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**Registering for the CRC Energy Efficiency Scheme:**
**General Guidance for Private Equity Firms**

What is the CRC Energy Efficiency Scheme?

The Carbon Reduction Commitment Energy Efficiency Scheme (CRC) is a mandatory climate change and energy saving scheme that is being introduced as part of the UK's strategy to control carbon dioxide ($CO_2$) emissions. The CRC operates on a "cap and trade" basis. The government will sell CRC allowances (carbon credits) each year, in units representing the right to emit one tonne of $CO_2$. Participants can then trade allowances between themselves at a free market price, creating a financial incentive to reduce $CO_2$ emissions and sell surplus allowances. At the end of each year, participants must surrender sufficient allowances to cover their carbon emissions for that year.

Am I affected?

Any private equity firm whose portfolio included, on 31 December 2008, a controlling stake in a company with UK operations must consider whether it is required to register with the Environment Agency as a CRC participant. Any UK-based business that had, during 2008, a 'settled half hourly' electricity meter is required to comply with the CRC in some way. The level of participation required is determined by annual electricity consumption for 2008.

Group participation

Organisations are required to participate in the CRC on a group-wide basis. Only UK energy consumption is counted for the purposes of the CRC, both when assessing the level of participation required and when reporting annual usage and surrendering allowances, but all members of the group, even non-UK members, are jointly and severally liable for CRC compliance. In particular, the highest parent entity within a structure has additional administrative responsibilities.

Membership of a group is determined for CRC purposes by applying the same tests used for determining an accounting group, as set out in the Companies Act 2006. So, for many firms, a practical starting point when assessing whether entities fall within a CRC group may be to look at the analysis undertaken for the purposes of determining existing accounting consolidation groups. However, as member firms will be aware, a number of difficult technical issues arise when applying the Companies Act 2006 grouping tests to private equity fund structures, and this analysis will be highly specific to the circumstances of individual firms.

As the CRC forms a central part of the UK's commitment to action on climate change, the Department of Energy and Climate Change is looking, as a policy matter, to include as many organisations and entities within the scheme as possible so as to maximise the overall reduction in carbon emissions. We understand from preliminary conversations with the Environment Agency that it will, therefore, be expecting firms to take an inclusive approach to CRC grouping. As a result, when applying the grouping tests for CRC purposes, firms may wish to interpret the legislation conservatively so as to include entities within a CRC group that might properly be excluded for accounting consolidation purposes.

As the application of the Companies Act 2006 grouping tests to limited partnership structures is a complex and technical area, the BVCA's Legal & Technical Committee has sought the advice of leading corporate counsel, David Chivers QC, on the proper application of those tests in the context of the CRC legislation. A summary of Counsel's advice, which has been approved by Counsel, is set out in the Appendix to this bulletin.

Disaggregation

Where a CRC group can be divided into two or more sub-groups each of which would qualify as a CRC participant in its own right, each of those sub-groups (or potential sub-groups) constitutes a 'significant group undertaking' (SGU) for CRC purposes. Firms may elect to register each SGU as a separate CRC participant, which may be desirable where individual portfolio companies have substantial $CO_2$ emissions. In addition, the acquisition or disposal of an SGU during the scheme will trigger reporting obligations, and will result in adjustments to the organisation's baseline emissions figures.

Steps to take

The first step is to establish whether or not your organisation falls within the qualification criteria for the scheme:

1. Determine your group structure as at 31 December 2008. Member firms may find the guidance in the Appendix helpful in making this determination. However, the position of individual firms will vary as a result of differences in fund structure and/or the terms of the limited partnership agreements governing individual funds, and you may need to take specific legal advice based on your individual circumstances.

2. Determine whether the UK-based operations of any portfolio company forming part of that group had, at any time during 2008, a settled half hourly electricity meter ("HHM"). If not, your group is not within the CRC and no further action is required.

3. If any member of the group had a HHM, it is necessary to assess the group's aggregate half hourly metered UK electricity consumption for the calendar year 2008, calculated on the basis set out in the CRC legislation.

    (a) If the total is less than 3,000 MWh, each group entity that has one or more HHMs must provide details of those HHMs to the Environment Agency through an online registration system. The Environment Agency recommends, for administrative purposes, that groups make a single information disclosure on behalf of all group entities.

