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DON'T GET CAUGHT OUT

Energy efficiency The CRC energy efficiency scheme may have dropped out of the headlines but, as Sue Highmore and Peter Williams explain, landlords and tenants still need to understand its implications

The CRC energy efficiency scheme ("the scheme") is not new. It was implemented in 2010, giving property owners, tenants and building managers the opportunity to familiarise themselves with it. However, many have never come across it, and know little about its pitfalls.

The principal concern for owner-occupiers, landlords and tenants is that the scheme can add to the cost of occupation of a property. Since it can also reduce the net yield of a building, affecting investors and lenders, it is vital to understand how it operates.

Basics of the scheme

The scheme affects only commercial property. In simple terms, those who use large amounts of electricity and gas ("participants" in the scheme) must buy permits ("allowances") from the government to emit the resulting CO_2. This extra expense was meant to encourage those who paid for allowances to adopt more energy-efficient behaviour.

Originally the scheme was intended to reward energy-efficient participants, and penalise less energy-efficient ones. The government would retain a small proportion of the proceeds of sale of the allowances (to cover the costs of running the scheme) and return the remainder to the participants, with more money being distributed to the energy-efficient (named at the top of a published league table). In addition, the pot of allowances was finite, so that participants who underestimated the number needed would either have to reduce their energy consumption to match their allowances or pay considerably more to buy spare allowances from other

REX FEATURES

participants. This was a "cap and trade" system as envisaged by the Climate Change Act 2008 (the 2008 Act).

The financial crisis changed things. In October 2010, the chancellor announced that the Treasury would keep the proceeds of sale of allowances and not recycle them to participants. This made the scheme look more like a tax and less like an incentive scheme to encourage reduction of carbon emissions. The scheme proved very complex and costly for participants to operate, leading the government to consider replacing it with something simpler. It didn't do so, perhaps because it is a very efficient way of raising revenue whilst incentivising heavy energy users to reduce their consumption so as to help meet the government's ambitious CO_2 reduction targets.

2013 Order

The 2013 CRC Energy Efficiency Scheme Order did simplify the scheme. The changes of greatest interest to the property industry are set out in box 1 (below) and mostly came into force in April 2014. It is possible that the unrestricted

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Correction

In the article *Homing in on mixed-use challenges*, published on 5 April, p86-87, it was incorrectly stated that three months' notice is required for an auction sale under the Landlord and Tenant Act 1987. It should have read four months.

supply of allowances will emasculate any intended trading of allowances between participants. Section 44 of the 2008 Act authorises a "trading scheme", not a tax. The amended scheme incorporates so few features of a trading scheme that its statutory authority could be questioned.

Effect on leases

Participation in the scheme generates expense. Not just the cost of the allowances but also the administrative costs of registering for the scheme and submitting annual returns. The debate remains whether the landlord or the tenant should bear these.

It is important to remember that this question arises only where the landlord is a participant and is responsible for the energy supplied (to the tenanted areas of the building, its common parts, or both). This generally applies to multi-tenanted offices though it can affect single-tenanted buildings on an estate with a communal electricity or gas supply (for example, an industrial estate). Where a tenant has its own supply of energy, and is a participant in its own right, it must purchase the appropriate allowances.

In an FRI lease, the landlord aims to recover all its management expenses, so that there is no drain on its investment return from the rent. Ideally, it wants to recover both the cost of allowances and a proportion of its administration costs under the scheme. By contrast, tenants who expected their total occupation costs (rent, rates, outgoings and service charge) to be at a particular level will be reluctant (perhaps unable) to pay more, to reflect the extra costs incurred under the scheme. They may argue that these arise only because their landlord for the time being happens to be in the scheme as a result of its aggregate energy consumption across its portfolio (rather than just in this building) and the landlord should bear the additional expense.

Recovery of costs

The landlord may try to recover its costs under the scheme through:

- the service charge provisions; or
- the clause obliging the tenant to pay any rates, taxes or other outgoings.

