

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

Summary of Responses Received

SECTION 1: INTRODUCTION

In December 2009, an industry working party¹ issued a consultation addressed to all property owners and occupiers, following on from a publication called 'The Carbon Reduction Commitment: A Guide for Landlords and Tenants'² published by a group of industry bodies in June 2009.

The primary purpose of the consultation was to explore whether a cross-industry consensus could 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 Carbon Reduction Commitment Energy Efficiency Scheme (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 co-operation. It is intended that the working group will carry out further work in this regard as it is a complex topic in itself.

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

The consultation exercise culminated in a workshop with representatives from the owner, occupier, agent, valuer and advisor communities. This document summarises the joint findings of the consultation and the workshop, and sets out some potential next steps.

¹ Please see list of industry working party members set out at **Annex A**

² The latest version of the guide for landlords and tenants is available here: http://www.bpf.org.uk/en/files/bpf_documents/CRC_Guide_A4.pdf

SECTION 2: GLOSSARY

Term	Definition
<i>Administrator</i>	The <i>administrator</i> will be responsible for regulating and auditing the <i>scheme</i> . In England and Wales, the <i>administrator</i> will be the Environment Agency, in Scotland, the Scottish Environmental Protection Agency and in Northern Ireland, the Northern Ireland Environment Agency.
<i>Automatic meter reading</i>	The technology of automatically gathering data relating to the usage of utilities (e.g. electricity or gas) and sending that data to a central database for billing/analysis purposes. <i>Automatic meter reading</i> technologies include handheld, mobile and network technologies based on telephony, radio frequency and powerline transmission. These technologies are designed to minimise administration and to provide billing based on actual use rather than on an estimate based on previous consumption.
<i>Capped phase</i>	Following the <i>introductory phase</i> (running from April 2010 to March 2013), where the cost of <i>allowances</i> will be fixed and an unlimited number of <i>allowances</i> will be made available, the Government will introduce auctioning of <i>allowances</i> and will restrict, or 'cap', the number of <i>allowances</i> that are available for CRC <i>participants</i> to purchase in any one year.
CO ₂	Carbon dioxide gas. Though naturally occurring in the Earth's atmosphere, industrial processes are increasing the ratio of CO ₂ to other gases present in the atmosphere. It is very likely that the observed increase in the concentration of CO ₂ and other greenhouse gases derived from human activities contributes to climate change.
<i>Compliance year</i>	The year running from 1 April (where emissions for the coming year must be forecast) to 31 March in the following calendar year.
<i>CRC Co-ordinator</i>	This is a term used in this document to mean an individual when at highest UK parent undertaking of a CRC <i>participant</i> with overall responsibility for the CRC <i>participant's</i> participation in, and compliance with, the CRC.
<i>CRC Officer</i>	This is a term used in this document to mean an individual at the building level in the case of a property responsible for taking the necessary steps to ensure the CRC <i>Co-ordinator</i> has the requisite information to administer the CRC <i>participant's</i> participation in the <i>scheme</i> (e.g. to forecast emissions).
<i>CRC participant</i>	This is a term used in this document to mean a single undertaking, or group, if undertaking, that is within the <i>scheme</i> .
<i>Emissions allowances</i> (also referred to as "allowances" or "CRC allowances" throughout the text)	<i>Emissions allowances</i> under the CRC represent one tonne of CO ₂ . <i>Participants</i> will be expected to purchase sufficient <i>allowances</i> to cover the energy supplies they are responsible for from the <i>administrator</i> .
<i>Half hourly metering (HHM)</i>	Buildings with an electrical demand of over 100 kilowatts will probably have a <i>half hourly</i> utility or peak demand meter, which automatically records how many <i>kilowatt-hours</i> are used every thirty minutes. Newer buildings and installations of fixed services (e.g. heating, lighting and ventilation) may have sub-meters installed that do much the same thing.
<i>Footprint report</i>	The report that contains information about an organisation's energy use during a <i>footprint year</i> that must be submitted to the <i>administrator</i> by the end of July after the end of that <i>footprint year</i> .
<i>Footprint year</i>	The first <i>footprint year</i> runs from 1 April 2010 to 31 March 2011. Participants must collate data about all their energy usage for this year and submit a report containing the data (the <i>footprint report</i>) by July 2011. This report 'fixes' a participant's CRC emissions for the relevant phase. In subsequent phases, the <i>footprint year</i> will be the year immediately following the qualification year. This will be 2011/12 and 2016/17 for the second and third phases respectively.
<i>Introductory phase</i>	The CRC commenced in April 2010, with a three year period or <i>introductory phase</i> to March 2013 during which the price of <i>allowances</i> will be fixed and there will be an unlimited number of <i>allowances</i> for sale. Following the end of this three year period, the number of <i>allowances</i> that are available will be restricted and they will be sold via an auction at the price that balances supply with demand.
<i>Kilowatt-hour (KWh)</i>	The kilowatt-hour is a rating of energy consumed. If a 100 watt lightbulb is on for

