

# Brainstorming on Reform of the CRC Energy Efficiency Scheme



**The Government has begun consulting on potentially wide-ranging changes to the CRC scheme. Whilst it is looking specifically at certain areas, e.g. organisational structure rules, it is clear that the Government is open to considering more fundamental reform and possibly even replacement of CRC with other carbon-related instruments. This briefing gives a rundown of the options being considered and offers some suggestions to Participants and other stakeholders.**

## Introduction

The Department of Energy and Climate Change has begun an informal consultation exercise (the Consultation) on how the CRC Energy Efficiency Scheme could be reformed for Phase 2 and beyond. In the Consultation, DECC sets out possible options for reform based on discussions with stakeholders since April 2010. However, it is at pains to highlight that these options are not government policy, but simply form a background for discussion which will help DECC prepare proposals for wider reform of the scheme<sup>1</sup>. It is understood that a more formal consultation will follow later this year when the government has had the opportunity to consider feedback from this current exercise. Responses to the Consultation need to be made by 11 March 2011.

The Consultation takes the form of 5 separate papers on different aspects of the scheme and these are discussed in brief below. It should be noted the options set out in the papers are not necessarily mutually exclusive. A common thread through them is that changes would be implemented in time for registration for Phase 2 of the Scheme (currently envisaged in April / September 2013).

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<sup>1</sup> These will follow on from the initial changes and interim proposals for reform of Phase 1 set out in the October 2010 Comprehensive Spending Review and the November 2010 consultation on initial proposals to simplify CRC (respectively) – for more detail on these initial stages see our client briefing "Interim changes to the CRC Energy Efficiency Scheme" dated November 2010.

## Private (business) sector organisational rules

A number of concerns with the current scheme are noted by DECC including the administrative burden of determining group structures (in particular for trust arrangements and private equity funds) and difficulties for Participants that have no UK presence. DECC seeks to simplify the rules and the following options are proposed:

- Option 1: Retaining the current rules using the Companies Act to determine the extent of a Participant; any undertaking could, however, be disaggregated.
- Option 2: Assessing qualification for the scheme at individual entity level (most likely with reduced energy supply thresholds); entities could, however, decide to aggregate with those further up the corporate chain.
- Option 3: Determining a Participant group as per accounting rules for financial reporting (a solution sought by the private equity industry).
- Option 4: Establishing a separate method for dealing with assets held in a fiduciary capacity; no particular suggestion as to how this could be achieved is given but it would be aligned with new "energy supply" rules (see below).
- Option 5: Replacing the current "ultimate parent" rule which aggregates entities up to their parent (wherever the parent is located), with a rule that aggregates entities only up to the UK parent level. Potentially this would create a number of different Participants for each current Participant.
- Option 6: Considering whether the designated changes obligations which occur when Significant Group Undertakings are bought or sold (i.e. notifications, registrations, changes of emissions baseline) should be triggered in different circumstances (e.g. based on the proportion of a Participant's energy supplies being acquired / disposed of).

## "Responsibility for Energy Supply" rules

DECC's objective is to align responsibility for energy supplies under the CRC with the company that has most influence on improving energy efficiency. In many instances (e.g. for land held under trust, landlord and tenant relationships and PFI management arrangements), the current rules struggle to meet that objective. DECC proposes a number of options including principally:

- Option 1: Changing to a rule based on who is the "contract counterparty" and then applying certain exceptions (e.g. to deal with facilities management arrangements); this would remove complicated criteria based on whether a party has made a payment for the energy or has a meter in place.
- Option 4: Excluding fuels from the definition of supply (i.e. only gas and electricity would be covered).
- Option 6: Allowing parties within the scheme to agree CRC responsibility between them. This was originally suggested for landlords and tenants before being rejected in the finalised version of the scheme.
- Option 7: Basing responsibility on "consumption" rather than "supply". This would particularly affect landlord and tenant arrangements (transferring more responsibility to tenants) but could also impact on PFI arrangements.

Other options consider the rules for treating supplies made by the organisation to itself (i.e. self-supply for generation purposes); transport supplies; and removing or altering the requirement to have 90% of emissions within CRC and other regulated schemes.

## CRC Qualification Criteria

DECC is considering changing the current 2 stage qualification test so that an organisation would qualify if it had both:

- one **settled**<sup>2</sup> half-hourly meter (1st test); and also
- **settled** half hourly supplies of [XXX] MWh (2nd test).

