



The Carbon Reduction Commitment: An Overview

July 2009

The Carbon Reduction Commitment (CRC) is a new mandatory emissions trading scheme that aims to improve energy efficiency and reduce the amount of carbon dioxide (CO₂) emitted in the UK. The CRC is due to come into force in April 2010 and will affect large organisations in both the public and private sector.¹ The purpose of this note is to help you identify whether the scheme will apply to your organisation and if so, what impact it will have.

Qualification

In summary, organisations which have one or more half hourly electricity meter settled on the half hourly market (HHMs) and which exceed 6,000 megawatt hours (MWh) of half hourly electricity use in a qualification year (the first of which was the year to 31 December 2008) will be obliged to participate in the CRC. That equates to an electricity bill of approximately £500,000. It is important to note that whilst qualification is assessed on the basis of electricity consumption, once a participant qualifies for the scheme they will have to report on and purchase and surrender allowances in respect of their total energy consumption (which includes the CO₂ emissions from all fuel sources listed in the draft order (e.g. electricity, gas, liquid petroleum gas, diesel etc)).

Qualification packs are due to be sent to organisations which have HHMs in September 2009, although an earlier information pack is expected to be delivered in July 2009.

For qualification purposes, transport emissions are excluded from an organisation's total emissions.² Also there will be no administrative emissions overlap between CRC and either EU ETS³ or Climate Change Agreements⁴. Organisations will not have to purchase allowances for emissions that are already covered by either an EU Emissions Trading System or Climate Change Agreement.

With qualification packs due to arrive very shortly, now is the time for companies to calculate their 2008 electricity usage and assess if they qualify under the CRC.

If qualification under the CRC is likely, total energy usage should be monitored and plans to reduce emissions considered.

Assess likely impact of CRC scheme on cashflow, especially in 2011.

¹ This note is based on the draft Carbon Reduction Order 2010 and the consultation and guidance published on 12 March 2009 (see www.decc.gov.uk).

² The draft order defines energy used for the purpose of transport as "consumption of energy in the transport of people or goods". The transport exclusion does not apply to the transport of people within a place of entertainment, recreation or amusement, culture, scientific, historical or similar interest. Furthermore, conveyor belts, lifts, escalators and any other similar fixed mechanism or device which is used to move goods or people from one part of a premises to another, will not be deemed to be transportation. Further guidance will be required on what is caught by this exemption.

³ The EU Emissions Trading System is a greenhouse gas emissions trading scheme covering the energy intensive sectors within EU Member States.

⁴ Climate Change Agreements relate to the Climate Change Levy which allows energy intensive business users to receive a discount from the Climate Change Levy in return for meeting energy efficiency or carbon saving targets.

Subsidiary organisations and their parents are grouped together for the purposes of the CRC scheme under the highest parent organisation. Each member of the group will be joint and severally liable for failure to comply with the scheme. For administrative purposes, each group must nominate a primary member, which is likely to be the highest parent organisation. The group will be classified as the CRC participant and will report emissions and surrender allowances for all the relevant operations of the parent and subsidiaries. The group will appear in the league table and receive associated revenue recycling payments.

The CRC does not apply to group companies incorporated outside of the UK. If the aggregate half hourly electricity use of the UK subsidiaries of an overseas parent company exceeds 6,000 MWh in a qualification year then the UK arm of the group will qualify for CRC and will need to nominate a UK-based group member as its primary member. Similarly, principal subsidiaries of overseas companies will be subject to the same rules as principal subsidiaries of UK parent companies.

A principal subsidiary is defined as an undertaking that would have qualified for the CRC scheme were it not a subsidiary of a larger participant group. Therefore, any subsidiary undertaking of a participant that used at least 6,000 MWh of half hourly electricity in 2008 will be classed as a principal subsidiary.

The scheme includes a number of specific provisions relating to the qualification of certain types of business organisations:

Joint Ventures

In the case of a joint venture company which qualifies for the CRC scheme and in which no parent company has a greater than 50 per cent. controlling stake, the joint venture company itself will have to participate in the scheme; responsibility for compliance will not be shared by the shareholders. Neither will the joint venture company's energy consumption be aggregated with that of its joint owners for the purposes of ascertaining eligibility for the scheme. By contrast, a party with a greater than 50 per cent. controlling stake in any joint venture will be considered to be the CRC participant and will aggregate all energy use from the relevant joint venture subsidiary with its own for CRC qualification purposes.

