



## *The Carbon Reduction Commitment: Changes to Group Structures*

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 (CO<sub>2</sub>) 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.<sup>1</sup>

Organisations 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 (Participants). Participants will have to monitor their total CO<sub>2</sub> emissions (not just electricity) and purchase allowances which will be surrendered for each tonne of CO<sub>2</sub> they emit. The CRC is a cap and trade scheme. In addition to being sold by the Government, allowances will 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, revenue raised by the Government in selling allowances will be recycled back to Participants.

For more information on the terms, scope and phases of the CRC, the qualification requirements and the penalties for non-compliance, please see *The Carbon Reduction Commitment: An Overview*.

### **Group structures and participants**

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.

*Where a change to group structure is deemed to be a Designated Change, responsibilities and liabilities will transfer to the new group/owner.*

*CRC to become a due diligence point on M&A transactions.*

*Consider negotiating the acquisition of allowances from sellers.*

<sup>1</sup>

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](http://www.decc.gov.uk)).

Therefore when a Participant is described, in this note, as the purchaser in an M&A transaction, the purchasing entity could be the parent or one of its group companies. In contrast, when a Participant is described as the target it is the entire group that is being purchased. If only one or some of the subsidiaries are being purchased the CRC scheme will not specifically apply unless the subsidiaries are deemed to be Principal Subsidiaries (see below).

The scheme includes a number of special rules relevant to certain types of business organisations, further details of which are set out below.

#### **i. Overseas Companies**

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.

#### **ii. 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.

#### **iii. 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.

#### **iv. 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.

### **Principal subsidiaries**

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".

### **Changes to group structures**

The CRC does not contain any specific rules governing changes to group structures which involve either the acquisition or disposal of assets or businesses (as opposed to corporate entities), or share sales of companies which are not entire Participants or Principal Subsidiaries (see above).

Where an M&A transaction does not involve a Designated Change, the Participants will not be obliged to notify the Environment Agency of the completed transaction. For CRC purposes, the acquisition or disposal will be deemed to take effect at the time of purchase. If either party to the transaction is a Participant then that Participant will have to account for the acquisition or disposal when reporting its emissions in its annual report. A purchasing Participant will therefore need to report and surrender allowances to cover the part of the emissions year for which it owned the new asset/company. An acquiring Participant will therefore need to consider whether it has sufficient allowances to cover its enlarged group in these circumstances.

By contrast, where there is an M&A transaction which involves a Designated Change, the CRC scheme specifically provides for how the obligations under the scheme are to be transferred. Figure One (at the end of this note) illustrates how the CRC scheme applies to M&A transactions. The remainder of this note focuses on how a Designated Change is dealt with under the scheme and concludes with an analysis of the commercial implications and points to consider.

### **Designated Changes**

In summary, a Designated Change is an organisational change involving a Participant or Principal Subsidiary. 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.

Where there is a Designated Change the responsibility for participating in the scheme will transfer to the new group/owner.

**(a) Transfers Involving a Participant and a Non-Participant**

The scheme's Designated Change rules will cover three types of change involving both Participants and non-Participants:

- i. Existing Participant taken over by non-Participant;
- ii. Principal Subsidiary taken over by non-Participant; and
- iii. Mergers between a Participant (or Principal Subsidiary) and a non-Participant.

In each of points (i) to (iii) above, where a Participant or Principal Subsidiary merges with or is taken over by a non-Participant, the purchasing organisation will become a new CRC Participant. Responsibility for complying with the scheme will transfer to the new owner. In these instances the new owner will be required to register for the scheme. However, the new owner will have to report emissions only from the original Participant. For the remainder of the phase, it will not have to report on emissions from parts of its business that were not previously included in the scheme. When assessing qualification for the next phase of the scheme, the new owner will be assessed on the basis of the enlarged group.

