

## Private (business) sector organisational rules of the CRC Energy Efficiency Scheme

### Introductory Notes

- In the light of feedback about the operation of the CRC scheme, the Government is considering simplification of the CRC. In doing so, Government will take into account feedback from stakeholders including:
  1. The effectiveness of the framework for driving energy efficiency in large private and public sector organisations, in the light of wider policy developments in other areas such as the implementation of a carbon price floor<sup>1</sup>, electricity market reform<sup>2</sup>, implementation of a Green Deal for business<sup>3</sup> and the review of Climate Change Agreements<sup>4</sup>, and company reporting of greenhouse gas emissions<sup>5</sup>.
  2. The complexity of the CRC scheme and hence the need to reduce the administrative burden on:
    - those organisations which are subject to the scheme; and
    - the administrators of the scheme (Environment Agency, Scottish Environment Protection Agency, Northern Ireland Environment Agency).
  3. Optimising the projected emissions savings attributable to the CRC scheme<sup>6</sup> due to an increased focus on energy efficiency by the target sectors.
- This is one of a series of discussion papers which aim to stimulate an informal dialogue between Government and participants about the simplification of the CRC Energy Efficiency Scheme. As such, this paper is not a statement of Government policy.
- These papers have been developed on the basis of feedback from participants about the operation of the scheme since April 2010. Ideas for simplification arising from this dialogue process will help inform consideration for amendment to the current legislation underpinning the scheme. Any formal legislative proposals would be subject to public consultation with the intention that they would come into force through affirmative Orders in Council before registration for the second phase of the scheme begins in April 2013.

<sup>1</sup> [http://www.hm-treasury.gov.uk/consult\\_carbon\\_price\\_support.htm](http://www.hm-treasury.gov.uk/consult_carbon_price_support.htm)

<sup>2</sup> <http://www.decc.gov.uk/en/content/cms/consultations/emr/emr.aspx>

<sup>3</sup> [http://www.decc.gov.uk/en/content/cms/legislation/energy\\_bill/energy\\_bill.aspx](http://www.decc.gov.uk/en/content/cms/legislation/energy_bill/energy_bill.aspx)

<sup>4</sup> [http://www.decc.gov.uk/en/content/cms/what\\_we\\_do/lc\\_uk/ccas/ccas\\_policy/ccas\\_policy.aspx](http://www.decc.gov.uk/en/content/cms/what_we_do/lc_uk/ccas/ccas_policy/ccas_policy.aspx)

<sup>5</sup> <http://www.defra.gov.uk/environment/economy/business-efficiency/reporting/>

<sup>6</sup> Projected savings attributable to the CRC are outlined in Annex G of the June 2010 DECC energy and emissions projections.

- It is essential that all participants continue to comply with the existing scheme, in full, as set out in the current legislation. The CRC remains a mandatory scheme, and the Environment Agency and other administrators continue to provide support to participants with their CRC compliance. Organisations who fail to comply may be subject to enforcement action and civil penalties. Participants should continue to fully comply with the scheme and use the introductory phase to gain experience on reporting, complying and surrendering allowances in CRC. For advice and support on compliance with the first phase of the CRC scheme participants should refer to the CRC Energy Efficiency Scheme Order 2010<sup>7</sup> and Environment Agency guidance.<sup>8</sup>

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<sup>7</sup> [http://www.opsi.gov.uk/si/si2010/draft/ukdsi\\_9780111491232\\_en\\_1](http://www.opsi.gov.uk/si/si2010/draft/ukdsi_9780111491232_en_1)

<sup>8</sup> <http://www.environment-agency.gov.uk/business/topics/pollution/98263.aspx>

## Issue

Feedback from participants has identified the organisational rules and definitions underpinning the scheme as an area where simplification should be considered.

This paper discusses and invites views and contributions on:

1. Participants' experience of the organisational rules of the scheme during the 2010 registration period; and
2. Potential options for revisiting the organisational rules in order to simplify them, whilst ensuring that the environmental benefits of the scheme are protected and that the current level of coverage is retained.

