

The Carbon Reduction Commitment Energy Efficiency Scheme (CRC): Consultation on the treatment of the CRC in the context of Landlord and Tenant Relationships

SECTION 1: THE PURPOSE OF THIS CONSULTATION AND HOW TO RESPOND

This is a consultation addressed to all property owners and occupiers and follows on from the publication called 'The Carbon Reduction Commitment: A Guide for Landlords and Tenants'¹ published by a group of industry bodies in June 2009. This consultation has similarly been put together by a working party² representing all interests in the property industry.

The primary purpose of this consultation is to explore whether a cross-industry consensus can be reached on how CRC costs should be apportioned between landlords and tenants in new leases.

From extensive discussions with representatives from investors and occupiers it is clear that the CRC is going to challenge all parties. The CRC is intended to incentivise its participants to reduce their emissions. There is much to be done in rented buildings to encourage landlord and tenant cooperation. It is intended that the working group will carry out further work in this regard as it is a complex topic in itself.

Appendix 1 contains an overview of some of the complexities relating to the CRC and landlord and tenant relationships. Further examples of these issues are set out in the Guide.

If the response to the consultation suggests that a consensus is possible, it is proposed to ask a small group of commercial property lawyers to produce a range of standard CRC lease provisions. Such provisions could be incorporated into new leases either as a whole or in part according to the wishes of the parties. They could also be supplemented – if that is what the parties wish to do – with additional text within a lease.

Although the primary focus of this consultation is on new leases, standard CRC lease provisions could also be used to vary existing leases, for example by using a template deed of variation, but this is something that would require the express agreement of the parties.

¹ The latest version of the Guide for Landlords and Tenants is available here: <http://www.bpf.org.uk/topics/document/23672/carbon-reduction-commitment-crc---a-guide-for-landlords-and-tenants>

² A list of the working party members is set out in Appendix 3.

There are three important reasons for encouraging the property industry to adopt a standard approach to the manner in which CRC costs are apportioned between landlords and tenants:

- Standard CRC lease provisions will not need to be individually negotiated between landlords and tenants, saving time for both lawyers and their clients. Similarly it will not be necessary for solicitors to read through, and report upon, complex administrative arrangements when reporting upon existing leases in the context of investment sales and purchases.
- Standard CRC lease provisions will help to ensure that property sales and purchases do not become overcomplicated, which would inevitably be the case if a multitude of different solutions to apportion CRC costs and benefits between landlords and tenants were adopted.
- Standard CRC lease provisions will assist the management, letting and trading of properties. Different methodologies of calculating the costs and different methods of allocating the recycling payments will make it very difficult to set up standard systems for tracking and accounting for the CRC.

In order to help those responding to this consultation paper, please note that:

- **Section 2** sets out a list of questions to which responses are invited;
- **Section 3** sets out explanatory notes that all those seeking to answer the questions in **Section 2** are strongly advised to read, particularly if they are unfamiliar with some of the issues raised by CRC in relation to leased buildings; and
- **Appendix 1** contains a brief explanation of the CRC and some information about its impact on landlords and tenants.

Responding to the consultation

The questions in **Section 2** have been grouped together under the following themes:

- General Concepts
- Costs of Complying with and Administering the Scheme
- Purchase of Allowances
- Recycling Payments
- Changes in Landlord or Tenant
- Energy Reduction Measures

When responding, please bear in mind that the value of your feedback will be enhanced if you set out your reasoning for your answer. We welcome free text responses as well but only in addition to responding to the consultation questions, not as an alternative.

Also please bear in mind that the objective of the CRC is to achieve a reduction in carbon emissions.

Please send your response to the consultation, preferably by email (with an MS Word compatible document attachment) by close of play 5th February 2010 to:

Patrick Brown
Secretary to the CRC Working Party

at:

crc@bpf.org.uk

or:

c/o British Property Federation
7th Floor
1 Warwick Row
London
SW1E 5ER

A word version of **Section 2** of this document, containing the questions, will be available on the BPF website in early January 2010.

For any additional enquiries, please direct them in the first instance to the email address above.

NOTE: The contents of this consultation paper are based on the draft legislation contained in the consultation published by DECC in March 2009 and the subsequent policy changes stated in the Response to the consultation issued in October 2009. Although the policy framework of the CRC is now nearly final, a revised version of the draft legislation is due to be published to reflect the policy changes that have taken place since the draft was published earlier this year. It is anticipated that an amended version of the legislation is likely to be published during the period of this consultation.

SECTION 2: CONSULTATION QUESTIONS ON WHICH YOUR VIEWS ARE SOUGHT

Explanatory notes are contained in Section 3 to assist in responding to the questions in this section. This consultation paper uses the terms that have been defined in both the draft legislation and the various government consultations and other policy papers that have been published. A glossary of these terms was included in the Guide for Landlords and Tenants. If you are not familiar with the defined terms used in this document, or the manner in which the CRC will operate, you may wish to refer to the Guide for Landlords and Tenants.

A separate MS Word document will be made available shortly to assist in responding to the questions below.

A. Respondent Information

In order to help us to balance the responses that we receive, we would be grateful if you would please supply some information about you and the capacity in which you are responding. We may wish to contact you after the deadline for responses in order to clarify aspects of your response. In publishing any summary of responses, we will not name any respondents without their express permission.

1. Contact Details

Name	
Title	
Organisation	
Telephone	
Email	
Website	

2. What is your primary interest in the Carbon Reduction Commitment?

Role	(please tick – may be more than one)
As a landlord who expects to participate in the CRC as soon as it starts	
As a landlord who expects to participate in the CRC not immediately, but in future phases	
As an occupier within a building where the landlord will be within the CRC	
As an occupier within a building who expects to participate directly in the CRC in its own right	
As a managing agent	
As an occupier who is unsure whether any of its space or its landlord(s) will fall into the CRC	
As a legal services firm	
As an environmental consultancy	
As a trade association (if so, please specify who you represent)	
Other (please specify)	

B. General Concepts

3. Do you believe, in principle, that tenants should contribute proportionately towards the CRC costs incurred by their landlords in relation to:

(a) energy use within a tenant's own premises

(b) Energy use within the common parts of the buildings that they occupy

(c) administration of the CRC by the landlord (e.g. consultancy fees, submission of the paperwork)

If you do not think that tenants should contribute, please explain why you do not think that they should.