	<p>one hour, the energy used is 100 watt-hours or 0.1 kilowatt-hours. A power station would be rated in watts, but its annual energy sales would be rated in kilowatt hours. 1,000 kilowatt-hours = 1 megawatt-hour.</p>
<i>League table</i>	<p>The <i>administrator</i> will rank all <i>participants</i> in the CRC according to a number of metrics. In the <i>introductory phase</i>, the three metrics are absolute reductions, early adoption of energy efficiency measures and change in emissions per unit of turnover. In subsequent phases, only absolute reductions and changes in emissions per unit of turnover will be the metrics used to rank CRC <i>participants</i>.</p>
<i>Megawatt (MW)</i>	<p>1,000 kilowatts = 1 megawatt.</p>
<i>Qualification year</i>	<p>The period during which electricity consumption through all <i>half hourly meters</i> must be monitored to determine whether an organisation is required to participate in a forthcoming phase of the CRC. The <i>qualification year</i> for the <i>introductory phase</i> is the 2008 calendar year.</p>
<i>Registration period</i>	<p>The period from April to September 2010 during which organisations that are required to participate in the scheme will have to report on participant's emissions and declare themselves within or outside the CRC based on their <i>HHM</i> electricity supplies during calendar year 2008. For subsequent phases, the registration deadline will be the last working day of the <i>footprint year</i> (i.e. 31 March 2012 for the second phase).</p>
<i>Revenue recycling payments</i>	<p>Revenues achieved from the sale of <i>allowances</i> will be redistributed to CRC <i>participants</i>, based on their emissions in the <i>compliance year</i> and adjusted by bonus or penalty amounts. It is the Government's intention that over time payments will recycle a greater proportion of the revenue from <i>allowances</i> from those who have fared worse on the <i>league table</i> to those who have fared better.</p>
<i>Safety valve</i>	<p>A mechanism by which CRC <i>participants</i> can buy <i>allowances</i> from the <i>scheme administrator</i> throughout the year if the price on the <i>secondary market</i> becomes prohibitively high. The price will be linked to the EU ETS price of carbon. In the Introductory Phase a price floor of £14/CO₂ per <i>allowance</i> will be set for safety valve purchases.</p>
<i>Scheme</i>	<p>The term "<i>scheme</i>" is sometimes used as an alternative to "CRC" in this document.</p>
<i>Secondary market</i>	<p>CRC <i>participants</i> can choose to buy or sell their <i>emissions allowances</i> during the year from/to other CRC <i>participants</i> or from/to third parties outside the CRC (on the <i>secondary market</i>). This allows a CRC <i>participant</i> that believes it will comfortably meet its emissions reductions targets to sell surplus <i>allowances</i>, or to buy <i>allowances</i> if it believes that it will not have sufficient <i>allowances</i>.</p>

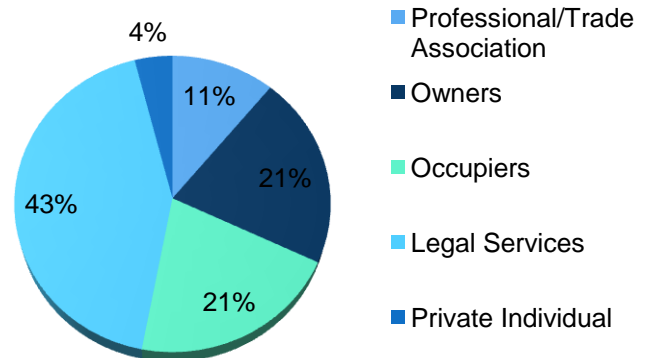
SECTION 3: SUMMARY OF CONSULTATION RESPONSES

Questions 1 and 2: who responded and in what capacity did they respond?

In total, we received 24 responses, which was supplemented with interviews with key industry bodies and individuals. A workshop was held in mid-February 2010 to present summary responses and to distil early reactions from industry.

As **Figure 1** shows, the Consultation received responses from across the property industry, with the majority of respondents being legal services firms. Owners and occupiers responded in equal numbers.

Figure 1: Who Responded?



Question 3: do you believe, in principle, that tenants should contribute proportionately toward the CRC costs incurred by their landlords in relation to:

- A. energy use within their own premises
- B. energy use within the common parts of the buildings that they occupy
- C. administration of the CRC by the landlord

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

The majority believed that tenants in buildings belonging to landlord participants should contribute in some way toward the cost of CRC participation, but opinions varied as to how far they should do so.

The vast majority of respondents believed that allowances purchased in relation to energy used in tenant demises should be the subject of tenant contribution.

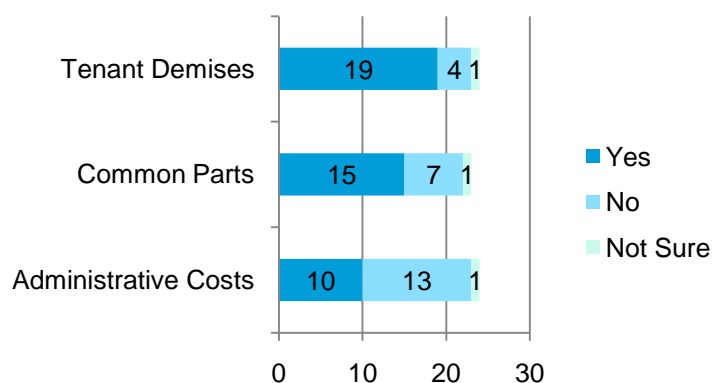
In relation to contributions to common parts, the majority felt that tenants should contribute. However, a small number of respondents issued caveats, including that if tenants were required to contribute to the cost of *allowances*, then they should have a say in the management of the common parts of the building.

In relation to administrative costs, responses to the consultation and views expressed at the workshop were conflicting on whether or not this was a cost to be borne by the landlord as a 'head office cost' since the CRC imposes obligations on the landlord's corporate group. Splits of opinion on this sub-question were not divided along owner and occupier lines, and there were clear differences of opinion among legal service firms.

The minority who believed that tenants should not contribute at all to the landlord's costs in participating in the CRC (whether for *allowances* or for administrative costs) felt that this would lead to negative effects on the liquidity of the property market. Such complications were felt to undermine the aim of the *Scheme*, and to have a potentially distortive effect on rents as tenants might not be willing to furnish market rents for leases which contained additional obligations arising from the landlords participation in the CRC. A concomitant effect would be realised at rent review.

Others felt that any attempt to allocate costs fairly would be fraught with difficulty, owing to the lack of predictability which accompanied the *League Table's* effect on whether a positive or negative benefit would be accrued from the *revenue recycling payment*.

Figure 2: Question 3 Responses



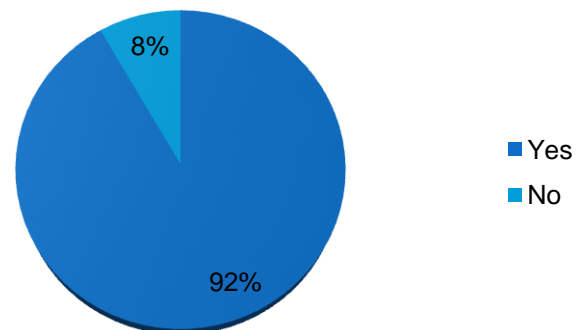
Question 4: do you believe that tenants should only contribute if they are credited with a fair share of the *revenue recycling payment* received by their landlord that reflects their contribution to emissions? Please explain your reasoning.

