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Briefing note March 2017

Minimum Energy Efficiency Standard – 10 Key Questions for Commercial 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". This updated briefing considers 10 key questions for property owners. It concentrates on the measures for commercial (non-domestic) property as informed by the recently published Department for Business, Energy & Industrial Strategy (BEIS) Guidance[1].

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")[2]. Certain exemptions from the Penalty Provisions apply, described below (see questions 7 to 10).

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 and Climate Change Agreements), 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. The Government 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); or
- 3 months and over in breach: 20% of the rateable value of the property (but minimum £10,000 and maximum of £150,000).

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1 The Non-Domestic Private Rented Property Minimum Standard - Guidance for landlords and enforcement authorities on the minimum level of energy efficiency required to let non-domestic property under the Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 – Department for Business, Energy & Industrial Strategy.

2 Under the Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015

For each breach, the Guidance makes it clear that either of the above penalties could be applied, but not both. It is not wholly clear whether a penalty could be applied on each occasion that the landlord grants a lease of different unit in a building, but this seems likely. 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.

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 Energy Performance of Buildings regulations (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 Energy Performance Certificate (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 (however, see Question 4 below in relation to voluntarily obtained EPCs).
- 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 there is provision for renewing the term or extending it beyond 6 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"). The Guidance does at least finally acknowledge that listed buildings may not be exempt. However, given the potentially more significant implications for enforcing the Penalty Provisions as opposed to the EPC regulations, it is unfortunate that the Guidance does not provide significant further help in this area.

4. Do the Penalty Provisions apply where an EPC is prepared voluntarily by a Landlord?

The Regulations provide that MEES will only apply where the building (or relevant part) is required to have an EPC under the relevant regulations. There has long been debate over what "required to have an EPC" means. The Guidance suggests that where a Landlord has obtained an EPC voluntarily the Penalty Provisions will **not** apply to a letting of that property; "voluntarily" for these purposes covers two situations, either:

(i) where the property is an exempt type of building such as discussed in Question 3 (i.e. there would be no obligation to obtain an EPC even if there was a prospective sale or letting); or

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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).

(ii) where the landlord of any other type of building obtained an EPC, but not as a result of duties under the relevant regulations (e.g. it just wanted to assess the energy performance of its portfolio and was not preparing for a sale or letting or carrying out relevant building works).

An exclusion from the Penalty Provisions on the basis of point (ii) could have a number of implications. Significantly, if a Landlord obtained an EPC for a property in the coming year in readiness for the introduction of MEES (but not triggered by sale / letting / relevant building works), the application of the Penalty Provisions to that property would be excluded for up to 10 years (until such time as a new EPC was "required" to be produced because of a sale / letting / relevant works being carried out)[4]. We feel that this interpretation in the Guidance is not wholly convincing, especially in relation to lettings after 1 April 2018 (since an EPC is technically "required" for such a letting even if a pre-existing voluntarily produced one can be used for this purpose). Also, while this interpretation would be advantageous to Landlords, this is likely to provide a headache to enforcing authorities who will not easily be able to determine whether an EPC was required to be provided as a result of a sale / letting / relevant works, or was produced voluntarily for some other reason.

Landlords should seek specific advice before seeking to take advantage of the use of voluntary EPCs to delay the impact of the Penalty Provisions on their properties.

5. 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 6 month grace period applies in situations where an entity becomes a landlord in certain specified circumstances. For example:

- As from 1 April 2023, 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 to any 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; however, it is not clear why this should apply to all agreements for lease entered into after this date. The Guidance suggests it was only intended to apply to situations where the contract was contingent (e.g. an agreement conditional on planning), whether entered into before or after entry into force of the MEES regime. In our view, given that the regulations themselves do not limit the exemption in this way, it seems likely that a landlord will be able to rely upon it even where the contract is not contingent (e.g. for any lease entered into as a result of an agreement for lease even if the agreement is signed after 1 April 2018).

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 it seems unlikely that exemptions are transferable, e.g. from seller to buyer (See Question 10 below).

See also the exemptions in relation to the Green Deal (see Question 7 below) consents (see Question 8 below), and other exemptions (see Question 9 below). Significantly, mortgagees going into possession will not benefit from any exemption from the Penalty Provisions or temporary grace period.

6. 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. The Government had considered whether to include a

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4 An EPC is generally valid for 10 years unless superseded by a subsequently prepared EPC.

trajectory of projected changes to the standard beyond 2018 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.

7. Is a landlord exempt from the letting restriction if it is not cost-effective to do improvement works or it cannot get upfront finance to carry them out?

The regulations provide for a "cost-effectiveness exemption". The landlord is only exempt if both: (i) there is no Green Deal[5] 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 (the 7-year payback test). Recommendations for works would be made in a Green Deal Report, an EPC recommendation report or a surveyor's report.

Since the Green Deal funding mechanism for commercial property was never launched, this raised the question whether the Green Deal test would be replaced by another type of test or funding mechanism. The Guidance makes no suggestion of new tests or funding being introduced. For the time being, therefore, the exemption will apply simply if the recommended improvements fail the 7-year payback test, and seemingly even if the landlord cannot get funding for the works.

The Guidance clarifies that, when considering the test, a Landlord is exempt from installing a particular improvement (X), if, assessed alone, it fails the 7-year payback test. If installing it in conjunction with another improvement (Y) would mean the combined improvements (X and Y) would satisfy the test, this is irrelevant: the exemption would still apply for improvement X. The Landlord would, therefore, have to implement as many improvements as (individually) satisfy the test.

In practice, given the difficulties of carrying out significant works where there is a sitting tenant in place, a landlord is unlikely to carry out recommended works unless the property is empty or the lease is coming up for renewal.

8. 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 a "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[6].

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 (the Guidance suggests that this might necessitate contacting the third party on a number of occasions using different methods of communication)[7]. 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. Guidance suggests that unreasonable conditions might include those that have an impact on the ability to let, or cost. It is clear that this could lead to disputes and litigation.

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5 The Green Deal is a form of financing product introduced under the Energy Act 2011. It was intended to help owners and occupiers secure upfront finance for the carrying out of energy efficiency improvements to properties. The costs of the improvements would be recouped from whoever is the electricity bill payer for the property, from time to time, under an instalment regime.

6 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.

7 Interestingly, the Regulations do not require "reasonable endeavours" to be used when a landlord seeks to obtain consent from its tenant. By contrast, the Guidance suggests that reasonable endeavours still have to be made in these circumstances. 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.

9. Are there any other exemptions?

A letting would be exempted from the Penalty Provisions 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. BEIS expects this exemption to be applied only infrequently.

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

10. How long will exemptions last?

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

- The 7-year payback exemption (see Question 7), would need to seek new 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. The Guidance states that the exemption would fall away in any event if the tenant assigns or surrenders the lease before the end of the 5 year period.

Where a landlord wishes to benefit from an exemption, it will have to register the reasons for the exemption on a central register. Certain property-specific information relating to exemptions will be publicly accessible and this may cause reputational issues for landlords of "sub-standard properties".

BEIS intends the exemptions register to be open for lodging of exemptions from 1 April 2017.

Final Comments – Next Steps

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 Provisions 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). As noted above, the Guidance suggests that obtaining a voluntary EPC will not engage the Penalty Provisions for a property; however, this Guidance should be treated with caution.
- Apply for exemptions? If any properties are rated "F" or "G", determine whether any exemptions from the Penalty Provisions might apply, and decide whether and when to apply to register them.
- 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 Provisions 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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