Background

Over the last 10 years the way in which energy is generated and used in the UK has come under increasing scrutiny for a number of reasons, including a rise in the awareness of the impacts of climate change and issues in relation to energy security.

In 2005 Defra and HM Treasury published the Energy Efficiency Innovation Review,1 which identified the significant potential for cost effective energy efficiency measures to be introduced in relation to the activities of large, non-energy intensive organisations. In 2006 the DTI Energy Review2 announced that this would be a key area for the future and introduced an initial public consultation on a proposed mandatory emissions trading scheme. By the time the Energy White Paper appeared in 2007,3 the government had taken a decision to introduce a mandatory cap and trade scheme, ‘a Carbon Reduction Commitment, to target large, non-energy intensive public and private sector UK organisations’.

In 2008, the UK became the first country to commit itself to legally binding carbon emissions reduction targets through the Climate Change Act 2008. That Act also gave the government power to introduce ‘trading schemes’ to limit, or encourage the limitation of, activities emitting greenhouse gases or causing or contributing to such emissions. Two further public consultation exercises were undertaken to shape the scope of the proposed new trading scheme. The importance of the scheme to the government was reiterated in the UK Low Carbon Transition Plan, published in July 2009,4 committing the country to becoming ‘low carbon’ through an ambitious transition strategy.

On 17 March 2010 the CRC Energy Efficiency Scheme Order 2010 (SI 2010/768) (the CRC) was passed. It came into force on 22 March 2010, shortly ahead of the much pre-publicised commencement date for the CRC of 1 April although, in truth, the CRC could be said to have commenced some time before then, with qualification for the introductory phase having already been determined through the use of certain types of electricity during the course of 2008.

The CRC is a mandatory scheme requiring fully participating organisations to, amongst other things, record and report on their energy use and to acquire and surrender carbon allowances to offset against carbon dioxide emissions arising from their actual energy use. It is divided into seven phases, each of which has its own qualification period and then commences with a ‘footprint’ year (where, basically, total energy use has to be recorded and reported on) followed by ‘compliance’ years (where emissions relevant to the CRC have to be recorded and reported on and during which the purchase, surrender and trading of carbon allowances will commence).

After the first, introductory, phase the CRC will evolve into a ‘cap and trade’ process where the amount of allowances available will be limited and periodically reduced, in order to provide a financial incentive for participants to carry out energy efficiency improvements.

Who has to participate?

The CRC is specifically targeted at large, non-energy intensive, public and private sector UK organisations. Rather than attach obligations to specific installations or activities, as is the case with schemes such as the European Union Emissions Trading Scheme (EU ETS) or under climate change agreements (CCA), the CRC looks solely at energy use on an organisational, rather than site-based, basis, irrespective of the activities for which the energy is actually used.

Qualification is based first upon the use of electricity through a half hourly meter settled on the half hourly market and then on an assessment of the total amount of qualifying electricity used by an organisation during a predefined qualifying period. ‘Settled’ half hourly meters are generally supplied by licensed electricity suppliers where certain supply thresholds are met or exceeded and, like the CRC, this decision is based on energy use, rather than purpose or activity, and so organisations as diverse as government departments, universities, colleges, supermarkets, banks and commercial landlords are all supplied with such half hourly meters.

2 http://www.dti-stats.net/review/energy_review_report.pdf
4 http://www.decc.gov.uk/assets/decc/white%20papers/uk%20low%20carbon%20transition%20plan%20wp09/1_200907241535238_e@lowcarbontransitionplan.pdf
Any organisation that was supplied with electricity through at least one settled half hourly meter in 2008 will be under some form of obligation under the CRC, but certain types of electricity use do not (yet) have to be accounted for. Exclusions from qualifying electricity use include electricity for the purpose of domestic accommodation, electricity for the purposes of transport and ‘unconsumed supply’.

In seeking to apply the ‘polluter pays’ principle, the CRC dictates that if electricity is bought through a third party provider, it is the organisation that consumes the supply that then bears responsibility for it for CRC purposes. Effectively, it amounts to ‘unconsumed supply’ to the third party provider who does not, therefore, have to account for it for the CRC. Of course, there is an exception to this exclusion in the case of landlord and tenant arrangements. If a landlord procures an electricity supply which it then passes on to its tenants, charging for it on a sub-metered basis, it is the landlord that retains responsibility for that use even though it is not the ultimate consumer.

