Responsibility for the compliance with the scheme cannot be transferred between landlord and tenant but the parties can of course agree to pass on the costs between them as they desire. Indeed, where the landlord is responsible for CRC for an energy supply, it is likely to want to recoup costs arising out of the CRC scheme from its tenants under the lease (e.g. under service charge provisions) but careful scrutiny of lease provisions will be required to ensure that such costs can be recovered. In such a case, the landlord remains responsible for the energy consumption under the CRC.

Franchise Relationships

The responsibility for supplies of energy to franchisees will be attributed to the franchising organisation if certain criteria are met. Franchises in this context are sale, distribution or services agreements where a business is operated under the franchisor's name and in premises exclusively used for the franchise business and fitted out to the franchisor's standard

² Other types of fuel are subject to different rules.

³ The exception applies similarly to occupation of premises by licence.

specifications. Franchisees have to co-operate with franchisors e.g. in providing relevant information to the franchisor in order to facilitate CRC compliance.

Emissions to be included in the Scheme

Once a CRC Participant has been identified, in principle, all UK consumption of all fuel types (and attributed fuel consumption, e.g. from tenants and franchisees) for which it is responsible would be included within the scheme, subject to the following two main rules:

- All of the organisation's core emissions must be included; this relates broadly to principal metered electricity and gas sources except to the extent covered by Climate Change Agreements (CCAs) or the EU Emissions Trading Scheme (EU ETS);
- 90% of an organisation's total 'footprint' emissions must be either covered by CRC, CCAs or the EU ETS⁴. This rule allows small sources which might be onerous to monitor, and not provide much benefit in energy efficiency terms, to be excluded from the scheme. Organisations can, however, choose to include up to 100% of emissions.

Emissions covered by CCAs or the EU ETS would, once used in the above calculation, then be excluded from the scheme.

An organisation's total footprint emissions will be measured in the 'footprint year' which for the introductory phase is April 2010 to end of March 2011⁵. Once every phase, a footprint report containing, amongst other information, the residual sources which the organisation wishes to include in the scheme must be submitted (by the last working day of July 2011 for the first phase). The organisation must then continue to include at least the same percentage of energy sources within the scheme at the beginning of subsequent phases.

Electricity Generation

In brief, small-scale generation of electricity, where used within the organisation or on-supplied, benefits from an "electricity generating credit" (EGC) against footprint emissions⁶. There is an exception from this rule if financial incentives through Renewable Obligation Certificates (ROCs) or "Feed-in-Tariffs" (FITs) are received.

In addition, whenever an organisation supplies electricity to a third party or self-supplies it to a part of its organisation, that supply must be reported (as part of footprint emissions for CRC purposes) on a "grid average emissions factor" basis⁷.

Renewables example

If an organisation within the scheme (a CRC Participant) uses wind turbines to self-supply power to buildings on-site, but does not claim corresponding ROCs or FITs, it will need to report the self-supply of electricity as part of footprint emissions but it can claim EGCs for the self-supply. The EGCs will result in a net zero increase in footprint emissions.

If it receives ROCs or FITs for the supply, no EGCs will be available and the CRC Participant's footprint emissions will therefore include the supply at the grid average.

If the input fuel to generate the electricity was a fossil fuel, e.g. a fuel oil burner, then the CRC Participant would need to add the input fuel as well as the electricity self-supply to its footprint emissions. It would still be eligible for the EGCs in respect of the electricity self-supply⁸ but would be left with only the input fuel emissions as part of its footprint emissions total.

Controversially, electricity purchased from suppliers under 'green tariffs' is not treated any differently from any other form of electricity supply for CRC purposes.

"Controversially, electricity purchased from suppliers under 'green tariffs' is not treated any differently from any other form of electricity supply"

⁴ Footprint emissions are made up of all the CRC Participant's energy use sources but with certain sources removed: e.g. those used for transport and domestic accommodation, emissions of organisations which already have over 25% of their energy use emissions covered by a CCA; electricity generating credits (See section "Electricity Generation") are credited against footprint emissions at this stage.