As **Figure 3** shows, the vast majority of respondents agreed with the philosophical premise that if tenants contribute to the cost of *allowances*, then they should be entitled to a share of the *revenue recycling payment*.

Of those who said that tenants should not be entitled to a *revenue recycling payment* solely on the basis of contributing to the cost of *allowances*, some felt that the amount of the *revenue recycling payment* received by the landlord would have little to do with the tenant's emissions. The implication would be that the landlord would be unable to guarantee a fair recycling payment as the *Scheme* itself did not include such a dynamic of fairness.

Others who disagreed did so as a consequence of their answers to other questions (e.g. where they had answered that the tenant should be charged only retrospectively for the cost of *allowances* less the *revenue recycling payment*).

Figure 3: Question 4 Responses



Question 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)?

Responses to this question showed significantly divided opinions.

Several respondents felt that if landlords were unable to pass costs through to tenants, a natural step would be for the additional costs to be reflected in higher rents. However, some respondents pointed out that such increased rents could only be invoked in existing leases at the time of rent review. A handful of respondents suggested that the question assumed that the attempt to introduce CRC obligations upon prospective tenants (whether fiscal or behavioural) would not be met by tenants offering lower rents for more onerous leases. A corollary of this would be that landlords who were more successful in the *Scheme* might be able to offer their tenants more attractive terms.

Other respondents thought that there was growing anecdotal evidence for increased rental value from energy efficient buildings compared to less efficient counterparts. In line with broader industry debate on the link between sustainability and financial performance, valuers are not obliged to factor sustainability performance into valuations, and without specific agreed denominators of performance, it is difficult for them to do so in a comprehensive way.

A key difficulty in channeling the cost of CRC through rents is that participation in the *Scheme* is fixed for a *phase*, but the ownership of an asset could change during that *phase*, and potentially from a CRC *participant* to a non-CRC *participant* and vice versa. With rents fixed at the outset of a lease, the only opportunity for adjustment lies

in the rent review at pre-agreed intervals. Any approach which sought to feed CRC costs through rents would need to take account of this dynamic.

Others suggested that if the lease did not permit the pass-through of costs, then it should not be permissible for the landlord to seek to pass on the costs in another way. One respondent suggested review of the service charge regime, to follow the model adopted in Sweden, where tenants have a choice of a hiring space along the lines of a serviced office, or to take an interest in property with lower rents but with an attendant property risk.

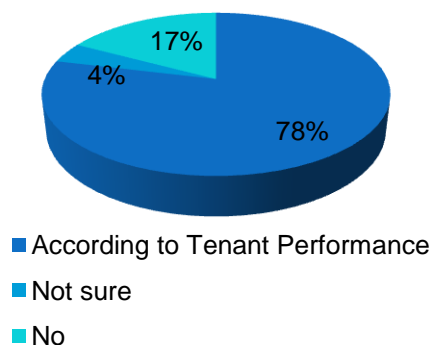
Question 6: do you agree that any standardised approach to CRC for leased buildings should allocate costs and benefits to individual buildings and even individual tenants by reference to actual energy use (wherever this can be ascertained) i.e. following polluter pays principles? Whether you answer yes or know, please explain your reasoning and give any hypothetical examples if possible.

The vast majority of respondents to this question believed that costs and benefits should be recycled to tenants based on their actual performance. Among those respondents who favoured allocations according to tenant performance, several recognised the inherent difficulties of allocating costs and benefits in this way, citing administrative burden and the difficulties in calculating performance improvements in the wake of acquisitions and sales.

Some respondents favoured a differentiated approach for tenant demises and common parts. One respondent favoured the apportionment of costs for common parts and administrative costs to tenants on a per square metre basis.

Of those who did not favour apportionment of costs and benefits to tenants on a performance-related basis, one respondent argued that the *Scheme's League Table* mechanism would not guarantee benefits which could be recycled by the landlord to tenants to reward good performance.

Figure 4: Responses to Question 6



Question 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 the CRC to the tenant? If so, please can you supply a copy of the wording of the specific clause that leads you to believe that this will be the case?

Over half of respondents to this question felt that current leases would not permit the pass-through of costs from landlord to tenant. Many pointed out that Holding & Management vs Property Holding and Investment Trust (1990) had held that sweeper clauses in leases only expanded on specific items in the list and did not apply to new items.

Others identified that clauses referencing 'tax or other fiscal impositions on the landlord in relation to carrying out the service' might permit the pass-through of costs, but that application of the term 'fiscal' to the CRC was questionable.

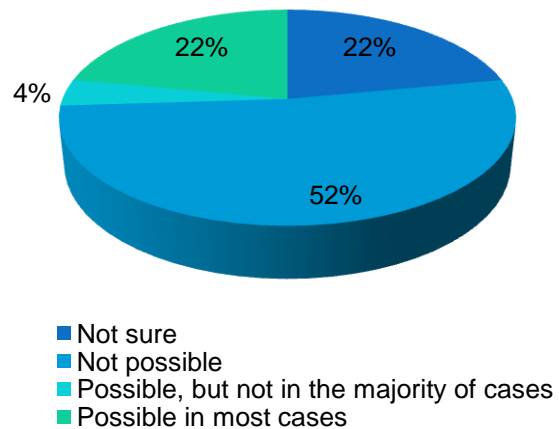
One respondent suggested that service charge clauses might permit the net recovery of costs (i.e. if the landlord purchased allowances on the tenant's behalf and charged the tenant only the difference between a fair allocation of allowances and recycling payment at the end of the *compliance year*).

Some respondents differentiated between the types of cost which accompanied participation in the *Scheme*. One respondent felt that most existing leases would permit the pass-through of costs relating to the purchase of *allowances*, but not for *administrative costs*. Another respondent felt that *service charge* clauses could permit the pass-through of the costs of administering *allowances*.

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

As the majority of respondents to **Question 7** thought that the pass-through of costs would not be possible, only a few respondents answered this question. Of those who did, opinions on the degree to which the pass-through of costs would be permitted varied considerably. Some owners who responded suggested that it would apply to the majority of their leases, whereas others felt that only a very few leases contained specific wording which would permit the costs to be passed through. One respondent identified differences between what their retail leases permitted and what office leases allowed in terms of pass-through of costs. However, the number of responses to this question, and the varied opinions expressed, leave it impossible to say with any certainty whether any existing leases will permit costs to be passed through.

