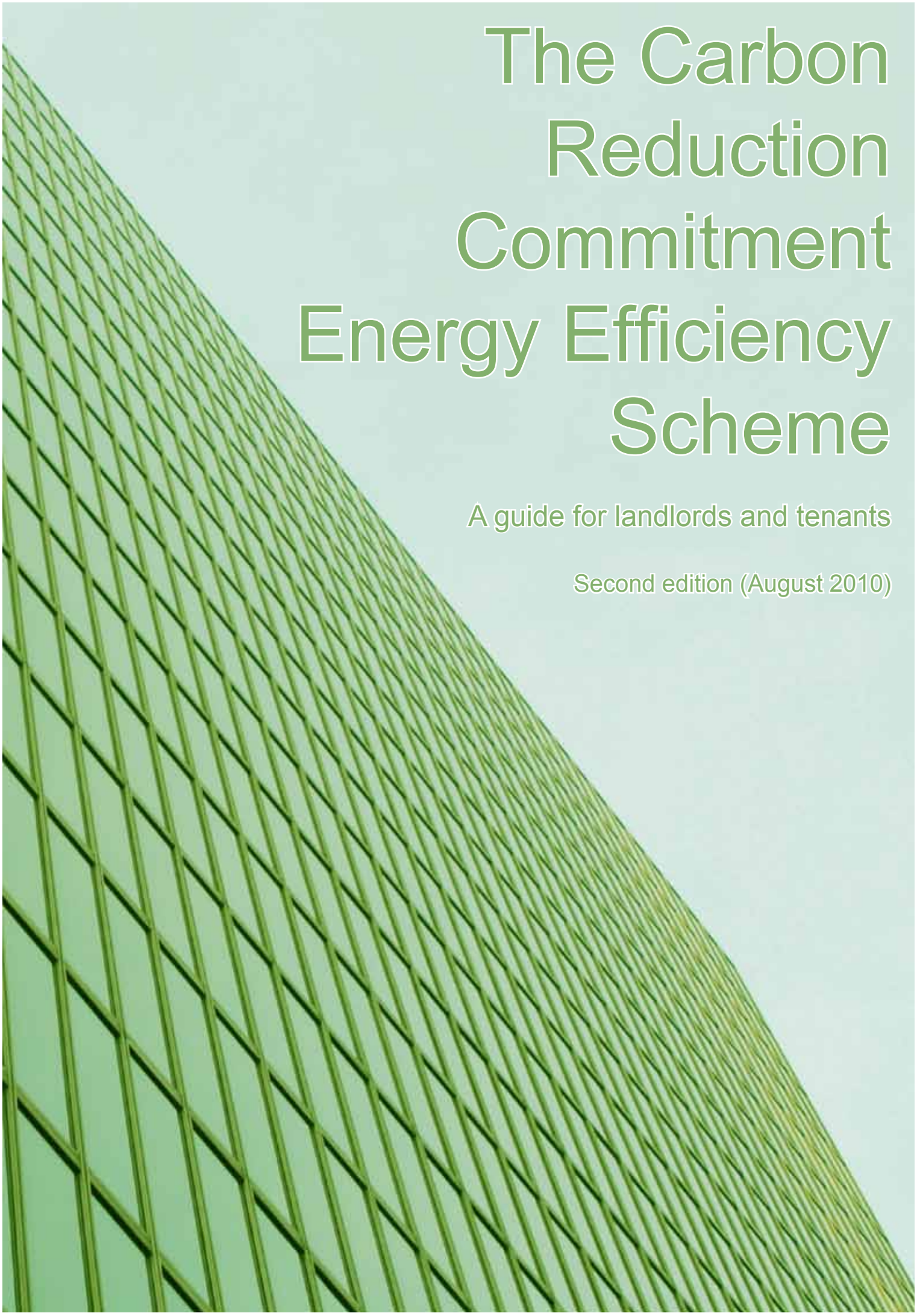

The Carbon Reduction Commitment Energy Efficiency Scheme

A guide for landlords and tenants

Second edition (August 2010)

Contents

Acknowledgements

This guide has been compiled by a working party drawn from the following organisations, all of whom are members of the Green Property Alliance:

The British Property Federation
The British Retail Consortium
The British Council of Shopping Centres
The British Council for Offices
The Investment Property Forum
The Royal Institution of Chartered Surveyors
The UK Green Building Council

A list of those who have contributed is appended at Annex D.

Special thanks go to Charlotte Eddington for chairing the working party, Peter Williams (Eversheds LLP) and Becky Clissmann (Practical Law Company), Michael Coxall and Maureen Romeril (Clifford Chance LLP), Clive Stringer (NB Real Estate) and Julian Lyon (RICS Corporate Occupiers Group) for their advice and assistance in compiling this guide.

Second edition

The second edition of the guide represents a revised edition following the release of the final CRC regulations. It was created in August 2010 by Peter Williams (Eversheds LLP) Becky Clissmann and Sue Highmore (Practical Law Company), and Patrick Brown (British Property Federation).

This guide is correct as of 1 August 2010. It is intended as general guidance only, and is not a substitute for detailed advice in specific circumstances.

The purpose of this guide

The UK Government has set an ambitious target to reduce greenhouse gas emissions by 80% by 2050.

The carbon footprint of buildings is the source of just under 50% of greenhouse gas emissions in the UK (according to the Department for Communities and Local Government (CLG)). The Carbon Trust has estimated that more than 75% of the commercial buildings that will be standing in 2030 have already been built. The existing built environment will therefore be a key to the success of the objective of reducing carbon emissions, and the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) is a key part of that objective.

This guide is intended to assist owners and occupiers of commercial property to plan to implement the CRC, a new legally binding emissions trading scheme that will apply to large businesses and public sector organisations with effect from April 2010. All owners and occupiers of property should be aware that, even if they are not affected when the *scheme* is launched, the CRC is likely to affect the way properties are bought and sold. Furthermore, the scheme is organised in phases of seven years at a time, which may mean that some organisations that are not affected in the first phase will fall within the scope of the *scheme* in future phases.

The guide is divided into the following principal sections:

Section 1 provides some general information on how the CRC will operate, to whom it applies and the timeline for its introduction. The Department of Energy and Climate Change (DECC) has introduced the scheme, but the Environment Agency is the main *administrator* of the *scheme*.

Section 2 discusses how the cost of the CRC can be apportioned between landlords and tenants. It is not possible to give any definitive guidance about this as the legal position surrounding the application of the CRC, particularly in relation to existing leases, remains at best unclear. Many other problems in operating the CRC in the landlord and tenant context have also been identified. At present, there are no clear solutions to these problems. This section, therefore, examines some of the more significant issues that landlords and tenants are likely to face and discusses some possible approaches to dealing with them.

Section 3 discusses issues that are likely to arise when the ownership of a building changes and some possible procedures for dealing with them.

Section 1: what is the CRC?

In May 2007, the Government published the Energy White Paper and announced its decision to implement a new emissions trading scheme – the CRC. The *scheme*, which is a mandatory emissions trading scheme, aims to cut CO_2 emissions by requiring that organisations purchase *allowances* – priced in £/tonne – to cover the equivalent amount of CO_2 that an organisation produces from its operations in a given year.

The use of market mechanisms encourages organisations to reduce their energy usage as CO_2 becomes associated with a definable financial reward or cost.

The CRC applies to large commercial and public sector bodies whose total annual *half hourly metered* electricity use in 2008 was above the qualification threshold of 6,000 MWh. As a general rule of thumb, organisations with a total annual electricity bill in 2008 of around £500,000 to £1,000,000 or more will be covered by the *scheme* in relation to the *introductory phase* (2010-2013)

However, there will also be obligations on organisations with lower electricity usage during 2008. Even if an organisation's electricity consumption during 2008 was less than 6,000 MWh, it will still have to make an information disclosure during the registration period if it had at least one settled *half-hourly meter (HHM)*. Where its electricity consumption was less than 3,000 MWh, it will need to provide details of its *HHMs* (to make sure that all *HHMs* are accounted for) and the organisation's contact details. Where an organisation's electricity supply via *HHMs* was 3,000 MWh or more during 2008, it will additionally have to provide details of the amount of its energy supply during 2008.

Organisations covered by the *scheme* will be required to forecast and report annually their UK based CO_2 emissions, including energy used for lighting, heating and cooling. Metered electricity use is the defining criterion for inclusion, but participating organisations will have to purchase and surrender *allowances* to cover CO_2 emissions generated from energy supplies for which they are responsible, including fuels burned for heating and unmetered electricity use. However, organisations will not be required to report on or purchase *allowances* to cover their emissions from transport or domestic accommodation, except in very specific circumstances. The CRC is not designed to cover emissions that are regulated by the European Union Emissions Trading System (EU ETS) or Climate Change Agreements (CCAs), and will affect, mainly but not exclusively, organisations that have not previously been subject to emissions trading.

Organisations that import 'renewable/green electricity' via the main grid will have to report this under the CRC at the grid emissions factor.

In order to determine which of their emissions are covered by the scheme, organisations will need to collect energy supply data. Organisations should engage with their energy suppliers with regard to collecting the necessary data.

Once their eligibility has been determined, organisations will need to forecast their emissions to enable them to decide the number of *allowances* they should purchase. At the start of each *compliance year*, *allowances* can be purchased from the Government to cover these expected emissions. In the *introductory phase* (2010 to 2013), *allowances* will be sold at a fixed price. There will be no requirement to purchase *allowances* in the first year of the *introductory phase* (April 2010 to March 2011), as this will be a reporting-only year. The first sale of *allowances* will take place in April 2011.

Throughout each *compliance year*, organisations are expected to monitor their activities and, in order to reduce the number of *allowances* they need, to try to reduce their energy use. At the end of each *compliance year*, actual emissions will have to be reported and sufficient *allowances* surrendered to cover CO_2 emissions.

From April 2013, *allowances* will be purchased via auctions, with a diminishing number of such *allowances* available over time. Establishing a rising price for CO_2 by restricting the number of *allowances* that are available will encourage organisations to reduce energy use year-on-year.

Organisations that reduce their energy use will be rewarded both by making savings on their energy bill and by having to purchase fewer *allowances*. They will also be rewarded by receiving a *revenue recycling payment* based on their position in a *league table* devised by the *administrator*.

The *league table* will be based upon performance in three differently weighted metrics.