⁵ For subsequent phases, the footprint year will be the year beginning 2 years before the first compliance period of the phase (e.g. April 2011 to March 2012 in respect of the first capped phase starting in April 2013) – see timeline at Appendix 1.

⁶ Footprint emissions would include any input fuel.

⁷ For the introductory phase, this has been fixed at 0.541kCO₂ / MWh.

⁸ As no ROCs or FITs could be claimed.

Registration of CRC Participants

Qualifying CRC Participants will need to register with the online CRC registry (see below) during the registration period 1 April 2010 to 30 September 2010. Provision of information on the organisation, meters and electricity usage data will be required⁹.

Significantly, however, where a CRC Participant wants to disaggregate one or more SGUs at the beginning of a phase, it must register 3 months earlier than the general deadline (i.e. for the first phase of the scheme, it must register by the end of June 2010) to allow time for the SGUs to register separately. For the first phase, this deadline is rapidly approaching and companies will need to decide quickly upon their strategy for disaggregation.

Energy suppliers will be obliged to provide the Environment Agency with relevant information on electricity consumption to determine qualification for the scheme. The Agency will be able to use information from suppliers to identify if organisations should have registered for the scheme and use its enforcement powers as appropriate.

Phases and Cap Setting

The scheme will work on a 'cap and trade' basis. This means that a total 'cap' on the amount of emissions in the scheme will be set by way of 'allowances' issued by the government. An allowance is a right to emit a certain amount of CO₂ emissions representing the energy for which a CRC Participant is responsible. Each CRC Participant must buy enough allowances each year to cover its emissions either through fixed price or auction sales of allowances, trading of CRC's on the secondary market or the safety valve (see below).

The 'compliance year' to which the obligations relate would run from 1 April to 31 March with a 4 month subsequent reconciliation period to collate emissions data, buy / sell allowances and make returns to the Environment Agency.

"The Agency will be able to use information from suppliers to identify if organisations should have registered for the scheme and use its enforcement powers as appropriate"

Introductory Phase

The scheme is to have a three-year introductory phase beginning in 2010. This 'trial run' would allow participants to experience forecasting their expected allowance needs, buying and trading allowances, creating energy management strategies, and monitoring and reporting their emissions before the first capped phase is introduced.

In respect of both the introductory and capped phases, the government will sell allowances in April to be used in respect of emissions in the following compliance year (April to March). CRC Participants will not have to purchase allowances in respect of emissions in the first compliance year of the scheme (April 2010 – March 2011) which will effectively become a monitoring year.

For the second two years of the introductory phase (2011/2012 and 2012/2013), allowances will be sold in the April sale at a fixed price of £12 / TCO₂. There will be no cap on CRC Participants' emissions and they will simply have to buy sufficient allowances to match their emissions.

Capped Phases

Following the introductory phase, the first five-year capped phase of the scheme will be introduced in April 2013. The scheme will run in five-year capped 'phases' thereafter with steadily reducing caps over time¹⁰. This phasing correlates with carbon budget periods in the Climate Change Act 2008. In the capped phases, there will be a cap on the overall level of allowances available to all participants and they will have to bid for them at an auction each year. The government will take into account information on energy consumption from the initial introductory phase to set the cap; details of the cap are expected to be published in 2012.

CRC Trading and Safety Valve

An organisation emitting more than its purchased allowances during the year (either in the introductory or capped phases) would need to buy allowances on the secondary market or through the 'safety valve' (it will effectively have a 4 month window to do this following the end of the compliance year, when it knows its total emissions for the preceding compliance year, although there is nothing to stop it doing so at any other point during the year). Each participant would

⁹ CRC Participants will be charged a registration fee and annual subsistence fees as well as various other charges.

¹⁰ Phases are, in fact, seven years long including two preparatory years which overlap with the previous phase – see the timeline at Appendix 1.

have an online account at a new CRC Registry which will allow trading of CRC allowances. Whilst only CRC Participants would be able to take part in the auction for allowances, other entities may trade CRC allowances on the CRC registry.

