The CRC Energy Efficiency Scheme: An Overview

OVERVIEW

The CRC Energy Efficiency Scheme ("CRC") is a mandatory emissions trading scheme which was launched on 1 April 2010 with the registration period closing on 30 September, 2010. It is intended to cover the emissions from energy use of an estimated 5,000 non-energy intensive businesses and organisations in the private and public sectors (e.g. retailers, banks, hotels, utilities). These account for approximately 10% of the UK’s CO₂ emissions.

<table>
<thead>
<tr>
<th>Timetable</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>2008</strong></td>
<td>Qualification year for the introductory phase. Participants with more than 1 half-hourly meter determine their total half-hourly electricity use.</td>
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<tr>
<td>July 2009</td>
<td>Registration packs provided by the EA to all potential participants.</td>
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<tr>
<td>April 2010</td>
<td>Start of first Compliance Year and Footprint Year for introductory phase. First year of a three year introductory phase in which allowances are uncapped. This year is a reporting year only (i.e. no need to purchase carbon allowances). Note: 1 April 2010 – 31 March 2011 – Qualification Year for second phase.</td>
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<tr>
<td>April – September 2010</td>
<td>Registration Period. Organisations are required to register on a group basis. Registration deadline for organisations wishing to disaggregate any SGUs is 30 June 2010 otherwise it is 30 September 2010.</td>
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<tr>
<td>April 2011</td>
<td>Second Year of the introductory phase. First fixed price allowance sale.</td>
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<tr>
<td>October 2011</td>
<td>Performance league table for year 1. First recycling payment made adjusted by +/- 10%.</td>
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<tr>
<td>April 2012</td>
<td>Third Year of the introductory phase. Fixed price allowance sale for year 3 emissions.</td>
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<tr>
<td>July 2012</td>
<td>Surrender allowances for year 2. Second annual report due – submit footprint report (for phase 2) and annual report.</td>
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<tr>
<td>October 2012</td>
<td>Performance league table for year 2. Second recycling payment made proportionate to the first scheme year’s emissions and adjusted by +/- 20%.</td>
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<tr>
<td>April 2013</td>
<td>Year 1 of CRC second phase with allowances capped.</td>
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KEY FEATURES

**CRC Qualification and Registration**

There is a basic qualification test to determine whether a group is subject to CRC. In summary, the test for CRC is as follows:

- determine whether the UK operations of any group member had at any time during 2008, a Half Hourly Meter (“HHM”);

- determine whether any such group members had a direct contract with the electricity provider.

In considering the contract with the electricity provider, it is worth noting that contracts may be: (i) made directly with a group member or (ii) made with a group member through the agency of another person. In the case of (ii) this may be regarded as an “unconsumed supply” on part of the agent and the agreement is treated as made directly with the member of the group;

- if any member of the group had a HHM, it is necessary to assess the group’s aggregate half-hourly metered UK electricity supply for the calendar year 2008; and

- if the total aggregate annual electricity supply through all those HHMs is more than 6,000 MWh (after deducting all energy use from the specified CRC excluded sources), the group will qualify for CRC and all supplies through HHMs will be covered, not just supplies individually exceeding the 6,000 MWh threshold.

It is important to note that, if a group qualifies, then all members of the group are subject to CRC, not just those members of the group which receive the qualifying supply through their HHMs.

**CRC Group**

The Government has adopted the Companies Act 2006 (“CA 2006”) test for parent and subsidiary undertakings in order to determine the entities which form part of a CRC group.

In summary, an undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if:

i. it holds more than 50% of the undertaking’s voting rights;

ii. it is a member of the undertaking and has a right to appoint or remove a majority of its directors;

iii. it has a right to exercise a dominant influence over the undertaking by virtue of the undertaking’s articles or a control contract;

iv. it has the power to exercise, or actually does exercise, dominant influence or control over the undertaking; or

v. it and the undertaking are managed on a unified basis.

All entities meeting that test will be grouped together under their highest parent. The highest parent will be deemed the account holder with the responsibility of registering and administering the scheme on behalf of the group. However, if the highest parent is not a UK-based entity any other UK-based entity within the group can be nominated as the account holder. If there are no UK-based entities within the group a UK-based representative must be appointed. CRC imposes joint and several liability to all members of the CRC group for any compliance failures.

The CRC group’s energy use and group structure are assessed by reference to the qualification year for each CRC scheme phase. For the first scheme phase (2010-2013), the qualification year was 1 January 2008 to 31 December 2008. Thus for the introductory phase the group must be defined by applying the CA 2006 definition of group discussed above to the organisational structure as at 31 December 2008.

