

# CRC: The Detailed Rules for Phase 2 and beyond are published

The Government has finally published a draft Order establishing Phase 2 of the CRC Energy Efficiency Scheme which begins on 1 April 2014. The first deadline under the scheme is registration of CRC Participants by 31 January 2014. The structure of potential CRC Participants for Phase 2 will be broadly fixed on 31 March 2013. After that date, organisations should begin to analyse if they will be in the CRC Scheme in Phase 2, and make preparations for registration as necessary.

This Briefing sets out recommended next steps and includes a summary of Phase 2 and timeline chart.

## Introduction

The major changes between Phase 1 and Phase 2 were considered in our recent briefing on the Department of Energy and Climate Change's December 2012 Response to Consultation (**DECC Response**)<sup>1</sup>.

We now set out in Appendix 1 a revised timeline showing the cross-over in the scheme between the end of Phase 1 and Phase 2. We have also set out a summary of the scheme for Phases 2 and beyond at Appendix 2, highlighting the major changes from Phase 1.

We investigated with DECC a number of apparent errors or differences in the Draft CRC Energy Efficiency Scheme Order 2013 (**the Draft Order**) compared with the DECC Response as described in that briefing. DECC confirmed that technical amendments to the Order will be made later in 2013 to correct some errors. We make reference to relevant issues where necessary in Appendix 2.

## Key issues

- The Draft Order establishing detailed rules for Phase 2 has been published.
- This briefing set out:
  - Next steps
  - A timeline for Phase 1 / 2 Cross-over
  - A summary of the scheme for Phase 2

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<sup>1</sup> [CRC: DECC's Final Decision on Reform Measures Published – December 2012](#). The Draft Order also makes various changes to the remainder of Phase 1 and the briefing also covered these changes.

## Next Steps for Phase 2

Although many CRC Participants who qualified for Phase 1 of the scheme will still be involved in Phase 2, there is likely to be some change in qualifying groups, in particular, due to the following:

- The new restriction upon "qualifying electricity" to that measured by "settled" half-hourly meters (rather than all half-hourly metered electricity) will mean fewer groups will meet the 6000 MWh qualification threshold;
- The new rules for properties held under trusts (see Appendix 2, "*Real Estate held under Trusts*") which now attribute responsibility for electricity supplies in some cases to trust beneficiaries, or operators of regulated trusts, will cause some beneficiaries and operators to qualify for the scheme while some trustees may fall out of the scheme; and
- Changes in group structures since Phase 1 began may take groups into, or out of, the Scheme.

Qualification to be a CRC Participant in Phase 2 will be determined by a group's structure as it is established on 31 March 2013 and based on electricity supplies between 1 April 2012 and 31 March 2013<sup>2</sup>. Registration opens on 4 November 2013 and is required by 31 January 2014. Any entities that wish to disaggregate will need to register separately by 30 April 2014.

From April 2013 onwards, therefore, businesses (whether corporate groups, private equity or infrastructure funds, or trustees) should:

- Begin to consider whether they will need to participate (or continue to participate) in Phase 2 of the scheme. They should look at which entities in their structures form part of a CRC Participant and register prior to expiry of the registration period on 31 January 2014;
- Consider their strategy for disaggregating undertakings (see Appendix 2 under heading "*Disaggregation*") with a view to registering any disaggregated CRC Participants by 30 April 2014; there is much more scope to disaggregate entities in Phase 2 than Phase 1;
- Nominate a UK representative for any CRC Participant whose parent is overseas; and
- Put in place, as necessary, a compliance function for each CRC Participant to ensure ongoing compliance, and consider whether environmental advisers are required to assist you with this.

