

CRC: Primer for the Initial Phase (Phase 2)

The Initial Phase (formerly called Phase 2) of the reformed CRC Energy Efficiency Scheme began substantively on 1 April 2014. This primer briefing sets out the steps participants should now be taking in relation to the scheme. It also describes the major elements of the scheme and a timeline showing the overlap with the final aspects of Phase 1.

Next Steps

For groups that qualified as CRC Participants for the Initial Phase of the Scheme (see Appendix 2 for further details), registration should have been completed by 31 January 2014.

Next steps are as follows:

- Where any group intended to disaggregate part of its group during registration, the disaggregated parts will need to register separately by 30 April 2014.
- If they have not already done so, groups should urgently consider their strategy for purchasing allowances. For the coming Compliance Year (1 April 2014 to 31 March 2015), allowances can be bought upfront in April 2014 at £15.60/TCO₂ (in the "forecast" sale); alternatively they can be bought after the end of the Compliance Year in June / July 2015 at the higher price of £16.40/TCO₂ (in the "buy to comply" sale).
- To the extent they have not already done so, CRC Participants should 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 (including monitoring and reporting of emissions), and consider whether environmental advisers are required to assist you with this.
- CRC Participants in Phase 1 of the scheme should continue to comply in respect of Phase 1, including reporting on CRC emissions for the 1 April 2013 – 31 March 2014 Compliance Year by 31 July 2014, purchasing allowances in July 2014 and surrendering them by 31 October 2014.

Groups which are CRC Participants in both Phase 1 and the Initial phase, should note the possibility of double allowance purchases required in 2014: If Participants decided to buy in the forecast sale for the 2014 – 2015 Compliance Year, they will have to buy allowances in April 2014 (payment made in June 2014). Then, in respect of the 2013 – 2014 Compliance Year, they would have to buy allowances in June / July 2014 (payment made in September 2014). This could clearly have cashflow consequences.

