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Minimum Energy Efficiency Standard for Buildings – Regulations published

The Department of Energy and Climate Change has published further detail on the financial penalty provisions which will apply to landlords who let out commercial premises falling below an 'E' energy performance rating progressively as from 1 April 2018.

Essentially, where a commercial building falls short of the "Minimum Energy Efficiency Standard" (MEES) (which is rating "E" in an Energy Performance Certificate) and the landlord wishes to let all, or part, of a building, the landlord must carry out works to improve the building's energy performance up to the MEES or pay a penalty in the form of a civil fine.

The key new details and clarifications published in the Response to consultation [1] and draft Regulations [2] include:

- Length of lease: The penalty provisions will apply to leases granted for more than 6 months and less than 99 years.
- Penalties: The maximum penalty for breach of the MEES requirements will be £150,000 (with the actual amount dependent on the rateable value of the property and the length of time that the landlord is in breach). Leases granted or existing in breach of the MEES requirements will remain valid and enforceable.
- There will be a number of exemptions:
  - Third Party Consents exemption: Landlords will have to demonstrate lack of required consent e.g. from tenants, from superior landlords, or refusal of planning permission.
  - Cost-effectiveness exemption: Landlords will have to demonstrate **both** that there is no Green Deal available for the relevant improvement works; and that the works would not pay for themselves over seven years based on energy bill savings.
  - Devaluation exemption: Landlords will have to demonstrate that the relevant improvement works would reduce the market value of the property by over 5%.
- Pre-registration: Exemptions will have to be pre-registered on a central register to be effective.
- Entry into force: The provisions will come into force on 1 April 2018 for grant of new leases, and 1 April 2023 for all existing leases.
- Future Trajectory of MEES: DECC has declined to say when any changes to the MEES would be made (e.g. raising the MEES to "D" rating) and will simply review the regulations after 5 years. Interestingly, the Labour Party would increase MEES to "C" rating by 2027 for residential property and is considering whether this would also be appropriate for commercial property.

In the Appendix, we have set out an updated version of our primer "Minimum Energy Efficiency Standard – 10 Key Questions for Commercial Property Owners" which analyses the regime in more detail. In this briefing we concentrate on measures for commercial property (separate arrangements apply for residential property).

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[1] Government response to 22 July 2014 Consultation on the non–domestic private rented sector energy efficiency regulations (England and Wales) - DECC

[2] The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015

Final comments

If they have not done so already, current or prospective landlords should identify if they have any 'F' or 'G' rated properties, and if so, consider creating a strategy for carrying out works to improve energy performance. See Question 10 in the appendix for further considerations to bear in mind.

APPENDIX

Minimum Energy Efficient Standard – 10 Key Questions for Commercial Property Owners

1. How will the Minimum Energy Efficiency Standard (MEES) work? Why is it being introduced?

Essentially, where a building falls short of the MEES and the landlord wishes to let all, or part, of a building, the landlord must carry out works to improve the building's energy performance up to the MEES or pay a penalty in the form of a civil fine (in this briefing, these requirements are referred to as the "Penalty Provisions"). Certain exemptions from the Penalty Provisions apply, described below (see questions 6 to 9).

The Government is seeking to encourage improvements in the energy efficiency of non-domestic buildings in the private rented sector to meet its energy efficiency and carbon reduction targets. Despite the existence of current measures (such as the CRC Energy Efficiency Scheme, Climate Change Agreements and the Green Deal), leased buildings are considered to require more encouragement because of the different way in which landlords and tenants value energy efficiency measures (i.e. landlords normally pay for them but tenants benefit from them). The introduction of the MEES is required by the Energy Act 2011 as a further regulatory encouragement to force landlords to carry out energy efficiency improvements to poorly-performing stock.