**(b) Transfers between Participants**

Four different types of change would be accounted for involving the transfer of emissions between Participants:

- i. Participant purchased by another Participant:  
The purchased entity will become a Principal Subsidiary of its new owner (i.e. the Participant group);
- ii. Principal Subsidiary of one Participant taken over by another Participant:  
The purchased entity will become a Principal Subsidiary of its new owner (i.e. the Participant group);
- iii. Principal Subsidiary becomes a stand-alone entity (de-merger):  
The Principal Subsidiary will become a full Participant in CRC; and
- iv. Merger between two Participants (or participating Principal Subsidiaries):  
The new undertaking will become a full Participant in CRC and take on the responsibility that was held by the previous Participants (or Principal Subsidiaries). The new group will take on all the responsibilities from the original Participants and be listed in the league table.

**Timing and effect of Designated Changes**

Designated Changes are deemed to have taken effect at the start of the emissions year during which the change took place. When a Designated Change takes place, affected Participants must notify the Environment Agency within three months and provide details of the date the change took place and the other parties involved.

Where a Participant or Principal Subsidiary is purchased by another party in the middle of the year, the purchaser that owns the Participant or Principal Subsidiary at the end of that emissions year would need to report and surrender allowances for the original Participant or Principal Subsidiary for the entire year. Whilst the effect of this is that the purchaser becomes liable for emissions that were attributable to a company before it owned such company, conversely the purchaser stands to benefit from potentially greater revenue recycling payments.

It will be strongly advisable for the purchasing organisation to ensure that it has purchased sufficient allowances to cancel in respect of the increased emissions. Where the purchaser is a non-Participant it will not have already purchased allowances and will therefore need to acquire allowances through the safety-valve mechanism under the scheme or through the secondary market. This will also be the case where a Participant has purchased insufficient allowances. Whilst it is unclear at this stage how the secondary market will be operated, we suggest that purchasers may seek to negotiate the purchase of allowances from Participant sellers when negotiating the company acquisition.

## Commercial implications

In terms of the introductory phase of the CRC scheme, which commences 1 April 2010, the Participant group structure will be defined as the one in place as at 31 December 2008. Therefore M&A activity between 1 January 2009 and 31 March 2010 will not affect organisation's CRC obligations, other than to the extent that such changes affect the assessment of whether the organisation may qualify for phase two of the scheme (starting April 2013).

There will however be a number of points that organisations conducting M&A activity from April 2010 onwards, will need to consider, including the following:

- CRC liabilities will become a key part of due diligence, as purchasers assess the emissions usage of target entities, whether there are existing liabilities for non-compliance with the scheme, whether to negotiate the acquisition of allowances from the Seller and whether the target entities have surplus allowances which can either be used to meet the increased emissions liability of the enlarged group or traded on the secondary market.
- Purchasers will need to notify the Environment Agency of Designated Changes and ensure that they purchase sufficient allowances to ensure that they have enough allowances to cancel in respect of the enlarged group.
- Compliance with the CRC scheme will have cash-flow implications both for Participants and for non-Participants which obtain CRC obligations following M&A activity. In the introductory phase, purchase of allowances will be at a fixed price of £12/tCO<sub>2</sub> and the allowances will be sold by Government in April 2011 to cover actual emissions in the first emission year (to April 2011) and the projected emissions in the second emissions year (to April 2012). The revenue recycling payment for the first emission year will not be paid to until October 2011.
- Effects on cash-flow could also impact more widely upon organisations, such as affecting compliance with banking covenants under existing facilities.
- M&A activity which increases the size of group structures will also increase the administrative burden of complying with the scheme. Organisations will need to ensure that they have adequate resources to comply with the scheme, which will have associated cost implications.
- It remains to be seen what level of public interest there will be in the publication of the league table but the potential effects of adverse publicity may become a pre-deal consideration on M&A transactions.