- **The absolute metric** – the change in annual emissions of each *CRC participant* relative to the average of its emissions over the preceding 5 years (to the extent this data is available). This metric makes up 45% of the overall score during year 2 of the *introductory phase,* and 60% in year 3 of the *introductory phase*.
- **The early action metric** – a measure of action taken prior to the start of the *scheme*. This is based on both the percentage of electricity and gas consumption covered by voluntary *automatic meter reading* and the percentage of CO_2 emissions of a *CRC participant* that are covered by the Carbon Trust Standard (or a recognised equivalent scheme). This metric will be the only criterion to determine the ranking in the *league table* in the first year. For year 2 of the *introductory phase* it will have a 40% weighting, and 20% for year 3. Thereafter it will cease to exist.
- **The growth metric** – the change in emissions per unit of turnover (private sector) or revenue expenditure (public sector) as compared to an average of its emissions per unit of turnover (or revenue expenditure as relevant) over the preceeding five *compliance years*. This metric will have a 15% weighting of the overall score in year 2 of the *introductory phase* and a 20% weighting in year 3 of the *introductory phase*.

The absolute metric is the most significant metric, and rewards absolute reduction in emissions, reflecting the ultimate goal of the *scheme*. The other two metrics are designed to reward organisations that take action prior to the *scheme*, and to account for organisations that are growing but doing so in an energy efficient manner.

Weightings for the absolute metric and the growth metric beyond 2012/13 will be 75% and 25% respectively (but this will be reviewed in light of evidence from the *introductory phase)*.

The CRC is intended to be revenue neutral for the Government. Revenue raised will be recycled to *participants* proportional to their emissions in the first *compliance year* (2010/11). In the second year, *participants* will receive back by way of the *revenue recycling payments* a proportion of the total fund of revenue from the fixed price sale based on their emissions in 2010/11 adjusted by a bonus or penalty up to +/- 10% based on their *league table* position. In the third year, this will rise to +/- 20% and so on incrementally to +/- 50% bonus/penalty in the sixth year. The Government will consider advice from the Committee on Climate Change (set up under the Climate Change Act 2008) on appropriate levels for the bonus/penalty in subsequent years.

The method of calculation for the *revenue recycling payments* is complex. A sample calculation is provided on the Environment Agency's website at http://www.environment-agency.gov.uk/business/topics/pollution/98263.aspx.

CRC participants will be required to self certify their data. *CRC participants* will be required to submit reports via an online registry to the *scheme administrator* using their own meter readings or with reference to annual energy bills. The Environment Agency, the Scottish Environment Protection Agency and the Northern Ireland Environment Agency will regulate and audit the *scheme* in their respective jurisdictions. More detailed information on the purpose and operation of the CRC can be obtained from the website of the Environment Agency (www.environment-agency.co.uk).

Penalties for non-compliance

Due to the lightly regulated nature of the CRC, strict penalties will be applied for non-compliance within the *scheme*.

The key requirements for CRC *participants* (the failure to comply with which will be the subject of penalties) are:

- registration/information disclosure
- reporting and record keeping
- surrendering sufficient *allowances*.

Depending upon the offence, there is a range of civil and criminal penalties. Civil penalties include fines and publication of the name of the CRC *participant* that is not in compliance. Criminal penalties include fines and/or imprisonment.

To ensure compliance and adherence to the self-certification regime, a risk-based audit of 20% of CRC *participants* will take place each year.

Will the CRC apply to my organisation?

An organisation will be included within the *introductory phase* of the *scheme* if it had an agreement with a supplier for the supply of electricity through **at least one meter settled on the half hourly market and its total electricity supply through *half hourly meters* was at least 6,000 MWh during calendar year 2008.**

The CRC will target emissions in the UK of businesses and public sector organisations that meet the above criterion. Under CRC, the highest parent undertaking within a CRC *participant* will need to consider the energy use in the UK of all its subsidiaries to assess whether the group as a whole is included in the *scheme*. The parent undertaking will also be responsible for reporting on the total energy use emissions of the whole group, unless this responsibility is assumed by another group company.

Accordingly, subsidiaries will need to pass on information about their energy use to their parent to enable the highest parent undertaking to report to the *administrator* at the end of each *compliance year*. Where the highest parent undertaking is not based in the UK, it will have to nominate a group member with its principal place of activity in the UK as the primary member (or a third party representative with its principal place of activity in the UK where no such group member exists).

It will be possible for parts of a group that qualify for CRC in their own right (known as “significant group undertakings” in the regulations) to be separated out of the group and registered as individual entities (this is termed “disaggregation”). Such disaggregated entities will then be treated as separate organisations for the purpose of the league table.

Joint ventures will be treated as independent entities unless one of the parties has an interest of over 50% (or otherwise meets the control tests in section 1162 of the Companies Act 2006), in which case the energy use of the joint venture will need to be aggregated with the energy use of the group of which the majority shareholder is a part.

Rented property

The situation for rented property will depend upon who is responsible for the energy supplies to the property:

- where the tenant is supplied directly with energy by the supplier, this energy counts towards the total energy use of the tenant (or the highest parent undertaking of the tenant).
- where the landlord is providing energy supplies in respect of areas occupied by tenants or providing common services in a building (e.g. lifts, lighting, heating and air conditioning in common areas), such as in a shopping centre or an office building, this energy counts towards the total energy use of the landlord (or the highest parent undertaking of the landlord).

Table 1: landlords' and tenants' responsibilities for CRC

Type of building	Description of energy provision arrangements	Landlord responsibilities under CRC	Tenant responsibilities under CRC
Whole building let to tenant	Whole building is fully let to tenant and the tenant is likely to be responsible for purchasing the supplies of energy that it consumes.	If the landlord supplies the energy to the tenant's premises, and recovers the cost from the tenant, then the landlord (or the highest parent undertaking of the landlord) will be responsible under the CRC. However, in most cases where the whole building is let to a tenant, the tenant will be responsible for these supplies and will be the *CRC participant* (if it meets the qualification criteria).	Tenant usually has responsibility for buying the energy that it consumes. Responsibility for compliance with CRC will rest with the tenant (or highest parent undertaking of the tenant).
Multi let type 1	Landlord provides energy used for the common parts but tenants have their own energy supplies for the demised areas.	Landlord responsible for energy used in common parts.	Tenant responsible for energy supplies to its premises. It must be added to its other energy uses for purposes of gauging inclusion in the CRC, and for calculating its total emissions.
Multi let type 2	Landlord procures the energy supplies to the common parts and also to the tenant's premises. With no sub-metering, the landlord would normally bill the tenant its share for the rest of the energy supplies based on a proportion of floor area.	Responsibility for compliance with the CRC falls entirely on the landlord.	None.
Multi let type 3	Landlord procures all the energy supplies to the common parts, and also to tenant's premises – but with such energy sub-metered. Sub-metering enables landlord to bill tenants for their actual energy use.	Responsibility for compliance with the CRC falls entirely on the landlord.	None.

Organisations that own both tenanted buildings and buildings for their own use

The majority of *CRC participants* will own buildings for their own occupation, as well as tenanted buildings. They will need to aggregate the energy use of both types of buildings. For the purpose of the CRC, where a landlord is supplied with the energy, it is immaterial whether that energy is used by the landlord for its own business, by the landlord within the common parts of a tenanted building or by the landlord to supply on to tenants for use within the tenants' premises.

This is illustrated in figure 1.

Figure 1: The CRC 'Pool' – which entities are CRC participants and therefore responsible for trading carbon allowances?

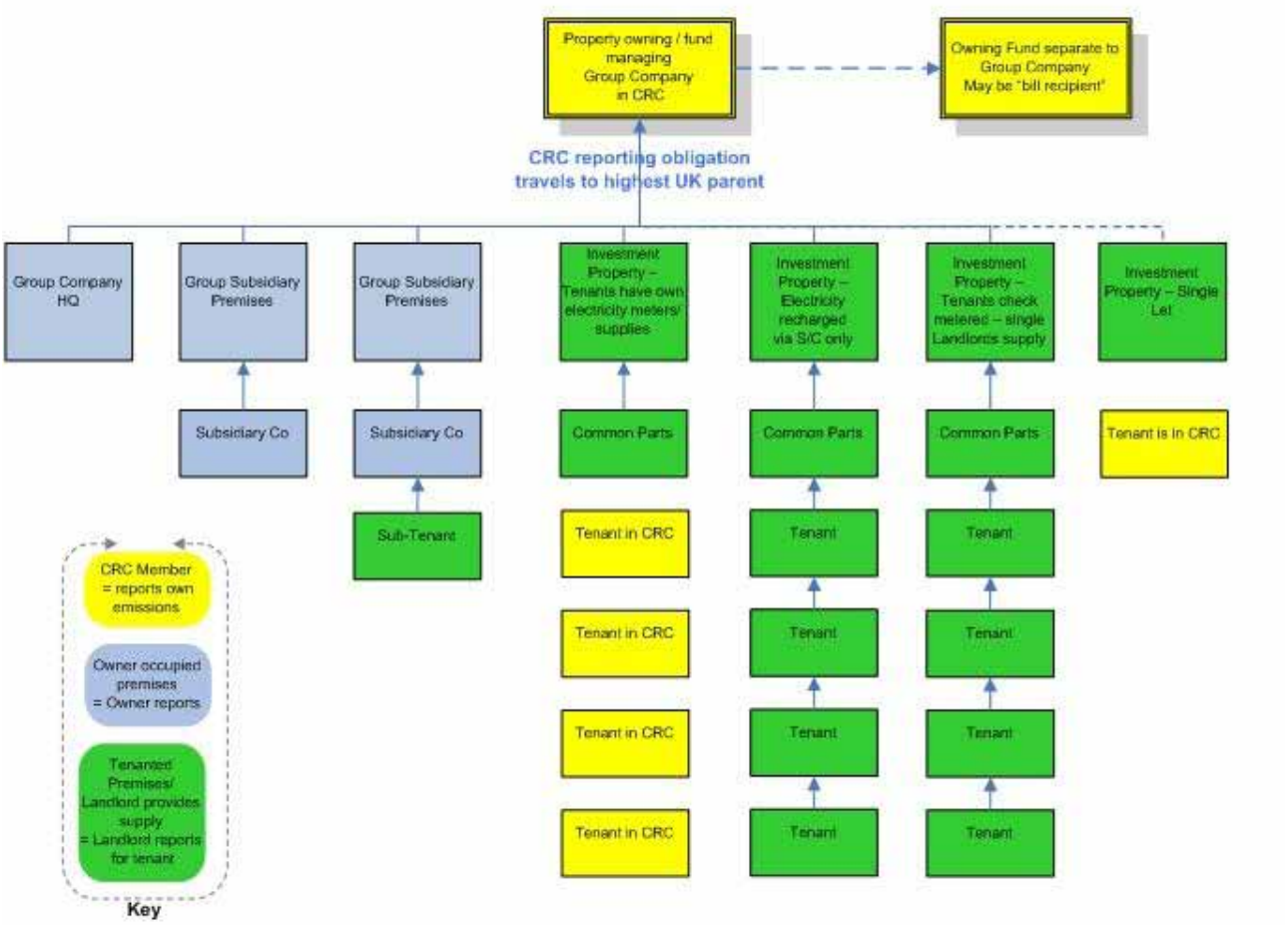

Diagram courtesy of NB Real Estate

NB: recent guidance issued by the Environment Agency indicates that in cases where property unit trusts are employed, the legal owner may acquire responsibility for managing the CRC in relation to a property rather than the beneficial owner. The relevant guidance is available here: http://www.environment-agency.gov.uk/static/documents/business/crc_guidance_-_trusts_v1.pdf