Figure 7: Responses to Question 10



Question 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/revenue recycling payments* (e.g. the landlord's internal or consultancy costs incurred in administering the CRC)?

Costs of Complying

The majority of respondents felt it was justified to pass through the costs of compliance with the CRC to tenants. Some respondents argued that such an approach was in keeping with the spirit of a key principle of the Industry *Service Charge Code* – that the landlord should not be out of pocket in providing services to tenants.

One respondent differentiated between the costs of reporting and administration, which they believed should belong with the landlord, and the costs of complying with the performance requirement, which they believed should be shared. The latter costs were felt to derive from the tenant's consumption of energy and hence landlords would have limited control over such costs.

Those who felt that tenants should not contribute to the cost of complying with the CRC offered varied reasons for their point of view. One respondent thought that the tenant does not take risk on the nature of the landlord's organisation by virtue of their occupation of the landlord's property. If the landlord is left to choose when to buy allowances, and in what quantity, the landlord should accept the risk and reward of the choice. Others felt that the costs of compliance were a 'head office' cost which belonged with the *participant*, given that the CRC focuses on the *participant* at the corporate level.

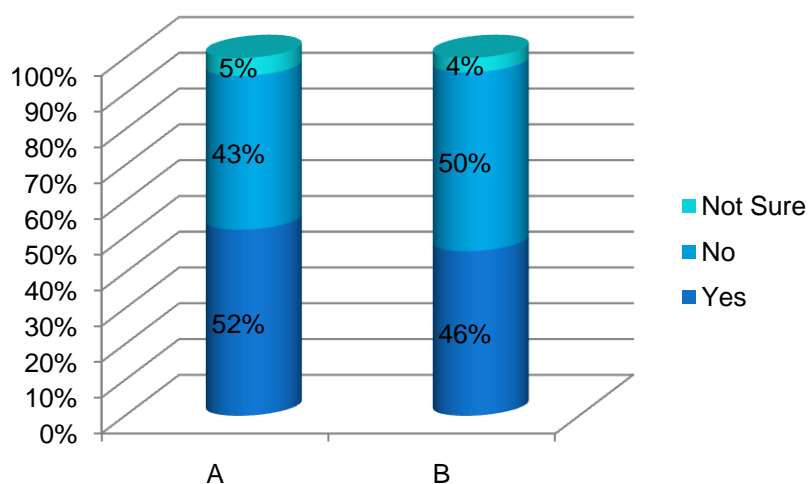
Costs of Administering

There was a much closer margin between respondents in relation to whether or not tenants should contribute to the costs of administering the transfer of *allowances/revenue recycling payments*.

Of those who felt that such costs should not be passed-through, some argued that the size and complexity of the landlord's portfolio was unrelated to the to the tenant's occupation.

Those who felt it was justified for costs to be passed from landlords to tenants relating to administering the transfer of *allowances/revenue recycling benefits*, felt it was so as these costs were derived from the tenant's use of energy. Others suggested, as with the **Question 9a**, that the pass through of costs was in line with the principles of the Industry Service Charge Code – that the landlord should provide the service to the tenant on a 'not for profit, not for loss' basis.

Figure 6: Responses to Question 9



One respondent suggested that, in **Questions 9a and 9b**, the answer would be different depending upon the length of the lease. If a tenant was party to a long lease with the landlord, it might be reasonable to assume that the tenant would acquire some share in the risk and reward of ownership of the building.

Question 10: if the administration costs and cost of *allowances* were to be passed on to tenants (*revenue recycling payments* are considered in later questions), please indicate how you believe the costs should be dealt with:

- A. split among 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).

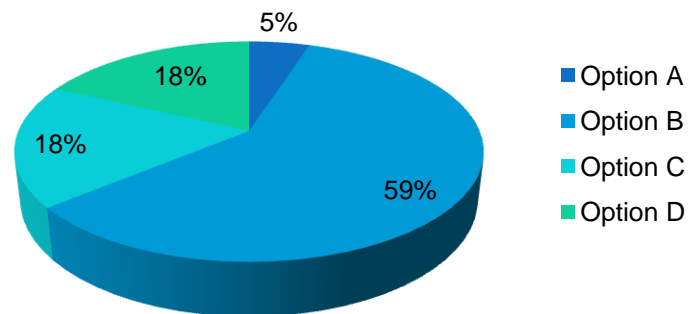
The majority of respondents favoured **Option B**, given that it accepted that robust energy use information may not always be readily obtainable in the early stages of the *Scheme*. Several respondents who favoured **Option B** suggested that the apportionment of costs should differentiate between the cost of *allowances*, which could be passed through, and the cost of administration which should be borne by the landlord as the *CRC participant*.

Tenants largely favoured **Option C**, with a number indicating that administrative costs should be borne entirely by the landlord. Some tenant respondents indicated that the landlord should bear the cost of *allowances* that related to energy used in *common parts* of the building, or at least make a significant contribution to it.

Option D sought alternative suggestions from those respondents who did not agree with the other proposed approaches. One respondent suggested that many property owners may in addition to their tenanted buildings purchase large amounts of energy for buildings occupied by other parts of their *CRC Organisation* (as a tenant or owner/occupier). These include large industrial/financial conglomerates that may have a property investment arm, or insurance companies that operate a consumer facing business. In these circumstances, the proportion of the landlord's emissions from its own directly used/controlled energy could be greater than or equal to that coming from its portfolio of tenanted buildings. With such scenarios possible, it would seem sensible to ensure that where costs are passed on to tenants, that they are directly attributable to the tenant.

Others asserted that any assessment of the tenant's contribution toward allowances should be made at a building level rather than at a portfolio level (as suggested in **Option B**). This is because the tenant receives no benefit from the landlord determining a liability as part of a portfolio; rather there are non-auditable risks of

Figure 7: Responses to Question 10



disproportionate charges. The building may be transacted during a *compliance year* or the landlord may sell other buildings in the portfolio which would make it difficult for the tenant to track its liability. A landlord levying a charge on such a basis could also find it difficult to take action against a tenant for non-payment if the basis of the charge was not clear and pre-agreed.