Under the 'safety valve' mechanism, CRC Participants can buy EU ETS emission allowances to satisfy their CRC obligations. They will be charged the higher of the EU ETS market price or a minimum floor price (set at £14). This is a safety net which aims to ensure both that CRC market prices do not rise unrealistically high and also that CRC Participants cannot easily circumvent their obligations by buying cheap EU ETS allowances (an experience the government would want to avoid in view of the collapse of the EU ETS market price during its first phase). To give a measure of flexibility, allowances can be banked for subsequent years although all remaining allowances at the end of the introductory phase of the scheme will be cancelled.

It is significant that allowances can only be surrendered for the compliance year in which they were issued or for subsequent years. By way of example, In April 2011, a CRC participant will buy allowances from the government for the coming compliance year (April 2011 – March 2012). Allowances for this compliance year, however, are not surrendered until July 2012. This rule prevents CRC Participants conveniently using allowances from the April 2012 government sale to partially satisfy their 2011 / 2012 compliance obligation.

"The government has sought to design the recycling payment to give financial incentives to reduce energy consumption"

Recycling Payments and the Performance League Table

On the neutral revenue basis of the scheme, receipts from allowances in any compliance year (paid in April) will be returned to scheme participants in October of the same year by way of a recycling payment. The government has sought to design the recycling payment to give financial incentives to reduce energy consumption on the following basis:

- Core payment: participants would be refunded a proportion of the 'funding pot' based on their emissions in the initial footprint year (April 2010 to March 2011);
- Bonus element: the core payment would be increased or reduced based on each participant's place in a league table identifying its emission reduction performance in the previous compliance year (based on metrics described below). The best performers would receive the largest increase to their payment back and the worst performers, the smallest; for the first 5 compliance years of the scheme, the maximum increase / reduction of the core payment will be as follows:
 - April 2010 - March 2011 (1st year introductory phase) : +/- 10%
 - April 2011 - March 2012 (2st year introductory phase) : +/- 20%
 - April 2012 - March 2013 (3rd year introductory phase) : +/- 30%
 - April 2013 - March 2014 (1st year 1st capped phase) : +/- 40%
 - April 2014 - March 2015 (2nd year 1st capped phase) : +/- 50%

The percentages for future years will be determined at a later date but it seems likely that these will increase to give ever greater reflection to participants' emissions reduction performance.

The Performance League Table

Given the financial benefits at stake (and the penalty aspect for poor performance), how the metrics for the league table are calculated is of significant importance. The table is designed to grapple with a number of issues around measuring the performance of a body of participants which will comprise a wide variety of types of organisations with varying abilities to reduce their energy use.

There will be with 3 potential metrics which would be applied with different suggested weightings.

- Absolute metric - based on the percentage reduction in carbon emissions relative to annual emissions in the previous 5 years. This of course favours those sectors that might find it easier to reduce emissions than others.
- Early action metric - this will be based:
 - 50% on the proportion of emissions covered by automatic metering which has been voluntarily installed by 31 March 2011; and

- 50% on the proportion of emissions covered by the Carbon Trust Standard or comparable energy efficiency accreditation schemes.
- Growth metric - this metric would assess the reductions in emissions per unit of turnover and therefore measure energy efficiency improvements whilst taking into account growth or decline of business. It is questionable whether the growth metric will give sufficient recognition to businesses that are growing or declining e.g. by buying or selling buildings in any particular year (see 'Changes to Group Structure and Operations' below).

"It is questionable whether the growth metric will give sufficient recognition to businesses that are growing or declining"

Because of the limited availability of data at the beginning of the scheme and a desire of government to phase out the early action metric, the weightings in the scheme will change over time as shown in the table:

Metric	Introductory Phase Year 1	Introductory Phase Year 2	Introductory Phase Year 3	Subsequent Years (to be reviewed)
Absolute	0%	45%	60%	75%
Early Action	100%	40%	20%	N/A
Growth	0%	15%	20%	25%

Changes to Group Structure and Operations

In order to create administrative simplicity, avoiding some of the concerns with the EU ETS, the CRC participants are, in principle, fixed at the beginning of the phase; therefore:

- If a CRC Participant is identified as a participant in the scheme at the beginning of a phase, it will remain in the scheme for the duration of that phase (five years) even if it falls below the 6,000 MWh inclusion threshold for any particular year. The organisation will then be reassessed for eligibility at the start of the next phase;
- Similarly, if an organisation is not eligible at the start of the phase, changes which bring its emissions above the threshold will only lead to inclusion of its emissions at the start of the next phase¹¹.