    (b) If the total is between 3,000 MWh and 6,000 MWh, details of electricity consumption for 2008 must also be provided.

    (c) If the total is 6,000 MWh or more, the group will be a full CRC participant, and must register online for the carbon allowances trading scheme.

By default, the entity with responsibility for registration will be the highest parent entity within the group. However, if this is a non-UK entity, the highest parent must nominate a UK-based member of the group to be the CRC Account Holder, with responsibility for administering the scheme on behalf of the group, and private equity firms will need to consider which entity should undertake this role.

Timing

Registration opened on 1 April 2010. The deadline for registration is 30 June 2010 if you intend to 'disaggregate' any SGUs, and 30 September 2010 for all other participants.

Penalties for Non-Compliance

An organisation that fails to register as a CRC participant is potentially liable to a penalty of up to £45,000, and may also be 'named and shamed'. In addition, the Environment Agency may serve an enforcement notice requiring the organisation to register for the scheme. Failure to comply with an enforcement notice is a criminal offence for which a company's officers may be prosecuted personally.

Failure to report details of a HHM carries a penalty of £500 for each meter not reported.

Additional Guidance

Extensive guidance on CRC compliance is available on the Department for Energy and Climate Change website and the Environment Agency website.

Member firms may find the following resources particularly useful:

- DECC CRC User Guide;
- The Environment Agency guides:
  - "Am I In? A guide to qualification and organisational structure";
  - "Registering as a CRC Participant";
  - "Making an Information Disclosure";
- Annex A to the DECC Response to the CRC Consultation, which explains the basis on which SGUs may be disaggregated through a series of worked examples;
- The Environment Agency guidance on Organisational Change in the Private Sector.

**May 2010**

**Appendix**
**Application of section 1162 of the Companies Act 2006**
**to Limited Partnership Structures**

This Appendix aims to provide guidance for firms on the general legal principles that apply when assessing whether entities within a fund structure are grouped for CRC registration purposes. However, the analysis is both legally complex and highly fact-specific, and the position of individual firms will vary. This guidance should not be viewed as a substitute for obtaining specific legal advice. It may also be appropriate to consult with the firm's auditors and the auditors for each fund.

This guidance has not been endorsed by the Environment Agency. **No responsibility can be taken for decisions made by individual member firms as to whether and/or how they are required to participate in and/or comply with the CRC.**

Environment Agency Policy Position

Firms should note that, notwithstanding the technical legal position described below, the Environment Agency has indicated that its preferred approach would be for firms to treat all entities in each of the structures described as a single CRC group, subject to the rules on disaggregation. The Environment Agency will be auditing firms to assess CRC compliance, with each firm being audited on average once every five years. Where, following a detailed legal and factual analysis, a firm decides that its organisation consists of a number of separate CRC groups rather than a single CRC group, the firm should ensure that the supporting analysis is documented and retained as it is likely to be requested by the Environment Agency as part of the audit process.

The Companies Act 2006 Tests

In essence, two or more entities will be grouped for CRC purposes if they are group undertakings in relation to each other as defined in section 1161(5) of the Companies Act 2006. This is determined by reference to the definitions of parent undertaking and subsidiary undertaking contained in section 1162 of the Companies Act 2006.