Others under **Option D** suggested that CRC costs should be dealt with in the same way that service charge costs are apportioned between tenants. However, this would need to be considered carefully where tenants have service charge caps or weighted *service charge* arrangements in their leases.

One respondent who favoured **Option D** suggested that *administrative costs* should be levied on a floor area basis, but that costs associated with *allowances* should be based on tenant forecast of emissions. These costs would then be settled before *allowances* were purchased. Any additional *allowances* which were bought on the *secondary market* due to tenant underestimation would be settled directly.

Option A was favoured by only a small minority of respondents, and there was a general recognition that proceeding straight to an apportionment by floor area was not in keeping with the central tenets of the *Scheme*. Of those who favoured **Option A**, responses suggested that this was the most administratively simple option.

Question 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:

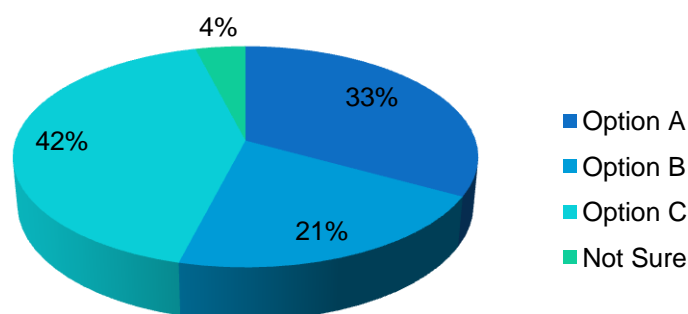
- A. split amongst tenants in the building depending on square feet occupied;
- B. paid for by the landlord; or
- C. other?

Please provide reasoning for your answer.

A sizeable minority of 42% in response to this question favoured **Option C**, the proffered and favoured options differed widely. Some respondents thought that the approach toward apportioning the cost of common parts to tenants should follow typical service charge provisions for the building, which are usually based on floor area or rateable value. Other respondents felt that the cost should be split among tenants based along lines of relative energy use where available. Some respondents saw landlords contributing toward the cost of allowances for common parts and/or for own operations.

The second largest minority favoured **Option B**, but no owners favoured this option, with its core supporters formed of occupiers and legal services firms.

Figure 8: Responses to Question 11

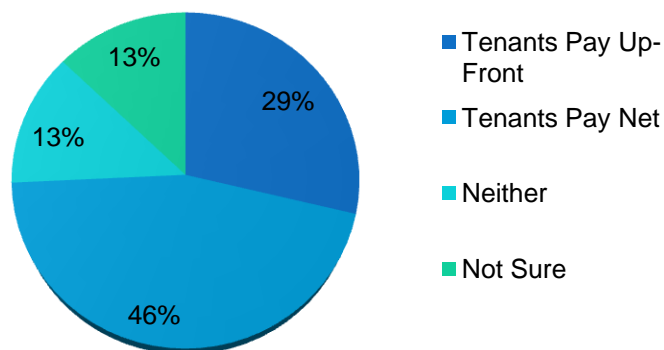


Question 12: should tenants provide landlords with the money to buy *allowances* or should the landlord buy the *allowances* and then charge the tenants retrospectively? If the landlord uses the tenants' money to buy the *allowances*, to whom would the *allowances* belong?

Figure 9 opposite shows the responses in relation to the first part of **Question 12**, which asked respondents whether tenants should provide landlords with the money to purchase *allowances* in advance, or whether the landlord should buy *allowances* and charge the tenants retrospectively.

A sizeable minority favoured a model where tenants paid the net costs of the *allowances* (i.e. that the tenant should pay any difference between the *revenue recycling payment* and the cost of *allowances* only).

Figure 9: Responses to Question 12a



One respondent suggested that the *allowances* should be purchased by the landlord and held in an energy efficiency fund, investing a certain percentage, and that any interest accrued should be used in energy efficiency measures on an annual basis. At the end of the reconciliation period, the respondent suggested that the tenant should pay their contribution (by energy or floor area) into the fund plus or minus any *revenue recycling payments* and taking into consideration any energy efficiency fund investments.

The majority of those answering solely in the capacity of a tenant thought that the tenant should not contribute to the *cost of allowances*.

Figure 10: Responses to Question 12b

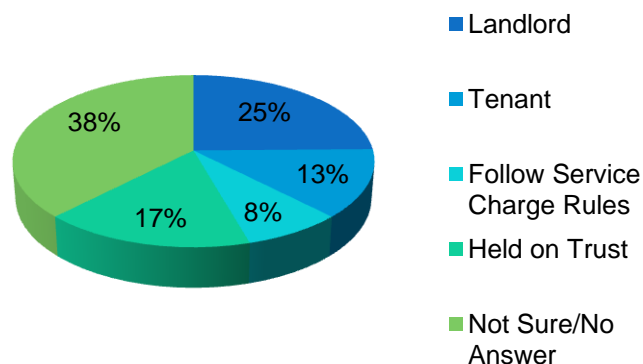


Figure 10 shows the breakdown of responses to the second part of **Question 12** which sought respondent views on the question of whether the *allowances* bought with tenant monies would belong to the landlord or the tenant.

38% of respondents were unsure to whom the *allowances* would belong or did not answer the question. This renders it difficult to draw meaningful conclusions from the responses to this question.

However, the responses did yield a number of issues it would be important to consider in providing a way forward on this issue. On the one hand, it is logical for the *allowances* to belong to the landlord, even if the tenant's money is being used, as the landlord is the CRC *participant* and the organisation which the *Scheme Administrator* will expect to honour obligations under the *Scheme*.

Some respondents suggested that tenants should own the *allowances* in order to avoid landlord insolvency issues. However, this is an argument which could equally apply in the case of tenants holding *allowances* and becoming insolvent.

Several respondents, including both owners and occupiers, suggested that *allowances* should be bought with tenant's money but held on trust. Ordinarily, service charge credits sit in the managing agents' client's accounts and the client has a proprietary interest.

One respondent concluded that if the tenant is paying the net cost of *allowances*, then the issue of determining ownership of the *allowances* does not arise.

Question 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?