The timetable for the introduction of the CRC

2008: *qualification year*

- Organisations with at least one settled *half hourly meter* (*HHM*) will need to calculate their total half hourly electricity use for 2008 based on information provided in their electricity bills. If their electricity consumption through all *HHMs* was at least 6,000 MWh in 2008, the organisation will be covered by CRC in the *introductory phase*.
- Organisations with a total electricity bill of around £500,000 - £1,000,000 or more are likely to exceed the 6,000 MWh threshold.
- Your electricity supplier can help you collect information about your electricity supplies.

2009: consultation and identification of *participants*

- In 2009, the *administrator* contacted all UK billing addresses with *HHMs*, providing them with registration packs. In 2010, all organisations with a *settled HHM* will have to provide a list of *settled HHM.*

2010: *scheme* begins with *introductory phase*

- Participants must register to disaggregate significant group undertakings by 31 July 2010.
- The first CRC *compliance year* (April 2010 – March 2011) is also the *footprint year.*
- The first CRC *compliance year* is also the *qualification year* for phase 2.
- Organisations that meet the qualification criteria must register to participate in the *scheme* by 30 September 2010.
- Organisations that had at least one settled HHM in 2008 but had electricity supplies of less than 6,000 MWh will need to make an information disclosure.

2011: second *compliance year*

- The first sale of *allowances* takes place in April for the 2011/12 *compliance year*.
- *Allowances* will be sold to participants at a fixed price of £12/tonne CO_2.
- The first *recycling payment* will be made in October.
- 2011/12 is also the *footprint year* for phase 2: participants in phase 2 will need to register between April and September.

2012: third *compliance year*

- The second sale of *allowances* takes place in April for the 2012/13 *compliance year*.
- The *footprint report* for phase 2 needs to be submitted by July 2012.
- The second *revenue recycling payment* will be made in October 2012.

2013: first *capped phase* begins

- Auctioning of *allowances* begins in April 2013.

Key steps for landlords in implementing the CRC

Stage 1: set up CRC responsibility chains

Landlords who have established that they will be within the CRC on the basis of criteria outlined in section 1 above should take action at both the organisational and the building level.

Organisational level

At the organisational level they should identify an individual (the *CRC Co-ordinator*) within the highest UK parent undertaking with overall responsibility and accountability for the organisation's participation within the CRC. This individual should ideally be at main board level and act as, or appoint a person reporting to him/her as, the central contact and reference point for CRC information at a senior level, as well as making decisions on the purchase of *allowances* and the allocation of *revenue recycling payments*.

It will be important to ensure engagement and to define CRC strategy and processes at such a high level in the parent company, even if day to day responsibility is to be delegated to an agent, consultant or more junior member of the organisation's staff.

Building level

Identify an individual (the *CRC Officer*) for each building owned by the landlord to act as the contact point with responsibility for the CRC within that building. This person, probably the building manager or equivalent, should be given authority and resources to identify whether the tenants in the building are responsible for their own supplies of energy.

It is necessary to do this as soon as possible, in order to assess if the organisation is required to participate in the *introductory phase* of the CRC, and also to collect the necessary data to submit as part of the registration by the deadline of 30 September 2010.

If tenants are not responsible for their own energy supplies, the landlord needs to address the following questions.

- Who is responsible for identifying and progressing energy improvements in the building? If this is not already the *CRC Officer*, responsibility should be transferred to them.
- Is it clear what lies within landlord's services and common parts and what lies outside them in terms of energy use?
- Who is in control of each form of energy supplied to the building?
- What energy usage is currently included in the service charge and how are charges for energy use allocated?
- Do the leases allow the landlord to recover the cost of purchasing *allowances* directly from the tenants and/or through the service charge?
- How well can energy for landlord's services, for tenant direct usage and whole building usage be distinguished?
- Is there reliable data on occupation and floor areas for demised areas?
- What metering is in place?
- Are there good meter reading routines in place that minimise the use of estimated usage?
- Are tenants aware of the CRC?
- Is there service charge transparency between the landlord and tenant that alerts tenants to the potential increase or decrease of charges regarding energy usage?

Stage 2: 1 April 2010 - 31 March 2011 – monitor all energy sources and use this data to prepare a footprint report to submit by the end of July 2011

Landlords should collate electricity and other fuel bills, where they are responsible for the energy supply under the CRC, to establish total energy supplies and associated CO_2 emissions. Emissions associated with all energy sources must be monitored from April 2010 onwards.

Landlords should also seek to understand aspects of their tenants' businesses which might affect the tenants' energy consumption and therefore the number of *allowances* required for surrender at the end of each *compliance year*.

- How many occupants are there in the demised areas of the building?
- What are the main occupancy hours per weekday?
- Is the space used on weekends/Saturday only/Sunday only?
- In offices, for example, what percentage of floor area is used for dealing rooms, call centres, data centres/server rooms/storage?
- Is there catering provided on site and if so what is the ratio of hot meals to staff members?
- Are there any additional uses that might affect energy use?
- What is the occupant density (m^2/person)?
- Are any spaces likely to become void/become occupied?

Although it will be a challenge to collect and interpret such information, these factors as well as changes in the landlord's own operations and within common service provisions (such as air-conditioning hours) will all have an effect on emissions associated with each building.

Landlords will also need to ascertain, as far as they are able, which (if any) buildings in their portfolio they are planning to sell within the current *compliance year* and also identify buildings (or the type of buildings) they are likely to acquire in that period, as both factors will affect the number of *allowances* that they will need to acquire.

A deeper understanding of these factors will help landlords plan their *allowance* purchases. Engagement with tenants will assist by giving landlords an insight into how their energy use, and therefore emissions, may vary over the course of a phase.

Stage 3: purchase allowances for forecast 2011/12 emissions or purchase allowances via auction from 2013

In the first fixed price sale in April 2011, participants will buy *allowances* to cover forecast emissions for the second *compliance year* (2011/2012). CRC *participants* who find they have not bought enough *allowances* to cover their emissions will have to purchase from the *secondary market* (i.e. those *allowances* traded by other *CRC participants* who have a surplus, or other trading organisations in the market) or from the *safety valve* (which is a buy-only link to the EU ETS operated by the *administrator)*. It is in landlords' interests to calculate emissions as precisely as possible so that they do not have to purchase additional *allowances* unexpectedly to cover 'emissions creep' at a later date.

In the *introductory phase* of the CRC, organisations will be required to purchase *allowances* for 2011/12 and 2012/13 at a fixed price of £12/tonne CO_2. *Allowances* will be sold by auction from the start of the second phase in April 2013, with a variable price for *allowances* depending on demand.

To determine the number of *allowances* that should be purchased in both the *introductory* and *capped phases*, an organisation should calculate the likely level of its CO_2 emissions, based upon:

- energy bills and meter readings
- energy audits, where available
- service agreements from energy services companies
- Display Energy Certificates (including any background data used to create the DEC), where available
- collated landlord energy statements and tenant energy reviews (www.les-ter.org)
- building performance benchmarks
- Carbon Trust audits.

Even though some buildings may have an Energy Performance Certificate (EPC), this alone will not provide an accurate measure of a building's emissions, since it will focus only on certain fixed services and make certain assumptions about hours of operation, intensity of use and so forth.

It should be noted that, although the methods listed above can be used by *CRC participants* prior to the *scheme* coming into force to assess their likely emissions, only certain records will be accepted as evidence once the CRC is in operation to prove the amount of energy used. In general, these are primary documents such as meter readings, energy bills or fuel delivery invoices. Where estimation techniques are used, estimated values in annual reports will be increased automatically by 10%. Further guidance on what constitutes an appropriate estimation technique has been published by the *administrator*.

The installation of sub-meters, given their ability to record the energy use of individual tenants, should be made a priority, provided their installation is appropriate for the building concerned (for example in listed buildings, archaic wiring structures can make installation of sub-meters difficult).

Stage 4: monitor emissions over the compliance year (1 April – 31 March)

At the start of each *compliance year*, the *CRC Co-ordinator* will need to purchase *allowances* to cover their organisation's total emissions. There will be no legal requirement to buy *allowances* from the Government at the start of each *compliance year*. Technically, a CRC *participant* could choose only to buy *allowances* via the *secondary market* or through the *safety valve*, although this is likely to prove a more expensive way of buying *allowances*.

The *CRC Co-ordinator* will need to monitor, assess and manage emissions throughout the *compliance year*. As *allowances* are available for purchase at the beginning of the *compliance year*, the organisation may (towards the end of that *compliance year*) need to purchase additional *allowances*, or choose to sell surplus *allowances* via the *secondary market* if (towards the end of that *compliance year*) it feels it will emit fewer emissions for which it has bought *allowances.* Alternatively it may choose to carry forward *allowances* for use in the subsequent year.

At the end of July following the end of each *compliance year*, the *CRC Co-ordinator* will have to report the *CRC participant's* emissions for the previous *compliance year* via the CRC registry and surrender sufficient *allowances* to cover its emissions. *Participants* holding excess *allowances* at the end of the *compliance year* can bank these for use in future *compliance years*. The only exception is at the end of the *introductory phase* when all outstanding *allowances* will be cancelled.

