

The Non-Domestic Minimum Building Energy Performance Standards Working Group – Report to Government

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The Non-Domestic Private Rented Sector (PRS) Regulations Working Group was chaired by Miles Keeping, Partner and Head of Responsible Property Investment at Deloitte Real Estate, and the secretariat was provided by the Department of Energy and Climate Change with support from the British Property Federation. In order to ensure a broad range of perspectives, group members were drawn from leading landlord, tenant, environmental and property professional organisations. The Department of Energy and Climate Change would like to thank all the group members for their hard work and advice throughout the working group's programme, and for the delivery of this recommendations report. The Department would also like to thank the British Property Federation in particular for its support in undertaking the secretariat responsibilities.

Please note that representatives from Government departments have helped guide the group members to consider the key issues, and have provided clarification on matters of fact where appropriate. However this report reflects the views of its sector and interest group representative members only. This report does not reflect the opinion of the Government.

Furthermore, the Working Group has on occasions raised issues that do not relate directly to the regulating powers within the Energy Act 2011, but rather to wider energy efficiency matters that may be relevant, and has on occasions made suggestions that would require further investigation to determine the vires, and wider policy implications, before adoption could be considered.

This report should not be taken as legal or technical advice and as such no liability is accepted by its authors. The report is a reflection of the joint views of the working group for the non-domestic private rented sector, not of the Department of Energy and Climate Change or of the Secretary of State.

Chapter 1: Introduction

SECTION A: THE COMMERCIAL PROPERTY SECTOR

i. Introduction

The commercial property industry makes up a major part of the economy in its own right, as well as providing a platform for virtually all of the country's major industries. It is a sector that plays a crucial role in providing places in which people work, shop and enjoy leisure activities. Larger than banking, leisure, communications and transport sectors, commercial property is also a significant investment asset for the pensions industry and so contributes to the financing of many people's retirement¹.

The EU is currently reviewing its EU 2030 energy efficiency targets, with buildings identified as a key agent in controlling and managing energy demand. Commercial property contributes to just less than a fifth of all UK carbon emissions, and the Intergovernmental Panel on Climate Change (IPCC) has said that the built environment holds the greatest opportunity for cost-effective emissions mitigation of any sector². These opportunities will require:

- significant investment in skills and capacity to enhance building management and deliver energy efficient refurbishment;
- installation of low carbon generation capacity; and
- the design, manufacturing and fabrication of energy efficiency products and services.

All of the above can also play their part in contributing to the growth of the UK economy.

The Working Group's focus has been upon how Minimum Building Energy Performance Standards (MEPS), introduced by provisions in the Energy Act 2011, will function in practice in the rented commercial property sector (MEPS will not apply to owner-occupied property). Many of the recommendations from the Group may apply to the broader swathe of non-domestic buildings³ but in the interests of clarity the group has focused on 'core' commercial property⁴ as the asset classes which account for the highest contribution to the UK economy by value and which have the highest lease turnover, and are therefore likely to be most affected. Whilst the focus of attention has been the detail of the secondary legislation under the Energy Act 2011, the Group has on occasions also set out views or recommendations that are relevant, but are not directly linked, to the secondary legislation.

¹ Property Industry Alliance (2012), Property Data Report, London, UK

² Urge-Vorsatz, Diana, Koepfel, Sonia and Mirasgedis, Sebastian (2007), Appraisal of Policy Instruments for Reducing Buildings' CO₂ Emissions, Building Research and Innovation, 35:4, 458-477

³ Non-domestic property includes all non-residential property, encompassing a range of commercial and public property building types and sub-types. CIBSE Guide TM42 gives a good survey of the types of commercial property available.

⁴ By core commercial property we mean retail, office and industrial buildings. A number of the recommendations in this report will be applicable to the broader array of types of commercial property, such as hotels, restaurants and pubs, car showrooms, petrol stations, cinemas and theatres, but the group's core areas of discussion have concerned the largest sectors by value. We also understand that in excess of 90% of current EPC certificates relate to the 'bulk classes', thus further illustrating their dominance in terms of overall impact.

This report is not intended to cover any development of energy performance standards for existing non-domestic buildings in Scotland or arrangements for energy performance certificates that exist there.

To date, Scottish Ministers have opted to use Section 63 of the Climate Change (Scotland) Act 2009. Under Section 63, 'Energy Performance of Non-Domestic Buildings', there is a duty on Scottish Ministers to regulate for:

- assessment of the energy performance of non-domestic buildings and emissions produced; and
- owners of such buildings to improve the energy performance and reduce emissions.

Consultations on policy development are available from the following links: <http://www.scotland.gov.uk/Topics/Built-Environment/Building/Building-standards/publications/pubconsult/consultepprops> and <http://www.scotland.gov.uk/Publications/2013/03/5662>

SECTION B: BACKGROUND TO THE NON-DOMESTIC MINIMUM BUILDING ENERGY PERFORMANCE STANDARDS (MEPS) WORKING GROUP

i. The Energy Performance of Buildings Directive

According to the [Directive 2010/31/EU](#) (EPBD recast), Member States must implement mandatory certification of new and existing buildings, along with periodic certification of public buildings. Certification schemes are addressed in Articles 11 (energy performance certificates), 12 (Issue of energy performance certificates) and 13 (display of energy performance certificates) of the Directive.

