



# WHAT IS THE CRC ENERGY EFFICIENCY SCHEME?

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**THE CRC ENERGY EFFICIENCY SCHEME (CRC) IS PART OF THE UK GOVERNMENT'S POLICY TO TACKLE CLIMATE CHANGE AND IS COMPULSORY LEGISLATION AIMED AT LARGE UK BUSINESSES AND PUBLIC SECTOR ORGANISATIONS. THE SCHEME OFFERS FINANCIAL INCENTIVES FOR ORGANISATIONS THAT IMPROVE EFFICIENCY AND REDUCE ENERGY CONSUMPTION WHILST PENALISING ORGANISATIONS THAT DON'T.**

### TARGET ORGANISATIONS FOR LEGISLATION

Energy intensive industries/utilities have already been targeted by regulation (EU ETS and CCA) and given the nature of their business they have an incentive to reduce energy consumption, however the large non-energy intensive industries (and public sector) have historically been less focused on energy reduction for a number of reasons:

- Energy use is a small part of cost base.
- Distributed building energy use.
- Lack of senior management buy in.
- Lack of awareness.

### WHO QUALIFIES?

The first step that an organisation needs to take is to confirm the organisational structure which is covered by the new CRC legislation. Only UK emissions are covered by the legislation, and a group is defined as it is in Companies Act 2006 (ie subsidiary over 50 per cent). The highest parent organisation must liaise with the administrator of the scheme and if that is outside the UK a nominated Member Firm must be made. There are also specialist rules for governmental departments, universities, joint ventures, franchisees and franchisors.

The organisation must establish if it has at least one half hourly meter (ie settled on the half hourly market) in order for CRC to apply. If more than 6,000 MWh (roughly an electricity bill of £500,000) for the period between 1 January 2008 to 31 December 2008 are consumed then CRC applies. Below that threshold information disclosure may well still apply. Only electricity that as an organisation you are responsible for counts towards the 6,000 MWh's, see below for more detail. The qualification criteria is solely on energy consumption whereas the actual CRC covers all carbon emissions from all fixed point energy sources (ie non vehicular) including electricity, gas, and all other fuel types such as coal, LPG, and diesel.

### A QUESTION OF RESPONSIBILITY

The basic rule is that that 'any electricity consumption counts as your responsibility if your organisation holds the contract with the electricity supplier for that electricity supply'. Generally meaning whoever pays the bill will be responsible for that electricity, however where an agent procures and pays energy services it will be the organisation that contracted this agent. This question does pose an interesting issue surrounding landlords and tenants but the same rules will apply as above, more detailed guidance is expected over the coming months.

### WHAT DOES THIS MEAN?

If a group is included within CRC then they must disclose information regarding fuel consumption and buy allowances for their carbon emissions. They will be ranked in a public league based on there performance of reducing their emissions over time, the league recycles all cash received in the purchase of allowances. Their league ranking will determine the repayment they will receive, for example finishing near the bottom of the league means a net loss will be incurred.

The CRC introductory phase starts in April 2010 and runs until April 2013, throughout this phase the allowances will have a fixed price. The first year (April 2010 – March 2011) is a reporting year only. The first sale of allowances is in April 2011 for the forecasted period between April 2011 and March 2012. From April 2013 the purchase mechanism changes to an auction process where the Government will start to cap the number of allowances and reduce in future years.

## ▶ IMPLICATIONS OF CRC FOR BUSINESS

There are a number of implications surrounding CRC that will impact businesses in a variety of ways, these can be split into three sections as follows:

- Cash flow
- Compliance/Administrative costs
- Reputation

### CASH FLOW

The scheme operates through purchasing carbon allowances for your organisations anticipated emissions in the coming year; these are initially set by the Government at £12 per tonne of CO<sub>2</sub> emitted for the introductory phase. Subsequent years are capped by the Government (in order to reduce emissions overall) and will be sold by auction which is widely expected to increase the price significantly. Companies that are going through significant change may find it more expensive as extra allowances may be needed through the secondary market.