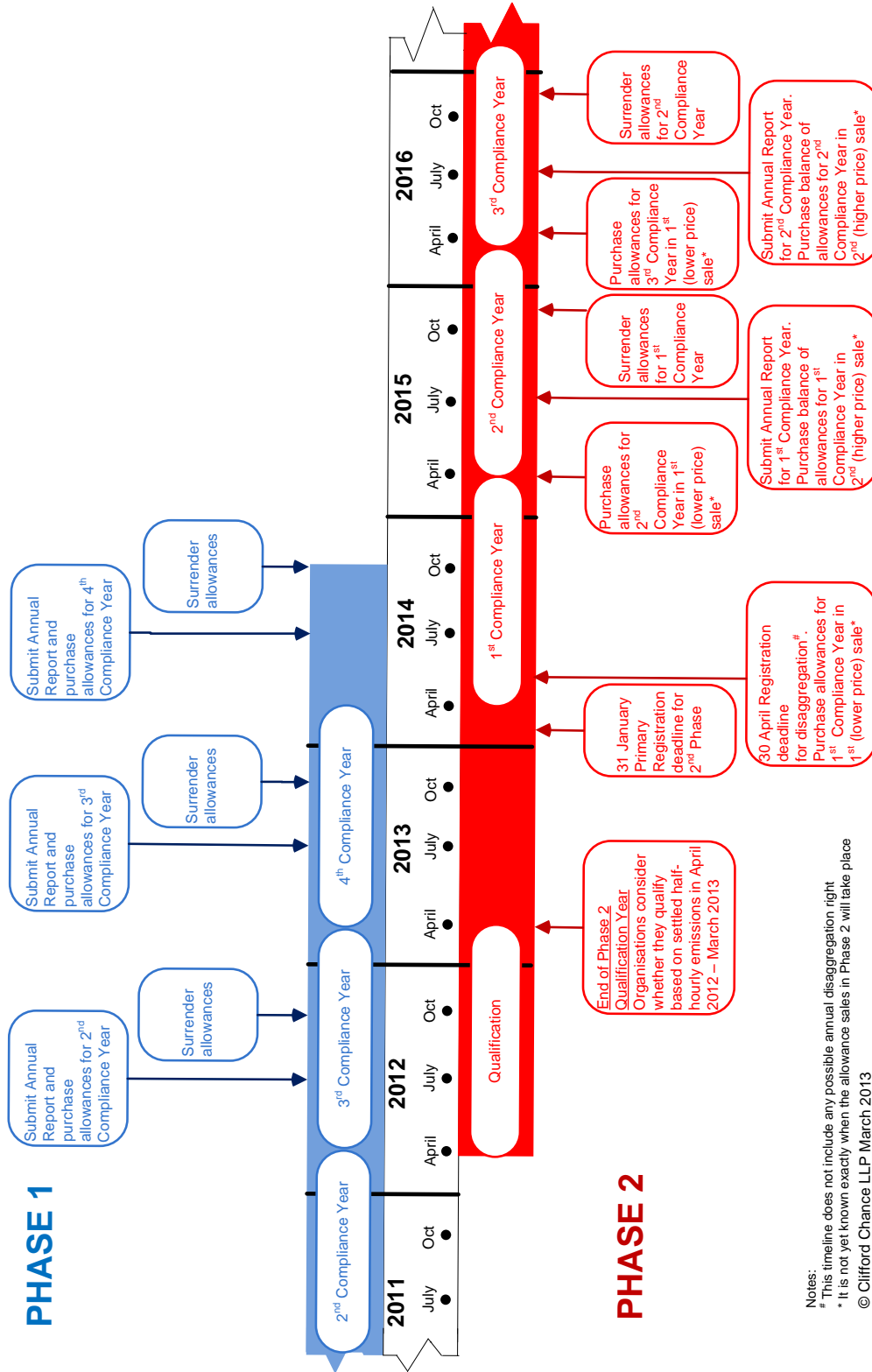
In addition private equity and infrastructure fund businesses should:

- Ensure investment documentation for portfolio companies provides, or continues to provide, for sufficient information and record-keeping requirements and addresses funding and allocation of allowances to enable future compliance; and
- Ensure CRC Participant status and level of emissions is covered as a diligence item on future transactions, including bolt-ons or disposals and consider what warranty/indemnity protection is appropriate.

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<sup>2</sup> Note that the actual registration requirements for Participants may alter depending on further corporate changes to the Participant's structure between 31 March 2013 and registration.

Appendix 1 - CRC Energy Efficiency Scheme Timeline – Phase 1 and Phase 2 Cross-Over



Notes:  
 \* This timeline does not include any possible annual disaggregation right  
 \* It is not yet known exactly when the allowance sales in Phase 2 will take place  
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## Appendix 2 - Summary of the CRC Energy Efficiency Scheme Phase 2 – Principal Elements

### Introduction

The CRC Energy Efficiency Scheme (**the Scheme**) is a 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 (CO<sub>2</sub>) emissions by 80% by 2050. The Scheme will operate in successive "Phases". Phase 1 of the Scheme runs from 1 April 2010 to 31 March 2014. Phase 2 runs from 1 April 2014 to 31 March 2019<sup>3</sup>. Successive 5 year Phases then continue with a final 4 year Phase ending in 2043. The Environment Agency will be the principal regulator for the scheme in England & Wales<sup>4</sup>.

