TRAVERS SMITH

CRC Energy Efficiency Scheme:

Impact of new rules on private equity and complex group structures

May 2013

As widely reported, the Government confirmed last December that, contrary to speculation, the CRC Energy Efficiency Scheme (the "**Scheme**") will not be scrapped and replaced with a straight carbon tax. Instead, the Scheme is to continue, but in a simplified form. This update summarises some of the key changes, with particular focus on how these changes will impact private equity and more complex group structures as well as issues to watch on transactions.

In March 2013, the Government published the draft CRC Energy Efficiency Scheme Order 2013 (the "New Order") (available here), which will replace the CRC Energy Efficiency Scheme Order 2010 (the "2010 Order").

The Government expects that the reforms set out in the New Order will result in a reduction in administrative costs for participants equal to around £272 million by 2030.

A NOTE ON TERMINOLOGY

Under the New Order, the phases of the Scheme have been renamed, so that Phase 2 will now be known (somewhat confusingly) as the "initial phase". For the purposes of this briefing we have continued to refer to the next phase of the Scheme, which begins on 1 April 2014, as Phase 2.

KEY CHANGES – AN OVERVIEW

The key changes to the Scheme which will be implemented by the New Order include:

- The **qualification rules** will be simplified, so that only supplies of electricity through settled half-hourly meters will be counted in assessing whether an organisation meets the qualification criteria for Phase 2. The 6,000MWh qualification threshold (equivalent to an annual electricity bill of around £500,000) has been retained.
- The number of **fuels covered** by the Scheme has been reduced from 29 to 2 (electricity and gas used for heating). This change will apply to the last two compliance years in Phase 1, as well as in Phase 2 of the Scheme.
- There is a new **2% de minimis threshold for gas**, reducing the reporting burden for organisations with very low levels of gas consumption. The requirement under the 2010 Order to prove that at least 90% of an organisation's emissions are regulated (either by the CRC or by other climate change legislation) will be abolished.
- In Phase 2, there will be **two fixed price sales of allowances in each year**: one forecast sale and a second "buy-to-comply" sale, which will be at a higher price. The dates for the sales of allowances in Phase 2 are not yet known and further regulations on this are expected in due course. The Government has previously announced that the price of allowances will increase from £12 per tonne of CO_2 in 2013-14 to £16 per tonne of CO_2 in 2015-16, and will then increase annually in line with the Retail Prices Index. The date for surrendering allowances in each compliance year will be extended from the end of July to the end of October.
- Participants will be required to **retain data for 6 years** from the end of the relevant Scheme year, reducing the burden of data retention.
- There will be **greater flexibility for disaggregation**, to allow organisations to separate out into natural business units for compliance and reporting purposes (this is discussed further below).
- The rules relating to **large acquisitions and disposals will be simplified** (this is discussed further below).
- The rules relating to the **treatment of trusts** holding real property will be clarified.
- There will be a **reduction in overlap** with other climate change legislation.

Of note, the Government has announced plans to review the effectiveness of the Scheme again in 2016, so further changes are likely.

WHERE ARE WE NOW? TIMELINE FOR PHASES 1 AND 2

Under the New Order, Phase 2 of the Scheme will run from 1 April 2014 to 31 March 2019. However, before that each organisation will need to assess its electricity usage during the period 1 April 2012 to 31 March 2013 to establish whether it qualifies for Phase 2.

Changes to the qualification criteria and supply rules, as well as any changes to group structures that may have taken place since the beginning of Phase 1, could mean that some participants in Phase 1 of the Scheme find that they now fall below the qualification threshold and will not be required to participate in Phase 2. Conversely, organisations that did not qualify for Phase 1 may now be caught. The Environment Agency has published guidance on assessing qualification for Phase 2, which can be accessed here.

When assessing whether an organisation qualifies for the Scheme, electricity usage must be calculated on a group-wide basis, with subsidiary undertakings grouped together under their highest parent undertaking for these purposes. Whether an undertaking is part of a group must be assessed as at 31 March 2013 (the last day of the qualification year for Phase 2).