All revenue raised by the scheme from the sale of allowances is 'recycled' back to the participants depending on their league position. Hence an organisation could effectively gain from the scheme for a number of reasons:

- **Reduced consumption of energy will reduce energy bills.**
- **Recycled payment could be more than the initial outlay.**

There is obviously a delay between cash purchase of allowances and recycled cash from league performance; this is currently estimated at six months by the Government. This will essentially work like working capital as provided league performance is satisfactory the cash will just be unavailable for six months rather than it costing money.

The Government states that reducing energy consumption and efficiency will mean that organisations save money through reduced energy bills and that these savings should be well in excess of the costs of participating in the scheme.

There could also be opportunities for organisations to make money from the scheme if they identify organisations where significant reductions can be made at a low cost hence improving their chances profiting from finishing higher in the league table.

### COMPLIANCE/ADMINISTRATIVE COSTS

The cost of compliance for organisations is likely to be higher than the cost of allowances especially for private equity firms (see below). The legislation is complicated and requires significant amounts of information to be disclosed. The main issues are:

- **Identification of qualification for CRC, depending on organisation complexity this could be a laborious task. According to the carbon trust information gathering can take between two weeks to three months.**

- **Compiling evidence packs that summarise organisation energy consumption:**
  - electricity
  - gas
  - any other fuel types such as coal, LPG, diesel etc.
- **Calculating from this energy consumption the level of CO<sub>2</sub> emitted as each source has different emissions factors.**
- **Exclude any emissions that relate to transport or onward supply.**
- **Specific rules on organisational structure changes.**
- **Companies need to report three months after the year end (of the scheme) which is a tight deadline to get the data together.**

The legislation is complicated and the strict penalties are in place penalise non-compliance in the mandatory scheme. The Government has also targeted a figure of 20 per cent of all organisations within the scheme to be audited annually on a risk based approach based on the following factors:

- **Organisational complexity.**
- **Significant changes in emissions.**
- **Mergers and acquisitions.**
- **Compliance record.**
- **League table performance.**
- **Organisations that claim exemptions.**
- **How many make estimations instead of actual results.**

### REPUTATION

Perhaps the greatest cost could be the brand damage as a result of the public availability of league table performance. According to the Carbon Trust 70 per cent of people they surveyed believed that organisational carbon emissions performance would impact their view on that organisation. Although the league table doesn't compare companies in similar sectors of similar sizes it only compares the performance against its own past performance. Consumer facing customers will face the biggest cost for poor performance, as will companies that currently promote themselves as green focused if they do not meet expectations. Newspapers and trade press are likely to report on organisational performance and this will also impact director's reputations.

## ▶ SIGNIFICANT ISSUES FOR PARTICULAR COMPANIES

### LANDLORDS VERSUS TENANTS

As discussed earlier the company who is the counterparty on the energy supply contract is a key element to qualification for CRC:

- Where the tenant is paying the energy bill direct to the supplier, that energy consumption counts towards the total energy use of the tenant.
- Where the landlord is paying the bills on behalf of tenants, such as common services for a building (eg lifts, lighting, heating, and air conditioning in common areas), this energy counts towards to the energy use of the landlord.

This will pose some interesting questions for landlords and tenants such as:

- Who is responsible for making improvements to energy efficiency in the building?
- How can a landlord influence the energy consumption of a tenant? The Government has introduced a provision that requires the tenant to cooperate with the landlord for compliance purposes but relies on commercial arrangements for reducing demand.
- Is it clear what compromises the common parts of the building?
- Future investment decisions will need to be incorporated into allowance purchase.

### PRIVATE EQUITY

The qualification criteria per Companies Act 2006 for CRC means that private equity companies (and possibly venture capitalist companies) may well become part of the legislation as discussed further below.

