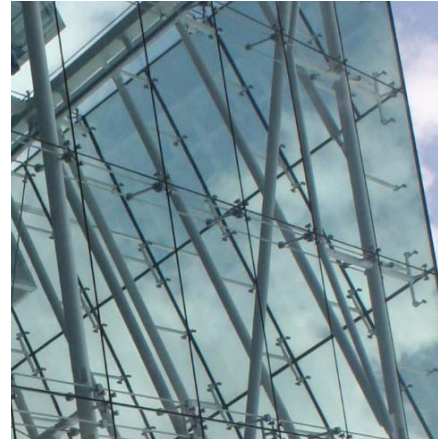


Commercial Property Bulletin

June 2010

How the CRC Efficiency Scheme will affect Landlords and Tenants

The CRC Energy Efficiency scheme is a mandatory scheme affecting the whole of the UK, which requires participants to annually buy and surrender allowances priced in pounds per tonne to cover the amount of CO2 a participant emits each year. It is part of the 2008 Climate Change Act, which was introduced to try to meet the Government's target of reducing greenhouse gases by 80% by 2050. The scheme's main purpose is to drive down energy consumption. This article looks at the CRC and its impact on both Landlords and Tenants.



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Fitting the scheme into leases

The Government has not introduced legislation to dictate how the scheme is to be implemented between Landlords and Tenants. The number of existing leases which specifically refer to the scheme is exceptionally low, so very real issues are going to arise as it is fitted into existing leases. The Government hopes that Landlords and Tenants may "revise" lease terms to take into account the effect of the scheme, but will this happen? The Government's user guide, published this January, states that Tenants are "*obliged to co-operate with their Landlords where necessary for the purpose of complying with CRC, for example by providing data related to its energy supplies*".

Any comments or queries?

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What will landlords and tenants consider?

Costs

Buying Allowances

Does a lease which was granted two years ago allow the Landlord to claim from its Tenants the cost of purchasing allowances? It will depend on the precise wording of the lease, but many people think the wording found in a "standard" lease (insofar as there is such a thing) probably does not allow the Landlord to do so. Clauses a Landlord might seek to recover the cost of buying allowances under are:

- The Tenant's covenant to pay for utilities, but this is not a payment that is made by the Landlord to the supply company
- The Tenant's covenant to contribute towards common items, which generally include service media, but the cost does not relate to repairs of service media

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- The Tenant's covenant to pay rates and taxes. If it is simply a covenant to pay these then the clause will not enable recovery. Maybe it could be argued the purchase is an outgoing?
- Can it be recovered under the service charge? Arguing that the cost of buying an allowance is the cost of supplying a service is not straightforward. Is it a cost of complying with law? Or can it be swept up into the general sweeper clause?

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What if the costs of buying the allowances or administering the scheme are incurred by the Landlord's parent, rather than the Landlord? The Tenant might raise this in a dispute with the Landlord – express wording in a lease would cure this.

Administration Costs

There will be another revenue cost, that of administering the scheme, which will be high – especially early on. Many think that as between Landlords and Tenants, the administrative burden is likely to outweigh the costs if Landlords seek to allocate costs/benefits to individual assets and occupiers. Can the Landlord recover the administration costs? Is administering the scheme a service that the Landlord provides to the Tenant? Again, there is a lot of doubt.

It is far from clear that an existing lease allows the Landlord to recover the costs of buying the allowances. Lets assume that it does, or the Landlord decides that it will try to do so. There are a host of issues around the timing of payments and rebates and hence the amount the Landlord should or can recover. Each April a participant purchases the allowances it thinks it will require until the following March; if there is an under estimation additional allowances will have to be purchased on a secondary market. What happens, though, if a Landlord accurately predicts the annual consumption and so buys the right number of allowances but then mid-way through the year buys another property? That new property is now caught by, and falls within, the scheme, so the Landlord will need to buy additional allowances. Who pays for them? What if the Landlord's portfolio is mixed and it has some very modern and energy efficient buildings but also some old stock which is far less energy efficient? How are the (net) costs of buying allowances shared between the Tenants of these different buildings?

Cost of capital improvement works

Will Landlords be able to recover all the capital costs of implementing energy enhancement works? Especially early on, when allowances are £12 per tonne, such costs could well exceed the maximum rebates that the Landlord could recover under the scheme. Here again the wording of the lease and case law will determine whether or not this is possible. You may well get different answers depending on the length left on a Tenant's lease. There might be some quick, cheap one-off steps to improve efficiency, but some improvements will be very expensive.