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

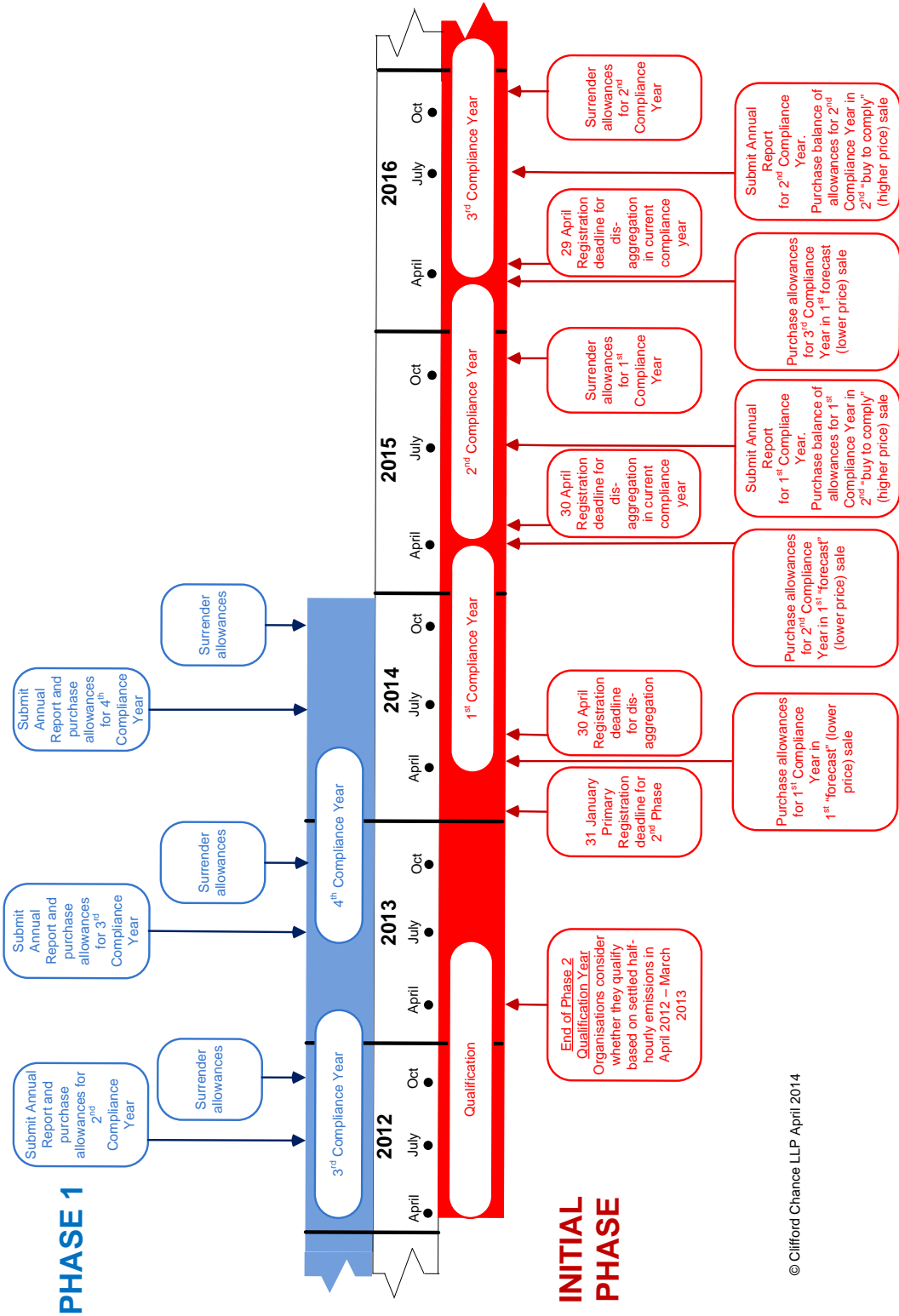
Key issues

- This briefing set out:
 - Next steps
 - A timeline for Phase 1 / Initial Phase Cross-over
 - A summary of the scheme for the Initial Phase

- 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.

Appendix 1 to this note contains a timeline showing the overlap of the beginning of the Initial Phase with the end of Phase 1. Appendix 2 contains a description of the major elements of the CRC scheme in the Initial Phase.

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



Appendix 2 - Summary of the CRC Energy Efficiency Scheme in the Initial Phase – 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 (CO₂) emissions by 80% by 2050. The Scheme will operate in successive "Phases". Phase 1 of the Scheme ran from 1 April 2010 to 31 March 2014. The Initial Phase runs from 1 April 2014 to 31 March 2019¹. 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 & Wales².

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)³. For the Initial Phase, the qualification year ran from 1 April 2012 to 31 March 2013.

A number of supplies are 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**)⁴.

If the organisation, including all grouped entities and electricity supplies as determined above, does not qualify for CRC for the Initial Phase, 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 needed to be applied for the Initial Phase; if the 6000 MWh threshold was not reached on that occasion, the organisation will not participate in the Initial Phase.

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

Group participation and Disaggregation of Undertakings

In brief, the CRC 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 the Initial Phase). 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

¹ Confusingly the Order refers to the phase following Phase 1 as the 'Initial' Phase, and the subsequent phase as the "Second Phase".

² The Natural Resources Body for Wales is the regulator for certain purposes in Wales.

³ In Phase 1, a more complex qualification threshold involving all half-hourly metered supplies applied.

⁴ 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 the Initial Phase 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 is of particular benefit to private equity and infrastructure funds which are able more freely to disaggregate their portfolios.

Disaggregation of undertakings can be done as part of the registration process, or on an annual basis before the last working day of April at the beginning of the relevant Compliance Year. In order to disaggregate for the Initial Phase, the wider organisation had to register by 31 January 2014. The relevant entities to be disaggregated must then register separately by 30 April 2014⁵.