## Background

The CRC Energy Efficiency Scheme (CRC) aims to drive energy efficiency in large public and private sectors organisations in the UK. The aim of the CRC is to tackle barriers to the uptake of energy efficiency in large organisations. These include: insufficient financial incentives to reduce emissions; uncertain reputational benefits of demonstrating leadership; split incentives between landlords and tenants and organisational inertia.

An energy threshold approach for entry into the scheme was adopted to focus the CRC on larger public and private sector organisations with significant energy use (over 6,000 MWh per year of electricity use). The focus on large and often complex organisational structures warranted the development of a set of organisational rules to determine how organisations should participate in the scheme.

Analysis of organisational structures undertaken during the policy formulation phase of the CRC<sup>9</sup>, coupled with public consultations, informed the development of the organisational rules which exist in the CRC today. During the policy formulation phase of the scheme, organisational rules for the private sector were developed following the guiding principles outlined below:

- Ensure that the scheme captures a wide range of large organisations to provide extensive coverage of emissions;
- Whenever possible align the emissions responsibility with the energy user;
- Be legally robust and enforceable;
- Use existing company law;

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<sup>9</sup> Burges Salmon/Ecofys, 'Carbon reduction Commitment – Organisational Structure': <http://www.decc.gov.uk/assets/decc/what%20we%20do/a%20low%20carbon%20uk/crc/policy/organisational-structure.pdf>

- Be flexible enough to accommodate major business changes during each phase of the scheme;
- Ensure that the scheme obtained Board level engagement;
- Minimise, where possible, administrative burden for participants; and
- Accommodate a range of organisational structures, including joint ventures, franchises, trusts and private equity/venture capital funds.

### **What are the organisational rules underpinning the CRC scheme?**

Organisational rules for undertakings are set out in part 2, chapter 4 of the CRC Order. The definitions of undertakings and significant group undertakings (SGUs) are set out in Schedule 4. Rules on changes to participants that are undertakings are set out in Schedule 6, part 3. These rules are explained further in Environment Agency Guidance<sup>10</sup> and are summarised in Annex 1.

In addition, sections 1 to 5 of Schedule 1 to the Order sets out what counts as a supply for the purpose of qualification. They also set out other specific rules in relation to franchise agreements and landlord/tenant relationships.

### **Your views on the organisational rules?**

During the policy formulation phase of the CRC, consultees were broadly supportive of adopting an approach to define qualification for and participation in the scheme based on organisational rules using Companies Act 2006 definitions<sup>11</sup>.

Since the beginning of the operational phase of the CRC, feedback from a number of participating organisations has shown that they would be content with retaining the existing organisational rules now that registration for phase one is complete. However, other organisations have flagged a number of difficulties with the organisational rules which, in their view, should be addressed. The particular issues which have caused difficulty include:

- Determining the group structure and highest parent, particularly when there are large and complex structures (e.g. joint ventures) has led to unanticipated levels of administrative burden for some organisations.

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<sup>10</sup> 'Am I in? A guide to qualification and organisational structure': <http://publications.environment-agency.gov.uk/pdf/GEHO0410BSGK-e-e.pdf>. Further guidance on: organisational change; CRC and franchises; CRC and trusts; CRC and private equity funds; CRC and PFIs - is available at: <http://www.environment-agency.gov.uk/business/topics/pollution/117436.aspx>

<sup>11</sup> See Annex 1. The CRC draws on the Company Act 2006, sections 1161 and 1162, and Schedule 7, to define 'undertaking' and to define the relationships within the group. Specifically, the definition of 'group undertaking' is set out in section 1161(5) of the Act. See the Companies Act 2006 - <http://www.berr.gov.uk/bbf/co-act-2006/index.html>.