4. Do you believe that tenants should only contribute if they are credited with a fair share of the recycling payment received by their landlord that reflects their contribution to emissions? Please explain your reasoning.

5. If you do not agree that tenants should contribute to the CRC costs incurred by their landlords, how do you think that such costs should be met (e.g. by an increase in the overall cost of rents per square foot)?

6. Do you agree that any standardised approach to CRC for leased buildings should allocate costs and benefits to individual buildings and even individual tenants by reference to actual energy use (wherever this can be ascertained) i.e. following polluter pays principles? Whether you answer yes or no, please explain your reasoning and give any hypothetical examples if possible.

7. It is possible that some existing lease wording will allow the costs of the CRC to be passed through to the tenant (perhaps as part of the service charge). Are you a party to an existing lease that contains wording that you believe would allow the landlord to pass the costs of CRC to the tenant? If so, please can you supply a copy of wording of the specific clause that leads you to believe that this will be the case?

8. If you answered yes to the preceding question, please give an indication in general terms of the percentage of your portfolio (whether you are a landlord or tenant) that this applies to.

C. Detailed Aspects

i. Costs of Complying with and Administering the Scheme

9. Do you believe that landlords should be able to pass on to their tenants the costs of (a) complying with the CRC (purchasing allowances to surrender, completing reports to submit, etc), and / or (b) administering the transfer of allowance costs / recycling payments (e.g. the landlord's internal or consultancy costs incurred in administering the CRC?

(a) Yes/No

(b) Yes/No

Explanation:

Explanation:

10. If the administration costs and cost of allowances were to be passed on to tenants (recycling of benefits will be considered in the Section below entitled 'Recycling Payments'), please indicate how you believe the costs should be dealt with:

(a) split amongst all tenants according to the area they occupy as a percentage of the landlord's portfolio;

(b) split according to actual energy use where information exists but otherwise according to area occupied as a percentage of the landlord's portfolio;

(c) one of the above (please specify) but with a proportion paid by the landlord (please also specify the proportion that you think the landlord should pay); or

(d) other (please explain).

ii. Purchase of Allowances

11. In relation to the common parts, how do you envisage CRC allowances for energy consumption should be dealt with? Do you believe that the cost of them should be:

- (a) split amongst tenants in the building depending on sq ft occupied;
- (b) paid by the landlord; or
- (c) other?

Please provide reasoning for your answer.

12. Should tenants provide landlords with the money to buy allowances or should the landlord buy the allowances and then charge the tenants retrospectively? If the landlord uses the tenants' money to buy the allowances, to whom would the allowances belong?

13. If the tenants are providing the landlord with money to purchase allowances, when should they provide this money?

- (a) In advance, where estimates are made on consumption, so that the landlord has the money to buy the allowances that it has estimated will be needed for the forthcoming compliance year?
- (b) Retrospectively so that the landlord receives the money at the end of the compliance year once it is known how much energy was actually consumed across its estate?

14. It has been suggested by some participants, in relation to the parts of a building occupied by tenants (although not the common parts of a building), that a landlord and a tenant may agree that those tenants who are CRC participants and therefore able to buy allowances will buy allowances for their own consumption and then pass them to the landlord before it is necessary for the landlord to surrender them at the end of each compliance year. Do you believe that landlords would be interested in operating such a system? Provisions in the lease (e.g. enabling the landlord to buy sufficient allowances to cover the tenant's default, and pass the cost to the tenant) could set out what should happen if the tenant does not have enough allowances to pass to the landlord³.

³ See notes in Section 3

iii. Recycling Payments

15. If the recycling payments are to be passed to the tenant, what methodology do you believe should be put in place to calculate the tenant's share of the recycling payment? Possibilities might include the use of internal league tables based on the performance of individual buildings or the landlord's property portfolio or the use of formulae based on reductions or increases in energy usage year on year, etc.

16. Do you think it is feasible and cost-effective for landlords who purchase allowances relating to their tenants' energy consumption to operate league tables of their buildings and their tenants within those buildings? Are there any alternative approaches that could achieve a similar result while being cheaper and easier to operate?

iv. Changes in Landlord or Tenant

17. What should happen where a tenant changes during the compliance year? If the landlord is passing costs and recycling payments to the tenants, do you think that the landlord should continue to deal with the current tenant and leave the incoming and outgoing tenants to sort out their respective CRC costs contributions and share of recycling payment between them, in the same way as happens now between incoming and outgoing tenants in relation to service charges?

18. Where a landlord changes during the compliance year, the landlord who sold the building will receive the recycling payment but it will no longer have a contractual relationship with the tenants of that building that would require him to pass on to tenants a share of the recycling payment. The landlord who has bought the building now has a contractual relationship with the tenants of that building but will not receive a recycling payment that related to the emissions from the building. What do you think should happen in the case of:

- (a) a CRC participant landlord selling to a different CRC participant landlord;
- (b) a CRC participant landlord selling to a non-CRC participant landlord; and
- (c) A non-CRC participant landlord selling to a CRC participant landlord (for example, will the tenants be entitled to any recycling payments)?

D. Energy Reduction Measures

There is much to be done in rented buildings to encourage landlord and tenant cooperation. It is intended that the working group will carry out further work in this regard as it is a complex topic in itself.

19. If CRC costs are not passed on to tenants by a landlord, how do you envisage that landlords and tenants could be incentivised to work together to reduce carbon emissions associated with the building?

20. Assuming that the costs are passed on to the tenants, do you think that the concept of a fund (into which the recycling payments would be paid) for improving the energy efficiency of an individual building, or a portfolio of buildings, could be practicable? Please explain your reasoning.

SECTION 3: EXPLANATORY NOTES TO QUESTIONS IN SECTION 2

Notes relating to B. General Concepts

Notes relating to question 3

There are two different scenarios that should be taken into account here:

- Where the landlord pays the energy bill for *the premises occupied by the tenants*, and passes on the cost of energy to the tenants, either (where the energy is sub-metered) according to the amount of energy used or (where there are no sub-meters) usually on a floor area basis.
- Where the landlord pays the energy bills for *the common parts* (which will normally include the energy used for the heating and ventilation systems and also fuel for any standby generators).