An additional option to disaggregate occurs when "Participant Equivalents" 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 metered⁶, or if A contracts with a supplier to supply directly to B⁷, B will be responsible for the energy supplied to B).

Using guidance developed during Phase 1, the Environment Agency follows complex rules to determine whether

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⁵ The previous requirement to notify (3 months before the registration deadline) an intention to disaggregate, has been abolished in the Initial Phase.

⁶ The metering requirement is a new rule in the Initial Phase.

⁷ This is a new rule in the Initial Phase.

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 supply⁸. 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 the Initial Phase, 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 Scheme⁹.

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"

⁸ 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 Initial Phase 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.

⁹ 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 confirmed that they will cure this in a technical amendment to the Order but this has yet to be made.

Emissions to be included in the Scheme

Once a CRC Participant has been identified, in principle, all UK supplies of electricity and gas for heating¹⁰ (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 the Initial Phase: Electricity from certain domestic meters is excluded; and
- As from the Initial Phase: 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 the Initial Phase), the CRC Participant can decide not to include these supplies in the scheme.

In the Initial Phase, 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

The rules on electricity generation are complex. In brief, where an undertaking 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, or is from certain post-2008 on-site renewable generation facilities).

Given that input supplies of gas or other fuels used for electricity generation no longer have to be included in the Scheme, the previous complex system of Electricity Generation Credits (EGC) has been abolished as from the Initial Phase.

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 had to register for the Initial Phase with the online CRC registry during the registration period ending on 31 January 2014. Provision of information on the organisation, meters and electricity usage data was required¹¹. Phase 1 CRC Participants were able to migrate data within the CRC Registry for use in the Initial Phase.

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

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

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¹⁰ In the Initial Phase applicable energy sources have reduced from 29 down to 2: electricity, and gas for heating purposes.

¹¹ CRC Participants are 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 CO₂ (TCO₂). The Government sets the allowance prices. In the Initial Phase and onwards, CRC Participants buy allowances at twice-yearly intervals with a lower price at the first "forecast" sale (in April at the beginning of the Compliance Year) than at the second "buy-to-comply" sale (in June / July after the end of the Compliance Year). The lower price in the first sale 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 are then required to purchase all remaining allowances so that they can all be surrendered by the last working day in October in the same year.

There are an unlimited number of allowances (i.e. there will be no cap). For the Compliance Year 2014 / 2015, allowance prices in 2014-15 are set at £15.60 per TCO₂ in the forecast sale in April 2014, and £16.40 per TCO₂ in the "compliance" sale in June / July 2015. The Government has previously announced that from the Initial Phase, allowance prices will rise in line with RPI from 2015-16 onwards.

" from the Initial Phase, allowance prices will start at £15.60 / £16.40 per TCO₂ 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. It is not yet clear whether the 5% differential between the "forecast" and "buy-to-comply" sales will lead to significant trading.

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 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

The Initial Phase 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 Scheme¹²;
- 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 change¹³; 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 acquires¹⁴.
- In certain circumstances, where a disaggregated CRC Participant does not contain a PE and is sold by a group, that CRC Participant can decide to withdraw from the Scheme.

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.

Annual Disaggregation

CRC Participants will be able to disaggregate entities at any time during the phase¹⁵. Where disaggregation is completed before the last working day in April in a Compliance Year, it will be effective for that Compliance Year. Otherwise, it will be effective from the beginning of the next Compliance Year.

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.

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

Whilst the formal Performance League Table has now been abolished, the Environment Agency will be able to publish

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

¹³ Depending on when the transaction occurs, these deadlines could be shorter than those under Phase 1 where a 3 month deadline always applied.

¹⁴ In Phase 1, the acquiring entity had to register as a CRC Participant in these circumstances.

¹⁵ In Phase 1, disaggregation could only occur at the beginning of the Phase upon registration.

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
- Failure to surrender allowances corresponding to reported emissions: fine of £40 / tCO₂ 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, and identifying non-compliance will be facilitated.

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