- Where the highest parent is an overseas entity, the requirement to nominate a UK member of the group as the compliance account holder has caused significant administrative burden and practical complexity for some organisations, particularly where the UK companies have no common UK parent.
- For some organisations, the requirement to participate in the scheme as a group and to allocate responsibility for compliance with a member of the group may not align with existing energy management structures, in particular where legal ownership and management responsibilities are separate.
- Identifying the group structure for trusts and some private equity funds.
- The concept of Significant Group Undertakings (SGUs) and designated changes do not capture a number of important business changes (e.g. transfer of significant assets) which may impact on performance league table positions.

We would welcome views on your experience to date of the operation of the organisational rules underpinning the scheme. For contact details about sending your views to us, please see the section 'Contributing to the dialogue'.

### **Conceptual options for simplifying the CRC organisational rules**

In the light of feedback to date, we are seeking proposals on simplifying the organisational rules underpinning the scheme, but in a way that ensures that any new set of simplified rules still meet the guiding principles outlined in the 'Background' section of this paper.

Annex 2 of this paper suggests a number of conceptual options for simplifying the organisational rules in CRC. Please note that these conceptual options are not a statement of Government policy and we have no preferred option for simplification. Rather, they serve to stimulate a dialogue between Government, CRC participants and other interested parties on approaches to simplifying the CRC organisational rules.

A detailed consideration of these and further options will be undertaken in light of the evidence gathered as part of this dialogue, emissions data submitted by organisations in July 2011 and other sources of evidence.

We would welcome your comments and views on these options and the points for further consideration arising from them.

In addition, we would welcome proposals you may have for wholly new options

for simplifying the organisational rules underpinning the scheme. Should you wish to propose wholly new options, we would be grateful if you could outline how the suggested approach would meet the guiding principles outlined in the 'Background' section of this paper.

For contact details about sending your views to us, please see the section 'Contributing to the dialogue'.

### **Contributing to the dialogue**

If you would like to submit written views on simplifying this aspect of the CRC scheme, or if you would like to make wider comments and suggestions about the scheme as a whole, please send your comments to [crc@decc.gsi.gov.uk](mailto:crc@decc.gsi.gov.uk) or CRC Team, National Carbon Markets, Department of Energy and Climate Change, 3 Whitehall Place, London, SW1A 2AW) by 11<sup>th</sup> March 2011.

## **Annex 1 – Summary of the current organisational rules<sup>12</sup>**

### ***Definition of a participant – grouping under the highest parent***

Qualification under the CRC for private sector undertakings is assessed at group level, defined on the basis of Companies Act 2006 definitions of parent and subsidiary relationships within the group, as set out in section 1161(5) of the Act. Subsidiary undertakings will be grouped together under their highest parent undertaking, the tests to determine the parent undertaking being set out in section 1162 and Schedule 7 of the Companies Act. The members of the group of undertakings have joint and several liability in relation to compliance with CRC. The highest parent will be the default account holder for the purposes of CRC on behalf of the group, unless the group nominates another member of the group to hold the account.

Undertakings are as defined for the purposes of the order by section 1161(1) of the Companies Act 2006 and as if that definition included an unincorporated association which carries on a charitable activity.

The group so determined is classified as the CRC participant and reports emissions and buys allowances for all the relevant operations of the parent and subsidiaries, and appears in the Performance League Table as a group (unless it has chosen to disaggregate significant group undertakings (SGUs))<sup>13</sup>.

### ***Disaggregation of SGUs***

The participant can nominate a subsidiary that would qualify for CRC in its own right to participate in CRC separately, as set out in article 25 of the CRC Order. This can only be done as part of the registration process or when a 'designated change' occurs (see next section). Any disaggregation which results in the parent falling below the qualification threshold of 6,000MWh qualifying electricity is not permitted.

If the SGU consents to this separate participation, and registers accordingly, it is treated as a separate participant for the phase and will be required to comply with the same obligations as any other participant. Joint and several liability between the original group and a disaggregated SGU does not apply.

