



GREEN REAL ESTATE

THE CARBON REDUCTION COMMITMENT ENERGY EFFICIENCY SCHEME (CRC) 2012 UPDATE

The CRC is the UK's mandatory emissions trading and energy saving scheme. It came into force in April 2010 and is aimed at substantial organisations which are large consumers of energy but do not participate in the EU Emissions Trading Scheme and do not have a major part of their activities regulated by an existing Climate Change Agreement with the Department of Energy and Climate Change.

This briefing acts as a background note summarising the main developments since the CRC was introduced, and looking at what is likely to happen in 2012.

DLA PIPER COMMENT

The CRC scheme has now been in place for nearly two years and all organisations caught by the Scheme should now have got to grips with it. Towards the end of 2011, the first league tables, showing performance against the CRC metrics, were published although the jury is still out on whether these have had the “naming and shaming” effect that was presumably intended.

Following the abolition of recycling payments in the Government's comprehensive spending review (CSR) on 20 October 2010, there were strong protests from the Real Estate industry. Perhaps as a reaction to this, the Government announced proposed changes to the Scheme in June 2011 in order to simplify the Scheme and reduce the administrative and regulatory burden on participants. Draft legislation is due to be published in the Spring

of 2012 with a view to the reforms coming into effect during Phase 2 of the Scheme (April 2013 – March 2019). Brief details of the main proposed changes are set out in this update.

In the meantime, with the CRC more akin to a green tax, there has been sporadic discussion in the Real Estate industry as to whether the “rates and taxes” clause in a lease can be used to require tenants to contribute towards their landlord’s CRC costs. There is as yet no consensus on whether the clause can, or should, be used in this way but we would expect landlords to continue to look at this issue in 2012.

For the very latest thinking on the subject, please do speak to the individuals mentioned at the end of this note or your usual DLA Piper advisor.

INTRODUCTION TO CRC

The Carbon Reduction Commitment Energy Efficiency Scheme (“CRC”) took effect on 1 April 2010. It is the UK’s first mandatory emissions trading and energy saving scheme and is aimed at substantial organisations which are large consumers of energy but do not participate in the EU Emissions Trading Scheme and do not have a major part of their activities regulated by an existing Climate Change Agreement with the Department of Energy and Climate Change.

QUALIFICATION

Qualification for the first phase commenced on 1 April 2010 and related to electricity usage in the calendar year 2008. An organisation will qualify for CRC if it used more than 6,000 MWh of electricity in 2008 through all of its half-hourly meters – equating to approximately £500,000 worth of electricity that year.

The effect of the CRC legislation is that all companies or other legal persons which are under common ownership, control or management are treated as a single organisation. The highest parent undertaking within the CRC organisation will be responsible for CRC compliance, unless that undertaking appoints another undertaking (the Primary Member) within the organisation to perform this role. Where the highest parent undertaking is established outside the UK, it must nominate a UK group company to be the Primary Member.

The Primary Member is responsible for paying the total CRC commitment of its organisation to the Environment Agency and for managing the administration of CRC.

This approach applies even if the parent undertaking, or other Primary Member, has no involvement in the energy user’s management. A company may be caught by the CRC solely because that company holds a majority interest in a group of investment vehicles where the individual vehicles, or the individual properties owned by those vehicles, fall below the 6,000 MWh inclusion threshold. All entities within the organisation will be jointly and severally liable for each other’s compliance.

Qualification for Phase 2 will begin in April 2013 with the first compliance year being 2014/5.

IMPLICATIONS FOR ORGANISATIONS WITH COMPLEX CORPORATE STRUCTURES

The rules have a particular impact on organisations with complex corporate structures, such as private equity investors. A private equity house may hold a portfolio of businesses running on a largely independent basis. Notwithstanding this, CRC treats that private equity house and its businesses as a single organisation. Even if the relevant businesses are held in separate funds, but with an element of common management, they may fall to be considered as a single organisation.

In each phase of the CRC scheme, large organisations have the option of treating businesses, which would otherwise be included in a single organisation for CRC purposes, as separate participants. However the deadline for doing this in relation to the first phase has now passed.

Those organisations who missed the deadline for the first phase should have put in place arrangements between different parts of their business to ensure that relevant emissions information reaches the Primary Member and that the costs of compliance with the scheme are spread fairly amongst the group.

The 2011 consultation envisages that the rules on complex corporate structures will be simplified in Phase 2. It is suggested that organisations will be able to nominate separate participants in a way which better reflects its “natural business units”. However, more details of the proposals are required which will only become clear with the publication of the draft legislation.

FRANCHISES

The general rule is that it is the party buying the energy that qualifies for CRC. However, there is an exception in the case of franchises. The franchisor will have responsibility for CRC compliance both for itself and its franchisees. This is of particular importance to sectors where the franchise model is common, e.g. hotels.