Landlords

Where a landlord is the counterparty to the electricity supply contract for its tenant's energy use and is itself a CRC participant, then the landlord will carry the tenant's CRC obligations. Landlords are not permitted to agree with tenants to transfer these CRC obligations to the tenant itself, although the costs of the scheme could be charged back to the tenant by agreement.

Franchises

In the case of franchise or other vertical distribution agreements, both parties will generally be treated as a single entity under the CRC, with the onus on the dominant party (i.e. the franchisor) to comply with the CRC.

Organisations which do not qualify

Organisations which do not qualify will not need to participate in the scheme. However, even if an organisation does not qualify, if it has one or more HHM and it receives a qualification pack in September 2009, then it will need to make a non-participant information disclosure between 1 April and 20 September 2010. The non-participant information disclosure will outline details of the organisation's HHMs. Where the total half hourly electricity use exceeds 3,000 MWh, the non-participant information disclosure will also need to include details of the total half hourly electricity use.

Non-participants will also need to be aware of the implications of the CRC scheme if the organisation seeks to buy or otherwise acquire other organisations. Where non-participants acquire participants or principal subsidiaries of participants, responsibility for complying with the scheme will transfer from the original participant to the acquiring non-participant. In addition, even if a non-participant is acquiring another non-participant, CRC will be of interest, as it will be the total half hourly electricity use of the enlarged group that will be assessed when considering qualification for subsequent phases of the scheme.

Organisations which do qualify

Organisations which qualify as participants will need to complete the qualification pack and, in respect of the introductory phase, will need to register for the scheme between 1 April and 30 September 2010. It is advisable for organisations to take the following practical steps before April 2010:

- For qualification purposes, work out the best method of assessing electricity usage within the organisation.
- Start to determine the best method of assessing all relevant fuel usage within the organisation (i.e. the total emissions on which the organisation will need to report and purchase and surrender allowances).
- Consider who should be nominated primary member of the group to interact with the Environment Agency (the administrators of the scheme).
- Agree who will be the CRC co-ordinator within the primary member organisation. The coordinator will be responsible for coordinating the organisation's compliance with the scheme and acting as the principal contact with the Environment Agency.
- Consider the appropriate time to circulate a CRC strategy note to ask relevant questions of subsidiary companies in relation to energy usage/HHMs etc. The strategy note should include reference to the fact that the Environment Agency may be in touch directly with subsidiary companies and in which case they should not respond without speaking to the organisation's CRC co-ordinator.
- Identify any principal subsidiaries within the group, which will retain information and reporting obligations.
- Consider the cash-flow implications of purchasing allowances and any consequences that this may have, for example, on existing banking facilities.
- Seek accountancy and tax advice in relation to providing for the acquisition of allowances and the receipt of revenue recycling payments.

Overview of the CRC scheme

Participants will have to monitor their total CO₂ emissions (not just electricity) and purchase allowances sold by the Government. Allowances will be surrendered for each tonne of CO₂ emitted. The CRC is a cap and trade scheme. In addition to being sold by the Government, allowances will also be traded on a secondary market. This creates a direct financial incentive for organisations to reduce their emissions. Another feature of the scheme is that the greater an organisation's reduction in emissions, the higher it will appear in the Government's annual league table. On the basis of a participant's position in the league table, the revenue raised by the Government in selling allowances will be recycled back to participants.

The scheme will be divided into set time periods, known as phases. The first phase is the introductory phase, starting in April 2010 which will run for three years. Subsequent phases will last for five years. Each phase is comprised of a number of consecutive compliance years each running from 1 April to 31 March.

Before the start of each phase there will be:

- a **qualification period** in which organisations must determine whether they meet the qualification criteria for participation in the scheme. For the introductory phase, the qualification period is the calendar year 2008. For subsequent phases, the qualification period will be the year prior to the footprint year (i.e. 1 April 2010 – 31 March 2011 for the second phase).
- a **footprint year** for which participants must calculate their total energy usage, and determine their emissions responsibility under CRC. The first compliance year of each phase will be termed a footprint year.
- a **registration deadline** by which qualifying organisations must register as a participant in the scheme. For the Introductory Phase, participants will be able to register from April 2010 until September 2010. For subsequent phases, the registration deadline will be the last working day of the footprint year (i.e. 31 March 2012 for the second phase).