### ***Designated changes***

Designated changes rules are set out in Schedule 6, part 3 of the CRC Order. These rules act to transfer responsibility for participating in CRC with the sale, purchase or divestment of an SGU or a participant. Responsibility is transferred with effect from the start of the compliance year in which the change takes

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<sup>12</sup> See the CRC Order 2010 : <http://www.legislation.gov.uk/ukxi/2010/768/contents/made>. For policy background see also the March 2009 consultation document , Government response and Addendum to the Government response : <http://www.decc.gov.uk/en/content/cms/consultations/crc/crc.aspx>

<sup>13</sup> Defined in Schedule 4 paragraphs 2 and 4

place. Baselines for both parents for the purposes of the league table are updated in the league table to reflect the change.

These rules were designed to allow flexibility during a phase where groups change their structure (ie subsidiaries are bought and sold), whilst avoiding the administrative burden for businesses and the administrator to account for site-based 'changes of operation'. In these cases (eg selling small subsidiaries or any assets), business changes are not considered 'designated changes'. Participants must record these changes in the evidence pack and report emissions from assets or small subsidiaries in annual reports for the period for which they were part of the group.

### ***Overseas parent***

Where a group qualifies for CRC but its parent is based overseas<sup>14</sup>, it must nominate a UK based undertaking member of the group to register as the compliance account holder.

### ***Franchise Agreements***

Special rules apply to franchise agreements, where the Order allocates the responsibility for energy supplies to franchisees to the franchisor in order to achieve specific policy objectives. The rules are contained in Schedule 1, section 3.

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<sup>14</sup> Only electricity supplied within the UK is used to calculate qualification and only emissions within the UK must be accounted for under CRC.



## **Annex 2 – Discussion of potential conceptual options for the simplification of organisational structure rules in CRC**

- The conceptual options discussed in this Annex represent a spectrum of possible ways forward that have emerged from previous feedback and as such, they are not statements of Government policy. We collated them in this paper for consideration by a larger group of stakeholders and as an aid to stimulating further consideration of potential ways to simplify the organisational rules underpinning the scheme. They range from options which involve retaining the bulk of the existing organisational rules framework, to options where fundamental changes to the existing rules are considered.
- Suggestions and proposals for other conceptual options for changing the organisational rules of the scheme are welcome.
- It is recognised that some options may be more workable for certain types of organisations than others (eg incorporated structure versus non-incorporated). We have identified an initial list of issues, but have not performed a full analysis of the implications and whether these ultimately lead to a simplification of current rules across the board. We are aiming at gathering evidence during the course of the dialogue process to investigate the implications of a range of options for a number of different organisational types. This may involve holding separate discussions for particular types of private sector organisational structures (for example, franchises or where assets are held in a fiduciary capacity).

### **Option 1 – Retain current rules to determine groups for qualification purposes – with option to disaggregate any undertaking in the group for participation**

Under this option, the current rules for qualification would be retained. This means that organisations with one or more half hourly meters (HHMs) would have to group under their highest parent undertaking to assess whether the group qualifies for CRC. Disaggregation from the group would then be permitted for undertakings within the group at any level of electricity consumption, possibly subject to a *de minimis* rule (this approach extends the current rules whereby only 'significant group undertakings' can be disaggregated and participate independently in the scheme).

To allow further flexibility under this option, the current requirement for the disaggregation to be permitted only where the remainder of the participant does not fall under the qualification threshold would be removed.

Disaggregated undertakings would then be required to register and participate in their own right for the length of the phase. As such, they would submit their own yearly reports to the scheme administrator, appear independently in the

Performance League Table and purchase their own allowances to cover their emissions.

The decision to disaggregate a subsidiary is a business decision and Government could allocate the option to disaggregate to the highest parent, the undertaking that registers as the participant or the undertaking that wishes to disaggregate.

This option may warrant the extension of designated changes rules (Schedule 6, part 3) to account for changes to participants' structure, thus expanding current rules that accounts for designated changes for SGUs only.

The rationale for this approach is that it:

- Potentially allows participation at a level that is more closely aligned with natural business units and hence that more closely mirror the way in which energy is measured and managed within corporate structures.
- There is minimal emissions loss from the scheme.
- It addresses issues with nominating an account holder in the UK when there is an overseas parent and no UK parent subsidiary.