However, the drafting may not permit this. Leases granted before the scheme began will not address this type of expense expressly. Leases granted post 2010 may not do so either (see box 2 for why), so the parties must decide whether the language can be stretched to cover these costs. To date, there has been no litigation to resolve what wording works. Some examples are analysed in box 3, but ultimately it will be for the courts to decide.

Landlords and managing agents do not always bother to analyse the leases. They simply include the cost of the allowances (and sometimes the administration charges) in the service charge. The new edition of the *RICS Code of Practice for Service Charges in Commercial Property* prohibits the recharge of CRC administration expenses, but does not require CRC costs to be shown separately in the accounts. Consequently, the tenant may be unaware that CRC costs are being recovered. Even if it is, and it believes that the lease does not permit this, the additional amounts may be too small to justify costly litigation. As the cost of allowances rises, however, tenants may be less willing to turn a blind eye like this.

Sale of a building

A further issue can arise where a tenanted building is sold by a participant landlord, who has billed the tenants for allowances bought early on in the scheme year. The allowances paid for may exceed those required to cover emissions from the energy consumed up to the point of sale. Should the outgoing landlord refund the excess to the service charge? Where the new landlord is also a participant, and will need allowances to cover the energy consumed during its ownership, should/can the outgoing landlord's allowances be apportioned and handed on? Tenants may challenge paying for two sets of allowances.

There is little enthusiasm for standard protocols or clauses for this. Where due diligence exposes a problem, bespoke drafting is needed in the same way as for a service charge shortfall arising for other reasons.

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1. RECENT CHANGES TO THE SCHEME

- Unlimited allowances available
- Fixed prices for allowances (instead of an auction). 2014-15 prices are up from £12 to £15.60 per tonne at the start of the year; £16.40 at the end
- Estimating energy use in advance is unnecessary
- Allowances needed only for electricity and gas (not other fuels)
- Criteria for participation have been simplified: which electricity counts, which parts of a corporate organisation are aggregated, how trusts are assessed
- State-funded schools in England are now outside the scheme
- Performance league table abolished

2. REASONS WHY NEW LEASE CLAUSES MAY NOT COVER CRC COSTS

- No one thought about it
- The initial landlord was not a participant and did not want to risk irritating the prospective tenant by asking for express wording. The landlord may have decided that its likely successors in title would not be participants either so would not be put off by the absence of express wording
- The initial tenant struck out the express wording
- The draftsman thought the traditional wording would suffice

3. ILLUSTRATIVE DRAFTING OF THE OUTGOINGS CLAUSE

"The Tenant shall pay all present and future rates, taxes and other impositions payable in respect of the Property or its use."
This is not wide enough. Rates and impositions have a technical meaning which CRC costs do not fit. Nor do they satisfy all the traditional tests of a tax (regardless of the fact that the Treasury includes CRC costs under energy taxes). Nor are they payable in respect of the property or its use, but in respect of the consumption of energy.

"The Tenant shall pay all present and future rates, taxes, costs, charges and other impositions payable in respect of the Property, its use, occupation or in connection with energy supplied to it."
Including costs and charges and linking it not only to occupation of the Property but energy supplied to the Property should pick up the cost of allowances for energy to that part of the Property. It will probably not cover the cost of allowances for energy used in common parts (because they are not the Property) or the administration costs (because they arise because the landlord's business is big enough to make it a participant, not because of this particular building).

"Electricity Charges include the cost of electricity supplied to the Property and any other costs, charges or payments arising as a result of the supply of electricity to the Property (or a fair proportion of such costs, charges or payments where arising in relation to the Property and other property)" together with an obligation on the tenant to pay the Electricity Charges.
This wording will cover allowance costs attributable to the supply to the property, as well as any security deposit for that supply. For the same reasons as above, it will not cover the cost of allowances for energy used in common parts or the administration costs.