Key issues for tenants in relation to the CRC

The CRC will affect the relationships between landlords and tenants.

Whatever property tenants occupy, they need to find out whether they qualify as a *CRC participant* in their own right. They should check their own organisation's energy use against the qualification criteria set out in section 1 of this guide.

They may need to consider each lease individually to assess how the CRC will affect them.

This section is intended to raise a number of the key issues a tenant might consider. However, it is unlikely to be comprehensive or definitive as each property will have different characteristics. As the CRC Order is silent regarding existing lease provisions, landlords and tenants may interpret their responsibilities for CRC under their lease differently.

Preparing for the CRC

The following steps will assist tenants to understand the implications of the CRC for their own premises. They may wish to:

- contact their landlord to establish if it is likely to be a *CRC participant* (but they should bear in mind that even if their current landlord is not a *CRC participant*, it can sell the property in the future to someone who is a *CRC participant*);
- check how they currently pay for energy in the premises that they occupy:
    - do they currently procure energy supplies and pay the utility companies directly?
    - does their landlord invoice them for utilities by way of meter readings? or
    - does their landlord invoice them by apportionment of the total energy costs for the building?

If a tenant currently pays a service charge and its landlord proposes to charge a part of the cost of complying with the CRC in it, the tenant should seek some independent legal advice to establish whether the landlord has the right to do this.

Potential issues for tenants arising from the CRC

If a tenant's landlord is a *CRC participant*, it may seek to vary the terms of the tenant's lease and/or may attempt to recover CRC costs from the tenant, irrespective of whether the lease clearly allows it to do so.

The landlord's interpretation of reasonable grounds for withholding consent to sub-letting, assignments and alterations may in future take account of any adverse impact on carbon emissions. Tenants will need to assess the implications of any additional hurdles and consider whether agreement can be reached on this at the same time as any variations to the lease are discussed to accommodate CRC costs and *revenue recycling payments*.

Unlike tenants, who have to satisfy conditions to be able to sub-let or assign their leases, landlords do not need any consent from their tenants in order to sell a property. The problems this may generate depend on, initially, whether a new owner has a different CRC status from the previous owner. Subsequent issues will arise if there is no documentation of any established methodology for dealing with the CRC – including charging for CRC costs and allocation of *revenue recycling payments*.

Where a landlord proposes to set up a sinking fund for investment in energy saving systems and/or equipment, tenants should understand how this operates and whether they are entitled to any of the unspent fund when their lease expires.

Tenants will be expected to drive down energy use progressively over time and many landlords will seek to require tenants to act responsibly in their relation to their energy use. One way to achieve this might be for the parties to enter into a memorandum of understanding alongside the lease to encourage such behaviour and to provide a framework for the landlord to assist where possible.

Section 2: apportioning the cost of the CRC between landlords and tenants within leases

Part 1: introduction

As a related exercise, the Industry Working Party has consulted with the industry on potential avenues for standardised approaches to the CRC which can be incorporated by reference into leases. While this work is continuing, landlords and tenants are encouraged to engage in dialogue on the CRC, in relation to both new and existing leases, and to use this document as a starting point for those discussions in exploring possible options.

By way of introduction to this topic:

- The CRC Order does not impose any obligation on landlords to pass the cost of *allowances*, or other costs involved in complying with the CRC, to their tenants. Nor does it incorporate any obligation on landlords to pass the benefit of any *revenue recycling payments* to their tenants.
- Similarly, the Government has made it clear that the CRC Order deliberately does not contain any provisions that enable landlords automatically to pass on the cost of *allowances*, or the cost of complying with the CRC, to their tenants. In the Government's view, this is entirely a matter for agreement between individual landlords and tenants.
- Landlords should make clear at the outset those costs relating to the CRC that they expect to recover from the tenant, and the basis of such recovery, in order to comply with the Code for Leasing Business Premises in England and Wales 2007 (the "Lease Code") and the Service Charge Code 2007. Part 2 of this section considers the issues that landlords and tenants will need to consider.
- For leases that do not contain specific provisions relating to the CRC, the legal position will vary and may well be unclear. It cannot be assumed that existing leases will enable landlords to pass on to their tenants the cost of complying with the CRC, as this will depend on the wording of each lease. In particular, it is not at all clear that CRC costs fall within the common tenant's covenant to pay all outgoings on a property, either directly or through a service charge, or to pay all taxes in relation to a property. It will therefore be necessary for parties to obtain their own legal advice on this issue. Where existing leases do not permit recovery of such costs, landlords who are within the CRC will need either to approach tenants individually to agree a suitable variation to the lease (which will need to be documented by solicitors to ensure that the parties' successors are bound by the variation) or to absorb these costs themselves.

Part 2: provisions relating to the CRC to be included within leases

When agreeing the terms of a new lease, or varying the terms of an existing lease, landlords and tenants need to agree between them a number of issues relating to the CRC. This part attempts to set out those issues in a logical manner and suggests the specific points that need to be considered by the parties in each case.

This section has been compiled solely by the working party mentioned in the acknowledgements and is being put forward to assist property owners and occupiers to consider how to divide between them responsibility for compliance with the CRC and the costs associated with such compliance.

Issue 1: is the CRC an issue in relation to the lease?

Landlords that are not within the CRC at its inception will be tempted to ignore issues relating to the CRC completely. However, this is not recommended, for three reasons:

- In future years, more *participants* (including the landlord) may be brought into the CRC.
- Through corporate mergers and acquisitions, the landlord may become a *CRC participant*, or part of one.
- The property may be sold to an organisation that is within the CRC and that expects to see provisions relating to the CRC in the lease.

However, in the case of a letting of a whole building, where the tenant is the person responsible for all the energy supplies, it will not be necessary to include any CRC provisions in the lease, regardless of whether the landlord is a *CRC participant* or not, since there will not be any occasions on which the landlord will be responsible for the supplies and so will not need to pass on to the tenant the cost of energy (either directly or through a service charge).

The cost and complexity of allocating CRC costs and *revenue recycling payments* between tenants may lead some landlords to decide to absorb any CRC costs themselves, and similarly to retain the *revenue recycling payments*. In such a case, to avoid any uncertainty in the future, the parties may wish this to be stated expressly in the lease.

Issue 2: assuming that CRC is an issue, in what manner will liability arise?

The CRC will be an issue in the majority of multi-let buildings, as landlords will generally be responsible for the energy supplies to the common parts of a building, and to those areas occupied by tenants where the tenants do not have a direct supply contract with the energy provider.

Issue 3: assuming that the landlord wishes to pass on its CRC expenditure to the tenants, what costs need to be considered?

Expenditure in relation to the CRC can be divided into two different types, either or both of which the landlord may wish to pass on to the tenants:

1. The cost of the *allowances* that have to be bought and then surrendered (ascertaining and passing on these costs is considered as issues 4 and 5).
2. Other costs associated with being a *CRC participant*. How these costs are calculated is considered as issue 6.

Separately, the parties will need to consider whether the benefit of the *revenue recycling payments* should be passed on to the tenants. This is considered as issue 7.

Issue 4: calculating the cost of allowances

There is no obvious or simple methodology that can be used to calculate the cost of *allowances*, because *allowances* are not bought for specific buildings but for *CRC participants* at a group level. (Similarly, the *revenue recycling payments* relate to *CRC participants* at a group level.)

This issue is complicated further because landlords may acquire their *allowances* from a number of different sources, and at a number of different costs depending on whether they are acquired in the *introductory phase*, at auction, on the *secondary market* or by private arrangement (eg on the acquisition of a building, from the seller of that building). They 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 may wish to see detailed information as to the provenance and cost of these *allowances*.

The *compliance year* runs from 1 April to 31 March. As figure 3: 'CRC cycles plotted against service charge years' shows, once the scheme is running, *allowances* will be bought at auction at the start of the *compliance year*. But if an organisation uses more energy than predicted, it may need to buy additional *allowances* during or at the end of the *compliance year* in order to surrender them.

The working party has identified four possible ways in which the cost of *allowances* can be calculated:

1. Average cost of allowances

The first option is that 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*, the price that the landlord charges will either need to be related to the cost of 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.

None of these are 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. 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.

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 the proceeds of such 'sales' of *allowances* 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 revenue recycling payments)

In order to minimise the administrative costs of implementing the CRC, especially in the *introductory phase* while the *CRC participants* learn about the process, the landlord could wait until after the *revenue recycling payment* is received 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 the transaction costs and simplifying the calculation of costs or benefits to be passed down from organisation to building level, and ultimately to the tenants.

In effect, the landlord could decide to wait until the Government redistributes the proceeds of the sale of *allowances* back to the *participants* by way of the *revenue recycling payments*. The landlord could then calculate the real cost to it of the CRC over the previous *compliance year*, taking into account the cost of buying *allowances* (however they were bought), the administrative costs and the amount of the *revenue recycling payments* received. In years when the landlord is faced with a negative cost, it has the option to allocate a proportion of this cost to its various buildings. In years when the landlord makes a profit from the CRC, it has a choice of distributing that profit to the buildings where the occupiers have been

most successful at reducing emissions (see issues 7 and 8), distributing it between all buildings or using the profit to invest in those of its buildings with poor emissions that jeopardise the organisation's position in the *league table*. In the longer term this might provide greater savings for both landlords and tenants.

A landlord who adopted this fourth option would need to agree with its tenants that the tenants would, in effect, be paying out or benefiting from (as the case may be) the actions of the tenants who were in the building in the previous *compliance year*. So long as emissions continue to drop over a long period, tenants may be prepared to accept this. However, one can imagine that a tenant in year 2 might be unhappy about being asked to contribute to the wasteful energy use of tenants in the previous *compliance year*. The only way to avoid this would be for the landlord to recover its costs, or distribute profits, to the organisations that were its tenants in the previous *compliance year*. Landlords would not generally expect to be dealing with organisations that are no longer its tenants – but for those landlords whose tenants rarely change, this would not be a major issue.

This complexity over the timing of payments is considered in more detail in part 3: 'Complexities over timings for landlords and tenants'.

Issue 5: how might landlords pass on the CRC costs to tenants?

Where tenants are responsible for their energy supplies in respect of the premises they occupy, but pay a service charge to the landlord in respect of running the common areas, landlords may wish to include their CRC expenditure in the service charge.

In some buildings, in addition to paying a service charge in respect of the common parts, tenants pay the landlord for the cost of energy supplies in their own premises.

