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Briefing note July 2014

Minimum Energy Efficiency Standard – 10 Key Questions for Property Owners

From 1 April 2018, a financial penalty regime will begin to apply to landlords who let out commercial premises which do not meet the "Minimum Energy Efficiency Standard" (MEES). After a long wait, the Department of Energy and Climate Change has now published a consultation paper[1] containing detailed proposals. Draft regulations have not yet been prepared and there is still uncertainty over how a number of aspects of the proposals will work. This briefing considers 10 key questions for property owners. Separate proposals have been made for domestic property. This briefing concentrates on the measures for commercial (non-domestic) property.

1. How will the "Minimum Energy Efficiency Standard" 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. No level has been specified although DECC's preferred approach is to set the fine based on a percentage of the building's rateable value (similar to the approach under the Energy Performance Certificate, or EPC, regulations).

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1 Consultation on implementation of the Energy Act 2011 provision for energy efficiency regulation of the non-domestic private rented sector - DECC - July 2014

If a landlord fails to comply within a further 6 months of a fine being imposed, a further fine would apply. It is not yet clear how often a fine could be imposed.

In establishing the penalty structure, DECC will be alive to the fact that some landlords may simply wish to pay fines and not carry out the works. This concern may lead DECC towards its other expressed option of using "rent received for the period of non-compliance" as the reference point for fines.

Similarly to EPCs, Trading Standards will be the enforcing authority for the Penalty Provisions, with appeals likely to go 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:

- In principle, 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 and sub-leases). However, unlike the EPC, DECC is considering whether only to include leases of over 6 months and under 99 years. DECC considers that the grant of a lease renewal does not trigger an EPC, but the proposals also consider whether a lease renewal should trigger the Penalty Provisions in any event.

In the context of the EPC regulations, there has been considerable uncertainty over 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.

It should be noted that the Penalty Provisions will only apply where there is, in fact, an EPC in place. This raises the question over what happens if a landlord has not complied with a requirement to obtain an EPC. Will it then lawfully be able to circumvent the Penalty Provisions? This is not yet clear.

4. When will the Penalty Provisions come into force?

This has been one of the key areas of uncertainty around introduction of the Penalty Provisions. This is still being considered but DECC currently favours a "soft introduction" with a fallback position. On this basis:

- The Penalty Provisions will apply to any **grant of a new** lease to a new tenant from 1 April 2018; and
- It will apply to all **existing** leases (i.e. any that pre-dated 1 Apr 2018) from 1 April 2023.

The backstop 2023 deadline will give landlords with sitting tenants an additional 5 years to make the relevant improvements. See also the exemptions in relation to the Green Deal (see question 5 below) and consents (see question 6 below).

However, DECC is also contemplating an alternative "hard start" where the Penalty Provisions would apply to both new leases, and the continuation of existing leases, immediately as from 1 April 2018.

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 is considering whether a particular trajectory of

projected changes to the standard beyond 2018 is needed or whether, alternatively, there should simply be a formal process, or set of principles, to govern how a forward trajectory would be determined in the future.

This is an essential question as real estate owners will not want to be subject to an ever-moving target for which investment in building improvements cannot be efficiently planned or financed.

6. Is a landlord exempt from the letting restriction if it seeks a Green Deal?

The landlord benefits from an exemption from the Penalty Provisions 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. As long as the landlord carries out all improvements which qualify under the Golden Rule (and it is possible that none of them qualify), then the landlord would be exempt from the Penalty Provisions for 5 years[2], at which point a further assessment would be required.

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.

Given the difficulties of carrying out significant works where there is a sitting tenant in place, in practice a landlord is unlikely to contemplate a Green Deal package unless the property is empty or the lease is coming up for renewal.

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.

DECC is also considering whether an alternative to the Green Deal Golden Rule test could apply. This would allow landlords an exemption from the Penalty Provisions where they carry out all works that have a "reasonable payback period". This period has yet to be defined. Again this would be intended to give landlords more flexibility in complying with the Penalty Provisions, but it is not entirely clear how this additional choice would be useful to landlords.

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 exemption from carrying out those works. Other works that did not require consent, or which had gained consent, would still

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2 The landlord would have to obtain a specified number of quotes from Green Deal finance providers before an exemption could be claimed on this basis.

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 [3].

It will be for the landlord to demonstrate that there has been lack of consent. The position might also be complicated if consent comes with conditions (e.g. a tenant's consent or planning permission). In such a case, DECC suggests that the exemption would still apply if those conditions were unreasonable, and gives examples of impacts on ability to let, or cost as potentially relevant. 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 material decrease in a property's capital or rental value. This would require the landlord to carry out a formal valuation given that the works might have both positive and negative impacts on value. DECC has floated a possible 5 or 10% reduction as a possible threshold for this exemption. The scope for disagreement and dispute on valuations is clear.

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 (see question 5), would need to seek a new Green Deal assessment and relevant quotes for the work; and
- the exemption relating to impact on value (see question 8), would need to seek a new valuation.

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. Also, if the third party's lack of consent ceased to operate before the end of the 5 year period, the exemption would end. An example given in the consultation paper is where the tenant "moves out of the property". This is likely to cover not only a lease surrender but also an assignment of a lease. Presumably where an assignee then refuses to consent to the works, the exemption would apply again.

DECC is considering a process for certification of exemptions which could be run by the local authority. This would seem to be a burdensome additional requirement for landlords.

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

Responses to the consultation must be made by 2 September 2014, which gives little time over the holiday season. DECC plans to respond with draft regulations by the beginning of 2015.

Landlords should consider whether they have any 'F' or 'G' rated properties. Where they do not have an EPC for a property, they should consider whether to prepare one. The advantages of knowing whether the building could be subject to the Penalty Provisions will have to be weighed against the knowledge that the Penalty Provisions only apply to buildings that have an EPC (particularly relevant should the Government decide upon a "hard start" to the regulations in circumstances where the owner has a sitting tenant).

Landlords may also want to check their leases to see what level of consent is required for likely energy improvement works. They should also consider whether new leases should be drafted to make it easier to gain consent from tenants for relevant

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3 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.

works going forward. Again, the advantages of more easily gaining consent need to be balanced against the increased likelihood that the Penalty Provisions will apply where consent is easily obtained.

Landlords should also 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. will they breach loan covenants?), and also the reputational aspects of not being in compliance with regulations.

Authors

Nigel Howorth
Partner

Nigel is a partner and head of the Environment & Planning Group. Nigel advises on the planning, environmental and regulatory aspects of real estate developments and transactions

E: nigel.howorth
@cliffordchance.com

Michael Coxall
Senior Professional Support Lawyer

Michael is a Senior PSL in the Environment and Planning Group and focuses on the impacts of regulatory change on real estate developments and transactions.

E: Michael.coxall
@cliffordchance.com