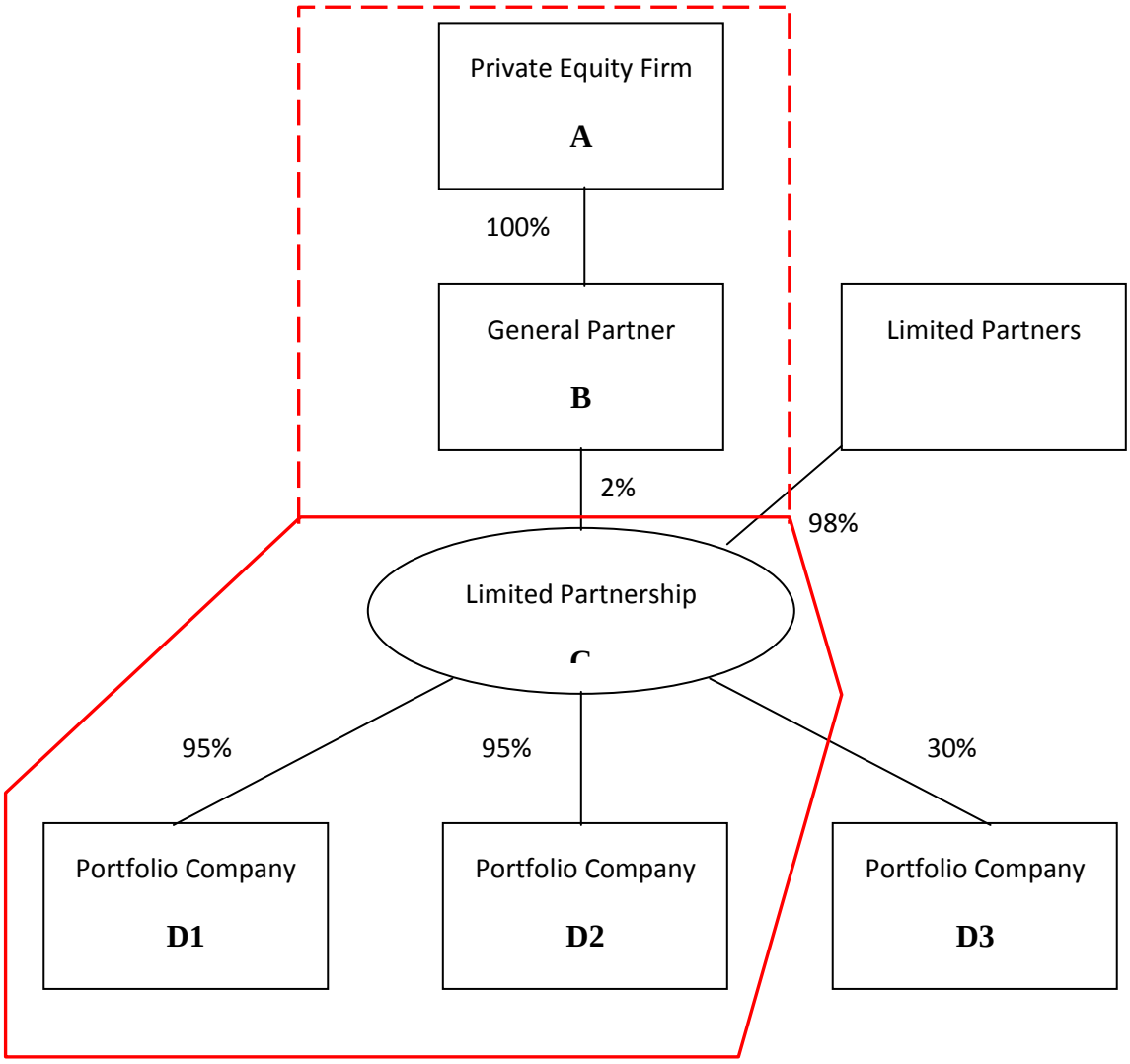
Section 1162 sets out a number of tests for determining whether one entity (A) is the parent undertaking of another entity (B). The detail of each test is complex, but generally speaking, A will be a parent undertaking of B if:

- A holds a majority of the voting rights in B, or A controls a majority of the voting rights in B by virtue of an agreement with the other shareholders or members;
- A has the right to appoint or remove a majority of the board of directors of B;
- A has the right to exercise a dominant influence over B, or A in fact exercises dominant influence or control over B even though it has no express right to do so; or
- A and B are managed on a unified basis.

If any of these tests are satisfied, A will be a parent undertaking of B, and A and B together will be required to register as a single CRC participant.

The Basic Limited Partnership Structure

Many private equity funds are structured as limited partnerships, and the basic structure is often similar to that shown in the diagram below:




In this structure, the CRC group for which the private equity firm is, in practice, responsible will typically include those entities surrounded by the solid red line. In some cases, it will also include those entities surrounded by the dotted red line.