The Environment Agency has indicated that the registration window for Phase 2 of the Scheme will open on 1 October 2013, and organisations must register to participate in Phase 2 by 31 January 2014.

A timeline setting out the key dates for the remainder of Phase 1 and the early years of Phase 2 of the Scheme is set out in the Appendix to this briefing.

PRIVATE EQUITY – DISAGGREGATION OF PORTFOLIO COMPANIES

A key change to the Scheme for private equity firms, which has been broadly welcomed by the private equity industry, will be the new ability for participants to disaggregate portfolio groups to allow them to participate in the Scheme in their own right.

Any subsidiary (or group of subsidiaries) can apply for disaggregation; there is no longer any minimum threshold and disaggregation is permitted even where the remainder of the group will fall below the qualification criteria as a result. Of note, if the remainder of the group falls below the qualification criteria following the disaggregation of a subsidiary (or subsidiaries), it will still be required to participate in the Scheme for the rest of the relevant Phase.

A clear advantage of disaggregating portfolio companies in this way for private equity firms is that the portfolio groups will be responsible for their own compliance with the Scheme, including the cost of purchasing allowances. Furthermore, the entities in the remaining group will no longer be jointly and severally liable for the disaggregated entities' compliance or emissions once disaggregated.

Under the New Order, an application for disaggregation must be made by the last working day of April in the year following the registration of the wider group. The New Order is slightly unclear in this respect (it is arguable that in Phase 2, "the following year" could mean April 2014 or April 2015, depending on when registration of the wider group takes place) and we are awaiting guidance from the Environment Agency which should confirm this deadline for disaggregation.

Previously, the Government had announced that disaggregation would be allowed annually throughout each Phase. However, there is nothing in the New Order to reflect this and it is hoped that any further guidance will also clarify this point.

ACQUISITIONS AND DISPOSALS – ISSUES TO WATCH

A target's (and its wider group's) CRC status should always form part of due diligence on any acquisition. We have had a number of recent experiences of CRC compliance issues impacting deal pricing as well as changing the CRC status of the acquiring entity.

The New Order introduces the concept of a "Participant Equivalent" which is a single undertaking which would have met the qualification criteria on its own, were it not part of a larger group.

When acquiring a Participant Equivalent, the buyer will assume responsibility for its emissions for the whole of the compliance year (i.e. both historical and future emissions) and the cost of allowances for the pre-completion period should therefore be factored into the purchase price (if the necessary allowances haven't already been purchased and are to transfer with target). On the sale of any other subsidiary, the seller will remain liable for the subsidiary's CRC compliance up to completion, with the buyer taking on responsibility from the completion date.

CARBON REPORTING – OTHER DEVELOPMENTS

As well as changes to the Scheme, there have been recent developments on carbon reporting: in particular, the new mandatory carbon reporting rules for companies listed on the London Stock Exchange (premium or standard), other EEA regulated markets or the NYSE or NASDAQ (click here for our July 2012 briefing on this issue).

The Government's target under the Climate Change Act 2008 to reduce CO_2 emissions by 80 per cent. by 2050 means that additional regulation in this area is likely.

HOW WE CAN HELP

Travers Smith has experience on a range of CRC issues, including:

- analysing group, fund and/or trust structures to determine participant group boundaries;
- disaggregation;
- registration, information disclosure and auditing;
- due diligence and provisioning in transactions; and
- compliance and regulatory defence.