In any building, there could be a combination of either or both of these scenarios. It is important to understand that there are some very large and some very modern buildings where the landlord purchases electricity for tenants for use in their own premises. These are not necessarily multi-let buildings as it is often cheaper for landlords to use their purchasing power to buy electricity for large parts of their portfolio.

Notes relating to C. Detailed Aspects

i. Costs of Complying with and Administering the Scheme

General notes relating to this section

The administrative costs of being a participant will be considerable, particularly for larger organisations. These costs may include:

- The cost of initial registration with the scheme administrator⁴.
- The cost of annual registration with the scheme administrator⁵.

⁴ Where a landlord has to participate in the CRC because all or most of its emissions constitute emissions from demised areas, it is likely to want to include these costs in those that it passes through to tenants. Where a landlord is participating in the CRC principally because of emissions associated with its own buildings, then it is harder to see why tenants should contribute towards this cost.

⁵ See footnote 10 above.

- Any installation of software needed to manage compliance with the CRC, both at a macro level to allow the CRC participant to submit data to the scheme administrator at organisation level, but also at the micro level so that it can identify costs and potentially distribute costs and benefits accurately and efficiently on a building by building basis / tenant by tenant basis.
- Forecasting emissions for the forthcoming compliance year taking into account the organisation's energy efficiency/carbon abatement strategies (including consultancy costs).
- Monitoring, assessing and managing emissions through the compliance year.
- Where necessary, the cost of buying or selling allowances through the secondary market or buying allowances through the safety valve.
- Reporting emissions and surrendering sufficient allowances to cover the organisation's emissions.
- Consulting tenants at each stage of the process.
- Managing the distribution of the recycling payments to tenants, which might involve the maintenance of a sinking fund, an internal league table of tenants or any other process agreed with tenants.
- Potential fines for non compliance.

ii. Purchase of Allowances

Notes relating to question 11

Working out how much to charge each tenant is difficult because, in respect of any compliance year, landlords may acquire their allowances from different sources, and at different times and for varying costs. A landlord may acquire the allowances it has forecast that it will need in the annual fixed price sale or auction (as applicable to the phase in question). It may buy allowances on the secondary market or by private arrangement (e.g. on the acquisition of a building, from the seller of that building). Allowances may also be held over from year to year (other than in the last year of the introductory phase). Transparency is key: where tenants contribute towards the cost of allowances bought by the landlord, the tenants will wish to see detailed information as to their provenance and cost.

Box 1: hypothetical example – buying allowances

Assume that a CRC participant owns a portfolio that comprises only three buildings: Alpha, Beta and Gamma. Alpha and Beta are fully occupied. Gamma is half empty. The landlord is responsible for supplying the energy for the common parts and the demised areas of all three buildings.

The landlord estimates the energy use at the start of the compliance year and decides that it is not likely to find a tenant for the empty part of Gamma. It buys allowances in the auction to reflect the expected energy use of the existing tenants.

The landlord's assumption that it would not find a tenant proves incorrect and later in the year the landlord has to buy extra allowances for Gamma at a much higher cost than in the auction, since there is now a shortage of allowances to cover all three buildings.

- Should the unexpected additional cost (because the additional allowances that the landlord had to buy were more expensive) be borne by the tenants of Gamma alone?
- Or should the unexpected additional cost be shared between all of the landlord's buildings?
- Or should the new tenant pay the increased cost for the allowances itself?
- Or should the landlord bear the responsibility for the unexpected additional costs itself despite the fact that this would presumably require an analysis (after the event) of when and why the landlord bought its allowances?

It should be noted that one of the issues highlighted by this example is the extent to which a tenant should share in the risks inherent in the CRC with its landlord. These risks may not always involve a shared cost. There may be occasions where a profit is made e.g. where the landlord sells surplus allowances in the secondary market. In this situation, should the tenant benefit from any profit made from the sale of these allowances?

Some possible methods of ascertaining the cost of allowances are set out below. This list is not exhaustive.

1. Average cost of allowances

The landlord passes on the average cost of allowances bought over the compliance year. However, since the average cost will not be known until the end of the compliance year, where the landlord is charging in advance for CRC, the price that the landlord charges will either need to be an average cost related to the allowances purchased during (for example) the landlord's service charge year, or the lease will need to build in a system of balancing the cost of allowances (as in the case of a rent review) after each year's service charge account has been closed.

Neither way is ideal, but the first option may be easier to administer.

Even if it is agreed that an average cost of allowances is to be used, it needs to be made clear in the lease whether there are to be any exclusions from the calculation of the average. For example, if the landlord was to decide to buy all its allowances in the secondary market at the end of the year, once its actual energy use is known, rather than from the Government at the beginning of the year, the tenants will not wish to pay more if the cost of allowances is higher as a result of this decision.

2. Buy allowances for specific buildings

A second option is that the landlord should buy allowances for particular buildings, which are then ring-fenced for each building and, where relevant, sold with the building. This seems a less attractive idea for landlords as it limits the use to which those allowances could be put later in the year when a more accurate assessment of different buildings' energy use is available. It would prevent spare allowances being diverted to different buildings or even to

different organisations within the same group of companies. However, for tenants it may be attractive as it will prevent double charging when an investment changes hands.

3. Landlord charges an unrelated price for the allowances

A third option, which may be adopted by some landlords, is to charge the tenants a price for allowances that is unrelated to the cost actually paid by the landlord. This could be either less or more than the cost price. By charging their tenants more than the nominal cost of allowances, landlords may wish to encourage their tenants to reduce their energy use even more than the CRC is intended to do. So long as any additional proceeds over and above the actual cost of such allowances to the landlord are channeled into energy-reducing schemes that directly benefit them, tenants may be prepared to accept such provisions and even come to welcome them.