Every phase will then be arranged in **compliance years** (1 April to 31 March). In each compliance year, participants will generally complete four steps:

1. At the beginning of each compliance year, participants will be able to **purchase allowances** from Government. In April 2011 allowances will be acquired for actual CO₂ emissions in 2010/2011 and expected emissions for 2011/2012. In subsequent compliance years participants will need to purchase allowances on the basis of expected CO₂ emissions for that compliance year.
2. Participants should monitor their energy usage, purchasing or selling allowances on the secondary market as necessary, and in July (following the end of each compliance year) they will be required to **report their total CO₂ emissions** to the administrators.
3. In July, participants will also need to **surrender allowances** equal to the total CO₂ emissions during that compliance year.
4. In October of the same compliance year participants **receive a revenue recycling payment** from the Government.

Figure 1 below, shows the timetable of the CRC scheme up until the year 2013:

2008	December	Year to 31 December 2008 was the qualification year for the introductory phase of the scheme. Organisations with one or more half hourly meters settled on the half hourly market and which consumed more than 6,000 MWh will qualify for participation
2009	July	Information on the CRC scheme to be sent out to all half-hourly billing points.
	September	A qualification pack will be sent out to all half-hourly billing points.
2010	April	The introductory phase begins. Participants must register between 1 April and 20 September, after which participants' CRC online registry account will be opened.
	September	Participants should begin compiling information on all their energy sources (not just electricity) for the evidence pack.
2011	April	Buy allowances from the Government for emissions years 2010/11 and 2011/12 at a fixed price of £12/t carbon dioxide.
	July	By 29 July, participants must submit a footprint report and annual report for emissions year 2010/11 and surrender or cancel corresponding number of allowances.
	October	First league table published and participants will receive the first revenue recycling payment.
2012	April	Buy sufficient allowances for emissions year 2012/13.
	July	By 29 July, surrender or cancel allowances for emissions year 2011/12 and submit annual report.
	October	Second league table published and participants will receive revenue recycling payment for emissions year 2011/12.
2013	April	Start of phase two of the scheme. Buy allowances for compliance year 2013/14.
	July	By 29 July, surrender or cancel allowances for emissions year 2012/13 and submit annual report.
	October	Third league table published and participants will receive revenue recycling payment for emissions year 2012/13.

Purchase of allowances

During the introductory phase, an unlimited quantity of allowances will be sold at a fixed price of £12/tCO₂ during a month long sale window. Following the introductory phase, the total emissions of the overall CRC sector will be limited by the Government by placing a cap on the number of allowances released to the market. In the capped phases (i.e. from the start of phase two onwards) allowances purchased directly from the Government will be done so via an online auction.

By the July reporting deadline of each compliance year, participants will have to purchase and surrender a sufficient number of allowances to cover their total reported emissions. Allowances can be purchased in one of three ways:

1. There will be an annual Government sale or auction at the start of the year. There will be no sale of allowances in the first year of the scheme. The first Government sale in April 2011 will be a double sale where participants purchase allowances to cover their actual emissions from 2010/11 and forecast emissions for 2011/12.
2. Allowances can be bought and sold by trading with others on the secondary market.
3. Allowances can be bought via the safety-valve mechanism. There will be a minimum price of £12/tCO₂ for allowances issued via the safety-valve in the introductory phase (but additional administrative costs will also be charged), and these allowances will generally be issued once a month.

Revenue raised from the Government sale of allowances will be recycled back to participants, based on their performance in the scheme as shown in the annual league table.

Participants will need to ensure that they budget for the double sale in April 2011. Organisations should also seek to establish effective carbon management systems to enable them to accurately forecast future CO₂ emissions and enable them to identify how many allowances should be purchased. It is anticipated that purchasing allowances directly from the administrators in the annual sale or auction will be cheaper than purchasing allowances on the secondary market or through the safety-valve mechanism.