### Qualifying for CRC

#### Qualification for the scheme – grouping entities together

The Scheme groups together certain entities which 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 Undertakings*".

#### Qualification for the scheme - threshold electricity supplies test

Once it is understood which organisations must be grouped in this way, qualification for the Scheme is based on a test applied once before each Phase. Under this test, the electricity supplies 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 receives aggregated UK electricity supplies of at least 6,000 MWh through "settled half-hourly meters" (representing an annual electricity bill of around £500,000)<sup>5</sup>. For Phase 2, the qualification year runs from 1 April 2012 to 31 March 2013.

There are a number of supplies excluded from this calculation (**Excluded Supplies**), principally:

- Those used for the purposes of transport or domestic accommodation; and
- Those made for the purposes of operating an EU Emissions Trading Scheme (**EU ETS**) installation or facility covered by a Climate Change Agreement (**CCA**)<sup>6</sup>.

If the organisation including all grouped entities and electricity supplies as determined above does not qualify for CRC for Phase 2, then it may qualify at a future date, but only at the beginning of a subsequent Phase. Even if an organisation qualified for Phase 1, the qualification test still needs to be applied for Phase 2; if the 6000 MWh threshold is not reached on this occasion, the organisation will not participate in Phase 2.

*"Even if an organisation qualified for Phase 1, the qualification test still needs to be applied for Phase 2"*

#### Group participation and Disaggregation of Undertakings

In brief, the Draft Order uses Section 1161 Companies Act 2006 to determine whether undertakings are part of a group and must participate in CRC together and this is considered on the last day of the qualification year (i.e. 31 March 2013 for Phase 2). 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

<sup>3</sup> Confusingly the Draft Order refers to Phase 2 as the 'Initial' Phase, and the subsequent Phase 3 as the "Second Phase". However, we understand the regulators will still refer to them as Phases 2 and 3 and we continue to use that terminology in this briefing.

<sup>4</sup> The Natural Resources Body for Wales is the regulator for certain purposes in Wales.

<sup>5</sup> In Phase 1, a more complex qualification threshold involving all half-hourly metered supplies applied.

<sup>6</sup> In Phase 1, these supplies were included in the qualification calculation.

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 Scheme. However, if the parent is not UK-based, then it will need to nominate a UK representative (either a group company or an agent) for this purpose.

### Disaggregation

In order to allow flexibility for groups to participate in the Scheme in a way that suits group operations, the scheme allows individual undertakings or groups of undertakings within a Participant to "disaggregate" and become CRC Participants taking part in the scheme on a standalone basis.

One possible limitation on the flexibility to disaggregate is the new rule in Phase 2 prohibiting disaggregation of a group of undertakings which includes the highest UK parent undertaking of the CRC Participant. However, there is considerably more flexibility for undertakings to be disaggregated than under Phase 1 where only "Significant Group Undertakings" could be spun out and other restrictions on taking entities out of the wider CRC Participant applied. Advantageously, where an undertaking or group of undertakings is disaggregated, the remaining entities in the Participant will no longer be jointly and severally liable for the disaggregating undertakings' compliance and will not need to report on their emissions. This change will be of particular benefit to private equity and infrastructure funds which will be able more freely to disaggregate their portfolios.

Disaggregation of undertakings can be done as part of the registration process or at the beginning of subsequent Phases. In order to disaggregate for Phase 2, the wider organisation must register by 31 January 2014. The relevant entities to be disaggregated will then need to register separately by 30 April 2014<sup>7</sup>. The DECC Response stated that annual disaggregation would be permitted, but this was not translated into the Draft Order. DECC has confirmed that the Order will be amended later this year to allow annual disaggregation.

An additional option to disaggregate "Participant Equivalents" occurs when they are acquired by another entity (see further "Changes to Group Structure and Operations" below).

## Responsibility for Energy Supplies under CRC

### General rule

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

- It is party to a supply agreement with an energy supplier;
- The energy is supplied to A by reference to a meter; and
- A uses some or all of the energy for itself (if A on-supplies some or all the energy to a third party B and this on-supply is metered<sup>8</sup>, or if A contracts with a supplier to supply directly to B<sup>9</sup>, B will be responsible for the energy supplied to B).

*"One possible limitation on the flexibility to disaggregate is the new rule in Phase 2 prohibiting disaggregation of a group of undertakings which includes the highest UK parent undertaking of the CRC Participant"*

<sup>7</sup> The previous requirement to notify an intention to disaggregate 3 months before the registration deadline has been abolished from Phase 2.