There are some refinements to this general position:

Acquisition at SGU or disposal of a entire CRC Participant

- Notification of the transaction (and other details) to the Environment Agency within 3 months is required;
- Transactions will be deemed to occur at the beginning of the compliance year; this means that the acquiring CRC Participant will be responsible for the whole year's worth of emissions of the acquired entity in the scheme¹²;
- The footprint of both seller and buyer¹³ is updated - this will assist the buyer in ensuring that its performance in the absolute emissions metric does not suffer by the acquisition. The core payment element of recycling payments is similarly altered.

Other Changes

If a CRC Participant sells any other subsidiary during the course of a compliance year, it will be responsible for emissions up to the date of completion of the sale. Thereafter, the new owner will be responsible for those emissions (which may or may not be within the CRC scheme depending on whether the buyer forms part of a CRC Participant) and will have to buy additional allowances accordingly.

However neither the 'footprint' of the seller nor buyer will be updated to reflect the change in this scenario. Without this update, the extra emissions attributed to the buyer's CRC Participant will have an adverse effect on a buyer in the

¹¹ Although it will become a CRC Participant in the scheme in respect of the emissions of any SGU it acquires.

¹² Where the acquiring entity is not already in a CRC Participant, emissions from the acquired entity alone continue in the scheme until the end of the phase.

¹³ The footprint of the target group (SGU or CRC Participant) would simply be carved out from that of the selling group where the acquiring entity is not already a CRC Participant.

absolute metric of the league table as their emission reduction performance will appear to have deteriorated. It will also not benefit from an increase in the core payment element of the recycling payment. Conversely, sellers will benefit. Similarly, where a building is bought or sold, neither the buyer's nor seller's footprint will be updated, leading to similar impacts on their performance in the table. It is intended that the growth metric of the table will counteract these effects but it remains to be seen whether this will be sufficient.

Changes before Registration

There are also some detailed rules relating to changes that occur to group structures (including purchases of SGUs or whole participants) between the qualification period and when an organisation registers. The obligations relate to resolving which entities should register following the change and whether, for example, an SGU **transferred into a CRC Participant should participate on a disaggregated basis.**

Administration

Administration, Reporting and Monitoring

There is heavy reliance on self-certification of emissions (backed up by the possibility of regulatory inspection) rather than the third party verification required by the EU ETS. Inevitably, given the complexity of the scheme, in addition to registration (see above), there are significant ongoing reporting obligations which will be satisfied through the online registry:

- **Submission of footprint report - detailing energy use within and outside of CRC (July after the end of each footprint year);**
- **Submission of annual report collating all CRC emissions (each July after the end of each compliance year);**
- Generally keeping an evidence pack containing organisational records and data on energy use.

"To re-inforce the light touch nature of the scheme, there are strong civil enforcement penalties in order to encourage compliance (backed up by some criminal offences)"

Enforcement

To re-inforce the light touch nature of the scheme, there are strong civil enforcement penalties in order to encourage compliance (backed up by some criminal offences). Penalties take the form of financial sanctions, together with other options including blocking of trading accounts and publication of non-compliance, and are analogous to those currently used in other schemes such as the EU ETS. Examples of financial penalties include:

- Late registration or submission of annual report: immediate fine of £5,000 + £500 daily default fine subject to limits;
- Failure to surrender allowances corresponding to reported emissions: fine of £40 / tCO₂ per missing allowance, requirement to obtain all outstanding allowances, cancellation of recycling payment.

At these levels, fines are likely to provide a significant incentive to ensure that companies comply. It should be remembered that the government will have details of all half-hourly metered electricity consumption direct from suppliers so identifying non-compliance will be facilitated.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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