Levels of obligation

The level of obligation under the CRC depends upon the amount of qualifying electricity used during a relevant qualification period. As mentioned earlier, for the purposes of the introductory phase the qualification period was the calendar year 2008.

An organisation supplied with electricity through a settled half hourly meter during a qualification period must provide to the CRC administrator (the Environment Agency), during the registration period for the phase relevant to the qualification period, a list of its settled half hourly meters with the identification numbers of those meters and confirm whether or not the qualifying supply equalled or exceeded 3,000 MegaWatt hours. If that level is met or exceeded then the amount of the supply must also be provided.

An organisation using 6,000 MegaWatt hours of qualifying electricity or more during a qualification period (which, for the introductory phase, is estimated to have equated to an electricity bill for 2008 of around £500,000 or more) is required to fully participate, necessitating registration, the recording and reporting of energy use and the acquisition and surrender of carbon allowances.

Organisations and group structures

The CRC is intended to apply to large organisations which, because of their size, will use an appreciable amount of energy but where, because of the nature of their operations, consumption is more likely to be through diffuse point sources instead of directly through a single installation or process. In order to maximise coverage of, and participation in the CRC, organisations that are ‘related’ to each other are treated as a single entity, whose energy use must be collated to assess qualification and obligation.

The CRC adopts the definitions set out in the Companies Act 2006 – ‘parent undertaking’, ‘subsidiary undertaking’ and ‘group undertaking’ – in order to determine the extent of the relevant CRC participant structure. It should be noted that parents and subsidiaries are determined on more than the holding of shares and voting rights alone. If a dominant influence is exercised by one company over another, for example, by virtue of articles of association or a control contract, then the two companies are sufficiently closely linked for the purposes of the CRC that they are treated as a single energy-using entity. Additionally, the CRC extends the definition of ‘undertaking’ for its own purposes so that it includes unincorporated associations carrying on charitable activities.

Public bodies are defined, for the purposes of the CRC, as being ‘public authorities’ within the meaning of the Freedom of Information Act 2000, subject to certain exclusions including the House of Commons, the House of Lords and the National Assembly for Wales.

Significant Group Undertakings

Some organisations will contain, within their structures, subsidiary undertakings which, alone or in combination with their own subsidiary undertakings, themselves meet the qualification criteria and would therefore have to participate fully in the CRC in their own right were it not for the fact that they were part of a larger organisational structure. Such subsidiaries are known as Significant Group Undertakings (SGUs) for the purposes of the CRC and they receive special treatment. Where an organisational structure contains an SGU, separate information on the SGU’s half hour electricity supplies has
to be provided as part of the group registration process and separate information on the SGU’s emissions must be supplied as part of the reporting process.

Given the wide definitions under the Companies Act 2006 of parent and subsidiary undertakings, some organisations may face considerable administrative difficulty in collating energy use and information from a diverse and disparate corporate structure. If the corporate structure contains one or more SGUs then that administrative burden may potentially be reduced by the ‘disaggregation’ of the SGU so that it can participate in its own right. This is a voluntary process that must be instigated upon registration of the group but which must, according to the guidance of the Environment Agency, as scheme administrators, be undertaken within three months of the start of the registration period of the relevant phase, to then enable the SGU to complete its own separate registration process before the registration period expires. From that time on, the SGU will participate entirely independently, bearing responsibility for the relevant fees and charges, reporting and allowances obligations in its own right, until the start of the next phase when the whole process starts again.

It is interesting to note, as the expiry of the registration period for the introductory phase approaches (30 September 2010), that the Environment Agency allowed some slippage in the ‘disaggregation deadline’, allowing groups to register by 31 July to then enable SGU disaggregation instead of 30 June as originally proposed. The statements from Greg Barker, Energy and Climate Change Minister, and Tony Grayling, head of Climate Change at the Environment Agency in August 2010, extolling businesses to register with the scheme before time runs out, suggests that registration, which is required to be undertaken by 30 September, is lower, perhaps considerably lower, than the government and the Environment Agency had been anticipating. This means there is likely to be a considerable ‘registration rush’ as the end of the registration period approaches and may lead to a very early ‘teething problem’ in the lifetime of the CRC given that registration is, in fact, the first obligation that has arisen. Organisations required to register should therefore look to do so sooner rather than later because the penalties for late or non-registration are, intentionally, significant – sanctions for noncompliance are specifically designed to eliminate any financial gain or benefit from non-compliance.