In such a case, there are two variants. In the first, the tenants' energy consumption is not metered, and so the cost of energy supplied is typically divided between tenants on a floor area basis. In the second, the tenants' supplies to their premises are sub-metered, which enables an accurate division of the cost between tenants. In either case, the landlord will wish to recover its CRC expenditure in respect of both the common areas and the energy supplied to the tenants.

The principles are identical in relation to the common parts and the tenants' own premises. However, for a lease where the tenant pays its own energy costs for its premises, the CRC provisions will need to relate purely to the supplies to the common parts, whereas for a lease where the landlord supplies the energy for the tenant's premises, the CRC provisions will also need to relate to those supplies.

Issue 6: passing on other costs associated with being a CRC participant

The administrative costs of being a *CRC participant* will be considerable, particularly for larger organisations, and landlords and tenants need to agree within a lease which costs will be borne entirely by the landlord (as part of the cost of being a landlord), and which will be paid through the service charge account or directly by the tenants.

Annex A contains a list of costs associated with being a *CRC participant* and suggests which costs should be borne entirely by the landlord and which should be paid by the tenants.

Issue 7: should the landlord give the tenants the benefit of the revenue recycling payments?

Where the tenants are paying towards the cost of the *allowances*, it seems likely that the tenants will want the landlord to pass back to them the benefit of the *revenue recycling payments* (net of the cost of doing so, which has been taken into account within issue 6).

Failure to pass on *revenue recycling payments* in some manner (see issue 8) 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 vis-à-vis sustainability, carbon management and so on.

It seems unlikely therefore that landlords will seek to charge their tenants for the cost of *allowances*, but decline to pass on the benefit of the *revenue recycling payments*.

Issue 8: how could landlords give the tenants the benefit of the revenue recycling payments?

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

The allocation of costs and benefits to individual buildings within such a portfolio 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. Landlords could, therefore, choose to comply with the CRC at the organisation level with costs and benefits simply apportioned across the whole portfolio and taking no account of the performance of individual buildings.

Centralising the cost and benefit 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.

Where landlords wish to allocate the *revenue recycling payments* at a building level, they could choose to do so:

- as a collective benefit to all tenants (e.g. energy efficiency improvements to buildings channeled through a specially created CRC fund); this is discussed as issues 9 and 10 below.
- where the landlord supplies the tenants' energy and sub-metering is in place, directly to tenants in line with their performance in reducing emissions; this is discussed as issue 11 below.
- for common areas, and where the landlord supplies the tenants' energy but no sub-metering is in place, directly to the service charge account, or to the tenants on the basis of floor space occupied but taking no account of individual performance; this is also discussed as issue 11 below.

Issue 9: should there be a specially created fund for revenue recycling payments?

The chief advantage of using *revenue recycling payments* in a specially created fund, particularly one established at the building level, is that:

- the funds would be used for future work that improves the energy efficiency of the building and so provides a benefit to tenants through lower future energy bills.
- this work would probably lead to the biggest reduction in carbon emissions.
- agreement on the use of the funds would foster increased dialogue between landlords and tenants.

It is often the case, however, that similar kinds of funds such as sinking funds are unattractive to both landlords and tenants of commercial property because of the administrative burdens of operating them and the tax implications for landlords of holding monies in the fund. In particular, the cost of operating such funds on a site by site basis, compared with the *revenue recycling payments* that are available to put into the fund, could well make the idea impracticable.

Having said that, most tenants are likely to prefer any such fund to be established on a site by site basis, rather than applied by the landlord organisation as a whole. If there is to be a mini fund for each building, then the amount of the total *revenue recycling payment* into each mini sinking fund could be simply proportional to the contribution to the landlords' CRC costs that each building paid.

The size of the overall *revenue recycling payment* to each landlord that is a *CRC participant* will depend on where the landlord appears in the *league table* – and then the overall pot would be divided up between the buildings in proportion to their contribution to the landlords' CRC costs.

Before a fund is set up, tenants would probably look for certain assurances that the landlord will use money from the fund for energy efficiency measures that will benefit tenants, including:

- encouraging behavioural measures, such as adjusting heating controls, ensuring lights are turned off when they are not required, and ensuring that all computers, printers and other electronic equipment are turned off at the end of the day.
- introducing sub-metering.
- introducing more energy efficient technologies such as lighting, printers and boilers.
- taking structural measures, such as introduction of double glazing and more efficient wall insulation.

There should be a mechanism, such as a building committee, to enable decisions to spend money from any fund to be made. Such a committee should include both landlord and tenant representatives. In the scenario that money accrues in the fund and the fund committee fails to identify sufficient energy efficiency investments, then ultimately the fund could be distributed amongst tenants. There will need to be a policy to determine the entitlement of tenants past and present who have contributed to the fund.

Issue 10: how might a CRC fund arrangement be put in place?

In the case of existing leases, ideally each lease should be varied to include provisions, at the option of the landlord, for the setting up and running of the CRC fund on the basis that the fund is administered by the landlord on behalf of the tenants in a similar manner as service charge sinking funds are currently managed e.g. with a tax and costs indemnity.

Until such time as all existing leases are so varied or replaced by new leases that include CRC fund provisions, landlords should try to obtain:

- the agreement of all, or at least the majority, of tenants to a CRC fund being established and run on the principles discussed above.
- on a lease assignment, the new tenant's agreement to this arrangement.
- on a sale of its interest, the new landlord's agreement.

In addition, it will be necessary to provide for what is to happen should the landlord sell the building to another owner who is not a *CRC participant*. It will also be necessary to provide for payment of tax in respect of the payments into the fund.

Issue 11: paying the revenue recycling payments to the tenants

That proportion of the *revenue recycling payment* which is attributed (by the landlord) to energy use in the common parts, could be paid directly to the service charge account.

For energy use in tenants' own premises, in many buildings there is no sub-metering in place and the energy costs are simply apportioned according to a formula such as the amount of floor space occupied. Where this is the case there is no way of distinguishing the performance of individual tenants and so distributing *revenue recycling payments* to the best performers.

This means that the option for the landlord might be to apportion *revenue recycling payments* between tenants on the same basis that the overall energy bill is apportioned, taking no account of the relative energy efficiency performance of individual tenants. In this situation, the *revenue recycling payments* would do little to encourage tenants individually to operate in a more sustainable way.

Where sub-metering is in place, the landlord would have the option of allocating *revenue recycling payments* to tenants on the basis of some kind of league table or other means of differentiation. League tables can be an effective means of driving behaviour, particularly in situations where those listed are mindful of their public standing.

Where a landlord chooses to rank tenants, it would need to establish robust measurement criteria. There are several possible approaches to ranking:

- Landlords could allocate a *revenue recycling payment* to tenants that is proportional to their average annual energy use emissions over the previous five years.
- Ranking could be based on reductions in energy use emissions relative to a baseline (although this could penalise those who have achieved a high degree of energy efficiency before the baseline date).
- Ranking could be based on the rating in a DEC (where DECs apply or are used voluntarily).
- There may be potential to combine the workings of an annual DEC score and the EPC score for the premises (e.g. a league table where the placing is based upon DEC/EPC); this would have the benefit of enabling direct benefits to accrue from good behaviour – the metric demonstrating how well the tenant has used its premises.
- Ranking could be based on adherence to a tool such as LES-TER (landlord energy statement and tenant energy review), which acts as a means for landlord and tenant to manage their energy use, with a view to reducing emissions.

None of these suggestions is without problems.

In any league table or ranking approach it would be important to bear in mind that there are differences in building usage that might impact upon a building's performance – intensity of use running for 15 hours a day or more may be a common feature of a legal firm, whereas a retail outlet might operate for no more than 8 hours. An investment bank might have a trading floor with high HVAC demands whereas another tenant might not. There are additional complexities, therefore, that also require consideration. A league table based on a LES-TER approach would be better able to show the reasons for increased energy use/higher carbon emissions than would be the case for DECs, because LES-TER factors in intensity of use, occupancy and other matters.

From a landlord's perspective the main problem with any options that involve redistribution of *revenue recycling payments* to individual tenants on the basis of a league table is the disproportionate effort involved in redistributing what may well be very small amounts of money and the fact that the prospect of a small bonus is unlikely to be a significant driver of tenant behaviour in relation to carbon reduction.

Issue 12: what is to happen where tenants leave and are not replaced, and equally where one tenant assigns its lease to another tenant?

As explained above, the landlord and the tenant will need to agree whether the landlord deals only with the current tenants, or whether the landlord will continue to deal with former tenants (for the purpose of payments relating to the CRC). The former approach would be more usual, and would fit better with landlords' existing administrative systems.

But if an approach such as option 4 in issue 4 (landlord to charge only the net cost of *allowances*) is adopted, this could require the landlord to charge sums relating to the CRC, or to distribute profits relating to the CRC, to organisations who were its tenants at the relevant time (ie the previous *compliance year*) but are no longer its tenants. It remains to be seen whether this approach is attractive to landlords.

Issue 13: are there any other parts of a lease that will be affected by the introduction of the CRC?

Landlords may wish to tighten up provisions relating to alienation, alterations and user in order to have more control over the tenant's use of the premises, with a view to preventing tenants increasing their emissions. Annex B sets out some of the issues that will concern landlords and tenants.

Part 3: complexities over timings for landlords and tenants

Assume that a tenant has agreed that the landlord may pass on the net costs of the CRC (after receipt of its *revenue recycling payment*) to the tenant through a building's service charge. It will then be necessary to work out the times at which the sums are to be charged. As service charges typically operate on a calendar year basis and CRC works on a compliance year basis, there will be a mis-match between the timing of payments.

There are two specific complications in terms of timing that need to be considered.

(a) revenue recycling payments

Where a landlord wishes to distribute a *revenue recycling payment* to tenants on the basis of their emissions performance, this will entail delaying making the distribution until the *compliance year* has ended, and the tenants' proportions of the landlord's total energy use have been calculated. It is only at this point that the landlord will know how each tenant has performed and what proportion of the *revenue recycling payment* each tenant should receive in respect of that *compliance year*.

This situation must be distinguished from the time-frames by which the *administrator* pays *revenue recycling payments* to CRC participants. The *administrator* holds the proceeds of the fixed price sales/ auctions for only six months. This period of time was chosen by DECC as one that minimised the impact on CRC *participants'* cash flow and is achieved by using the proceeds generated by the fixed sale/ auction in April of one year to fund the *revenue recycling payment* that is made in October of the same year.