4. Landlord charges only the net cost of the allowances (after allowing for the recycling payments)

In order to minimise the administrative costs of implementing the CRC, the landlord could wait until after the recycling payment has been received in October after the end of the relevant compliance year before allocating the net costs to the tenants. While landlords would need to be aware of the cash flow implications of this, it could provide a way of reducing transaction costs and simplifying the calculation of costs or benefits to be passed down from organisation to building level, and ultimately to the tenants.

Notes in relation to question 13

The issue of the timing of payments between landlords and tenants is an extremely complex area as the timings of payments are themselves dependent upon what the payments will comprise – which is the subject of other parts of this consultation paper.

However, for the purpose of this section, we have assumed that tenants will contribute towards their landlords' CRC costs. We now compare the effects of two different methods of passing on costs:

(A) The costs incurred in connection with the CRC are passed from landlord to the tenants or to a service charge account as those costs are incurred.

On first sight this option seems the simplest way to manage the CRC between the two parties. However, it is very difficult to work out exactly what costs should be passed from landlord to tenant/service charge account, and when.

The landlord will be buying allowances for a given compliance year across a period of 16 months. The Government's sale takes place in April, at the start of each compliance year. The landlord may buy allowances then, or it may buy allowances in the secondary market, at any time up to the end of July in the following year, which is when its annual report for the given compliance year has to be submitted and its allowances surrendered. This may include buying allowances by private arrangement on the acquisition of a property. Similarly, the landlord could be disposing of allowances by private treaty or on the secondary market during the same period.

In relation to any one compliance year (with the exception of the beginning of the second phase), a landlord could be using up allowances left over from previous compliance years

(allowances cannot be carried over from the introductory period into the first auction period but otherwise they may be banked for use in future years).

In a real-time accounting system, the landlord would charge to the tenants the sums expended, as they were expended. Two advantages of this method for the landlord are that:

- it removes any credit risk (i.e. that a tenant could become insolvent after the landlord has incurred expenditure but before it is repaid by the tenant); and
- it removes any cash flow issue in that it is effectively the tenants' money that is being used to buy allowances.

The landlord could either ask the tenants to put it in funds just before it incurs the cost, or send demands afterwards (either on demand or on the next quarter day). (Note – where applicable, “quarter day” should be read as “rent payment day” or “service charge day”, whichever is most appropriate in the circumstances.)

When a recycling payment is received, the tenants could be given their proportions immediately, or these could be held by the landlord on account until the next payment is due. At some stage the landlord might wish to recover any administrative expenses, if it has been agreed that tenants will pay these (see the discussion in **Section 3C** above).

There are two possible disadvantages to this approach:

- The cost of each allowance is set once and for all at the time when the landlord buys it, rather than being averaged out over the compliance year with the cost of all the other allowances bought by the landlord for its emissions (which could include those relating to its own business(es) as well as those relating to other properties that it owns). This could be a disadvantage to the landlord if it needs to buy additional allowances on the secondary market at the end of a compliance year, at a higher price. This is demonstrated in the example in the box above. This is connected to the second disadvantage explained below.
- Allowances, once bought, would effectively have been allocated by the landlord to the particular building, since it would be the tenants in that building that would have paid for them. It is not yet clear whether that is how landlords and tenants will wish to treat allowances. Imagine that a landlord owns three buildings, Kappa, Lambda and Mu. It occupies Kappa and the other two buildings are tenanted. It buys 100 allowances for each at the start of each year, using the tenants' funds for this purpose in relating to the two tenanted buildings. At the end of the year Kappa and Lambda each have emissions equal to 120 allowances and Mu has emissions equal to 60 allowances. Overall, therefore there are sufficient allowances. Assume now that additional allowances on the secondary market now cost twice as much as the allowances bought at the beginning of the year. Can the landlord allocate the 40 “unused” allowances from Mu to Kappa (its own building) and Lambda (the other tenanted building)? It is arguable that, on the basis that the tenants in Mu have paid for the allowances, they are no longer the landlord's allowances to reallocate. The tenants may not wish to sell them to the landlord, or to the tenants of Lambda, since they may believe that the price of carbon will be even higher next year and they wish to hold them over until then.

So if this option is to be adopted, it will require an understanding on everyone's part that allowances are permanently allocated to a particular building once they have been bought.

(B) The costs incurred in connection with the CRC are only passed on by landlords after the end of each compliance year and once all the relevant costs are known.

In this option, tenants are charged annually for the landlord's CRC costs, but (subject to possible advance payments being made by the tenants) nothing is charged to tenants until at least three months after the end of a compliance year. By this time, all the allowances for that compliance year will have been bought, and the recycling payment relating to the energy consumption in the previous compliance year will have been received. The landlord's annual report (which has to be delivered in July following the end of the compliance year) will have been submitted, so that it will be possible to work out exactly how much of the landlord's energy use is attributable to each building. That amount can then be charged to the tenants and/or to the service charge account (as appropriate).

There are of course disadvantages to this option as well:

(1) The key disadvantage to a landlord is that the tenants will always be paying the landlord in arrears, in some instances up to 16 months after the landlord has incurred the costs. This is not an insurmountable problem as it should be possible to compensate the landlord in some manner, and to cover the credit risk on the tenants. Two possible methodologies are (i) for the landlord to receive an additional payment (perhaps calculated by reference to interest rates) in August when the tenants pay the landlord after the allowances are surrendered for the relevant compliance year (this would cover the cost to the landlord, although not the cash flow or the credit risk on the tenants); (ii) alternatively the tenants could make payments on account to the landlord of (say) either one quarter of the expected total amount of CRC costs, or equal to what the landlord expects to pay that quarter (the largest expenditure is always likely to be in April when it is anticipated that the majority of allowances will be bought). This methodology would look very similar to a separate service charge system running in parallel with the building's main service charge system.

(2) Tenants would effectively be paying CRC costs one year after the relevant energy use is incurred. For example, for compliance year 2012/13 (1 April 2012 to 31 March 2013), the payment would not be due to the landlord until after the landlord's annual report had been submitted at the end of July 2013. This means that if tenants were particularly energy-efficient in that compliance year, they would not see the benefit of it in the form of a smaller payment for the landlord in relation to CRC until July 2013 at the earliest.

