



JONES DAY
COMMENTARY

THE UK CARBON REDUCTION COMMITMENT: THE EXTENSION OF EMISSIONS TRADING IN THE UK

Pursuant to enabling powers introduced under the Climate Change Act 2008, a new system of carbon dioxide emissions trading is set to be introduced into the UK as from 2010. The scheme, known as the Carbon Reduction Commitment ("CRC"), will apply to large non-energy intensive organisations. The scheme is one limb of the UK government's policy to cut carbon emissions by 80 percent by 2050 against the 1990 baseline.

On March 12, 2009, the Department of Energy and Climate Change launched a consultation on the Draft Order to Implement the CRC. As this is the third consultation on the CRC, it seems unlikely that the program will alter substantially from what has been proposed to date. Consultation on the Draft Order closed on June 4, 2009.

WHO MUST PARTICIPATE?

Full trading participation will be required if (a) an organisation has at least one meter settled on the half hourly market; and (b) the total of their half hourly

metered electricity consumption is greater than 6,000 megawatt hours ("MWh") per year during 2008 (about £500,000 per annum).

The CRC will directly affect an estimated 5,000 private and public organisations, including companies that own and occupy large property portfolios such as hotels, retailers, banks and property companies. Governmental organisations, local authorities and hospital trusts will also be affected. The government estimates a further 15,000 organisations on half hourly meters, but below the 6,000 MWh threshold, will also have to participate by providing information on their energy use, although they will not have to buy and sell allowances.

EXEMPTIONS

The CRC will not extend to emissions covered by Climate Change Agreements ("CCAs") or those dealt with under the EU Emissions Trading Scheme ("EU-ETS") which covers the CO₂ emissions of energy-intensive sectors of industry including

power stations, refineries, iron and steel plants, paper and cement. CCAs, like the EU-ETS, cover the energy-intensive sectors of industry. These agreements enable companies to receive up to an 80 percent discount on the Climate Change Levy (which is a tax levied on those who supply energy to non-domestic consumers (subject to exceptions) and subsequently passed onto such consumers) in return for meeting carbon/energy-saving targets. Emissions associated with transportation are also excluded from the CRC.

GROUPS AND SUBSIDIARIES

Special rules will require parent and subsidiary organisations to amalgamate their electricity consumption in assessing whether the CRC applies to them. If they qualify, they will have to participate on a combined basis through the highest parent organisation. The CRC will, therefore, affect non-UK companies with UK subsidiaries. Where the highest parent organisation is a non-UK company, another UK group member may be nominated subject to the agreement of the Administrator¹ of the scheme. Where one of the subsidiaries of the group satisfies the CRC criteria by itself, it is considered a “principal subsidiary” and is subject to further compliance requirements. Each principal subsidiary will need to be declared on registration for the CRC along with a separate report of each of their total energy use emissions figures.

HOW DOES THE CRC WORK?

The CRC scheme will operate by reference to phases and compliance years. It is due to start in April 2010 with a three-year introductory period (“Phase 1”). In April 2011, affected organisations will have to buy allowances to cover their actual energy use during “Year 1”, from April 2010 to March 2011, and their expected energy use for “Year 2”, from April 2011 to March 2012. Reported emissions for Year 1 will set the baseline against which participants’ future performance will be measured. Allowances during Phase 1 will be sold at a fixed price of £12 per tonne of carbon dioxide.

To calculate how many tonnes are emitted and therefore how many allowances are required, an organisation’s total

energy use will need to be calculated from all electricity, gas, oil and certain other fuel sources (not just half hourly electricity). Organisations are advised to consult their energy suppliers, energy bills and meter readings to calculate their total energy consumption. These figures should then be plugged into the CRC registry’s online calculator, where a tonnage of total CO₂ emissions will be provided. Those affected will need to allocate a minimum of £76,000 to buy allowances in April 2011 to cover Year 1 and Year 2, but participants will get most of their money back through the recycling of payments.