Issues to consider in relation to this option:

- Effect of the option on the Performance League Table.
- Consider liability issues to ensure this option does not lead to avoidance of liability for participants and an excessive administrative burden for enforcement on the administrators of the scheme.
- The extent to which this option would be taken up given that not many SGUs have disaggregated in phase one.
- Even if disaggregation would be optional, participation costs of organisations may increase as smaller organisations would be registering, reporting on their energy use and purchasing allowances.
- Consider to which party to give the option to disaggregate so that it does not create a burden for the group, group members and the administrators.
- Participation by smaller parts of groups may reduce the benefits realised by sharing of energy management expertise across a group as a whole.
- Revision of rules on designated changes within a phase to reflect the flexibility provided under this option.
- Provisions may be included that allow flexibility for participation in the scheme where assets are held in a fiduciary capacity (see option 4).

## **Option 2 – Bottom-up approach for qualification, with optional grouping for participation**

Under this option, qualification for the scheme would be assessed at single undertaking level, where an undertaking is defined in accordance with the current Order. Thus, the need to adopt a highest parent undertaking approach would be removed. In order to maintain emissions coverage it is likely that this option would need to be coupled with a lower qualification threshold for the scheme.

In order to enable participation at the level where compliance under the scheme would be administratively easier to a group and to exploit energy management structures in place, organisations would be allowed to 'aggregate up' to higher structures within their group for the purposes of compliance. In such cases, an undertaking within the group would be nominated for registration purposes and liability would be joint and several across the structure participating as a group.

This option may warrant the revision of designated changes rules (Schedule 6, part 3) or their replacement with the introduction of, for instance, rolling registration (e.g. annual registration).

The rationale for this option is that it:

- Allows participation by entities which are more closely aligned with natural business units and hence more closely mirror the way in which energy is measured and managed within corporate structures.
- Would remove burdens for some groups associated with working out top parent undertaking relationships.
- Permits undertakings to decide how to group themselves.

Issues to consider in relation to this option:

- Effect of the option on the Performance League Table.
- A lowering of the threshold would potentially extend the coverage of the scheme to include organisations which are not participating in phase one. The level of any lowered threshold would have to be considered to ensure that compliance costs on 'new entrants' would not be disproportionate.
- Participation costs of organisations may increase as single undertakings would be registering, reporting on their energy use and purchasing allowances.
- Participation by smaller parts of groups may reduce the benefits realised by sharing of energy management expertise across a group as a whole.
- New designated changes rules may have to be considered to cope with business changes.
- Provisions may be included that allow flexibility for participation in the scheme where assets are held in a fiduciary capacity (see option 4).

### **Option 3 – Group structure determined following accounting rules**

Under this option, qualification and participation would be determined on the basis of groups as determined by accounting rules. Responsibility for compliance with CRC would be placed on the parent company that consolidates accounts for the group and the company itself.

Under this option section 1162 of the Companies Act 2006 would be used to define the scope of a group, and accounting methods would be used to

determine how consolidation applies to different types of organisational structures<sup>15</sup>.

The rationale for this option is that it:

- Would be based on current business practice to determine business structures and reflect the approach used to define financial reporting.

Issues to consider in relation to this option:

- Ensure there is no carbon leakage from the scheme or double counting.
- Implications of allocating supplies to multiple parents according to their percentage shareholding and interaction with current Joint Ventures (JV) rules.
- Treatment of entities that are exempted from the requirement to prepare accounts and of the ability to report separately (so no consolidation is required).
- Potential loss of emissions resulting from differences in determining groups under accounting rules, which may warrant lowering emissions threshold in order to maintain current emissions coverage. This would potentially extend the coverage of the scheme to include organisations which are not participating in phase one. The level of any lowered threshold would have to be considered to ensure that compliance costs on 'new entrants' would not be disproportionate.