(3) The cost of the allowances bought by the landlord (and indeed the whole of the landlord's CRC organisation) will be averaged out across the entire year. This could benefit either the landlord or the tenant depending on how the market reacts to the scheme.

(4) The CRC is designed so that recycling payments that are calculated by reference to a given compliance year (say 1 April 2016 to 31 March 2017) are paid in the October following the end of that compliance year (October 2017) using auction revenues that relate to the next compliance year (April 2017 to March 2018). In other words there is a disconnect between the costs of CRC (i.e. the purchase of allowances) for a given compliance year and the recycling payment for a compliance year. For CRC participants that are landlords, this feature of the scheme causes problems because matching CRC costs (which are being charged to tenants in relation to a particular compliance year) to the recycling payments that relate to that compliance year is important. This matching is important because the tenant paying the costs relating to a compliance year may not be the same as the tenant that receives the recycling payment for that compliance year, where the original tenant of the demised premises changes. If landlords allocate recycling payments to tenants that do not equate to their contribution to the costs of CRC or their period of occupation and hence

energy consumption, then the tenant receiving the recycling payment will be receiving a share of the recycling payment that relates neither to its contribution to costs nor its actions in trying to reduce energy consumption. Some tenants will gain a windfall and others will not receive a fair share of the recycling payment that their contribution and energy efficiency efforts should have resulted in. As the bonus or penalty payment to be applied to recycling payments will increase from +/- 10% to +/- 50% in the first 5 years of the scheme, and may increase further over time, this problem is exacerbated.

To attempt to address this difficulty, it would be possible to delay balancing the year's CRC account until the recycling payment that relates to the compliance year for which CRC costs have been contributed is paid. This is paid in October, three months after the annual report is submitted (i.e. for compliance year 2016/17 where CRC costs would have been contributed by tenants during the course of that compliance year, the recycling payment that is calculated relating to that compliance year's data is paid in October 2017. To try to match CRC cost contributions for a given compliance year to recycling payments that relate to that compliance year would result in a delay in the settling-up process for that compliance year by a further three months, so that it would not occur until at least seven months after the end of the compliance year.

(5) It is not clear who is to pay for allowances that are bought by the landlord but not used in any one compliance year. Apart from in the last year of the introductory period, it will be permissible to carry over the allowances into the next year. If the price of allowances rises over time (as it is anticipated will happen), banking allowances in this way may become very common. This would require careful account management from landlords participating in the CRC.

Notes on question 14

Potential for tenants to purchase their own allowances

This method would enable landlords to pass to those of their tenants who are CRC participants responsibility for buying allowances related to energy used by the tenants in their own premises, where it is supplied through the landlord's meter and billed to the tenants by the landlord. Tenants who are not CRC participants in their own right will not be able to buy allowances from the Government in the fixed price sale/auction at the start of each year so the landlord would have to retain responsibility for those non-CRC participant tenants.

A landlord could therefore agree with tenants that are CRC participants that they will buy their own allowances, and then pass them to the landlord before it is necessary for the landlord to surrender them at the end of each compliance year. Provisions in the lease could set out what should happen if the tenant does not have enough allowances to pass to the landlord. These are likely to provide that the landlord could buy sufficient allowances to cover the tenant's default, and pass the cost to the tenant. Given that the landlord might need to buy the allowances at that late stage through the secondary market, it is possible that the tenant could end up paying a considerable sum for its failure to buy sufficient allowances but could pay less if the cost of allowances is less in the secondary market if companies have over purchased at the beginning of the year.

This method could be used whether or not the tenant's energy supply was sub-metered. In practice, tenants would find it easier to operate if the supply were sub-metered as they would be able to keep an eye on their energy consumption – although the landlord could

provide (say) weekly figures even if the supply were not sub-metered, dividing up the total energy use by all tenants into individual figures using the same proportions as will be used when the account itself is divided up among tenants.

This method could not be used for the common parts of buildings, so it could not be used on its own. It would still be necessary to incorporate some sort of service charge provisions of the kind set out in options A and B (see **pages 13 and 15**).

The landlord would still be responsible for distributing the recycling payments that it receives. It should also be noted that the landlord will still be responsible for the tenants' emissions under the terms of the scheme notwithstanding that it has effectively contracted out its obligation to acquire allowances. If a situation arises where the landlord has insufficient allowances, it is the landlord not the tenant who would face enforcement action under the CRC Regulations.

iii. Recycling Payments

General notes on this section

Where the tenants are paying towards the cost of the allowances, tenants will want the landlord to pass back to them the benefit of the recycling payments.

Failure to pass on recycling payments in some manner would mean that tenants would be less motivated to reduce their carbon emissions and, as a result, the landlord's position in the league table would suffer, which may then impact on the landlord's reputation relating to sustainability, carbon management and so on.

For these reasons the working party considers it unlikely that landlords will seek to charge their tenants for the cost of allowances but decline to pass on the benefit of the recycling payments.

Specific notes in relation to question 15

A key problem for landlords is that the CRC operates at a group, not at a building, level. A large landlord may have a portfolio of many types of building, held in various group companies. Additionally, some buildings may be let to third parties whereas others may be occupied for the purpose of the landlord's own business.

The allocation of costs and benefits to individual buildings within such a portfolio, and then to individual tenants with those buildings, would involve a considerable amount of work, which some landlords might be reluctant to undertake, particularly if they envisaged difficulty in recovering the administrative costs involved.

However, failing to allocate the costs and benefits to individual buildings, and individual tenants will probably be less effective in driving changes in tenant behaviour and less likely to foster dialogue between landlords and tenants about better management of energy and carbon emissions, which is one of the Government's stated aims for the CRC.

The amount of recycling payment that a landlord receives, and which might be expected to be distributed on to tenants, may be affected by arrangements within the particular CRC participant of which the landlord is a member, over which the tenants have no control whatsoever. This is best explained by an example.

Box 2: issues arising from the allocation of benefits

Assume that a large CRC participant (X Bank PLC) has a number of divisions, many of which contain companies that own property that is tenanted.

The number of allowances that X Bank PLC needs to buy and subsequently surrender is capable of being calculated, and indeed will need to be calculated, at the end of each compliance year.