Complexities?

Although only in its infancy, the CRC has already attracted criticism for being ‘complex and bureaucratic’. Greg Barker acknowledged, on 11 August 2010, that, ‘the original complexity of the scheme may have deterred some organisations’ and that he wanted to, ‘hear suggestions as to how we can make the scheme simpler in the future’.

One example of the complicated nature of the CRC is the mechanism for buying and surrendering allowances whereby the money raised from the sale of the carbon allowances by the government is redistributed back to the CRC participants.

First, the allowances are to be sold at auction by the government in April of each trading year (the first of which commences on 1 April 2011). For the introductory phase the sale will be at a fixed price of £12 per tonne of carbon dioxide equivalent and there will be no limit on the number of allowances that participant organisations can purchase. Organisations are required to estimate in advance what the emissions from their total energy use will be for the period from the April in which the allowances are sold to the following March and to acquire allowances accordingly.

It was never the intention of the government that the CRC should be a tax or revenue raising exercise and it will therefore ‘recycle’ the money it receives from the sale of allowances back to participants after a period of six months (ie the October following the April sale). Rather than simple reimbursement, however, the government proposes to redistribute money received during the sale of allowances proportionately, on the initial basis of the ‘footprint’ CRC emissions of all participants but then further influenced by the position of participant organisations in a performance league table, to be published annually.

Positions in the league table are determined upon assessment against previous performance, using three metrics. The first metric, the ‘early action metric’, is only of relevance during the introductory phase and rewards those who have introduced energy efficiency measures in advance, or at an early stage,
of the CRC. The ‘absolute metric’ measures organisational performance using a five-year rolling average (once available) so that ‘like for like’ emissions reductions can be measured. Finally, the ‘growth metric’ takes into account the fact that organisations may either grow or decline commercially and assesses performance against turnover in order to reflect ongoing variations in size.

An organisation’s position in this annual league table will be important because it can either increase or decrease the amount of recycling payment it will receive. Initially, the amount by which a recycling payment through league table position is influenced is between plus or minus 10 per cent but it is proposed that this be increased annually by 10 per cent until the ‘bonus’ or ‘penalty’ is between plus or minus 50 per cent. This will have a significant financial impact on organisations towards the bottom of the table.

The government feels that in this way organisations will be rewarded for energy efficiencies through lower energy costs, having to acquire fewer allowances and potentially also through securing greater recycling payments. What this also means, though, is that money spent on the basis of estimated future energy use is ‘recycled’ on the basis of past performance.

Following the recycling payment in October, organisations will, in the following April, then have to acquire allowances to offset against emissions for their estimated energy use in the next trading year. Four months later (ie the end of July) organisations will then be required to surrender carbon allowances acquired 16 months previously to match the calculated emissions from their actual energy use during that previous trading year, which they will report on at the same time. It is not possible to use allowances bought after the conclusion of a trading year (ie those bought in advance for the estimated energy use for the next trading year) to surrender against emissions from energy use in the previous trading year. This is where trading allowances on the secondary market will come into play and allowances may well become valuable commercial commodities once capping is introduced during the second phase.

With overlapping acquisition and surrender of allowances for different trading years together with the recycling of the costs of buying allowances for future energy use based on past performance, it is not difficult to see the justification for some of the allegations of complexity. Perhaps a further measure of the complexity of the CRC can be gained from the fact that, in addition to the 113 sections and 11 schedules of the CRC Order, the Environment Agency has published something in the order of 700 pages of detailed supporting guidance, with more likely to be published as experience of the CRC grows.

Boon or burden?

The concept of introducing a scheme encouraging improvements in energy efficiency is one that most people are comfortable with and ought to be of general benefit. However, despite the aspiration for the CRC to be ‘administratively light-touch’, the reality is that it is a highly complex and technical piece of new law and considerable complaint and scepticism has been expressed about the actual impact it will have.

