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Private Equity Real Estate Funds Affected by the UK's Mandatory Emissions Trading Scheme

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The Application deadline for real estate private equity funds holding UK real estate and subject to the UK's Carbon Reduction Commitment ("CRC") Energy Efficiency Scheme Order 2010 (the "Scheme") is 30 September 2010.

The approaching deadline of 30 September 2010 for registration applications to be made under the new UK mandatory emissions trading scheme is relevant to many non-intensive energy users in the UK, including private equity real estate funds. Summarised in this alert are the key action points that need to be considered by private equity real estate fund managers in advance of the application deadline and also some of the more surprising implications arising out of the legislation's broad application to private equity real estate fund structures.

Background to the Scheme

The Scheme introduces a regulatory incentive to reduce the carbon dioxide emissions of "undertakings" or "groups of undertakings" which were responsible for "settled half hourly" supplies of energy above a qualification threshold of electricity for the 2008 calendar year (the threshold is set at 6,000MWh which equates to an annual electricity bill of approximately £500,000). The Scheme is part of the UK's commitment to reduce overall carbon dioxide emissions by 80% (from 1990 levels) by 2050 and it is estimated that the likely participants in the Scheme account for approximately 10% of the UK's total carbon dioxide emissions.

The Scheme introduces a requirement for all participants to purchase and surrender tradeable carbon allowances corresponding to their annual energy emissions. As the total carbon allowances available will be capped and reduced over time to reflect the UK's emissions targets set under the Climate Change Act 2008 (which will have the effect of prices increasing year on year), there is a financial incentive for participants to reduce their emissions over the same period and sell any resulting surplus allowances. The benefits are compounded by the prospect that the money raised from the annual sales of allowances will be revenue-neutral (less the administrative costs of the Scheme) and recycled back to participants at a level that reflects their comparative CRC performances. Higher-rated performers, as calculated using three metrics, will receive their recycling payments plus a bonus whereas lower-rated performers will receive their recycling payments less a corresponding penalty. Whilst this encourages competition, it also carries reputational risk since the performance results of those covered by the Scheme are intended to be made public in the form of a CRC league table.

Group Undertakings

The immediate task for real estate fund managers is to determine the extent of their "group" or "groups" for the purposes of the Scheme. Real estate fund managers should note that all group members will be required to participate in the Scheme if the businesses of the group in aggregate exceed the 6,000MWh threshold so funds owning several smaller UK assets (in terms of energy consumption) may still be caught by the legislation. The relevant tests in determining the "group" for the purposes of the Scheme are those

used to determine companies' accounting groups as set out in the Companies Act 2006. These tests are not easily applied to the majority of private equity fund structures and can have some surprising and potentially unwelcome results. For example, the group can in certain circumstances include not just the relevant fund and fund's subsidiaries which are directly related to UK assets but also all offshore subsidiaries of the fund (which may be completely unrelated to the UK property business). Moreover, in certain circumstances the group can potentially also include the general partner of the fund and the wider group of the fund manager. The real issue for real estate fund managers is that each "group" company (wherever resident) covered by the Scheme is technically jointly and severally liable for any liabilities arising out of non-compliance with the Scheme by any other group member.

The UK private equity industry has been particularly concerned about the potential application of the "group" definition to fund managers and some comfort can be drawn from the guidance issued by the British Private Equity and Venture Capital Association (the "BVCA") regarding the application of these tests to limited and general partners of limited partnerships. In summary, the BVCA suggest that in circumstances where a general partner can be removed by limited partners pursuant to a "no fault divorce" provision in the relevant limited partnership agreement and the general partner does not otherwise exercise dominant influence over the affairs of the limited partnership, the general partner (and accordingly the fund manager's group) will fall outside of the fund's group for the purposes of the Scheme. We consider that the same analysis is applicable to real estate fund structures.

Care should also be exercised in relation to joint ventures. Whilst it is generally the case that the joint venture should be within the more substantial equity owner's group for the purposes of the Scheme, it is often important to allocate responsibility for compliance with the Scheme amongst the joint venture parties. Real estate fund managers should note that in a pure 50/50 joint venture situation, the joint venture entity itself will generally be the participant for the purposes of the Scheme and no further analysis will need to be made into the respective joint venture parties' groups.

Once the relevant group has been identified, the highest parent undertaking should commence the registration process on behalf of the group. If this undertaking is a non-UK entity and there is no other group member based in the UK, a UK-based representative must be appointed to administer the group's compliance with the Scheme.

Disaggregation – Accelerated Deadline of 30 June 2010

Real estate fund managers should also consider whether any significant subsidiaries or groups of subsidiaries should be disaggregated from the wider group. The key benefit of disaggregation (in addition to insulating the joint and several liability issue mentioned above) is that the administrative and financial burden of compliance with the Scheme can be more easily dealt with at the particular group level as a disaggregated group is treated as an entirely separate entity from the rest of the group for the purposes of the Scheme. Fund managers should note the accelerated timeline in relation to registration for disaggregation and that CRC groups that wish to disaggregate a significant group undertaking need to register the wider group by 30 June 2010 rather than 30 September 2010. Whilst disaggregation is likely to be of importance to pure private equity funds (who will be keen to segregate distinct investee companies for the purposes of the Scheme), it is not anticipated that disaggregation will be as relevant to the majority of real estate fund managers.

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