#### Who is included?

The parent is considered the 'limited partnership' as shown in the above diagram and all investments that are greater than 50 per cent are included for CRC purposes (hence this is less likely to include Venture Capitalists as their stakes in companies tend to be smaller in scale). For example if one investment has a half hourly meter and energy consumption is over 6,000 MWh then the entire group companies are within the legislation of CRC.

Definition of group is completed at 31 December 2008 any changes since then would be included and the identification procedures above are at this date (as this is the qualification year).

Portfolio companies may also be principle subsidiaries (a principle subsidiary is a CRC company within its own right ie 6,000 MWh on half hourly meters within one company) which means they will be disclosed separately within an Annex of the published report.

#### Why is CRC harder for Private Equity Groups?

Fundamentally private equity groups do not act like normal groups and do not contain the typical head office function that would administer and organise the CRC process. Add to this that fact that the groups tend to be large, diverse, and would be complex in nature to apply CRC legislation and be a primary target for audits on their CRC disclosures. The following are made more complex by the nature of being a private equity group.

- **Participation** – which companies are included? One large investment in a CRC company will draw all other investments over 50 per cent into the legislation.
- **Data gathering** – potentially information is needed from multiple sources. Who gathers the information (the fund manager?)? Who covers the cost of obtaining the information? How easy will data be available for smaller companies?
- **Forecasting** – if the information is not readily available forecasts must be made this incurs penalties and more audit scrutiny.
- **Compliance** – by their nature there is a higher risk of being audited on their information disclosed to the environment agency. The penalties can be strict and costly.
- **Financial issues**
  - Who actually pays for the allowances? It should be the limited partnership but how will these costs be raised within the investments?
  - Cashflow implications (as raised above) are potentially more acute in smaller companies which could be included with the PE group.
  - Allocation of any revenue recycling payments within the portfolio ie if one firm is doing well but others are not performing how should they be distributed.
  - Inability to reallocate resources from companies that are performing well to ones that are not like would be possible within a normal group.

## JOINT VENTURES, PFI'S, FRANCHISEES, AND FRANCHISORS

In line with the above issues faced by private equity other types of companies need extra consideration.

### Joint ventures and PFI's

The majority owner (>50 per cent) of the joint venture must aggregate the joint venture or PFI within its own organisation for CRC purposes. Where a venture has no single owner with a stake larger than 50 per cent the joint venture is counted as a separate organisation and must assess if it qualifies for the scheme in its own right.

### Franchisees and Franchisors

CRC legislates that franchisors are responsible for all energy use of all franchisees even if the franchisee is owned by another CRC organisation. The same rules apply for franchisors surrounding landlords versus tenants and if the franchisor is a subsidiary of a higher parent.



## CONCLUSION

The Government has finished its third consultation phase with no further changes expected before heading for legislation towards the end of the year. Time has almost run out for lobbying groups to be able to make changes to the law meaning that companies must start planning now to ensure they comply with all the legislation. CRC poses many challenges for large groups/businesses in the UK, some face more than others, which need to be addressed and planned for.



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For further information about the services provided by our Energy and Utilities Group please contact:

**Ian Plunkett** on 020 7893 2628, email [ian.plunkett@bdo.co.uk](mailto:ian.plunkett@bdo.co.uk)  
(Audit and Advisory services)

**Brent Goldman** on 020 7893 2243, email [brent.goldman@bdo.co.uk](mailto:brent.goldman@bdo.co.uk)  
(Transaction Services)

**Michael Ware** on 020 7893 3354, email [michael.ware@bdo.co.uk](mailto:michael.ware@bdo.co.uk)  
(Project Finance: advisory)

**Nick Udal** on 020 7893 2410, email [nick.udal@bdo.co.uk](mailto:nick.udal@bdo.co.uk)  
(Tax services)

[www.bdo.co.uk](http://www.bdo.co.uk)



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