The amount of recycling payment that each division and each landlord company of X Bank PLC, receives is in part related to the carbon management policy that X Bank PLC puts in place from time to time. For example, as part of an incentive scheme to cut emissions, X Bank PLC may decide to rate its divisions within a league table, and all of the recycling payments will be allocated to the three top-performing divisions. The other divisions receive none of X Bank PLC's recycling payments whatsoever. And that means that any tenant who, by its lease, is entitled to receive a proportion of the recycling payment received by the landlord will receive nothing, as the landlord has received nothing.

It is not immediately clear that this problem can be easily resolved. The landlord in any particular situation cannot realistically agree that there will be a minimum level of recycling payment, as there is no way of assessing what this should be. Nor can any landlord realistically agree in a lease how its group's policy on distributing recycling payments will operate. Only the group as a whole can agree that. And even if a landlord happens to be the highest parent company in the CRC participant and does agree such a provision, it may be incapable of being operated if:

- the property is sold to a different landlord; or
- the landlord itself becomes part of a larger CRC participant as part of a corporate sale and purchase transaction.

One suggestion that has been made is that, in these circumstances, the lease should provide that the particular landlord company should be deemed to have received a recycling payment proportionate to the floor area of the buildings occupied by the entire CRC participant. Tenants are likely to insist on such a provisions (since they have contributed to the cost of the allowances bought by the landlord), but they will be resisted by landlords for the obvious reason that they risk having to hand out to tenants money that they have not actually received.

Notes in relation to question 16

Another suggestion that has been put forward is for landlords to establish league tables of buildings, and league tables of tenants within those buildings. The aim is to identify those buildings within a landlord's portfolio where energy use has been most improved, and reward those buildings by allocating to them a greater proportion of the landlord's recycling payments. Similarly, within each building those tenants who have most improved their

energy use would also be identified, and they too would be rewarded with a greater proportion of the recycling payments allocated to that building.

Setting up and administering such a system would be time consuming and administratively burdensome but not impossible. Before time and effort is invested in devising such a scheme, the working party needs to understand whether landlords and tenants would be comfortable in adopting such a system.

To save duplication of effort, it is proposed that the same system of metrics should be used as is used for the CRC itself.

However, from the tenants' point of view, they could see all their hard work in reducing their own energy use fail to translate into an increased allocation of recycling payments through any or all of the following:

- The landlord scoring badly within the league table – either because of its other tenants' behaviour, or because of the manner in which its own buildings are operated, or because of the landlord's wider business (in the case, for example, of a landlord that operates industrial processes where letting is only a small part of its business).
- Other tenants failing to make improvements in energy efficiency.
- A new tenant coming into part of a building with a greater energy use than the tenant that it replaced.
- The building being sold to a different CRC participant, and such new owner being less energy-efficient than the previous owner (and therefore scoring lower in the league table).
- The ownership of the building changing to an organisation that is not a CRC participant, meaning that there are in the future no recycling payments to be divided between tenants, however energy efficient they become.
- The landlord not being allocated any recycling payments within its group (please see the notes to **question 15** for an explanation of how this might occur).

It would appear that the arrangement and maintenance of such league tables would be resource-intensive.

D. Energy Reduction Measures

Specific notes in relation to question 20

It has been suggested that recycling payments could be allocated by way of one or more specially created funds, to benefit tenants collectively, either within a building or within a portfolio of buildings. Such funds could be used to introduce energy efficient technologies and improve a building's component parts such as glazing or insulation.

There are considerable legal and practical complications in introducing such funds, and it is inevitable that they would involve a considerable amount of administration. There would also be tax issues to consider.

Additionally, it would be necessary for a decision to be made whether such a fund should be operated across the landlord's whole portfolio of buildings, or for buildings individually.

The Working Group has considered whether it would be possible for some landlords to operate such funds and for other landlords not to do so. However, this would cause difficulties when buildings change hands. If a landlord who did not operate such a fund bought a building where the leases are drafted to provide for a portfolio-wide fund, it would not be able to operate the system as none of its other buildings would contain provisions for operating a portfolio-wide fund. Such a landlord could in theory operate a building-wide fund but it would not be possible to operate a fund in conjunction with a league table of tenants (see the notes relating to question 16).

APPENDIX 1: HOW THE CRC APPLIES IN THE CASE OF LANDLORDS AND TENANTS

What is the CRC?

The CRC is expected to take effect in 1 April 2010 and will require large energy users, including large property investors, to buy and subsequently surrender allowances commensurate with their energy use. The aim of the CRC is to encourage participants to reduce their energy use, and hence CO₂ emissions, year on year. The CRC is being introduced to assist the government in meeting the legal obligation under the Climate Change Act 2008 to reduce emissions by 80% by 2050.

Organisations will be required to participate in the CRC if they (together with any group companies) used more than 6,000MWh of electricity settled on half-hourly meters in 2008 (this is likely to mean an electricity bill in 2008 of between £700,000 and £1,000,000). The Government estimates that between 4,000 and 5,000 organisations will be CRC participants.

CRC participants will need to buy and surrender allowances equivalent to their total emissions related to energy use covered by the scheme. In the first phase (2010-13), an uncapped number of allowances will be available for a fixed price from the Government (starting in the second year of the first phase – 2011/12), but from compliance year 2013/14 onwards they will be sold by an annual auction and the Government will cap the number of allowances that are available. The point of setting the cap, which will be lowered over time, is to increase the cost of allowances, providing an incentive to organisations within the CRC to reduce the amount of energy used.

Revenues derived from the sale of allowances will be recycled to participants based on their performance in the scheme. The amounts of these recycling payments will not be related to the number of allowances that participants buy, as this would create a perverse incentive to use more energy. Participants will not, therefore, receive back some of “their” payments into the scheme. Instead the total of the revenue raised from the annual auction will be divided between CRC participants and the amount of the recycling payments will be proportional to each participant's emissions in the first year of the scheme (2010/11), with a bonus or penalty payment according to improvements made by that organisation in terms of reducing its emissions, measured by its ranking in a performance league table. The bonus or penalty payments will increase from +/- 10% in year 1 to +/- 50% in year 5. The recycling payments will be paid out to participants six months after the purchase of the allowances (so the Government will retain the proceeds for only a limited amount of time).