2. If I don't comply, will it be illegal to let or continue to let out the property?

There had been real fears that failure to comply with the Penalty Provisions could invalidate a lease or require a landlord to evict a tenant. DECC has been very clear that this will not be the case. A landlord who fails to comply will be subject to a civil fine. The crucial aspect is how high the fine will be and how many times it could be applied. Penalties depend on the amount of time the breach has been outstanding and are based on the rateable value of the property (although the enforcing authority will have discretion on the amounts):

- Up to 3 months in breach: 10% of the rateable value of the property (but minimum of £5,000 and maximum of £50,000); and
- 3 months and over in breach: 20% of the rateable value of the property (but minimum £10,000 and maximum of £150,000).

It is not wholly clear whether these penalties could be applied on successive occasions (e.g. on each occasion that the landlord grants a lease of different units in a building). This uncertainty is also important since after 1 April 2023, the landlord will be continuously in breach if it "continues to let" property which does not reach the MEES.

In addition, the breach could be published on the exemptions register (see below).

Local authorities will enforce the regulations (although not necessarily through their Trading Standards departments which have to enforce Energy Performance Certificate-related obligations).

Enforcing authorities will be able to serve a compliance notice to identify whether there has been a failure to comply under the regulations. This may require the landlord to supply documentation, including a copy of the tenancy agreement. There is no provision for redacting leases, and it is hoped that guidance will clarify that redaction of confidential information is permitted.

The Penalty Provisions contain a right for landlords to seek a review of any penalty by the enforcing authority, with the possibility of appeal to the First-tier Tribunal.

3. What Properties will the Penalty Provisions apply to?

For the sake of simplicity, the Government has decided to broadly mirror the EPC regulations to determine which buildings are included, and which types of lease trigger the Penalty Provisions:

- The Penalty Provisions will only apply where there is, in fact, an EPC in place. If a landlord has not complied with a requirement to obtain an EPC, it appears that the Penalty Provisions will **not** apply.
- Generally, all buildings will be included. However, certain buildings are excluded, for example, "low energy demand" industrial buildings, buildings to be demolished, and certain protected buildings.
- In principle, all leases will trigger the Penalty Provisions (including building leases, occupation leases, sub-leases, lease extensions and renewal leases [3]). However, the Penalty Provisions will **not** apply to leases granted for:
  - 6 months or less (unless the tenant will have been in occupation of the property for over 12 months); or
  - 99 years or more.

In the context of the EPC regulations, there has been considerable uncertainty as to whether certain types of buildings are covered (e.g. listed buildings) and whether some sale or leasing transactions are covered by the regulations (e.g. so called "not-for-value transactions"). Given the potentially more significant implications for enforcing the Penalty Provisions as opposed to the EPC regulations, it is to be hoped that more detailed rules or guidance will be provided in this area.

4. When will the Penalty Provisions come into force?

The provisions will come into force on 1 April 2018 for grant of new leases, and 1 April 2023 for all existing leases.

A newly proposed 6 month grace period applies in situations where an entity becomes landlord in certain specified circumstances. For example:

- Where the landlord acquires an interest in a property (e.g. through buying the lease reversion), the penalty provisions will not apply for 6 months from the date of acquisition in relation any to existing tenancies.
- Where the landlord grants a lease pursuant to a contractual obligation, the penalty provisions will not apply for 6 months from the grant of any new or existing tenancies. This makes sense as a transitional provision to delay compliance where a landlord is contractually obliged as at 1 April 2018 to grant a lease; it is not clear why this should apply to all agreements for lease entered into after this date.

While these temporary extensions are unlikely to allow the landlord to improve a property so it meets the MEES, it will afford the buyer time to investigate and register relevant exemptions. This is significant since exemptions are not transferable, e.g. from seller to buyer.

See also the exemptions in relation to the Green Deal (see question 6 below) and consents (see question 7 below), and other exemptions (see question 8 below). Significantly, mortgagees going into possession will not benefit from any exemption from the Penalty Provisions or temporary grace period.

[3] Lease extensions and renewal leases will be included (although it is notable that DCLG does not consider that an EPC is required for a lease extension or renewal).