In relation to paying *allowances*, assuming that landlords and tenants share the costs between them, it is necessary to decide whether the *allowances* that the landlords buy should belong to the landlords or the tenants pending surrender. Views on this are clearly needed, as the landlord's flexibility to allocate *allowances* between different buildings will be compromised if *allowances* are allocated to tenants immediately as they are acquired.

In relation to payment for the *allowances*, there seem to be two options:

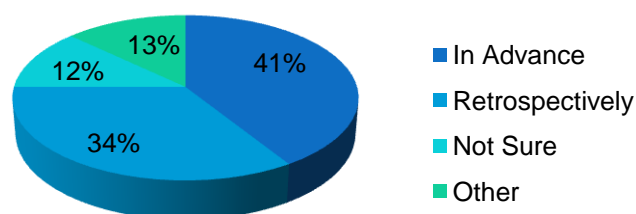
- A. If *allowances* are to belong to tenants immediately, tenants will need to pay for them immediately, and effectively the landlord will hold them on trust.
- B. If *allowances* are to belong to landlords until surrendered, it may be necessary for the landlord to reconcile the costs for each *compliance year* at the end of the year, and charge the tenants to pay at the end of the year. But it would be possible to ask tenants to pay sums on account or alternatively to cover the landlord's financing costs.

The industry working party has thought that paying sums on account would most likely not be done regularly since the landlord's main expenditure is likely to be the April sale of *allowances*, with little other outlay until the end of the year at which time the landlord would calculate whether more *allowances* will have to be bought in the *secondary market*.

In the case of B. it would be necessary to consider whether the landlord should charge separately for *allowances*, and pay out the *revenue recycling payment* share separately, or alternatively whether the two sums should be netted off against each other.

Responses to the consultation and discussions at the industry workshop were inconclusive on this particular point. Many of those who opted for one or other of the options highlighted clear concerns with each. We suggest,

Figure 11: Responses to Question 13



therefore, that this issue will have to be negotiated between landlords and tenants at the outset and that the industry will require a set of options to work to on this point.

Question 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. Do you believe that landlords would be interested in operating such a system? Provisions in the lease could set out what should happen if the tenant does not have enough *allowances* to pass to the landlord.

The approach detailed in **Question 14** was put to the industry as it had been suggested in other forums that this could be a potential way to transfer responsibility from landlord to tenant. The potential advantages of such an approach would be that it would align the costs of the *Scheme* with energy use, and provide efficiencies in the management of the *Scheme* to those tenants who were in the *Scheme* in their own right.

Respondents were overwhelmingly unsupportive of this approach, as evidenced in **Figure 12**. Respondents thought that such an approach could:

- have negative effects upon liquidity;
- lead to regulatory risk for the landlord as the tenant would hold no official responsibilities by virtue of their use of energy purchased by the landlord; and
- lead to incongruities with an industry-standard approach, if one was adopted.

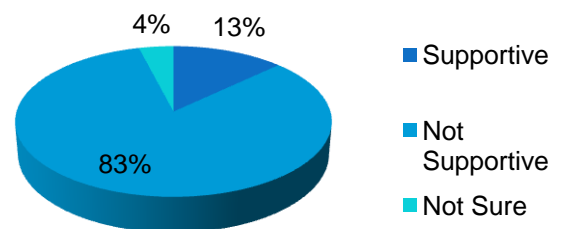
The Industry Working Party is therefore not minded to recommend the approach outlined in **Question 14**.

Question 15: if the *revenue recycling payment* is paid to the tenant, what methodology do you believe should be put in place to calculate the tenant's share of the *revenue recycling payment*? possibilities included 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?

Opinions differed significantly on the most appropriate way to recycle the benefits of the *Scheme* to tenants. *Revenue recycling payments* will be received in October in each *compliance year* (April to March). They will represent each participant's share of the proceeds of the *allowances* received by the Government in the six months earlier, as adjusted by a bonus or penalty according to the participant's position in the *League Table*.

However, the amount of the bonus or penalty within the *revenue recycling payment* each year will be assessed by reference to energy use in the preceding *compliance year*. A key conundrum to be resolved lies in what should happen if the tenants who are receiving a share of the *revenue recycling payment* are not the tenants who were in the building in the period by reference to which the *revenue recycling payment* is calculated.

Figure 12: Responses to Question 14



It is also difficult to identify the proportion of the recycling payment which each tenant should receive. It would seem fair that tenants should be rewarded for good performance, but should *revenue recycling payments* be reallocated to tenants on a proportionate basis to tenant energy use or should it include some measure of reward for reductions in energy use? If the latter, it would follow that some form of comparator would have to be used.

Discussions at the workshop concerning how recycling benefits should be passed to tenants suggested that there were a range of options, but each was not without problems:

- A. The landlord accepts the risk and reward of the *Scheme*, and incentivises tenants to act in an energy efficient manner within their demises on landlord supplies via behavioural obligations (e.g. green memoranda of understanding). Neither the costs nor the *revenue recycling payments* are passed on to tenants. The advantage of this approach is that the landlord can exercise marginal cost abatement strategies when deciding how many *allowances* to buy and can exercise a free choice in how the *revenue recycling payments* are spent or reabsorbed. Tenants do not hold the cost of participation in terms of purchasing *allowances* for the carbon associated with their use of landlord services and common areas. However, some respondents to the consultation cautioned that tenants might be unwilling to pay market rents for a tenant demise with a more onerous 'green lease' condition attached.
- B. The landlord reallocates to the tenant based on floor area. The advantage of this approach is its simplicity for the landlord but the tenant receives little, if any, incentive to improve its energy using behaviour. This is in the long term disadvantageous to the landlord as entry into *capped phases* of the *Scheme* will necessitate collaborative energy management between landlords and tenants in order to reduce exposure to the risk of having insufficient *allowances* to surrender.
- C. The landlord operates a scheme-within-a-scheme. It is generally thought that the use of internal league tables is the most practical way to make such an approach practicable. However, such *league tables* hold resource implications for their effective administration. Many respondents to the consultation felt that reallocation based on some form of performance measure would be preferable, but that the paucity of benchmarking data meant that this would not always be possible.