<sup>8</sup> The metering requirement is a new rule in Phase 2.

<sup>9</sup> This is a new rule in Phase 2.

Using guidance developed during Phase 1, the Environment Agency follows complex rules to determine whether organisations that contract for energy supplies on behalf of other end users (e.g. facilities management organisations and PFI contracting entities) will be responsible for the energy supplies for CRC purposes.

### Landlord & Tenant relationships

A significant exception to the general 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 supply<sup>10</sup>. 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 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 under the Scheme for an energy supply, it is likely to want to recoup costs arising 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 supplies under the Scheme.

### Real Estate held under Trusts

As from Phase 2, the scheme applies a hierarchical approach to working out which entity is responsible for the supplies to properties held directly under a trust. In broad terms:

1. Where a beneficiary is entitled to more than a half share of the assets in the trust, that entity takes responsibility for CRC purposes;

For other trusts, CRC will treat the trust as an undertaking, as follows:

2. If the trust is regulated under the Financial Services and Market Act 2000, responsibility would pass to the operator of the trust; and
3. In other cases, the trustee would be responsible.

In relation to categories 2 and 3 above, the trustee/operator would have to aggregate all trusts operated by them for the purposes of qualification and registration. Individual trusts can then be disaggregated and participate separately in the scheme<sup>11</sup>.

There is a continuing question over how the enforcement issues associated with looking through the trusts to the beneficiaries would work in category 1 above. The beneficiaries in such a case might not be easily ascertainable.

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

*"Where a beneficiary is entitled to more than a half share of the assets in the trust, that entity takes responsibility for CRC purposes"*

<sup>10</sup> The exception applies similarly to occupation of premises by licence. The exception does not apply (and the tenant would therefore be responsible under this new Phase 2 rule) where a landlord of a construction lease of 30 or more years supplies energy to the tenant, but this will only rarely apply since the tenant would normally be expected to contract directly for the energy supplies anyway in these circumstances.

<sup>11</sup> We pointed out to DECC an error in the Draft Order which provides that, where there are two 50% beneficiaries in any trust, the trusts cannot be disaggregated. DECC has confirmed that they will cure this in a technical amendment to the Order later in 2013.

## Emissions to be included in the Scheme

Once a CRC Participant has been identified, in principle, all UK supplies of electricity and gas for heating<sup>12</sup> (and attributed supplies, e.g. from tenants and franchisees) for which it is responsible would be included within the scheme, subject to the following two main rules:

- Again, Excluded Supplies are excluded from the calculations;
- As from Phase 2: Electricity from certain domestic meters is excluded; and
- As from Phase 2: Only gas supplies of over 73,200 kWh recorded by any one meter are included. In addition, where gas supplies represent less than 2% of the electricity supplied in the first Compliance Year of a Phase (1 April 2014 – 31 March 2015 for Phase 2), the CRC Participant can decide not to include these supplies in the scheme.

In Phase 2, there is no longer any concept of core emissions, and the footprint report used to report on such emissions and to police the requirement to ensure 90% emissions coverage has now been abolished.

### Electricity Generation

In brief, where an organisation generates electricity and uses it within its own organisation (self-supply), it will need to account for that self-supply under the Scheme (unless the self-supply is further used for certain electricity or gas generation or distribution purposes).

Given that input supplies of gas or other fuels used for electricity generation no longer have to be included in the Scheme<sup>13</sup>, the previous complex system of Electricity Generation Credits (EGC) has been abolished as from Phase 2. The emissions factor used to calculate CRC liability from self-supplied electricity will, however, now be changed to reflect the efficiency of self-supply<sup>14</sup>.

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

### Registration of CRC Participants

Qualifying CRC Participants will need to register for Phase 2 with the online CRC registry during the registration period ending on 31 January 2014. DECC has announced that the registration period will open on 4 November 2013. Provision of information on the organisation, meters and electricity usage data will be required<sup>15</sup>. It is understood that Phase 1 CRC Participants will be able to migrate data within the CRC Registry for use in Phase 2.

See above under "*Disaggregation*," in relation to requirements for registration where a CRC Participant wants to disaggregate one or more undertakings.

Energy suppliers will be obliged to provide the Environment Agency with relevant information on electricity supplies 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.

*"Qualifying CRC Participants will need to register for Phase 2 with the online CRC registry during the registration period ending on 31 January 2014"*

<sup>12</sup> Phase 2 has reduced the applicable energy sources from 29 down to 2: electricity, and gas for heating purposes.

<sup>13</sup> See Footnote 12.