**Disaggregation**

There has been a significant change to CRC, allowing disaggregation of large subsidiaries. Where a CRC group has any large subsidiaries that would meet CRC
qualification criteria independently, such subsidiaries, known as Significant Group Undertakings ("SGUs") may be disaggregated from the CRC group. This can only be done if the rest of the group, without the SGU, still qualifies for CRC. These SGUs will participate in CRC as separate participants distinct from the CRC group.

Ongoing Requirements
CRC qualification is based solely on electricity supply but once registered, the CRC group will be required to obtain a comprehensive record of its total CO₂ emissions and therefore all energy (including electricity, gas and any other fuel types) will have to be accounted for. However, CRC exempts emissions from sources such as domestic accommodation, transport, unconsumed supplies, activities covered by a Climate Change Agreement or the EU Emissions Trading Scheme and emissions from consumption outside the UK.

Cap and Trade
CRC will operate as a “cap and trade” system. Participants will be required to buy sufficient emissions allowances to cover their predicted energy use and, depending on their actual energy use, may then sell additional allowances or be required to buy extra allowances.

CRC launched in April 2010 with a three-year introductory phase. Fixed price allowances at £12/tCO₂ will be sold in April 2011 and April 2012 during this phase. CRC will continue from 2013 in five-yearly phases, with allowances being sold by auction in April each year. The Government will set a cap on the number of allowances available to be auctioned to CRC participants.

CRC includes a strong public disclosure element. Participants are obliged to comply with annual reporting requirements, and each year, the Government will publish a public league table ranking participants on their emissions reduction performance.

CRC as a whole is intended to be revenue neutral to the Government. At the end of October – three months after the reporting deadline, CRC revenue will be recycled back to participants modified by a bonus/penalty (starting at 10% of the cost of allowances and rising each year to 50% in year five) reflecting their performance.

CRC regulation is “light touch” relying primarily on self-certification. But non-compliance is a criminal offence and penalties are potentially substantial.

Complex Structures
For complex organisational structures such as private equity investments or pension funds, the approach taken by CRC in relation to the definition of group poses significant challenges. For example, there is a risk that by virtue of sharing a common top controlling member, funds could all be found to fall into the same CRC group with joint and several liability. This in turn may require special arrangements to ensure that costs and benefits under CRC are correctly allocated within the group.

Identifying the relevant CRC group (or groups) in complex organisational structures will require a detailed analysis of all ownership interests and control rights, including the constitutional documents of the relevant entities and any contracts dealing with control and management of the relevant entities.

IMPLICATIONS

Financial
The cost of allowances for smaller organisations is likely to be relatively low during the fixed price introductory phase. In the first year, a threshold level participant will require approximately £38,000 worth of allowances and receive a maximum bonus/penalty of about £3,800. These are not significant sums when set against an underlying annual electricity bill in excess of £500,000 but as the scheme progresses a poor performer with large energy costs could face substantial rising penalties.

In the subsequent auction phases the reducing cap in the number of allowances will potentially drive up demand and price. Cost will become a more material issue as participants become exposed to carbon market prices.
An organisation which reduces its emissions will benefit from the reduced cost of allowances and a reduced energy bill. Although there may be easy low-cost options for a participant to reduce its energy use initially, many well-run and progressive organisations will already have taken these steps, and the difficult task going forward will be to balance the cost of implementing further reduction measures (e.g. the cost of new equipment) against the benefit.

Reputational
A key driver for CRC is the public disclosure of performance in a league table. There is a potentially significant public relations risk from this league table as it enables participants within a sector/industry to be benchmarked. For comparative assessment, overall performance will be calculated using three different metrics, based on the participant’s change in CRC emissions.

It is likely that the publicity and reputational consequences of being at the top (or bottom) of the performance league table will prove to be more significant than the recycled payment itself, at least in the introductory phase.

Administrative
The CRC scheme presents a significant administrative and compliance burden, especially for those organisations which are not presently heavily regulated and so do not have the personnel or experience to easily deal with it. The scheme relies heavily on self-certification with a randomly chosen 20% of organisations being independently audited.

Non-compliance may arise in a number of ways (e.g. failure to register; failure to surrender sufficient allowances; or failure to correctly ascertain the extent of the “organisation”) and the penalties are severe, starting at £40/tCO$_2$ and rising to £70 or more in the future. Organisations which have a complicated relationship with customers or counterparties (such as landlords or some service providers) may encounter difficulties in structuring or standardising their relationships to accommodate CRC.

CONCLUSION
Organisations should be finalising the registration documentation and developing a carbon emissions reduction strategy. The CRC registration deadline is 30 September 2010 or 30 June 2010 (for any organisation wishing to disaggregate any SGUs).