The suggestion in the question of league tables across portfolios was not popular among respondents, who observed that such an approach would not compare like-with-like, preferring *league tables* on a building-by-building basis. Although it was not possible to introduce, via internal *league tables*, a dynamic which would provide adjustments to the *Scheme* to accommodate the relative improvement potential of tenants, comparison of office tenants with office tenants and retail tenants with retail tenants would seem to be the fairest approach.

- D. One respondent to the consultation suggested an approach in which *revenue recycling payments* could be passed to tenants based on a floor area apportionment, but with behavioural conditions attached to their receipt (such as reductions in absolute footprint). This approach would incentivise tenants to reduce their energy use, and permit the landlord to make strategic decisions on the number of allowances to purchase. This approach also has the advantage of rewarding tenants for behaviour without seeking to reconcile the rewards the *Scheme* provides for absolute reductions with the differing energy intensities of sub-sectors of the office and retail environment.

The working group at the industry workshop suggested that a lowest common denominator approach could be embedded in leases while the industry determined the most appropriate methods to be employed.

Question 16: do you think it is feasible and cost effective for landlords who purchase *allowances* relating to their tenant's 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?

Respondents thought that league tables were fairer and cheaper if operated on a building-by-building basis where they were an appropriate way to stimulate behavioural improvement. Many owners felt that mandating the operation of *league tables* was undesirable, as they were deemed not to be cost-effective in all cases and it would be administratively burdensome to run a *league table* in every building in a portfolio.

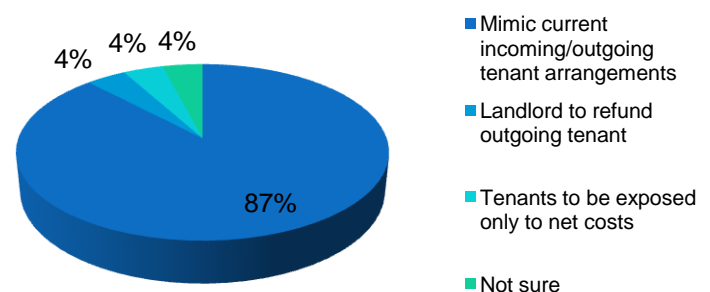
At least one respondent felt that internal *league tables* were an attractive idea but that they did not foresee that it would permit landlords to reapportion a limited pool of *allowances* in a manner which rewarded performance without being punitive toward energy intensive tenants. Further complications would arise by virtue of extraneous factors affecting energy use, such as climactic conditions and significant energy uses which would skew nominal energy use, and make it difficult to separate high energy use from profligacy. Some owners felt that a duty to reapportion on a fair and proper basis could have the same effect as the intent behind a *league table* approach.

Many respondents felt that software solutions were being developed which would permit automation of *league tables*, which in turn would invoke greater cost-effectiveness and reduce administrative burden involved in their use. However, the market would be the determinant of whether such products would come to fruition and be popularised.

Question 17: what should happen when a tenant changes during the *compliance year*? If the landlord is passing costs and benefits 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 *revenue recycling payments* between them, in the same way as happens now between incoming and outgoing tenants in relation to service charges?

The vast majority of respondents in relation to Question 17 thought that the current arrangements for settling service charge accounts were sufficient for the purpose of dealing with the costs and benefits of CRC.

Figure 13: responses to Question 17



Question 18: where a landlord changes in during the *compliance year*, the landlord who sold the building will receive the *revenue recycling payment* but 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 *revenue 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 *revenue recycling payment* that related to the emissions from the building. What do you think should happen in the case of:

- A. CRC *participant* landlord selling to a different CRC *participant* landlord;
- B. CRC *participant* landlord selling to a non-CRC *participant* landlord; and
- C. a non-CRC *participant* landlord selling to a CRC *participant* landlord.

CRC participant landlord selling to a different CRC participant landlord

Respondents' views varied significantly on this issue. Two respondents thought that the landlord should adopt all the risk and reward of participation in the *Scheme* simply to avoid the complications associated with this scenario.

A number of legal services firms observed that the sale contract should include a provision which requires the old landlord to forward the *revenue recycling payments* to the new landlord post-completion, within a reasonable period following receipt. The buyer would then be obligated to pass on the costs to tenants if passing benefit to them.

In the instance that the incoming landlord needs to buy additional *allowances*, he may pass on the cost via the lease.

CRC participant landlord selling to a different non-CRC participant landlord

Again, two respondents thought that the complications which arose from the pass-through of costs should be negated by the landlord accepting the risk and reward of the *Scheme*.

Other respondents held differing views as to how this particular issue should be negotiated. Some felt that the situation was not dissimilar to the one explored in **Question 18a** and that all should be dealt with in the contract of sale. Those who approved of this approach could be subdivided into two camps:

- The buyer and seller contract to pass-on *revenue recycling payments* under the contract of sale, with the seller surrendering *allowances* and receiving *revenue recycling payments* on trust for the buyer. The seller would then pass the *revenue recycling payments* to the buyer within a reasonable period following receipt of the *revenue recycling payment*; or
- The *revenue recycling payment* is reconciled with the tenant by the seller at the point of sale, where for an agreed price the landlord reimburses the tenant based on their contributions to the *allowances*. An alternative suggestion was that the landlord could sell the excess *allowances* no longer required for the building and place the monies accrued in the service charge account. Alternatively, the outgoing landlord could re-allocate these unwanted *allowances* to other parts of its portfolio, at a fair value (which it could pay into the service charge fund for the building that was sold).

Some occupiers suggested that the building should remain in the *Scheme* until the end of that *compliance year*. Clearly, this would visit CRC responsibilities upon a non-CRC *participant* landlord with the accompanying administrative costs of participation for a single building for a single *compliance year*.

Some felt that the process should be determined via individual negotiations at sale rather than setting universal principles as to what should happen at transaction. However, this would have a negative effect on the speed and ease of transactions.

Non-CRC participant selling to a CRC participant landlord

Many tenants believed that in this case, the building should join the *Scheme* not earlier than the following *compliance year*. One would expect that if such an approach would be followed, it would mirror the similar arrangements suggested in Question **18b**.