5. What is the applicable energy standard?

The Penalty Provisions will apply where a building has either an "F" or "G" rating in its EPC. Conversely, an EPC rating of "A" to "E" will mean that the Penalty Provisions do not apply. F and G rated properties make up 18% of the total building stock (or 200,000 properties in total). The total cost of the works for bringing F/G rated properties up to E rating (aside from other costs of assessment and financing etc) has been estimated by the Government at around £1 billion pounds.

Concern has been raised over whether the standard will be tightened in the future, either through raising the threshold above F/G or by making the A-to-G ratings themselves more stringent. DECC had considered whether to include a trajectory of projected changes to the standard beyond 2018 DECC but finally decided that it will simply review the regulations after 5 years (i.e. by 2020). This is disappointing and will make it more difficult for landlords to determine how far to go in improving their properties and when.

6. Is a landlord exempt from the letting restriction if it cannot get upfront finance for the improvement works?

The regulations provide for a "cost-effectiveness exemption". The landlord is only exempt if **both**: (i) there is no Green Deal available for the recommended improvement works; and (ii) the recommended improvement works would not pay for themselves over seven years based on energy bill savings. Recommendations for works would be made in a Green Deal Report, an EPC recommendation report or a surveyor's report.

Green deal element: The landlord is exempt under this element if it carries out all works that could be included in a "Green Deal" package aimed at securing the property an "E" rating, even where ultimately, the building does not reach that standard once the works are carried out. See box inset ("What is the Green Deal?"). Under the so-called "Golden Rule", only improvements that would pay for themselves in energy savings can be included in a Green Deal package, although this is only judged at the initial Green Deal assessment stage, and only guaranteed for the first year after the package is put in place.

Once it is understood what improvements would qualify for a Green Deal, the landlord would be free to choose whether to enter into a Green Deal package in respect of them, or it could independently carry them out and finance them. However, currently there is no Green Deal finance available for commercial properties; unless and until that situation changes, landlords will always be able to satisfy this element of the exemption.

Seven Year simple payback element: The landlord is exempt under this element where it can demonstrate that recommended improvement measures will not pay for themselves in savings over 7 years. This alternative was originally intended to give landlords more flexibility for compliance but the government appears to have added this as an extra obstacle to claim the exemption. Significantly, there is no requirement for the landlord to be able to obtain upfront finance to pay for these measures.

What is the Green Deal?

The Green Deal is a form of financing product introduced under the Energy Act 2011. It is intended to help owners and occupiers secure upfront finance for the carrying out of energy efficiency improvements to properties. The costs of the improvements are recouped from whoever is the electricity bill payer for the property from time to time under an instalment regime. Repayments (which would include an interest element) could last for example up to 20 years. Authorised providers offer Green Deal finance packages (Green Deal Plans) and these are intended to be attractive compared to standard commercial financing arrangements given that the repayments are effectively secured on the property with consequently lower risks of default.

Relevant works that might be included in a Green Deal plan include improvements to windows or to insulation or replaced systems that work more efficiently, e.g. ventilation or boilers.

Currently, there is no Green Deal finance available for commercial properties.

In summary, the landlord would benefit from the cost-effectiveness exemption if all recommended works that could be the subject of a Green Deal, or would pay for themselves after 7 years, are carried out (and it is possible that no such works qualify on this basis). In practice, given the difficulties of carrying out significant works where there is a sitting tenant in place, a landlord is unlikely to contemplate a Green Deal package or otherwise carry out recommended works unless the property is empty or the lease is coming up for renewal.

7. What happens if I cannot get third party consent to the works (e.g. from a sitting tenant)?

Where a third party has a right to prevent works being carried out and refuses consent, the landlord will benefit from an "third party consent exemption" from carrying out those works. Other works that did not require consent, or which had gained consent, would still need to be undertaken. The list of possible third parties would include a tenant, lender, superior landlord / freeholder or planning authority (but the list is not exhaustive). On that basis, a landlord could claim an exemption where a sitting tenant needs to consent to works under the lease and refuses to give that consent [4].