The key questions to consider are:

- *Is the limited partnership (C) a parent undertaking of each portfolio company (D1, D2 and D3)?*

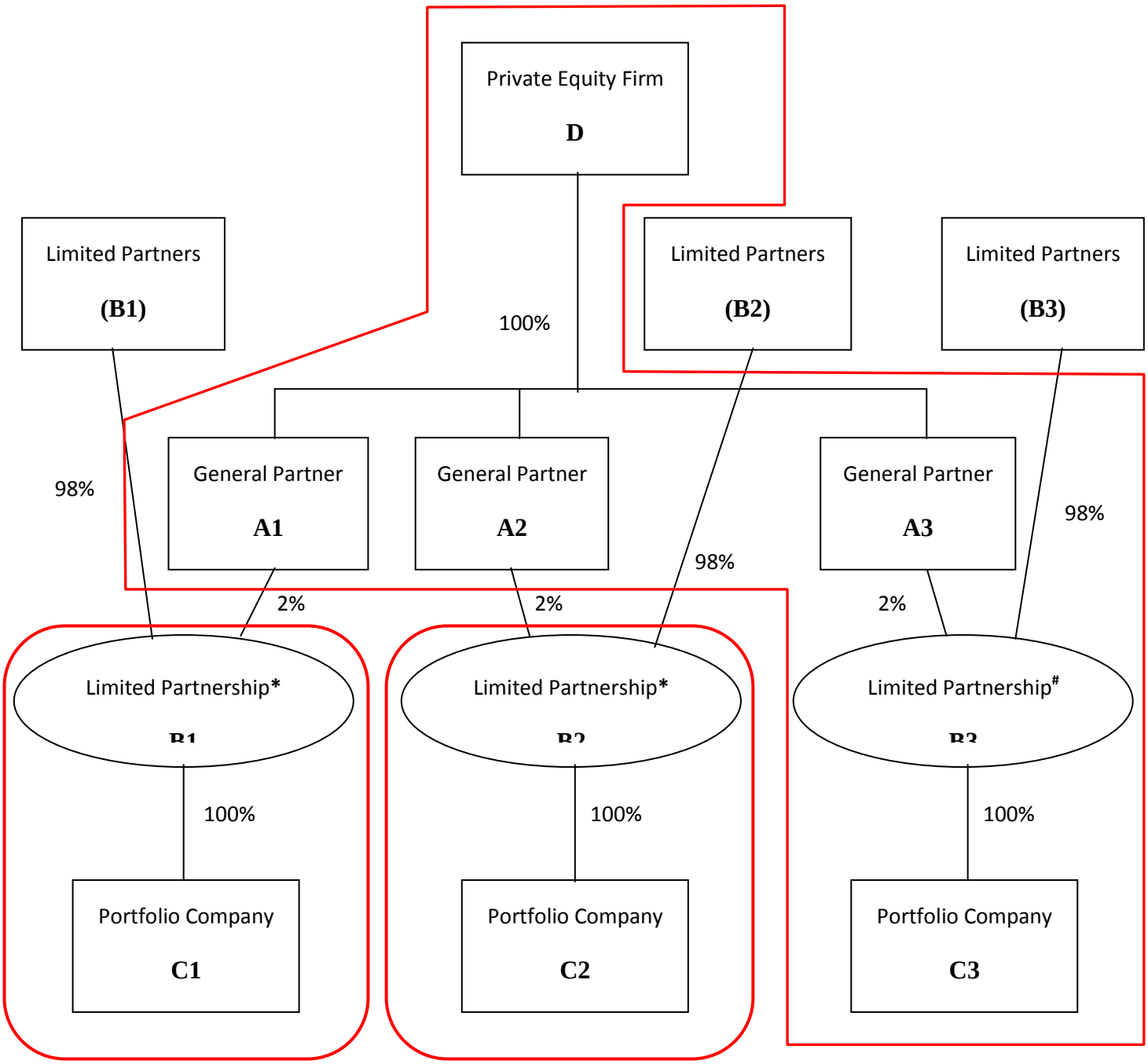
- Where a limited partnership has a majority (>50%) stake in a portfolio company, the limited partnership will typically satisfy one of the 'parent undertaking tests' and so should be treated as a parent undertaking of that portfolio company for CRC purposes.
- Where a limited partnership has a minority (≤50%) stake in a portfolio company, the limited partnership will not usually be a parent undertaking of that portfolio company. The exception is where the limited partnership, as a shareholder, has a right to appoint or remove a majority of the board of directors of the portfolio company, or where it controls the board of directors of the portfolio company to such an extent that it can be said to be exercising a dominant influence.
- So, in the example above, the most likely outcome is that the CRC group will include C, D1 and D2, but will not include D3.