#### **Option 4 - Provisions for assets held in a fiduciary capacity**

New provisions would seek to address the treatment of assets held in a fiduciary capacity under the Order. These new provisions could be applied alongside current rules to determining the group under CRC, with conceptual options set out in this paper or other options.

We could explore different options to define the appropriate level at which participation could operate. Government welcomes views on options for achieving this.

The need for any such provisions would need to be considered in line with discussions on responsibility of supply (see separate paper on 'Review of the CRC supply rules'<sup>16</sup>).

The rationale for considering this option is that it:

- Would help avoid the potential for directing responsibility for these emissions to a party that is not best placed to influence energy management.
- Would logically align CRC drivers without significant emissions loss.
- Would respect the separateness of individual trusts.

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<sup>15</sup> See also current rules to determine organisational boundaries in Defra's GHG voluntary reporting guidance: <http://www.defra.gov.uk/environment/economy/business-efficiency/reporting/>

<sup>16</sup> See 'Review of the CRC supply rules' paper at: <http://www.decc.gov.uk/crc>

Issues to consider in relation to this option:

- Devising robust legal definitions to clearly delineate legal structures that hold assets in a fiduciary capacity.
- Devising robust legal definitions that address perceived shortcomings of current rules without providing a loophole for these legal structures.
- There may be an emissions loss depending on how we define the rules around this provision.
- How we determine who the asset in trust belong to if they are held as investment for numerous owners.
- Consider whether separate provisions are needed for private equities.

**Option 5 - Replace the overseas top parent rule with a UK top parent rule**

Under this option, the requirement for organisations to group together with their overseas parent and for the highest overseas parent to nominate a UK based group member to be the organisation's compliance account holder would be removed.

In these circumstances, organisations would group under their highest parent in the UK (or participate as single undertakings if they are not part of a group of undertakings) for the purposes of qualification and participation in CRC.

This option could be applied either in combination with current organisational rules or with option 3 in this paper.

In order to maintain emissions coverage it is likely that this option would need to be coupled with a lower qualification threshold for the scheme. Alternatively, Option 1 provides a level of flexibility that should address the issues linked to overseas parents without the need to consider lowering the threshold, whilst Option 2 tackles the issues, but it would warrant a revision of the threshold.

The rationale for this option is that it:

- Removes the administrative burden associated with the requirement for organisations to engage with their overseas parent to determine qualification under CRC.
- It would remove the burdens for a nominated UK undertaking to register as the participant on behalf of the group, particularly where the UK members of the group have no common UK parent.

Issues to consider in relation to this option:

- Loss of emissions coverage from small multiple undertakings which are currently covered by the group owned by the same overseas parent or emissions loss from the parent undertaking itself. Thus with this option the qualification threshold may need to be lowered.
- Questions of equity regarding the treatment of entities owned by UK parents and those owned by overseas parents.

## Option 6 – Review of designated changes

We are willing to consider whether designated changes should be changed to be more reflective of the way businesses' operate/ are structured.

Options outlined in this document may address some of these issues and warrant a review of designated changes rules. A review of designated changes will be considered as part of each option. In addition, the following potential options could be considered, either to be applied in combination with current organisational rules or with conceptual options set out in this paper. In order to minimise the additional burdens for businesses, the following could be considered:

- a) In order to capture more emissions, remove the use of the SGU concept in the context of designated changes (note that option 1 and 2 would naturally involve the removal of the SGU concept and as such the need for designated changes for SGUs);
- b) In order to capture more emissions in designated changes, when deciding the re-baseline, do so when x% of an organisation's energy use is transferred and acquired, as opposed to transferring SGUs.

The rationale for this option is that it:

- Would respond to feedback from some participants who believe that the existing designated changes rules should be updated so that the effect of the transfer of assets can also be captured in considerations of energy efficiency when organisations change.

Issues to consider in relation to this option:

- Designated changes should capture business changes in a way that is not excessively administratively burdensome for participants and for the scheme administrators.

The options should not be seen as exhaustive rather are based on feedback already received from interested parties. Government welcomes views on other options and variations on the options above.