It will be for the landlord to demonstrate that there has been lack of consent and in most cases the landlord is required to use reasonable endeavours to obtain that consent [5]. It is not clear therefore what would happen and the landlord will have to use "reasonable endeavours" in seeking consent to benefit from the exemption. Where a landlord cannot reasonably comply with a third party's conditions for carrying out works, the landlord will still be able to claim the exemption. DECC previously suggested that unreasonable conditions might include those that had an impact on ability to let, or cost. It is clear that this could lead to disputes and litigation, and clear guidance is going to be essential in this area.

8. Are there any other exemptions?

DECC proposes to exempt a landlord where the required improvement works would lead to a reduction of over 5% in a property's capital or rental value. This would require the landlord to obtain a report by an independent surveyor given that the works might have both positive and negative impacts on value. The scope for disagreement and dispute on valuations is clear.

There is an additional exemption from installing wall insulation where the landlord can demonstrate that it would damage the fabric of the building.

9. How long will exemptions last?

In general, exemptions will last for 5 years. At the end of that period, a landlord exempt under:

- The Green Deal exemption, or seven year simple payback exemption (see question 6), would need to seek a new Green Deal assessment / independent surveyor's report and relevant quotes for the work; and
- The exemption relating to impact on value (see question 8), would need to seek a new report.

The third party consent exemption (see question 7) would again last 5 years. Where the tenant remains in occupation after those 5 years, it seems likely that the landlord would have to approach the tenant again with a further request for consent. It appears that the exemption would not fall away, however, if the tenant assigns or surrenders the lease before the end of the 5 year period (contrary to the government's initial proposals).

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[4] Conversely, a tenant sub-letting part of premises, could claim an exemption where works to the building are required and the landlord will not consent to those works being carried out.

[5] Interestingly, "reasonable endeavours" are not required to be used when a landlord seeks to obtain consent from its tenant. It is open to question whether a landlord who, for example unreasonably proposes works at inconvenient times to the tenant, will still be able to claim the exemption.

Where a landlord wishes to benefit from an exemption, it will have to register the reasons for the exemption on a central register. Providing some of this information might be problematic; e.g. where a landlord wishes to claim exemption on grounds that it cannot obtain consent from its tenant, it has to submit not only correspondence with the tenant, but also relevant documents, presumably including relevant lease terms. It is to be hoped that guidance will make it clear that redacted versions of leases or lease clauses will suffice. Also, certain property-specific information relating to exemptions will be published by the government and this may cause reputational issues for landlords of "sub-standard properties".

DECC intends the register to be open to lodge exemptions from 2016.

10 What are the next steps? As a landlord should I be doing anything now?

If they have not done so already, current or prospective landlords should identify if they have any 'F' or 'G' rated properties, and if so, consider creating a strategy for carrying out works to improve energy performance. There are various balances that will need to be made including:

- Prepare an EPC now? The advantages of knowing whether the building could be subject to the penalty regime will have to be weighed against the knowledge that the penalties only apply to buildings that have an EPC (particularly important given the application of the penalties to properties with existing lettings as from 1 April 2023).

- Make it easier in leases to obtain approval for improvement works from tenants? Whilst this might help avoid penalties, conversely this might make it more difficult to claim exemption from the penalty regime in due course on the basis of refusal of consent.

While landlords may be able to delay the requirement to improve properties, ultimately, they are likely to have to carry them out. Landlords should, therefore in any event, consider when their leases are coming to an end and where there are voids in order to establish a sensible programme for bringing properties up to at least 'E' rating where this is possible.

It will not be a criminal offence to fail to comply with the Penalty Provisions since civil fines are only enforceable as civil debts. However, landlords will need to consider the legal consequences of not complying, e.g. by not obtaining an EPC when they are required to, or by not applying with the obligation to increase the energy performance, they would usually be in breach of loan covenants; and they will also need to consider the reputational aspects of not being in compliance with regulations.

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