Unfortunately the *revenue recycling payment* for each year is calculated (via the three metrics and the league table) by reference to the CRC *participants'* relative performance in the preceding *compliance year*. This means that it is not realistic to try to match each tenant's proportion of the *revenue recycling payment* with its improved energy performance in the year to which that *revenue recycling payment* relates. There will be a one year time lag, during which time tenants may have changed in the relevant building. There would however be no obstacle to dividing up the *revenue recycling payment* received this year in proportion to the tenants' relative energy use this year.

(b) compliance years and service charge years

In any one service charge year, payments and receipts will occur that are related to the landlord's emissions performance in two *compliance years*. Similarly, each *compliance year* spans two service charge years (except where the service charge year runs from 1 April, which would be relatively unusual).

Take a typical service charge year – say January to December 2012. As Figure 3 on page 24 shows, there will be the following events relating to the CRC:

- The landlord buys *allowances* from the Government in April 2012 for the *compliance year* 2012/13.
- The landlord receives a *revenue recycling payment* in October 2012. This is the Government returning the proceeds of its sale of allowances in April 2012 (even though, as explained in (a) above, the calculation of each party's share of the proceeds is calculated by reference to performance in the previous *compliance year*, 2011/12).
- The landlord could buy *allowances* on the *secondary market* at any time during the year – between 1 January and the last working day in July 2012 in respect of the *compliance year* 2011/12, and between 1 April and 31 December 2012 in respect of the *compliance year* 2012/13.

Figure 3: CRC cycles plotted against service charge years

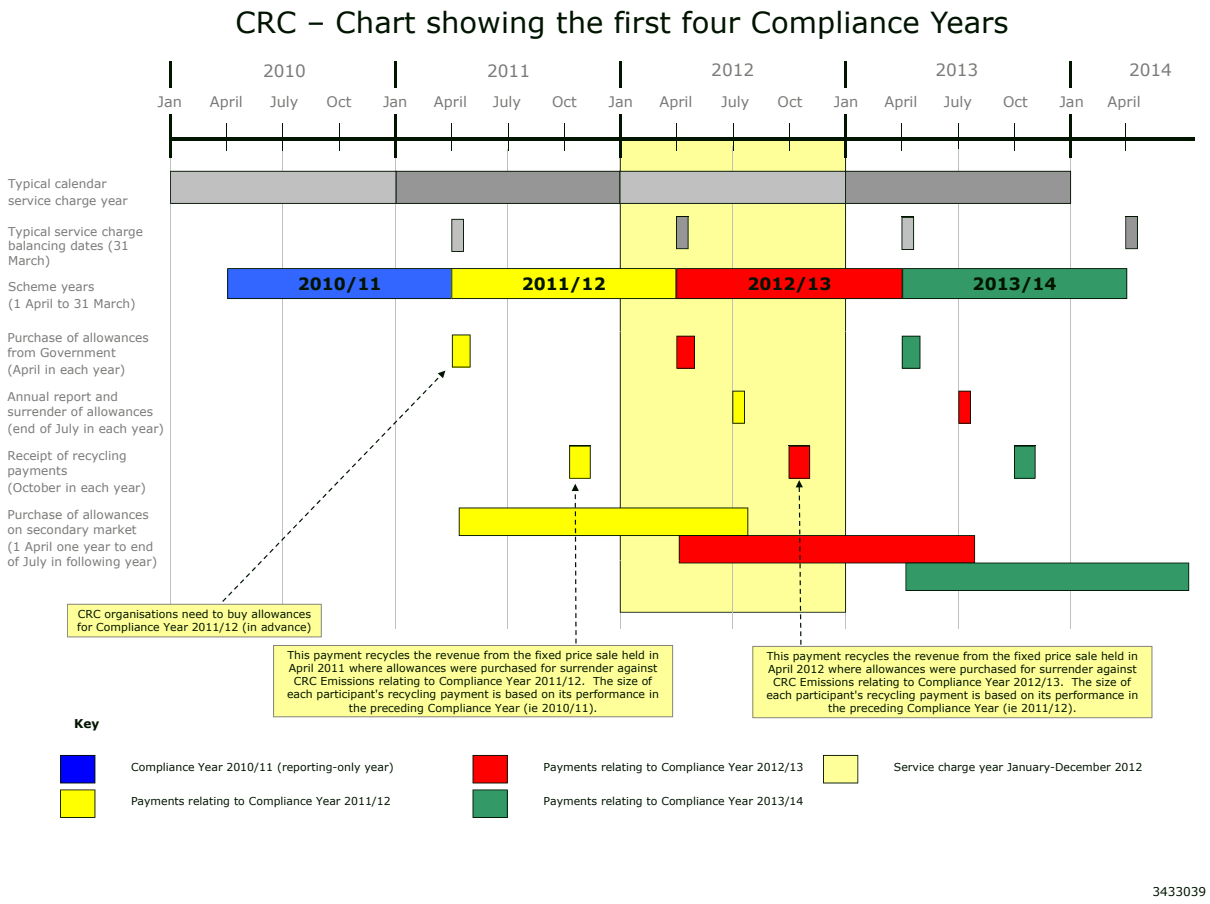

Diagram courtesy of Eversheds LLP and Clifford Chance LLP

Realistically, if CRC is to be included within a standard service charge, it will be necessary to allocate payments and receipts as they fall due – regardless of the *compliance year* to which the payment or receipt is related. By way of example, assume that a landlord buys *allowances* on the *secondary market* on 1 November 2012 (because they happen to be cheap at that time). The cost of those *allowances* will be included in the service charge for calendar year 2012, which will be reconciled in approximately February or March 2013. Any *allowances* bought on or after 1 January 2013 will be included in the service charge for calendar year 2013, which will not be reconciled until February or March 2014. Inevitably there will be a difference of a year in the reconciliation of the relevant service charge years, even though the payments related to the same *compliance year*.

Part 4: Four possible methods of incorporating CRC provisions into leases

The preceding parts of this section have considered the issues that landlords and tenants need to bear in mind when looking at how the CRC could be incorporated into leases.

This part compares and contrasts four different methods that landlords and tenants could use in order to incorporate CRC provisions into leases. These are:

- Including CRC costs in the normal service charge.
- Running a separate CRC service charge.
- Charging a levy on energy costs.
- Leaving the lease silent on CRC costs, or alternatively providing expressly that the landlord will not look to the tenants for any contribution towards its CRC costs, and will be entitled to retain all *revenue recycling payments* received.

It is important that each method is judged against consistent criteria. We have chosen the following:

- Does it achieve the aim of the CRC, which in a landlord and tenant context is for the parties to collaborate to improve a building's energy efficiency?
- Will it be simple to draft?
- Will it be simple and cheap to operate?
- Is it (broadly at least) fair?
- Could it adversely affect rental value?
- How will it work if the landlord changes?

Achieving the aim of the CRC - collaboration between landlord and tenant.

The aim of the CRC in a landlord and tenant context is for the parties to collaborate to improve a building's energy efficiency. Here lies the dilemma in any lease clause. If the lease is silent, the landlord bears all the CRC costs and keeps the full *revenue recycling payment*, but tenants are not penalised for failure to improve their energy efficiency (other than the cost of the energy itself). The landlord does have an incentive to improve the building, to reduce consumption and thus the cost to him, but has no real tools in a conventional lease with which to achieve this. For example, a landlord cannot hope to influence an investment bank's energy use on its trading floor.

However, if the lease charges all CRC costs to the tenants, the landlord has little incentive to invest its own money installing energy efficiency measures. The tenants do have such incentive, but can only carry out works within their demise and will do so only if they see a return on investment before the lease ends.

Therefore, what is needed, if this is possible, is a structure that provides incentives to both parties to improve the energy efficiency of the building. This includes both the efficiency of the plant within the building itself and the manner in which the building and the equipment within the building is used by the tenant on a day to day basis.

Simple and cheap to operate

Landlords will be wary of a clause that requires investment of significant time (either by their in-house team or by external consultants, such as managing agents). This is particularly true if the administrative costs of CRC are not recoverable from the tenants. Running a separate CRC charge account (alongside

the service charge account) will inevitably cost more. For some landlords this extra cost is likely to outweigh the net cost to them of retaining all responsibility for CRC costs, and keeping the *revenue recycling payment*.

Is it fair?

Sadly, it is impossible to achieve objective fairness in a clause that is simple and clear. CRC is just too complex to permit this, not least because CRC costs are incurred, and *revenue recycling payments* are paid, at the organisational level not the building level.

In particular, the manner in which the *revenue recycling payment* operates, in relation to an individual tenant's occupation, can never be described as fair. Each *CRC participant* receives one *revenue recycling payment* based upon the organisation's position in the league table, and the metrics for this relate to efficiencies during the previous *compliance year*. Furthermore, the actions of one occupier, or even all of the occupiers, within a building will have little effect on the landlord's overall position in the *league table*.

In relation to "fairness", what is fair may differ between types of property. As in any lease clause that uses "fair and reasonable" as its benchmark, there will be no certainty, at the outset, of what a court will view as fair. This will be influenced by then market practice as well as common sense. There is no established market practice on CRC cost division as yet. A "fair and reasonable" approach offers flexibility but at the expense of certainty. Tenants who are sensitive to the cost of occupation may be unnerved by this.

Will the clause affect value?

No landlord wants a CRC clause that will rebound at rent review. There is at least a risk that complex clauses may be held to be onerous, and thus command a lower rent. The converse, unfortunately, may also turn out to be the case. In ten years' time a lease without CRC cost recovery may be considered defective. Perhaps a new Government will introduce a completely different method for dealing with emissions, so that CRC clauses become unnecessary. It is not possible to draft for all these eventualities.

Change of landlord

One of the greatest difficulties to overcome with lease provisions is addressing what is to happen on a change of landlord. It is desirable for this to be set out within the lease itself, to protect all parties' interests and to avoid disputes. However, it is difficult to come up with any drafting that is fair yet also realistic to operate.

