

All Change for CRC...

Just as you thought you were beginning to grasp the complexities of the CRC Energy Efficiency Scheme (which came into force in April this year under the CRC (Energy Efficiency Scheme) Order 2010), it has already been subject to fundamental reform. Recycling payments are to be scrapped and the purchase of the first allowances delayed by a year.

Arguably the writing was on the wall when the Climate Change Committee, tasked with advising the Government on the level of the cap on allowances to be imposed in the second phase of the Scheme, issued a report in September stating that the introduction of an auctioning process and a cap on allowances would add complexity to an already complex Scheme. The Committee's report analysed three options for reform. It would appear that the coalition Government, in its Comprehensive Spending Review, published this Wednesday (27 October), has cherry-picked the most fiscally attractive measure from the Committee's report, perhaps without heeding the calls for more fundamental reform.

The Scheme, Pre-Reform

The first phase (known as the Introductory Phase) of the Scheme runs from 1 April 2010 to 31 March 2013. During this time allowances will be sold by the Government on 1 April in 2011 and 2012. Participants must purchase allowances based upon their forecasted carbon emissions for the following Scheme year. The price will be fixed at £12 per tonne of CO₂ and an unlimited number of allowances may be purchased. If a participant fails to buy sufficient allowances in the fixed price sale, then they can purchase additional allowances in the secondary market from other Scheme participants. The Scheme features a 'safety valve' which allows participants to request allowances from the Scheme administrator if prices on the secondary market become too high.

1 April 2013 marks the start of the Capped Phases, so called because allowances will be sold at auction, with a diminishing number of allowances available over time. It was intended that these limits would be based on emissions data gathered from the Introductory Phase and guidance from the Climate Change Committee. Pre-reform, organisations which have been energy efficient would have received a "recycling payment" from the Scheme administrator, based on their performance in reducing emissions, as shown by their position in a league table compiled by the Scheme administrator.

Background

The CRC Energy Efficiency Scheme (the "Scheme") is a mandatory emissions trading scheme designed to cut the carbon emissions of large commercial and public sector organisations. The Scheme will achieve this by simple economics; restricting the supply of carbon allowances ("capping") will increase their scarcity and price and thus incentivise Scheme participants to become more energy efficient. The CRC Energy Efficiency Scheme Order 2010 came into force on 1 April 2010 and it is estimated that around 5,000 organisations will be likely to participate in the Scheme.

The Climate Change Committee's Recommendations

The Committee's report set out three alternative options for the re-design of the Capped Phases:

Option 1 – Minimum Price for Allowances

Allowances are sold at auction as planned, but a floor, as well as a cap, is set on the price. Providing a minimum price for allowances is intended to mitigate the risk of a crash in the

price of allowances. The Committee rightly pointed out that the safety valve is intended to avoid a price spike, but the current Scheme design does not legislate for a situation where the cap is set at too high a level, resulting in a drop in the price of allowances. Whilst the report set this out as an option, it did not actively recommend pursuing it as this would leave the auction process largely intact and unreformed. The report was openly critical of the perceived benefits of a capped scheme and stated that there is no real evidence that such benefits would outweigh the additional cost to the Government of the complexities in administering it.

Option 2 – Scrap the Auction

Replace the auction with unlimited allowances sold at a fixed price, as for the Introductory Phase. The Committee noted that one of the apparent benefits of shifting to a capped scheme is that there would be greater confidence in the UK's ability to meet EU emissions targets. However, the Committee pointed out that this level of confidence could be achieved using the same design as the Introductory Phase of the Scheme, but with Government setting an emissions target for the Scheme and utilising some of the funds it raises from the sale of allowances to cover any shortfall.

Option 3 – Fundamental Reform of the Scheme

The Committee's most drastic proposal was to reform the Scheme either through the abolition or reformation of revenue recycling payments or, more fundamentally, by replacing the purchase of allowances altogether with strengthened financial incentives under other instruments, such as the Climate Change Levy. In the latter case, the Committee suggested CRC could be redesigned simply as a scheme providing only reputational incentives through mandatory reporting and the League Table.

Focussing on recycling payments, the Committee acknowledged that there is currently uncertainty as to how they will be passed back to participants (and this is particularly true for large institutional landlords who receive contributions from their tenants) and that further evidence is required as to the efficacy of such incentives in actually increasing energy efficiency amongst participants. The report noted the obvious revenue benefit for Government in dropping recycling payments, but notably was uncertain as to how this would impact on incentives for energy efficiency improvement. Additionally, there is no guidance in the report on how the additional revenue should be utilised.

The Committee's Recommendation

The only change that the Committee recommended was that the second phase of the Scheme is based on unlimited availability of allowances at a fixed price, as set out in Option 2. That, it said, would reduce the costs and complexities which a capped scheme would necessarily have introduced, whilst maintaining financial and reputational incentives. It also reiterated that there is insufficient evidence to suggest that a capped scheme would increase certainty as to emissions reductions.

The Government's Response

The Comprehensive Spending Review states that the Scheme will be simplified to "reduce the burden on businesses", with the first sale of allowances now taking place in 2012 rather than 2011. Revenues from allowance sales (which the Government believes will total £1bn per annum by 2014-2015) will be used to support public finances, rather than being recycled back to Scheme participants. This is a dramatic shift from the original Scheme design, which was intended to be fiscally neutral from the Government's perspective.

It is true that the administrative burden on participants will be reduced by dropping recycling payments, although of course the cost burden on participants will increase significantly, especially for those who make payments under the Climate Change Levy and are members of the EU Emissions Trading System, who may in effect be paying multiple carbon taxes. The Government's response to the advice in the Climate Change Committee's report is not surprising in the light of the radical changes to public spending and its commitment to cutting the nation's deficit.

However, the move is likely to be unpopular with business, not just because it is a new green tax, but also because there is as yet very little detail in the Spending Review as to how the sale of allowances will take place in future (will there be a cap?); whether the League Table will be maintained and, if so, what purpose it will serve, and how the funds raised from the sale of allowances will be applied so as to meet EU emissions targets. It is clear that businesses will need these details soon in order to manage compliance.

And Finally...

The silver lining to this cloud for landlord participants is that their contributions to the Scheme may well now be regarded as a tax or outgoing and as such, may be recoverable under the usual outgoings covenant in their existing leases, without the necessity for specific drafting. The

upshot of this is that many more tenants would be liable to make proportionate payments towards the cost of purchasing allowances in respect of the energy that they consume, than would have been the case under the Scheme as originally planned.

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