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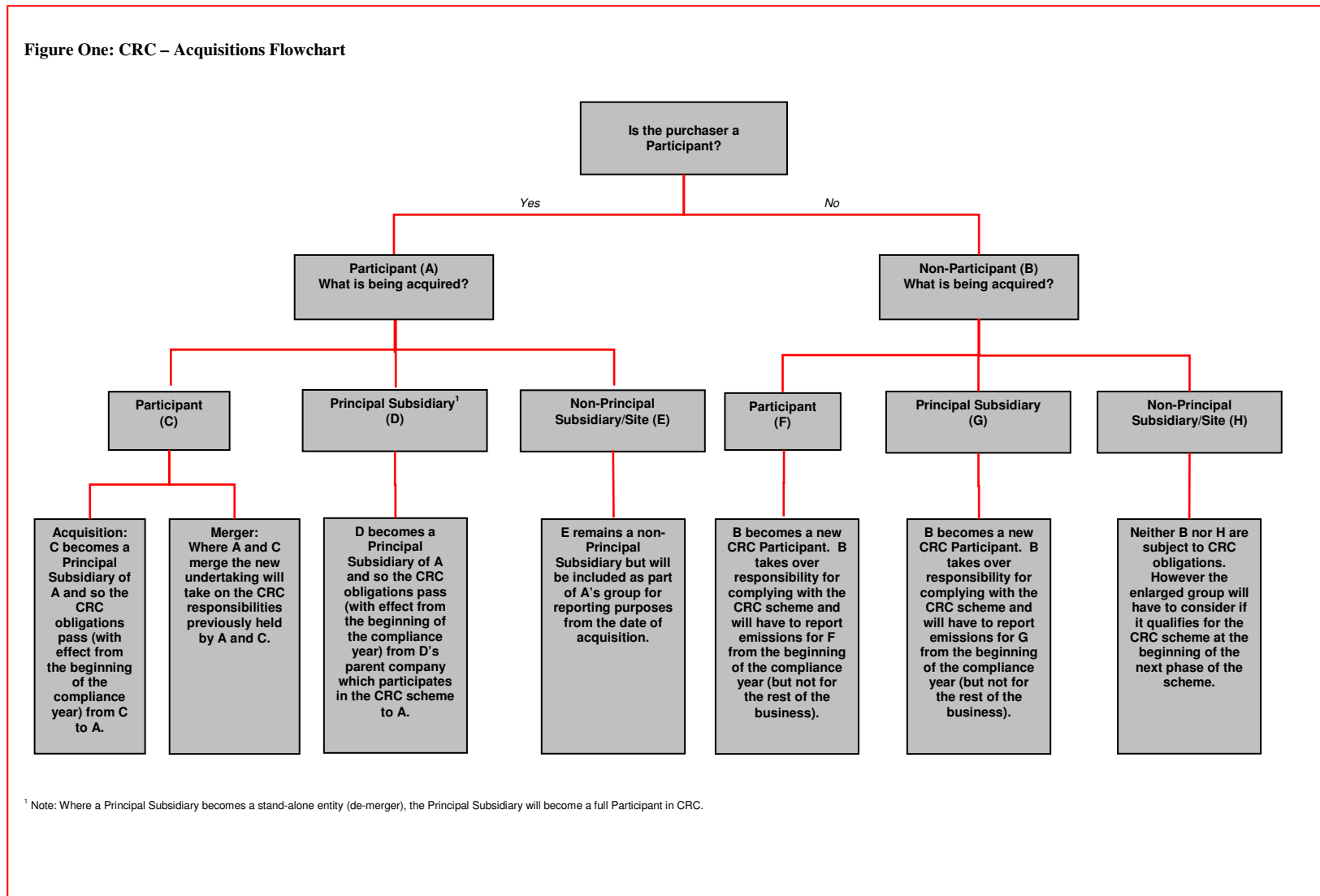
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## Disclaimer

Please note that the contents of this note provide an overview of CRC and changes to group structures. 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 Richard Skelton, Ian Shawyer or Steven McNab.

Figure One: CRC – Acquisitions Flowchart



<sup>1</sup> Note: Where a Principal Subsidiary becomes a stand-alone entity (de-merger), the Principal Subsidiary will become a full Participant in CRC.