The biggest problem is how to ensure that the "correct" amount of *revenue recycling payment* is credited against the CRC costs that the tenants in a particular building pay. Where the reversion is sold before the *revenue recycling payment* has been received, the seller landlord will still, post completion, ultimately receive a *revenue recycling payment* from the Government, based on (among other things) emissions from this property. The buyer may also receive a *revenue recycling payment* (if it is a CRC *participant*). However, the profile of the buyer (in terms of energy performance, or the nature of its other sites) may mean that it receives a lower *revenue recycling payment* than the seller would have done. The tenants (who have already paid in advance the bulk of the CRC costs) will therefore get less of a credit. Indeed, if the buyer is not a CRC *participant*, the tenants will receive no credit at all.

Further problems will occur where advance payments have been demanded under either proposed type of service charge arrangement, as the settling up at the end of the *compliance year* will be done by a landlord who did not receive the tenants' advance payments at the start of the year, and these payments will not necessarily have been passed across to him on completion of the acquisition. The *allowances* bought with those advance payments are likely to belong to the old landlord (or its parent company) and may not necessarily be sold to the new landlord at the same time as the building is sold. There is a clear risk here that tenants could find themselves paying twice for the same emissions, unless there are complex provisions within the CRC clause to obviate this.

Four possible methods of accounting for CRC in leases

Option 1: Including CRC costs in the normal service charge

Summary

- Introduce a new head of chargeable expenditure – the CRC costs properly incurred in the relevant period, in relation to the whole building, less the *revenue recycling payment* received during that period. "Properly" allows the tenant to challenge costs as too high (for example, that the landlord was disorganised and bought its CRC *allowances* late and at an unnecessarily high price).
- Where CRC costs are incurred in respect of several properties, the proportion allocated to this building should be fair and reasonable.
- The usual advance payment regime will apply (based on estimated net CRC costs).
- The parties can agree to exclude certain types of CRC cost, eg administration.
- The relevant period will be the normal service charge year.
- The normal service charge percentage (fixed or "fair and reasonable") is used to work out the tenant's share.
- The amount of the *revenue recycling payment* to be credited must be fair and reasonable when viewed at group level, portfolio level and tenant level.
- The landlord agrees to explain its calculations, if asked.

Advantages

- Simple to draft and flexible to operate – many factors can be raised when assessing what is "fair".
- Less energy-efficient tenants can be charged more (where the specified service charge proportion is "fair", rather than a fixed proportion).
- If the landlord finds it too expensive to quantify or justify its fair and reasonable calculation, it need not charge CRC costs to the service charge at all (but it would retain the right to do so in future, which will be important in future phases where the price of *allowances* may increase).

Disadvantages

- Uncertainty over how sums will be calculated, which will be important in future phases where the value of *allowances* may increase.
- A cashflow problem for landlords if advance payments are based on net CRC costs as there will be a shortfall in April when the *allowances* are bought at auction.
- Anomalies flow from the service charge year not coinciding with the *compliance year* (perhaps too many *allowances* being bought in the one service charge year). These may not be capable of being resolved by a requirement to be fair and reasonable.
- It is not possible to calculate the amount payable by each tenant until the end of the *compliance year*, as the cost of the *allowances* that the landlord will need to surrender for that year will not be known until then.
- The tenant is at risk if there is a change of landlord. The *revenue recycling payment* may be received, post completion, by the former landlord and thus not credited to the service charge account. This risk could be reduced by dropping advance instalments. The tenant would pay, at the end of the service charge year, to the then landlord, the relevant proportion of the then known net costs. This exposes the landlord to cash flow and credit risk and it might want to charge any finance cost to the account.

Option 2: running a separate CRC service charge

Summary

- There is a separate CRC service charge account for the whole building (both demised areas that are supplied with energy by the landlord, and the common parts).
- This account uses *compliance years* (not normal service charge years).
- CRC costs incurred during the year are debited to the account. CRC costs may again exclude certain expenditure.
- Where CRC costs are incurred in respect of more than one property, only a fair and reasonable proportion can be debited to this building's account. This means the landlord cannot attribute all its expensive CRC *allowances* to this building and cheaper ones to another building in its portfolio (or to its own occupation). It must average out the cost across the organisation. In practice, this means averaging out expenditure over the entire *compliance year.*
- The landlord must credit to the CRC account (when received) a proportion of the *revenue recycling payment* which its group actually receives during the year. The apportionment basis would be specified, both for group and building level (or "fair and reasonable" used as the benchmark).
- The basis for division of the CRC costs/*revenue recycling payment* between tenants can be different from the normal service charge (perhaps geared to relative energy efficiency). The normal fixed percentage is likely to be correct for division of common parts CRC costs.
- A similar advance payment and balancing exercise would be used as for a traditional service charge.
- Alternatively the landlord could finance the purchase of *allowances* itself, rather than asking for advance payments from tenants, and then bill the tenants for the net cost (after taking into account the *revenue recycling payment*) at the end of each *compliance year.*

Advantages

- Using the *compliance year* reduces the anomalies (the actual cost of *allowances* surrendered in that *compliance year* can be used).
- The tenant's contribution (particularly for CRC costs incurred in respect of consumption in the demise) could be tailored to relative energy efficiency (although this would add a further level of complexity).

Disadvantages

- There will be extra costs in administering this second CRC service charge account, which tenants may not wish to finance.
- Unavoidable use of "fair and reasonable" still introduces uncertainty.
- There are the same problems over change of landlord, or (if no advance payments are required) over cash flow and credit risk.
- Balancing can only be done when the *allowances* have to be surrendered (four months after the end of the *compliance year*), as that is when the final cost of the *allowances* will be known.

Option 3: Charging a levy on energy costs

Summary

- This is a completely new suggestion since the Industry Working Group's consultation on the allocation of CRC costs and *revenue recycling payments* in December 2009, but appears to be a non-starter for reasons given under **Disadvantages** below.

- The lease would allow a *CRC participant*-landlord, when billing tenants for their part of the energy bill for the building, to add a fixed percentage of the bill on top as a levy. The aggregate levies would be used to cover the landlord's CRC costs.

- The amount of the levy would be reviewed annually by reference to the cost of carbon in the Government's auction.

Advantages

- Simple to operate.

- Charge to the tenants is related to their energy consumption, which will encourage them to reduce their energy use from landlord supplies.

- Contributions are collected regularly so the landlord has no cash flow problem.

Disadvantages

- Setting a fair levy rate will be very difficult. It ought to be based on both the current price of CRC *allowances* and the net CRC cost to that landlord. But the cost to each landlord will be different (because its *revenue recycling payment* reward/penalty will differ). No uniform rate would be fair. Unless the amounts referable to the previous year are used, a landlord can only set its fair rate at the end of the period, when it knows its actual costs (in particular, of *allowances*) and *revenue recycling payment*. By then the energy bills have long since been paid.

- If the levy is based on estimated figures, then the clause still needs to cover end of year top-up or refunds, how to apportion *revenue recycling payments*, and changes of landlord. The clause could end up as complex as the preceding two approaches and less conventional.

Option 4: Leaving the lease silent on CRC costs

Summary

The lease is silent on CRC, or alternatively provides expressly that the landlord will not look to the tenant for any contributions towards its CRC costs, and will be entitled to retain all *revenue recycling payments* received.

Advantages

- Cost of administration (to which tenants may not wish to contribute) is kept to a minimum as it will not be necessary for the landlord to divide up the CRC expenditure and *revenue recycling payments* between the tenants.

- The landlord retains for itself the benefit of the *revenue recycling payments* it receives. Where the landlord is in the top half of the *league table*, it is likely (although not inevitable) that the *revenue recycling payment* received in a particular compliance year will be higher than the amount that the landlord has spent on *allowances* – so the landlord would be making a profit from the CRC, which it would retain for itself rather than sharing among the tenants.

- No apportionments relating to CRC payments from tenants are needed on the sale of the property. Also there will be no need to consider whether the outgoing landlord should account, post completion, for the *revenue recycling payment* that it receives (or a fair proportion of such a payment received by the organisation as a whole) to be paid to the incoming landlord for onward credit to the tenants who paid the CRC costs in advance.

- Relations with tenants will not be affected adversely by introducing an obligation to pay for CRC costs.

Disadvantages

- The landlord will be taking all of the risk in relation to increasing carbon costs.
- An institutional lease gives a landlord no say in how efficiently a tenant operates its business, yet the landlord will be responsible for buying *allowances* for the energy used in the tenant's premises. (This could be overcome by use of "green" provisions in the lease or in a memorandum of understanding.)

Section 3: procedures for dealing with changes in a building's ownership

Annex C sets out some issues that will arise when a building's ownership changes.

It is not possible to lay down any guidance at this stage as to how the CRC contributions by tenants to CRC costs, *allowances* and *revenue recycling payments* will be dealt with on a change of ownership. Different landlords within the CRC will have different ways of charging their tenants, and will need to agree between themselves how the payments are to be reconciled on a change of ownership. Tenants will be concerned that in such a case they do not end up having to make two CRC payments that relate to the same period, as a result of different landlords having different policies for recovering the cost of *allowances*.

Where a landlord that uses one recovery method within its standard leases buys a property that has a lease allowing a different recovery method, it is possible to envisage that some complex issues will need to be overcome.

Where a landlord that is a *CRC participant* sells a building to a landlord that is not within the CRC, one might expect the first landlord to continue to deal with the tenants in relation to CRC issues, since the incoming landlord will have no interest in the CRC.

CRC participant landlords are likely to experience difficulties where they own buildings for short periods.