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<sup>2</sup>. i.e. settled on the half-hourly market

Currently the 6000MWh threshold applicable to the second test applies to **all** half-hourly electricity (not just **settled** half-hourly electricity) and there are concerns that smart meters are not being installed to avoid electricity measured by them counting as half-hourly electricity. The figure for XXX would need to reduce from 6000 MWh accordingly to ensure the same coverage of emissions within the scheme. Other potential options include restricting the criteria to mandatory settled half-hourly meters or expanding it to include all electricity supplied.

### Reducing the Overlap between schemes

DECC recognises the administrative burden and complexity surrounding the interrelationship between CRC and other emissions-related instruments such as Climate Change Agreements (CCA) and the EU Emissions Trading Scheme (EU ETS). In an effort to simplify matters, DECC has listed some radical options:

- Excluding any groups which have emissions included in the EU ETS or CCAs. This would result in loss of emissions coverage.
- Assessing qualification on the basis of non-CCA emissions and removing CCA and EU ETS reporting from the scheme.
- "More fundamental approaches to merge or recast climate change instruments" including merging CRC with other climate change policies, e.g. the Climate Change Levy, or Display Energy Certificates. DECC acknowledges that this option would require abolition of the scheme as the Climate Change Act requires the CRC to be a trading scheme (see further "Comment" below).

### Timing and frequency of allowance sales from 2012 onwards

DECC previously announced that the first government allowance sales under CRC (for the scheme year 2011 / 2012) would be put back to the end of the scheme year in 2012<sup>3</sup>. Ignoring the possibility of the replacement of CRC, DECC is assuming that the CRC will revert to a "beginning of the year" sale structure for Phase 2. It is therefore considering how to create a gentle transition in time for Phase 2 (i.e. avoiding a compulsory double sale of allowances in one year, a proposal which was roundly criticised when CRC was first being developed). Options floated include:

- Holding two fixed price sales during the year from 2013/14 onwards, possibly with a higher price at the second sale to incentivise early purchases.
- Multiple sales throughout the year, providing an even more gentle transition.

DECC is also considering how different auction mechanisms could be introduced for Phase 2, and again, one option is "more fundamental reform of the scheme".

DECC has also confirmed that the allowance price for Phase 1, previously fixed at £12 / tonne CO<sub>2</sub> is subject to further consideration and will be determined as part of the Budget announcement in March 2011.

### Additional areas to consider

DECC has said that it is also open to revisiting other aspects of the scheme and gives some non-exhaustive examples:

- The nature of the reputational incentives of the scheme;
- Definition of transport used in the scheme;
- Treatment of public versus private sector participants;
- Energy threshold for qualification;
- Treatment of heat;
- Landlord/Tenant relationships and responsibilities.

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<sup>3</sup> The Consultation notes that the sale will take place at some point between April and July 2012.

## Comment

Whilst DECC has mentioned some specific areas and possible options for reform, it is clear from the totality of the latest consultation material that the future of the whole scheme is open for discussion. In September 2010, the Committee on Climate Change floated, among other concrete reform options, the idea of fundamental reform to CRC<sup>4</sup> by removing the obligation to purchase allowances and replacing it with a reformed climate change levy. These views have presumably helped the Government to go beyond the question of whether CRC can be improved, but also whether the CRC is the right scheme at all. Participants in the scheme and stakeholder groups now have everything to play for in seeking to have their concerns on CRC dealt with. They should get involved in the debate to ensure their voices are heard.

It should not, however, be forgotten that the first year in respect of which allowances will have to be bought is about to commence (in April 2011). DECC has re-emphasised that Participants should continue to comply with the current scheme requirements for Phase 1<sup>5</sup>. Although there is still uncertainty as to when allowances will need to be bought and the price of allowances, Participants should still prepare for the allowance purchasing and other aspects of the scheme; among other steps, they should:

- Establish and maintain monitoring and reporting lines for all sources of energy supply and identify their likely need for allowances in the coming compliance years;
- Understand whether and how they wish to pass on the costs of the scheme among different parts of the organisation or to third parties, e.g. tenants. This may include through intra-group contractual arrangements or provisions in new leases;
- Submit a footprint report and annual report and compile a residual measurement list (where needed) by the last working day in July 2011;
- Assess the impact of the CRC on property and M&A transactions and, in particular, how the need to purchase allowances at the end of the 2011 / 2012 compliance year will be dealt with in accounts, and the impact of any intra-group or landlord and tenant cost recovery arrangements on this; and identify any obligations imposed on the parties by the CRC Order.

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<sup>4</sup>In its report "The CRC Energy Efficiency Scheme - advice to Government on the second phase".

<sup>5</sup>Based on DECC's November 2010 consultation document, fixed price allowances will need to be purchased in respect of the compliance years 2011/2012, 2012 / 2013 and 2013 / 2014.

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