- *Is the general partner (B) a parent undertaking of the limited partnership (C)?*
  - Where the general partner of a limited partnership is entrenched as general partner and cannot be removed, deeming provisions in schedule 7 of the Companies Act 2006 mean that the general partner should be considered to be the parent undertaking of the limited partnership. Where the general partner can be removed and replaced at the discretion of the limited partners (for example, under a no fault divorce clause that is immediately exercisable at the relevant point in time), these deeming provisions will not apply.
  - It is also necessary to consider whether the general partner actually exercises a dominant influence over the limited partnership; if so, the general partner will be a parent undertaking of the limited partnership. This is a fact-sensitive analysis that turns primarily on the extent to which the general partner determines the operating and financial policies of the limited partnership and the manner in which the partnership business is run. In many cases, the general partner's discretion will be heavily constrained by the terms of the limited partnership agreement. For example, a typical investment policy will prescribe the geographic areas and industry sectors in which investments may be made, and will proscribe certain types of investments. It will also typically include diversification requirements, borrowing restrictions and other constraints on the general partner's freedom to manage the partnership's business. In most cases, a fund's investment policy can be changed only with the agreement of the limited partners; the general partner is not able to make changes unilaterally. In this scenario, the general partner should not normally be regarded as exercising a dominant influence over the limited partnership.
  - So in the example above, assuming that there are no dominant influence issues, the most likely outcome is that the CRC group:
    - <u>Will</u> include B (and consequently its parent, A) if the limited partnership agreement does not include a no fault divorce clause, or if the no fault divorce clause is not exercisable at the relevant point in time;
    - <u>Will not</u> include B (or A) if the limited partnership agreement includes a no fault divorce clause that was capable of being exercised by the limited partners on 31 December 2008.

Multiple Fund Structures:

Where a private equity firm sponsors a number of different funds, the above analysis must be applied to the structure as a whole.

A multiple fund structure is often similar to that shown in the diagram below.




* No fault divorce clause was exercisable on 31 December 2008.

[#] No fault divorce clause was not exercisable on 31 December 2008.

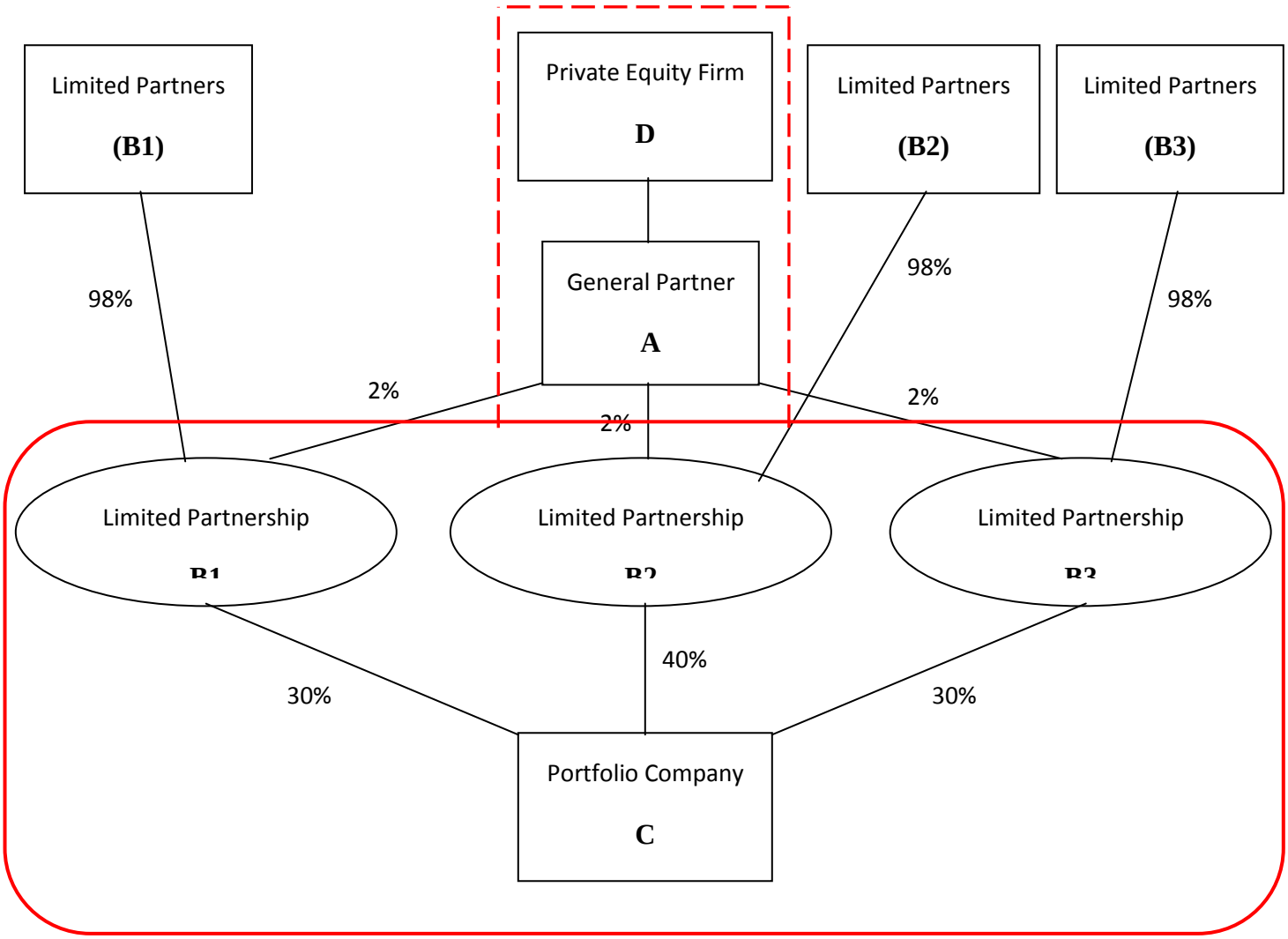
In this structure, the most likely outcome is that the private equity firm will, in practice, be responsible for a number of CRC groups.