A fuller explanation of how the recycling payments system operates is contained in **Appendix 2**. A worked example is contained in Annex D of the Government's recent response to the March 2009 consultation paper.

As a very approximate guide, at the initial price of £12 per tonne of CO₂ at the start of the scheme, the cost of the CRC allowances is expected to add something in the region of 10% to the cost of energy. This may rise significantly, however, if the price of allowances rises when allowances start to be sold by auction starting in 2013. In order to calculate the net cost of the CRC to participants, however, it is necessary to take into account the recycling

payments. At this stage it is very difficult to predict the level of recycling payments that CRC participants will receive.

How will the CRC affect the Property Sector?

Landlords who are CRC participants will be responsible under the CRC for energy consumed in relation to both the buildings they themselves occupy and their tenanted buildings where they procure the energy that their tenants consume. Where a tenant itself procures the energy it consumes, it will be responsible for that energy consumption and the resulting emissions (where it is large enough to be a CRC participant in its own right).

In addition to buying sufficient allowances to cover emissions associated with their own businesses, landlords will also need to buy allowances to cover emissions in respect of both energy supplied to tenants for use in their demised premises, and energy used within the common parts of their tenanted buildings.

The CRC presents an opportunity for landlords and tenants to work together to reduce energy consumption.

Implications for Leases

Existing Leases

In relation to existing leases, landlords who are CRC participants will need to examine the wording carefully to ascertain whether tenants will be required to contribute towards the costs incurred by their landlords in complying with the CRC. The wording will need to be analysed to see what CRC costs (if any) it will permit a landlord to pass to tenants. For example will such wording cover:

- the cost of the allowances that have to be bought;
- a proportion of a landlord's other costs of compliance such as the initial registration fee when joining the scheme; and
- the cost of employing additional staff to administer the scheme?

Since the CRC was not in existence when leases were drawn up in the past, the legal position as to tenants' liability to contribute to a landlord's CRC costs is untested, and it cannot be assumed that existing leases will enable landlords to pass on to their tenants the cost of complying with the CRC. Most modern leases include service charge wording to allow the recovery of certain costs associated with running the buildings e.g. energy in the common areas or taxes relating to such energy. As the proceeds of the auctions will not be retained by the Government, CRC is unlikely to be classified as a tax. Similarly it is unlikely to be classified as an outgoing in the normal sense of the word, or part of the cost of buying the energy and as such CRC costs may not be covered by these provisions in existing leases. Indeed, as the CRC allowances are to be bought at the highest level in a group of companies, in many cases the expenditure will be outlaid by a company that is not even the landlord.

A further problem is to how to calculate – based on typical current lease wording – what share of the recycling payments that the landlord receives should be passed to each tenant.

New leases

Quite apart from existing leases, landlords need now to be considering whether their standard forms of lease should be amended to include new provisions to require the tenants to contribute towards the landlord's CRC costs. This issue is considered in this consultation.

As mentioned above, the "polluter pays" principle would suggest that tenants, as the ultimate energy users, should be responsible for at least some of the costs incurred by the landlord in complying with the CRC. However, it is reasonable to expect that tenants who contribute to the landlord's CRC costs should also be credited with a suitable proportion of any recycling payments that the landlord receives.

The need for standard lease provisions

It has been suggested that standard lease provisions are desirable for the following reasons:

- It should be agreed how costs should be shared between landlords and tenants, as there are various different methods by which this could be achieved, and landlords and tenants will have different views of what will amount to a fair allocation of such costs.
- Owing to the complexities of the issues raised by the CRC, the provisions that need to be contained in leases are likely to be lengthy.
- Standard CRC lease provisions would not need to be individually negotiated between landlords and tenants, saving time for both lawyers and their clients. Similarly it will not be necessary for solicitors to read through, and report upon, many pages of complex administrative arrangements when reporting upon existing leases in the context of investment sales and purchases.
- Standard CRC lease provisions would ease the management, letting and trading of properties. If property owners are transferring costs of the CRC and they all have different methods of calculating the costs, and a different method of dividing up the recycling payments between their buildings and between their tenants, it will become impossible for owners of more than one property to set up standard systems for tracking and accounting for the CRC, and for billing amounts to their tenants. Similarly, tenants who are tenants of more than one landlord (especially multiple retailers) will find it helpful for all landlords to treat CRC issues in the same manner.

Standard CRC lease provisions that are recommended by a working party representing both owners and occupiers are most likely to be acceptable to both landlords and tenants.

NOTE: Assuming that it is agreed that CRC provisions should be included in new leases, initially it will only be in new developments that landlords will be able to include and fully operate CRC provisions. For existing buildings, landlords may be able to include CRC provisions in new leases but not operate them fully until there are sufficient new leases in a building to make this workable. In the meantime, the landlord may choose to cover the costs themselves.

APPENDIX 2: CALCULATION OF THE RECYCLING PAYMENTS

It is a fundamental component of the CRC that all the revenue raised by the annual sale or auction of allowances will be “recycled” back to participants. However, the manner in which this operates is not clearly understood. In particular, it is widely believed that the recycling payments are calculated by reference to the allowances that a CRC participant has purchased.

This is not how the system will operate. The proportion of the revenue derived from the annual fixed price sale/auction that each CRC participant receives is dependent upon the following factors:

- each CRC participant’s proportion of the total CRC emissions in the first year of the scheme (2010/11);
- each CRC participant’s position in the performance league table for the relevant compliance year.

The league table

The league table will be compiled annually by the CRC Scheme Administrator, based on three metrics:

- The absolute metric, which reflects the relative change in an organisation’s CRC emissions.
- An early action metric, which takes into account certain energy-saving measures that an organisation puts in place before the start of CRC (this is only applicable in the first phase of the scheme).
- A growth metric, which takes into account that a growing organisation may have increased its absolute emissions but have reduced its emissions per unit of turnover by measuring the change in emissions intensity. This metric therefore gives credit to organisations that are expanding in an energy-efficient way.