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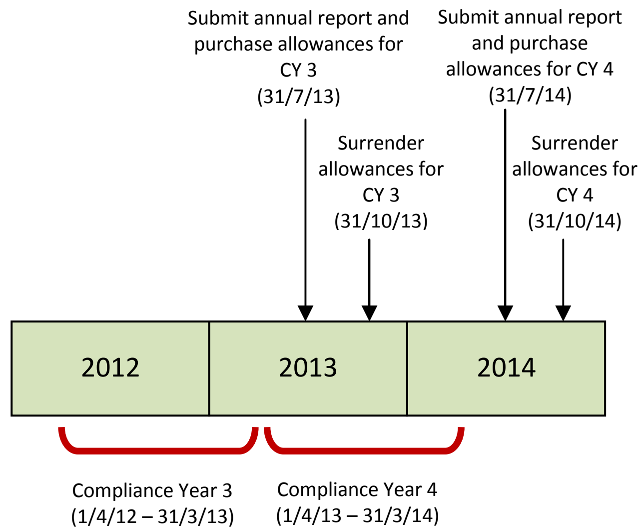
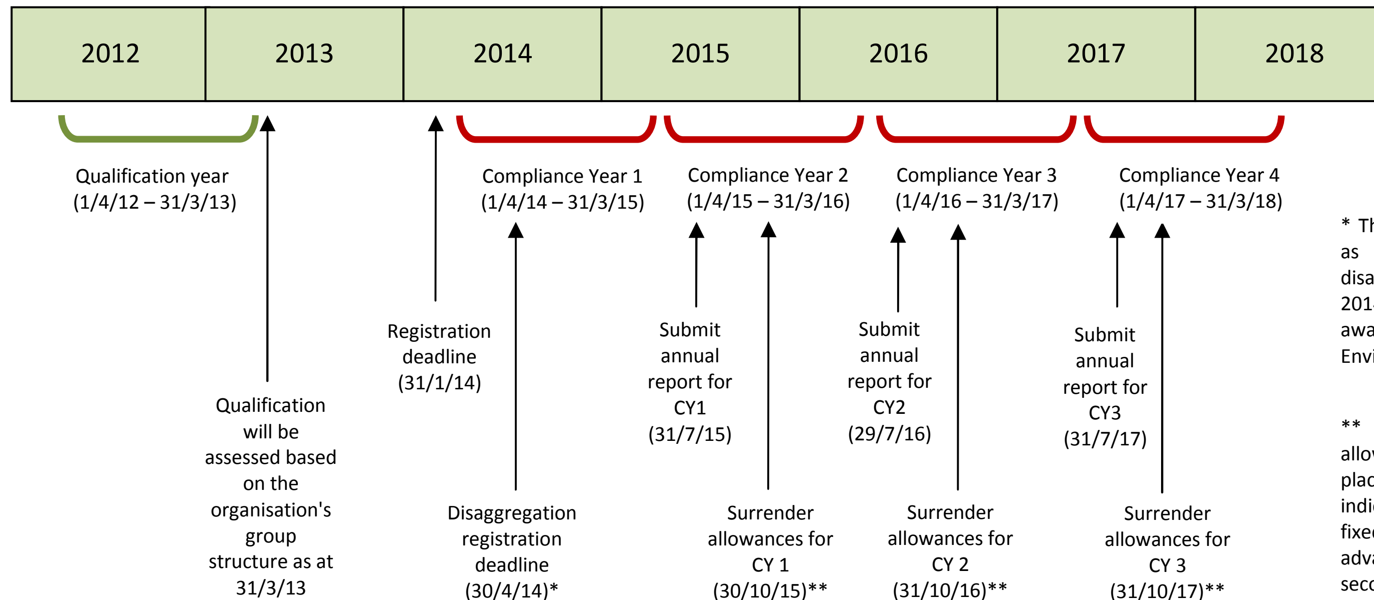
APPENDIX - CRC TIMELINE, PHASES 1 AND 2

PHASE 1



PHASE 2



* The New Order is slightly unclear as to when the deadline for disaggregation falls (i.e. 30 April 2014 or 30 April 2015). We are awaiting further guidance from the Environment Agency in this regard.

** It is not yet known when the allowance sales in Phase 2 will take place. The Government has indicated that there will be two fixed price sales in each year: an advance lower price sale and a second higher price sale.