Covenants

It's not just cost recovery that Landlords and Tenants need to consider. A number of covenants need to be considered.

There are the services the Landlord provides: Landlords may decide to reduce the energy consumption they directly consume, particularly where there are substantial common parts. What if a Landlord wants to reduce the hours it runs the air conditioning? Some Tenants may have negotiated express provisions in their leases requiring

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the Landlord to provide this during designated core hours, so the Landlord cannot unilaterally decide that because of the scheme, it can reduce the hours.

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Landlords will also look at Tenants' electricity consumption because, as mentioned before, if the Tenant reimburses the Landlord for the electricity the Tenant uses, that electricity counts towards the Landlord's aggregate consumption. The Government states that it believes Landlords can influence their Tenant's energy consumption. Agreeing to switch off the lights in the storeroom at the end of the day is unlikely to be controversial, and might be covered by a memorandum of understanding. But retail Tenants know full well the value to their business of keeping their shops well lit and having an open door, even though such actions increase the energy costs.

How does the Scheme affect Alienation and User?

What if a Tenant who is an undertaker wants to assign to a TV shop? The shop's electricity consumption is going to dramatically increase. Could a Landlord refuse consent to such an assignment? Current leases do not envisage the Landlord having an express right to do so, so the Landlord would have to argue that the increased energy consumption is a reasonable ground for withholding consent. What if a Landlord decided to expressly deal with such a point when negotiating a new lease by inserting a provision prohibiting the Tenant from assigning to someone who would use more energy than the original Tenant? Even if the Tenant accepts this, would this not have an adverse effect when it comes to rent review?

Alterations

Suppose a Tenant wants to carry out alterations which are going to lead to greater energy consumption within the building, such as installing air conditioning. Again, an existing lease will not expressly cover this. Is it reasonable for a Landlord to say that such works cannot be carried out?

Regulations

Leases often contain a clause enabling the Landlord to make regulations. Could the Landlord rely upon these to control the Tenant's energy consumption? Turning lights off might be fine, but is it controversial to expect Tenants to provide details of their energy consumption? It is hard to see, though, how regulations could take the scheme any further forward.

Extent of demise

Landlords may think that it is better going forward for them to retain parts of buildings to enable them to carry out energy enhancement works. This could be the installation of new plant, or double glazing. If the windows of a building have been demised to the Tenant, the Landlord does not have the right during the tenancy to enter the Tenant's demise and install double glazing.

Conclusion

As the scheme starts to kick in during 2010, Landlords and Tenants should be using what little time they have left to work out how they will be affected by the CRC Energy Efficiency Scheme. They need to be especially careful if the other party tries to place all the obligations on them; Tenants will not want to find that "through the back door" they are paying for improvements to the Landlord's building they would not otherwise have liability for.

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About the CRC

- In determining whether a company is caught by the scheme:
 - The electricity consumption of all companies within its group are aggregated together and if in 2008 the group had at least one half hourly meter and together consumed at least 6,000MWh (approximately £500k of electricity) supplied on the half hourly market then all companies in the group will be caught.
 - If the company pays the supply company for the electricity its Tenants use, even if it recovers the cost of such electricity from its Tenants, for the purposes of CRC the Tenants' consumption counts towards the company's or the group's use. So what determines whether a building is affected by the scheme is not the electricity consumed in that building, but the electricity consumption billed to the group the Landlord is in.
- It is thought about 5,000 organisations will be caught by the scheme
- The scheme started on April 1 2010 with a monitoring "dry run" year, when no allowances need be purchased
- Carbon allowances will initially carry a fixed cost of £12 per tonne of CO2 but from 2013 will be auctioned. Allowances will have to be purchased for gas and other fuels as well as electricity, but not fuels used for transport or domestic accommodation
- Participants will report on their performance and surrender existing credits equal to their carbon consumption at the end of each scheme year
- The revenue raised by the sale of credits is recycled into the scheme and returned to participants as a rebate six months after the allowances are bought. It is very unlikely a participant will receive the same amount as it puts in
- A league table will be compiled based on participants' self-reporting. Those who do well (by reducing energy consumption) will receive a rebate bonus while those who under-perform will be charged a penalty
- The bonus and penalty rate increases incrementally over the first five years, from 10% to 50% of the cost of the allowances
- The table will also have the effect of naming and shaming those who are at the bottom. For public bodies and quoted companies the fear of such bad publicity could be a very important reason why they embrace the scheme.

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