It is certainly rare for a government to request suggestions for the simplification of legislation still in its early infancy. Obviously, the current coalition government is not the body that passed the law but there was no substantial opposition to its passage through parliament and, of course, the coalition has been very public in its desire to be ‘the greenest government ever’.

There are other examples of the apparent complexities of the CRC, such as the fact that the main phases are seven years long but overlap on a five year basis, meaning that the first two years of each main phase are reporting years only. This overlap of phases means that the first year of the introductory phase is also the qualification period for the second phase which, in turn, means that the first two years of the CRC’s existence are both ‘footprint’ years for reporting purposes and both start with a phase registration period.

Treating related group companies as a single entity for the purposes of the CRC is also likely to cause significant problems for more complex and diverse corporate structures, in terms of information collation and management. There are already examples of large organisations outsourcing energy monitoring and management, rather than tying up internal resources with...
what is seen as an administrative burden. What this might mean for organisations in terms of responsibility for the accuracy of reported information remains to be seen, but the CRC is such a high profile part of the government’s efforts to meet the carbon reduction targets set under the Climate Change Act 2008 that its enforcement is likely to be a high priority.

One looming difficulty will be the accuracy with which organisations will be able to predict their future energy use over the course of a year, especially during the early years. It is likely to take a number of years before statistically robust and reliable figures can be generated with regard to energy use and there are so many imponderables that must be taken into account – for example, the cold winter using extra energy for heat and light, the hot summer using extra energy for air conditioning or the reverse with a mild winter and summer resulting in under-estimates of energy use – which may significantly skew the secondary market in which carbon allowances will be traded. Additional factors that must also be taken into account include the current economic uncertainty, together with projections for either growth or decline, so that estimates are as accurate as possible and allowances are not over-subscribed. All of this must then be placed in the context of a scheme where there is significant financial motivation to drive energy efficiency forward resulting in, the government hopes, ongoing reductions in energy use figures across all sectors which will, in turn, impact on recycling payments through league table performance.

The CRC is also likely to introduce significant, and possibly unforeseen, complications in both corporate and property transactions. Considerable unrest has already been expressed within the property industry because of the landlord and tenant rule in relation to responsibility for energy supply. Traditionally, landlords have looked to pass the costs of building management down to their tenants through service charges. The costs of CRC compliance, however, relate to collated energy use across a group structure and not to specific assets or properties and so standard service charge clauses are unlikely to cover these costs. Also, if landlords do, by whatever means, seek to pass these costs on to their tenants then the fact that the costs of allowances is governed both by estimates of future energy use and past performance will introduce considerable difficulties in apportionment should there be a change of tenants. There is no current consensus within the property industry as to how these issues should be addressed and that could result in additional complications if landlords change and wish to adopt different practices.

Similar considerations apply to the sale or acquisition of corporate entities forming part of a group structure. While the scheme makes the position a little more straightforward in transactions involving SGUs, complications will still arise when considering issues such as whether the buyer or seller is, or is not, itself a full participant? How should any allowances already acquired be dealt with? How should any recycling payments be dealt with since they take no account of the amount of allowances held by a participant at any given time?

In introducing the CRC, the previous government’s aspiration was always that the benefits to participants of lower energy bills should outweigh the costs of participation. In that way, the CRC, if successful, can be considered to be very much a boon, both to participants and to the government’s attempts to move towards a low carbon economy. While doubts have been expressed as to whether or not that will actually be the case, the reality is that until the CRC really starts to bite, with the introduction of allowance capping in 2013, it will be impossible to tell what the true impact will be. Benefit from the scheme will probably depend upon the commitment of individual organisations to ongoing investment in improving their energy efficiency.

What is clear is that, whatever the overall environmental benefits may or may not prove to be, there will be financial implications, potentially significant ones, for all organisations required to participate fully. Even the most energy efficient will be parted from the money they will have to pay for their carbon allowances for six months and the amount of money to be returned through recycling is simply not predictable since it is based on so many unknowns. In the current economic climate there can be few organisations comfortable with the idea of a six month cash flow deficit starting at around £39,000 but which, for virtually all participants, will be appreciably more.
Any savings generated from energy efficiency, even if they could be realised in that period, are not likely to amount to any substantive offset. Whatever the ultimate benefit of the CRC may be, there can be little doubt its burden will be felt first.

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