ALLOWANCES

Since April 2011, qualifying organisations have in theory been obliged to buy allowances, which are permits to make emissions, at a fixed price of £12 per tonne of emissions. Emissions from consumption of all forms of energy are covered, not just electricity.

However, it was announced in the CSR in October 2010 that no allowances would in fact be sold until 2012, and it was confirmed in the 2011 consultation that all sales in the first phase would be retrospective only.

Originally allowance sales for Phase 2 were intended to be auctioned with a limited number of allowances available in order to meet our national carbon budget. However, the 2011 consultation seems to move away from this, with the proposal that fixed price sales will continue.

At the end of each scheme year, participants must surrender allowances corresponding to their actual emissions during that year and must submit an annual report setting this information out. October 2011 saw the publication of the first league tables showing which organisations have improved their energy efficiency.

RECYCLING PAYMENTS

Originally the CRC was to be revenue neutral. The income raised by the government from the sale of allowances was to be recycled back to qualifying organisations depending on various factors, including energy performance.

In the 2010 CSR it was announced that recycling payments would not after all be proceeding, and that revenue from the sale of CRC allowances would be used to support the public finances, including spending on the environment.

IMPACT ON THE REAL ESTATE MARKET

The CRC is not a tax on real estate in same way as business rates, for example. However, the emissions levels from real estate are such that the costs of CRC will fall heavily on real estate investors.

The scheme counts landlords as consuming the energy that they supply to the common parts of a building or to their tenants' premises. A landlord which qualifies for the CRC will have to buy allowances to cover this consumption (and non-qualifying landlords will be concerned about how their investments will be viewed by prospective buyers who are qualifiers).

The British Property Federation (BPF), representing a diverse range of property interests, carried out a consultation in 2010 asking all those involved in the industry for their views on whether tenants should contribute to their landlords' CRC costs (which include administrative and financial costs) and how the costs and rewards of any recycling payments should be split. In response to the results of its consultation, the BPF proposed that landlords claim from their tenants a proportion of their costs of complying with the scheme and later return to their tenants a proportion of their recycling payments.

However, this outcome has not generally been reflected in the drafting of new leases, and revised guidance is now required following the abolition of recycling payments.

CRC costs will relate to all of the energy consumption of the landlord's group and not to individual buildings, so an apportionment between different sites and the various tenants there will be very complex. Even putting this complexity aside, it is not clear whether it will be in the interests of landlords to seek to introduce lease clauses which pass on CRC costs to tenants. Key issues are:

- Would such clauses damage the liquidity of property?
- As they will not be included in all leases in the foreseeable future, will a two-tier market develop?
- How will prospective tenants react to the inclusion of such clauses in leases? In particular, will they reduce the amount of rent they offer, thus leaving the landlord with roughly the same return on his investment?
- How will landlords deal with the administrative burden of apportioning costs? Is it worth it?
- What happens if a qualifying landlord sells to a non-qualifier mid-year?
- Will tenants want to participate with landlords in implementing more efficient energy performance?
- Will CRC affect how energy is procured and paid for in commercial property?

In the meantime, following the 2010 CSR, some landlords have asked if CRC costs can be recovered from their tenants under existing lease clauses. Well drafted leases will contain a clause allowing the landlord to recover taxes, outgoing and charges relating to the tenant's property. With the abolition of recycling payments, the CRC is more akin to a tax than previously and is certainly a charge. However, CRC is levied on organisations rather than buildings, so any clause which only covers costs relating to the tenant's property is vulnerable to challenge.

Perhaps in the absence of further BPF guidance, or other consensus in the Real Estate industry on how to deal with CRC costs in leases, 2011 saw some law firms break ranks and start to argue more strongly that the "rates and taxes" clause, if carefully drafted, could be used to claim CRC costs. This is by no means a universally held view nor, as stated above, is it clear that it would be a welcome outcome. However, tenants need to exercise greater vigilance in lease negotiations in resisting any attempt by the landlord to impose the costs on them.

OUR GreenRE TEAM

In recent years, the campaign to tackle global warming and promote sustainable development has gathered momentum. The built environment is having to face up to a range of new rules, policies and guidance. We are seeing more legislation governing climate change and the "greening" of new developments. This, in turn, will lead to a greater demand for more energy efficient buildings and low carbon generation/renewable source energy in new development schemes.

With specialists in all areas of Real Estate Law – Property, Planning, Construction, Environmental Law, Tax, Finance and Insurance – our Green Real Estate Team takes a holistic approach to devising solutions and trouble shooting. We are at the very forefront of exciting new developments.

HEALTH WARNING

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