The weight allocated to each of these three metrics will vary in the first few years of the scheme:

- In the first year all the weighting will be on the early action metric.
- In the second year the weighting will be 40% for the early action metric, 45% for the absolute metric and 15% for the growth metric.
- In the third year the weighting will be 20% for the early action metric, 60% for the absolute metric and 20% for the growth metric.

- In subsequent years the weighting is expected to be 75% for the absolute metric and 25% for the growth metric, although this is subject to review in the future.

The Scheme Administrator will prepare the league table by using a combination of the weightings and the score in each of the three metrics. This will produce a list of all the CRC participants, ranked according to their performance in relation to the three metrics.

Calculating the recycling payments

The table that follows has been copied from Annex D of the Government's October 2009 response to the March 2009 consultation. Some columns of figures have been omitted from the table for the sake of simplicity, where they are not relevant for the purpose of calculating the recycling payments.

Assume that the total revenue raised in the Government sale is £94,080. How this sum is made up is not relevant to the calculation of the recycling payments and therefore the figures (originally in columns F and G of this table) are not reproduced.

Recycling payments made in October 2011 for the 2010/2011 compliance year

A	B	C	E	H	I	J	K
CRC Participant name	2010/2011 emissions	Baseline % of total	Position in league table	Bonus or penalty	Unadjusted recycling payment	Bonus or penalty	Recycling payment
c	100	1.13	1	9.89%	£1,063	£105	£1,168
f	2000	22.60	2	7.51%	£21,262	£1,597	£22,859
a	1000	11.30	3	4.12%	£10,631	£438	£11,069
h	100	1.13	4	2.88%	£1,063	£31	£1,094
b	250	2.82	5	2.49%	£2,653	£66	£2,724
d	2700	30.51	6	-0.85%	£28,704	-£244	£28,459
g	200	2.26	7	-4.12%	£2,126	-£88	£2,038
e	300	3.39	8	-4.69%	£3,189	-£150	£3,040
j	1200	13.56	9	-6.38%	£12,757	-£814	£11,942
i	1000	11.30	10	-8.87%	£10,631	-£943	£9,688
Totals	8850						£94,080

This is how the recycling payment is worked out, using participant c which is top of the league table.

Step 1

Calculate the participant's percentage contribution to the total Baseline Emissions

$$(100/8850) \times 100 = 1.13\%$$

The result is shown in Column C.

Step 2

Calculate the bonus or penalty percentage

For participant c this is 9.89%. The method of calculation for this is complex and is set out in **Box 3** below.

Step 3

Calculate the recycling payment. This is done by multiplying the revenue achieved in the fixed price sale in April 2011 (which we are told is £94,080) by the participant's percentage contribution to the total baseline emissions (calculated in step 1 above), and then adjusting that amount by the percentage bonus or penalty (calculated in step 2 above).

For participant c, the unadjusted figure is $1.13\% \times £94,080 = £1,063$

This is then adjusted by adding a bonus of 9.89% = £105

The total recycling payment for participant c is therefore £1,168

Box 3: How to calculate the percentage bonus or penalty

(The information in this box has been supplied by the CRC Helpline, and is repeated verbatim. It is not apparent from the calculation in Annex D of the Government's response to the consultation.)

In order to ensure that the total amount of money recycled back (sic) to participants is equal to the monies available, each participant's payment is calculated taking into account the distribution of different sizes of organisation across the performance league table.

Column H is calculated as follows:

(1) Each participant's size coefficient for the reporting year is calculated based on the proportion of the total 2010-2011 CRC emissions associated with each organisation multiplied by the range between the maximum bonus/penalty.

For example:

In 2010/11 reporting period the maximum range is 0.2 (because the range is between +/- 10%). For example, the size coefficients of organisations c and f are:

Organisation c: $0.2 \times (100 / 8850) \times 100 = 0.23\%$.

Organisation f: $0.2 \times (2000 / 8850) \times 100 = 4.52\%$.

(2) The bonus/penalties for the participants are calculated to take into account the spread of different sized organisations across the performance league table. This is done as follows:

(i) The participants' size coefficients are subtracted in sequence from the maximum bonus/penalty (in order of the organisation's position in the league table) to give each participant their own, R value (upper boundary of an organisation's proportional share of the bonus/penalty range at the place determined by the distribution of the other participants according to the ranking in the league table). A participant's R is calculated by subtracting the preceding participants' size coefficient from the corresponding R.

For example:

Organisation c's R will be 10%, as c was 1st in the league table.

Organisation f's R will be 10% – 0.23%

(Org c's R – Org c's size coefficient) = 9.77%.

Organisation a's R will be 9.77% – 4.52%

(Org f's R – Org f's size coefficient) = 5.25%.

(ii) The 'applicable bonus/penalty rate' is then calculated by subtracting the participant's size coefficient midpoint (size coefficient/2) from the corresponding R value.

For example:

Organisation c's applicable bonus/penalty rate is $10 - (0.23 / 2) = 9.89\%$.

(Org c's R – half of Org c's size coefficient)

Organisation f's applicable bonus/penalty rate is $9.77 - (4.52 / 2) = 7.51\%$.

(Org f's R – half of Org f's size coefficient)

APPENDIX 3: LIST OF MEMBERS OF THE WORKING PARTY

- Charlotte Eddington, CBRE (Chair)
- Peter Williams, Eversheds
- Paul Bagust, RICS
- Tatiana Bosteels, Hermes (BPF)
- Stuart Bowman, Hurley Palmer Flatt (CoreNet)
- Becky Clissmann, Practical Law Company
- John Connaughton, Davis Langdon (BCSC)
- Daniel Cook, RICS
- Nick Darby, Denton Wilde Sapte (BRC)
- Paul Edwards, Hammerson (BCO)
- Louise Ellison, IPF
- Elizabeth Hinde, BRC
- Sarah Jeffcote, UK GBC
- Janet Kidner, Lend Lease (UK GBC)
- Philippa Latimer, BCSC
- Julian Lyon, GM (RICS)
- Patrick Brown, BPF (Secretariat)
- Michael Chambers, BPF (Secretariat)