Reporting obligations and surrendering allowances

Participants are required to report on total fixed point energy use, which is electricity and gas supplied by pipe and the use of a number of other fuel sources (as listed in the draft order) such as liquid petroleum gas and diesel. In contrast to the calculation of emissions for qualification purposes, participants reporting obligations relate to all energy consumption from fixed point sources and not just electricity.

Participants are obliged to produce a footprint report for each phase of the scheme showing details of their total energy consumption for CRC purposes and associated CO₂ emissions. The first footprint report will need to be submitted by 29 July 2011.

Participants will also be obliged to produce annual reports of their total energy consumption and associated CO₂ emissions in each compliance year. Participants will be obliged to surrender a corresponding number of allowances by reference to the total CO₂ emissions reported in the annual report.

Participants are required to maintain an evidence pack in relation to their energy emissions. The evidence pack should contain original copies of annual statements, bills, invoices etc. Participants will be required to submit their evidence pack to the administrators if they are selected for audit.

Performance league table and revenue recycling

On the basis of the annual reports submitted by participants, the administrators will score and rank participants in comparison with one another in respect of their performance over a compliance year. The main aim of the performance league tables is to show how well participants have reduced their CO₂ emissions.

In the first compliance year of the introductory phase the only performance table that will be produced will show the performance calculated using an early action metric. This is ranking participants based on the energy saving measures that have been put in place before the start of CRC. In the first compliance year this alone will determine a participant's ranking.

In compliance years 2 and 3 of the introductory phase the early action metric will account for 20 per cent. of the weighting of a participant's ranking. A further 20 per cent will be assessed by the growth metric which takes into account the fact that an organisation that is growing may have an increase in its absolute CO₂ emissions by measuring change in CO₂ emissions intensity. The final 60 per cent. will be assessed by the absolute metric which simply reflects the relative change in the organisation's CRC emissions.

In subsequent phases the weighting will be 75 per cent. absolute metric and 25 per cent. growth metric to determine a score and ranking.

Revenue generated by Government through the sale of allowances will be recycled back to participants. Each participant's revenue recycling payment is calculated on the basis of a base payment level (which is calculated as a participant's proportion of the total CRC emissions in the first scheme year) which is then adjusted by a bonus or a penalty payment determined by each participant's position in the overall performance league table. This means that the higher a participants position in the league the better the bonus payment.

Changes to group structures

Where an organisational change involves a participant or principal subsidiary, the scheme deems it to be a "designated change". Where there is a designated change the responsibility for participating in the scheme will transfer to the new group/owner. There are essentially two types of transfer of responsibility which would be accounted for by the CRC designated change mechanism:

- (a) those where a participant or principal subsidiary is sold to, taken over by or merges with a non-participant; and
- (b) those where the transfer occurs between existing participants.

For further information please see *The Carbon Reduction Commitment: Changes to Group Structures*.

Penalties for non-compliance

CRC was designed to be a light touch scheme which relies on participants' self-certification of energy use. There are therefore a number of civil penalties for failure to comply with CRC, including fines for failure to register, incorrect reporting and failure to keep adequate records. In addition there are a limited number of criminal offences which apply to circumstances where participants have actively and knowingly attempted to falsify evidence or to obstruct or mislead the administrators. The penalties for non-compliance will be of interest to participants both in terms of their own compliance and when conducting diligence on other participants' outstanding liabilities as part of an acquisition process.

Next steps

Now is the time to start considering whether your organisation will qualify for the scheme. You should consider who will be responsible for compliance with the scheme within your organisation and take steps to ensure that your organisation is prepared for the start of the scheme in April 2010. It is likely to be of particular concern to the finance and accounting functions in your organisation and action should be taken shortly after the qualification packs are received (if not before). You might also wish to consider how energy emissions from all fuel usage can be reduced in the near future in order to minimise the cost implications of the scheme. Steps to reduce total emissions are also likely to improve your organisation's position in the annual league tables.

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Please note that the contents of this note provide an overview of the new CRC regime only. This note is guidance only and should not be relied upon as legal advice. Clients' circumstances will differ in each case and so if you wish to discuss any of the issues covered, please contact your usual Travers Smith contact or any of the following:



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