The issues raised in responses to this question highlighted a number of key questions a participant buyer would have to consider in purchasing a building during the *compliance year*. The purchasing landlord would have to:

- Buy *allowances* for the building and it is likely that these would not be from the *Administrator* but instead on the open market;
- Some respondents suggested that the seller might have to take a discount to meet the *allowances* the buyer would have to purchase for the building. The opinion of professional valuers would need to be sought on this point; and
- Depending on the point in the *compliance year* at which the building is transacted, the buyer may have difficulties in negotiating cost-sharing or behavioural responses from its prospective tenants prior to the surrender of *allowances*.

It is likely therefore, that no obligations would be visited upon the seller, but the buyer would have to exercise due diligence to ensure that it could honour obligations arising from ownership of the asset which were associated with membership of the *Scheme*. Some aspects will be down to the landlord's strategy (e.g. whether to seek to pass through costs or not, how to apportion benefit) and others will be fixed requirements (e.g. purchasing and surrendering sufficient *allowances*). It may be that the buyer will seek to obtain additional information from the seller at the time of sale which will help the buyer to predict the number of allowances it will have to buy, and whether the building has scope for easy wins in energy efficiency terms or whether the seller has already made savings. If a display energy certificate or a recent energy audit report are available, it is likely that the buyer will seek to obtain them in order to inform this process. It may be that standard enquiries should be developed in order to streamline such enquiries.

Question 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?

If the costs of participation in the *Scheme* were not shared between landlords and tenants, respondents believed that the volatility of energy prices could be a motivational factor for further engagement between landlords and tenants on energy efficiency.

Others thought that investor/occupier preference for more sustainable buildings which arose from corporate social responsibility obligations, or pressure from elsewhere in the supply chain, might reorient preferences toward such principles.

Responsibilities arising from other legislation were also said to have a role in engendering institutional change in the landlord and tenant relationship. Directors' duties under financial reporting, and the looming prospect of mandatory carbon reporting under the Climate Change Act, could lead to greater visibility of performance and an accompanying desire by corporates to be seen to be doing good.

Associated mechanisms which were thought to be useful in fostering working relationships between landlords and tenants were green leases, memoranda of understanding and industry codes governing behaviour in operating leases. Undoubtedly, these will be increasingly important in the future, but the terms of such agreements and the precise wording will be important so that they are able to accommodate industry norms and legislation in the future.

Energy performance contracting, where energy services firms take on the risk and reward of agreed levels of reductions in energy use and associated emissions, were said to address issues of upfront investment in energy efficiency improvements as well as assisting in the promotion of engagement across the landlord and tenant divide.

Finally, fiscal incentives and penalties were mentioned as possible drivers for changing existing behaviours. However, it is likely that the Government would not seek to introduce additional incentives or penalties for behaviours that the CRC was intended to address.

Enhanced capital allowances and capital allowances are available against the purchase of energy efficient kit and against plant and machinery respectively.

Question 20: assuming that the costs are passed on to the tenants, do you think that the concept of a fund (into which the *revenue 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.

It has been suggested that *revenue recycling payments* could be allocated by way of one or more specifically 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 and insulation.

This approach was only supported by a very few respondents. The majority who opposed the use of *energy efficiency funds* argued that such an approach would run counter to established guidance on the use of sinking funds.

Many believed that the use of such funds would be administratively burdensome and not tax-efficient to administer.

Some observed that if a fund was run at portfolio level, and costs were being passed to tenants, such an approach would not invoke fairness in reapportionment of benefits. This is because monies would be likely to be apportioned to the poorest performers in the portfolio. Although this could have a positive effect on the position of the landlord participant in the league table, it would not reduce the better performing tenants' exposure to the capped *allowances* market. Moreover, the unpredictabilities of the *League Table* would mean that the overall improved performance of the landlord's portfolio would not automatically translate to an improved *revenue recycling payment*.

SECTION 4: CONCLUSIONS

The responses to the consultation revealed no consensus about the next steps to be taken. Even landlords did not agree amongst themselves. This makes it difficult to progress, as originally intended, to drafting a standard CRC lease clause.

Some of the ideas canvassed were rejected clearly: that tenants might buy their own CRC *allowances* and pass these to the landlord for surrender, or that the landlord would keep the whole recycling payment in a fund earmarked for making energy efficiency improvements to its portfolio. These will not be explored further.

There was agreement on the following broad principles:

- that a tenant *should* contribute to the cost incurred by its landlord in purchasing CRC *allowances* to cover emissions from that tenant's energy consumption in its premises. However, there was less consensus on this point at the industry workshop which followed the end of the consultation
- that a tenant who contributes to CRC costs should receive a *fair* part of the *revenue recycling payment*
- that, where CRC costs are divided between several tenants (perhaps in a multi-let building), the division should reflect their relative energy use

There was much less agreement on other issues such as:

- should tenants contribute to the cost of CRC *allowances* in respect of emissions from energy used in the common parts?
- should tenants be asked to contribute to the other costs relating to CRC that landlords will incur, such as registration fees, annual filing fees, record keeping, cost analysis and preparation of CRC accounts?
- should tenants pay their contribution in advance instalments or at the end of the year?
- should landlords divide the *recycling payment* according to energy use or improvements in energy efficiency (ie an "in-house" CRC *league table* for its tenants).

It seems, therefore, inevitable that one single, industry-standard, CRC lease clause is unachievable in the short term, and indeed may be undesirable as it could be seen to stifle innovations in energy improvement between landlords and tenants.

However, the working party believes there may still be merit in highlighting particular approaches that landlords may choose to follow, so that so far as possible similar structures are used to achieve the same objective and simplify the drafting and negotiation processes.

The Industry Working Party is therefore preparing a second edition of 'The Carbon Reduction Commitment: A Guide for Landlords and Tenants', which is expected to be issued in July 2010. This will contain suggestions for various methods under which tenants could – where this is agreed in heads of terms – contribute towards their landlords' CRC costs, and the advantages and disadvantages of each method. This will also take into account a number of proposals for CRC provisions within leases that have been put forward by landlords within the past month or so.

ANNEX A – WORKING PARTY MEMBERS

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- Tatiana Bosteels, Hermes (BPF)
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- Becky Clissmann, Practical Law Company
- Sue Highmore, Practical Law Company
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- Philippa Latimer, BCSC
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