If, as is often the case, the no fault divorce clause for each of the earlier funds (B1 and B2) has become exercisable, but the most recent fund (B3) is still in the initial 'entrenched' period during which the general partner cannot be removed, the CRC groups are likely to be those indicated by the solid red lines.

If more than one fund in the structure was still in the initial 'entrenched' period on 31 December 2008, then all such funds and their respective general partners are likely to form a single CRC group under the private equity firm (D) as the ultimate parent undertaking. (This position will, however, be different in situations where the general partners are not under common ownership; for example, in structures with 'orphaned' general partners).

Parallel Fund Structures:

In some cases, a single fund may be structured as a series of legally distinct parallel partnerships. An example of a parallel fund structure is shown below.



In this structure, it is necessary to consider whether the parallel partnerships should be treated for CRC purposes as, in effect, a single parent undertaking of the portfolio company (C) by aggregating the stakes held by each of the parallel partnerships (B1, B2 and B3). This is an extremely difficult analysis; the legal position is not clear, and the analysis is highly fact sensitive.

The central question is whether the parallel partnerships are "managed on a unified basis" such that they are treated as parent and subsidiary undertakings of each other. This is determined by a purely factual assessment of the degree of commonality that exists between the parallel partnerships, taking into account factors such as:

- whether decisions are taken by the general partner (or manager) on behalf of all parallel partnerships collectively or whether decisions are taken on behalf of each partnership separately;
- whether the parallel partnerships are "locked together" for all purposes by the fund documentation and any co-investment arrangements, or whether the arrangements include a degree of flexibility for each partnership;
- whether the parallel partnerships have identical investment policies, or whether the investment policies differ between partnerships (for example, to take account of investment restrictions applicable to certain groups of investors); and
- whether the general partner (or manager) has flexibility to transfer assets between the different parallel partnerships.

The most conservative course would be to assume for CRC purposes that parallel partnerships are managed on a unified basis, and should be treated as part of the same CRC group. On this basis, the CRC group would include:

- if there is a presently exercisable right to remove the common general partner, those entities surrounded by the solid red line (in which case, a practical approach would be to treat the largest parallel partnership as the highest parent undertaking for CRC registration purposes); and
- if there is not a presently exercisable right to remove the common general partner, also those entities surrounded by the dotted red line.

However, member firms may choose to undertake a more thorough analysis based on individual facts and circumstances, which may result in a different conclusion.

<u>Disaggregation</u>

Note that the above analysis stems from the direct application of the Companies Act 2006 tests to common limited partnership structures; it does not involve the application of the specific CRC

disaggregation provisions. It may, therefore, be possible further to sub-divide the CRC groups that arise within a private equity fund structure if the conditions for disaggregation are met.