Annex A: building types and associated administrative costs under the CRC showing suggested allocation between landlords and tenants

	Whole building fully let to tenant (assuming that the tenant is a CRC *participant*)	**Multi let building with service charge for common areas (assuming that the landlord is a CRC *participant*)**
Cost of initial registration with *administrator*	Tenant	Landlord
Cost of annual registration with *administrator*	Tenant	Landlord
Any installation of software needed to manage compliance with the CRC, both at a macro level to allow the *CRC participant* to submit data into the CRC at organisation level, but also at the micro level so that they can apportion costs and distribute benefits accurately and efficiently on a building by building basis	Tenant **if** it needs to acquire data/services from the landlord	Landlord at macro level, tenant at micro level
Forecasting emissions for the property for the forthcoming *compliance year* taking into account the organisation's energy efficiency/carbon abatement strategies	Tenant	Tenant
Monitoring, assessing and managing emissions throughout the *compliance year*	Tenant	Tenant
Where necessary, the cost of buying or selling *allowances* through the *secondary market* or buying *allowances* through the *safety valve*	Tenant	Landlord
Reporting emissions and surrendering sufficient *allowances* to cover the organisation's emissions	Tenant	Landlord
Consulting tenants at each stage of the process	N/A	Tenant
Managing the distribution of the *revenue recycling payment* to tenants, which might involve the maintenance of a sinking fund, and internal league table of tenants or any other agreed process	N/A	Tenant

Annex B: considerations relating to the tenant's use of the property and effect on landlord obligations under the CRC

	Whole building fully let to tenant	Multi let scenario – type 1 (tenants pay for their own energy)	Multi let scenario – type 2 (landlords supply energy to tenants – no sub-meters)	Multi let scenario – type 3 (landlord supplies energy to tenants – with sub-meters)
Sale of building by landlord	Probably none, as the tenant will not be affected by the CRC status of the owner	Buyer likely to require due diligence information but probably limited to common areas	Significant amount of due diligence required for buyer; impact on tenants if CRC status or approach of new owner is different	Significant amount of due diligence required for buyer; impact on tenants if CRC status or approach of new owner is different
Assignment of lease by tenant	Probably no different from current position as tenant's CRC status is not an issue for owner	For landlord, probably no different from current position; for assignee, additional due diligence on service charges/direct pass through costs	May prejudice landlord if assignment may lead to increased energy use (potential for good tenant to be locked into lease) Due diligence required for assignee	May prejudice landlord if assignment may lead to increased energy use (potential for good tenant to be locked into lease) Due diligence required for assignee
Sub-letting	Potential issue between head tenant and sub-tenant as head tenant would be responsible for any CRC obligations	CRC liability will apply where a sub-tenant is occupying space on an underlease from a tenant that is a CRC participant – requires additional effort for both parties in due diligence Probably no issues for owner	May prejudice landlord if sub-let may lead to increased energy use – potential for good tenant to be prevented from subletting if proposed sub-tenants are likely to use the space more intensively or install special uses Due diligence required for subtenant and head tenant	May prejudice owner if sub-let may lead to increased energy use – potential for good tenant to be prevented from subletting if proposed sub-tenants are likely to use the space more intensively Due diligence required for sub-tenant and head tenant
Alterations to premises	Possibly a problem if there is a danger the landlord would inherit alterations if the original tenant is insolvent or the lease ends	Possibly a problem if there is a danger that the landlord would inherit alterations that may be less energy efficient/result in the consumption of more energy if the original tenant is insolvent or the lease ends	Resistance from landlord if alterations might increase energy use Consideration to be given to energy use during build – including any landlord works to other vacant space and common areas	Resistance from landlord if alterations might increase energy use Consideration to be given to energy use during build – including any landlord works to other vacant space and common areas
Capital works	Capital works would probably be carried out by tenant	Capital works to improve energy efficiency may be carried out by either party – process for consent/charging needs to be robust	Capital works likely to be carried out by landlord – may need a process for billing amortised costs	Capital works likely to be carried out by landlord – may need a process for billing amortised costs

Annex C: considerations for owners and occupiers when a building is sold

	CRC *participant* to CRC *participant*	**CRC *participant* to non-*participant***	**From non-*participant* to non-*participant***	**From non-*participant* to CRC *participant***
Owners	Question over whether buyer will have sufficient *allowances* for acquisition (after acquisition completed). Will the buyer seek to acquire carbon *allowances* from seller? Does buyer have to/ can it inherit seller's approach to managing the CRC?	Buyer has no immediate need to worry about the CRC implications of the purchase but may consider impact on future CRC status Buyer may have to deal with allocation of r*evenue recycling payments* to tenants	May not be any difference due to the CRC unless buyer is concerned about onward saleability	Non CRC *participant* may not have the type of information a CRC *participant* buyer would need to assess future requirement for the CRC CRC *participant* would have to engage with occupiers for information and to agree how to deal with CRC costs for the building
Occupiers	Occupiers should be aware that although they might have expected a distribution of *revenue recycling payments* from one landlord, the new owner may be further down the *league table* and thus may receive a smaller *revenue reycling repayment* or may operate a different policy of redistribution to tenants	Occupier should find its CRC costs reduced where it pays its landlord for such costs Any anticipated *revenue recycling payments* would probably not be available to the occupier as a result of sale	Should be no change in the position of the occupier	Occupiers paying their landlords for energy can expect their costs to increase to meet the costs of the CRC Occupiers will need to engage with new owner to agree how to deal with CRC costs for the building

Annex D: contributions

We are grateful to the many individuals have contributed to the production of this Guide, and we would like to give particular thanks to the following:

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Davinder Jhamat	British Council of Shopping Centres
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Michael Chambers	British Property Federation
Elizabeth Hinde	British Retail Consortium
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David Hookins	Charterhouse Energy
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Maureen Romeril	Clifford Chance LLP
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Nick Darby	Denton Wilde Sapte LLP
Peter Williams	Eversheds LLP
Paul Edwards	Hammerson
Tatiana Bosteels	Hermes
Louise Ellison	Investment Property Forum
Michael Jefferson	Land Securities
Janet Kidner	Lend Lease
Clive Stringer	NB Real Estate
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Hilary Reid-Evans	Quintain
Julian Lyon	RICS Corporate Occupiers Group
Dan Cook	Royal Institution of Chartered Surveyors
Paul Bagust	Royal Institution of Chartered Surveyors
Patrick Brown	Secretariat to the Working Group (BPF)
Graham Baxter	Standard Life
Matthew Tippett	Upstream (Jones Lang LaSalle)
Anna Surgenor	UK Green Building Council

Glossary

This glossary has been provided to assist readers to understand some of the technical aspects of the CRC. The explanations in this glossary are not legal definitions or terms of art. Items in the glossary are *italicised* in the main text of the guide to signpost readers to terms within the glossary.

Term	Definition
Administrator	The *administrator* will be responsible for regulating and auditing the *scheme*. In England and Wales, the *administrator* will be the Environment Agency, in Scotland, the Scottish Environmental Protection Agency and in Northern Ireland, the Northern Ireland Environment Agency.
Automatic meter reading	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. *Automatic meter reading* 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.
Capped phase	Following the *introductory phase* (running from April 2010 to March 2013), where the cost of *allowances* will be fixed and an unlimited number of *allowances* will be made available, in subsequent phases (from April 2013 onwards until March 2043) the Government will introduce auctioning of *allowances* and will restrict, or 'cap', the number of *allowances* that are available for CRC *participants* 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.
Compliance year	The year running from 1 April (where emissions for the coming year must be forecast) to 31 March in the following calendar year.
CRC Co-ordinator	This is a term used in this guide to mean an individual within the highest UK parent undertaking of a *CRC participant* with overall responsibility for the *CRC participant's* participation in, and compliance with, the CRC.
CRC Officer	This is a term used in this guide to mean an individual at the building level in the case of a property responsible for taking the necessary steps to ensure the *CRC Co-ordinator* has the requisite information to administer the *CRC participant's* participation in the *scheme* (e.g. to forecast emissions).
CRC participant	This is a term used in this guide to mean a single undertaking, or group of undertakings, that is required to participate in a given phase of the CRC.
Emissions allowances (also referred to as "*allowances*" or "CRC *allowances"* throughout the text)	*Emissions allowances* under the CRC represent one tonne of CO_2.*Participants* will be required to purchase sufficient *allowances* to cover the energy supplies they are responsible for.
Footprint report	The report that contains information about an organisation's energy use during a *footprint year* that must be submitted to the *administrator* by the end of July after the end of that *footprint year.*

Term	Definition
Footprint year	The first *footprint year* 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 *footprint report*) by July 2011. This report 'fixes' a *participant's* CRC emissions for the relevant phase. In subsequent phases, the *footprint year* will be the year immediately following the qualification year. This will be 2011/12 and 2016/17 for the second and third phases respectively.
Half hourly meters (*HHMs*)	Buildings with an electrical demand of over 100 kilowatts will probably have a half hourly utility or peak demand meter, which automatically records how many kilowatt hours 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.
Introductory phase	The CRC will commence in April 2010, with a three year period or *introductory phase* to March 2013 during which the price of *allowances* will be fixed and there will be an unlimited number of *allowances* for sale. Following the end of this three year period, the number of *allowances* that are available will be restricted and they will be sold via an auction at the price that balances supply with demand.
Kilowatt-hour (KWh)	The kilowatt-hour is a rating of energy consumed. If a 100 watt lightbulb is on for 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.
League table	The *administrator* will rank all *CRC participants* according to a number of metrics. In the *introductory phase*, the three metrics are the absolute metric, the growth metric and the early action metric. In subsequent phases, only the absolute metric and growth metrics will be used to rank *CRC participants*.
Megawatt (MW)	1,000 kilowatts = 1 megawatt.
Qualification year	The period during which electricity consumption through all *half hourly meters* must be monitored to determine whether an organisation is required to participate in a forthcoming phase of the CRC. The *qualification year* for the *introductory phase* is the 2008 calendar year.
Registration period	The period from April to September 2010 during which organisations that are required to participate in the scheme will have to declare themselves within or outside the CRC based on their *HHM* electricity supplies during calendar year 2008. For subsequent phases, the registration deadline will be within 6 months of the beginning of the phase (i.e. 30 September 2011 for the second phase).
Revenue recycling payments	Revenues achieved from the sale of *allowances* will be redistributed to *CRC participants*, based on their emissions in the first year of the scheme (2010/11 for participants in the *introductory phase*) and adjusted by bonus or penalty. It is the Government's intention that over time payments will recycle a greater proportion of the revenue from *allowances* from those who have fared worse on the *league table* to those who have fared better. Initially the bonus/penalty will be set at +10% -10%, and it will rise to +50% -50% in the sixth year of the *scheme*.
Safety valve	A mechanism by which *CRC participants* can buy *allowances* from the *administrator* throughout the year if the price on the *secondary market* becomes prohibitively high. The price will be linked to the EU ETS price of carbon. In the *introductory phase* a price floor of £14 per *allowance* will be set for *safety valve* purchases.
Scheme	The term "*scheme*" is sometimes used as an alternative to "CRC" in this guide.
Secondary market	*CRC participants* can choose to buy or sell their *emissions allowances* during the year from/to other *CRC participants* or from/to third parties outside the CRC (on the *secondary market*). This allows a *CRC participant* that believes it will comfortably meet its emissions reductions targets to sell surplus *allowances*, or to buy *allowances* if it believes that it will not have sufficient *allowances*.

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June 2009 (Revised version August 2010)