LEAGUE TABLES AND RECYCLING

The Government will publish an annual “league table” ranking CRC participants based on their performance for the year. Revenue from the sale of allowances will then be recycled back to the participants (after deducting the government’s administration costs), incorporating a bonus/penalty adjustment of between +10 percent and -10 percent in Year 1, widening annually to reach +50 percent to -50 percent by the fifth year of the CRC, depending on their position in the CRC league table. Organisations that reduce their emissions will feature favourably in the league table and may benefit from a bonus payment. Those that fail to reduce energy consumption may lose money and risk damaging their reputation.

Performance in the league is assessed against certain metrics: (1) an Absolute Carbon Reduction Metric (60 percent of the performance score); (2) an Early Action Metric (20 percent of the performance score) and (3) a Growth Metric (20 percent of the performance score). At the end of first year of the CRC, performance will be judged *only* against the *Early Action Metric*, as (1) and (3) are dependent on data to be collated as part of the scheme. The criteria for the Early Action Metric are (a) the extent that an organisation has installed voluntary automatic metering above and beyond the legal minimum at the end of the first year (including those installed before the start of the CRC); and (2) the percentage of an organisation’s emissions certified under the Energy Efficiency Accreditation Scheme (“EEAS”) or its successor, the Carbon Trust Standard (“CTS”). To the extent a targeted participant of the scheme has not already done so, it would be worthwhile to install as many automatic

¹ For England and Wales, this is the Environment Agency.

meters as possible and seek compliance with the EEAS/CTS now, if an organisation wants to score highly in the league table at the end of the first year of the CRC.

After the first year, metrics (1) and (3) will also kick in, and at the end of Phase 1 the Early Action Metric will fall away. The weighting of metrics (1) and (3) will therefore change to 75 percent and 25 percent respectively. Metric (1) assesses the change in an organisation's emissions against the previous five years' average emissions (or a fewer number of years depending on how long a participant has been in the CRC), while metric (3) measures a participant's change in emissions per unit turnover. This metric recognizes the commercial background of each organisation—for example, where it is expanding but its emissions are increasing at a slower rate. Note that there is a legal requirement only to provide information for the Absolute Metric; however, it is worthwhile disclosing information on the other metrics to ensure the highest score possible is obtained.

CAP AND TRADE PHASES

Following the introductory period (Phase 1) of the CRC, subsequent phases will operate on a cap and trade basis. The government will establish a cap on total carbon dioxide emissions in any year and will then auction an equivalent number of allowances. For all phases and years, participants annually will have to report on emissions and surrender sufficient allowances to cover the amount of carbon dioxide they have emitted. Additional allowances to make good any shortfalls will have to be purchased from other participants or through a "safety valve" scheme via the EU-ETS. Those organisations which have purchased more allowances than their emissions may sell them in the secondary market and make a profit, acting as a further incentive for an organisation to reduce its energy consumption.

TIME TO ACT NOW

In preparation for the CRC, it would be sensible for all potentially affected businesses to allocate responsibility to an individual to list the buildings within an organisation for which it pays the electricity bill and identify all electricity,

gas and oil meters, since the energy used will be part of that organisation's carbon usage. This process for large organisations may take at least six months to complete and should be started now. All organisations with half hourly meters will need to register under the scheme even if they use less than 6,000 MWh annually, but only those that actually use this amount of energy will need to purchase allowances. If an affected organisation fails to comply with the CRC regulations (as currently drafted) it may face financial, reputational and criminal penalties.

REVIEW COMMERCIAL ARRANGEMENTS

Responsibility for the CRC, and how consumption of energy can be reduced by collaborative action, will need to be considered in particular by large commercial property landlords and tenants. Further, those who are party to a franchise agreement will also need to consider their role in the CRC as it may be the case (subject to certain exceptions) that the franchisor is responsible for the franchisee's energy consumption. Landlords and franchisors need to address what provisions should be included or should accompany leases and franchise agreements respectively, to ensure that the potential financial burden and risk to reputation, due to poor performance within the CRC, is addressed. More generally, going forward, the CRC will need to be factored into the due diligence process in all mergers and acquisitions deals.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Chris Papanicolaou

Partner, London

+44 (0)20 7039 5321

cpapanicolaou@jonesday.com

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