<sup>14</sup> As opposed to use of the grid average emissions factor as in Phase 1.

<sup>15</sup> CRC Participants will also be charged a registration fee and annual subsistence fees as well as various other charges.



## Allowances and Reporting

### Purchasing Allowances

Each CRC Participant must buy enough allowances each year to cover the energy supplies for which it is responsible in each compliance year (see below). Each allowance represents the emission of one tonne of CO<sub>2</sub> (TCO<sub>2</sub>). The Government will set the allowance prices. In Phase 2 and onwards, CRC Participants will buy allowances at twice-yearly intervals with a lower price at the first sale than at the second. The lower price at the beginning of the year is intended to encourage CRC Participants to forecast energy consumption, in order to avoid the higher prices when balancing accounts at the end of the Compliance Year.

The "Compliance Year" to which the obligations relate would run from 1 April to 31 March in each Phase year with a 4 month subsequent reconciliation period to collate emissions data and make returns to the Environment Agency. CRC Participants would then be required to purchase all remaining allowances so that they can all be surrendered by the end of October in the same year.

There will be an unlimited number of allowances (i.e. there will be no cap). The Government has previously announced that from Phase 2, allowance prices will start at £16 per TCO<sub>2</sub> in 2014-15, rising in line with RPI from 2015-16 onwards. However, we still do not know what the differential will be between beginning / end of year sale prices or when exactly the sales will take place.

*" from Phase 2, allowance prices will start at £16 per TCO<sub>2</sub> in 2014-15, rising in line with RPI from 2015-16 onwards "*

### Trading and Banking of allowances

DECC is still expecting a secondary market for emissions trading in CRC allowances to develop. Whether this happens will depend largely upon the differential in the two sale prices. It is not yet clear how trading would operate within the Scheme.

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, around April 2015, a CRC participant will buy allowances from the Government for the coming Compliance Year (April 2015 – March 2016). Allowances for this Compliance Year, however, are not surrendered until October 2016. This rule prevents CRC Participants conveniently using cheap allowances from the April 2015 first government sale of allowances to partially satisfy their 2014/2015 compliance obligation for which allowances will be surrendered in October 2015.

Banking of allowances will be allowed between different Compliance Years of the same Phase, but not between Phases.

## 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 an organisation is identified as a CRC Participant in the Scheme at the beginning of a Phase, it will remain in the scheme for the duration of that Phase (five years, or four for the final Phase) 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 Phase.

There are some refinements to this general position set out below.

### Transactions involving one or more CRC Participants or Participant Equivalents

Phase 2 introduces a new concept of "Participant Equivalent" (PE). A PE is an individual undertaking that would qualify for the scheme on its own, if it were not for the fact that it is part of a larger group. Where there is an acquisition or disposal of a CRC Participant or PE:



- 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 Scheme<sup>16</sup>;
- Notification of the transaction and other details to the Environment Agency, within 3 months (or earlier in some circumstances) is required and a new registration may need to be made by the last working day in April following the change<sup>17</sup>; and
- Where a non-CRC Participant acquires a CRC participant or PE, the acquiring entity has the option to choose to register as a CRC Participant in the scheme in respect of the emissions of any PE that it acquires<sup>18</sup>.

### Other Changes

If a CRC Participant sells any other subsidiary during the course of a compliance year, the selling CRC Participant 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 remain within the Scheme depending on whether the buyer forms part of a CRC Participant) and will have to buy additional allowances accordingly.

### Changes before Registration

There are also some detailed rules relating to changes that occur to group structures (including purchases of PEs or whole CRC Participants) between the qualification period and the time of registration by an organisation. The obligations relate to resolving which entities should register following the change and whether, for example, a PE or Participant 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 annual report collating all Scheme energy supplies (by the last working day in July after the end of each Compliance Year); and
- Generally keeping an evidence pack containing organisational records and data on energy supplies.

Whilst the formal Performance League Table has now been abolished, the Environment Agency will be able to publish information on a more informal basis about CRC Participants' performance in the scheme.

### 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; and

*" Fines are likely to provide a significant incentive to ensure that companies comply "*

<sup>16</sup> 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.

<sup>17</sup> Depending on when the transaction occurs, these deadlines could be shorter than those under Phase 1 where a 3 month deadline always applied.

<sup>18</sup> In phase 1, the acquiring entity had to register as a CRC Participant in these circumstances.

- Failure to surrender allowances corresponding to reported emissions: fine of £40 / tCO<sub>2</sub> per missing allowance, requirement to obtain all outstanding allowances.

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.



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