The energy performance certificate is a key requirement of the EPBD. EPCs may have a role to play in making commercial buildings more energy efficient. In this respect, it is paramount to increase energy efficiency in the building stock. In addition, Article 11 states that "*the energy performance certificate shall include recommendations for the cost-optimal or cost-effective improvement of the energy performance of a building or building unit,*".

In England, Scotland, Wales and Northern Ireland the energy performance certificate is mandatory on construction, sale or let of a building, and is a rating expressing the theoretical (design) performance of the building. The EPC rating must be included in property advertisements and are valid for 10 years.⁵

An EPC provides an energy rating for a building based on the performance potential of the building itself (the fabric) and its services (such as heating, ventilation and lighting). The EPC rating must be included in property advertisements and the EPC must be displayed in properties over 500m², where they are commonly visited by the public, and a valid EPC has already been provided.⁶ In England and Wales, public sector occupied buildings over 500m²

⁵For the latest guidance, see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/50268/A_guide_to_energy_performance_certificates_for_the_construction_sale_and_let_of_non-dwellings.pdf

⁶ ibid

that are frequently visited by the public must also display a certificate with a rating based on actual energy bills, called a display energy certificate (DEC).

However it is important to note, especially for the purposes of this report, that there is no obligation for an EPC to be prepared unless or until a property is brought to market, either for rent or sale. For properties which are owner-occupied and continue to be so, or are already let under long-term arrangements, there is no obligation though it is understood that some owners have voluntarily certified their entire portfolios.

ii. *The Energy Act 2011: Private Rented Sector Energy Efficiency Regulations (Minimum Building Energy Performance Standards)*

The new law relating to MEPS in the private rented sector is contained in the Energy Act 2011, although the relevant provisions have not yet been brought into force.

The Act provides the government with the framework for implementing the new policy, with the subsequent secondary legislation to set out the detail.

The non-domestic MEPS regulations will be enforced by local weights and measures authorities (i.e. trading standards officers). The level of civil penalty will be defined in secondary legislation.

iii. *The Energy Act 2011: The Green Deal*

The Green Deal is an innovative financing mechanism whereby owners and occupiers of property can finance energy efficiency improvements through the energy cost-savings that the improvements generate.

The energy efficiency retrofit is financed by credit to cover the upfront costs which is then repaid through instalments on the electricity bill. The entire package of measures installed in each building must meet 'the Golden Rule', such that the cost of repayments for the measures, including any finance costs, must not exceed the expected energy savings in the first year. Repayments must also not last longer than the improvements useful lifetime. The Golden Rule calculation is based on a property's actual energy use (where available) and can take into account void periods. Green Deal packages are assessed by Green Deal Assessors, and the finance provided by Green Deal Providers. Green Deal Installers ensure the measures are correctly installed. Green Deal Providers retain responsibility for the measures installed and are the first port of call should measures fail to perform as promised. Eligible measures for the Green Deal are set out in a list that is reviewed periodically. To be eligible for the list measures must repay their investment in energy cost savings.

If the building is sold or let to another occupier, then the obligation to repay the finance moves to the new electricity bill payer. In non-domestic buildings that are rented (except those on a fully-repairing and insuring lease), as the landlord will likely provide some of the energy to the tenant, the landlord may seek to recover the cost of the Green Deal Charge from the tenant. However, during any periods when a rented property is empty, the landlord must pay the charges.

The Green Deal offers the private rented sector an opportunity to improve the energy efficiency of its stock. Under the Green Deal, landlords will be able to make energy efficiency improvements at no upfront financial cost to themselves. Tenants will repay the cost of the measures through their energy bill savings, whilst enjoying a more energy efficient property. In this way, the Green Deal is said to be mutually beneficial to both landlords and tenants.

SECTION C: THE MINIMUM BUILDING ENERGY PERFORMANCE STANDARDS NON-DOMESTIC WORKING GROUP

Following industry representations, the Department of Energy and Climate Change (DECC) has brought together a Working Group of key stakeholders in order to examine how MEPS might work in practice, and to help identify key issues that should be considered in more detail and potentially included in the public consultation. This report is the product of the

Group's discussions and is based at time of writing on its best understanding of how MEPS might be introduced, and how they might interact with other policies designed to encourage energy efficiency and emissions reductions in non-domestic buildings.

Secretariat to the Non-Domestic Minimum Building Energy Performance Standards Working Group has been provided by DECC, with support from the British Property Federation⁷. The chair of the Group is Miles Keeping (Deloitte Real Estate⁸). The group is grateful in particular to those who produced primary research for the Working Group, and to those who have helped in the compilation of the final report. The membership of the Group is listed in the Acknowledgements at **Annex A**. Its membership has been cast widely so as to represent as broad a cross-section of the players involved in the non-domestic built environment as possible.

The report has been written to inform a public consultation on MEPS (both domestic and non-domestic) which is expected to be issued by DECC in early 2014.

EXECUTIVE SUMMARY

- The Energy Act 2011 has set a commitment for the Government to introduce energy efficiency regulations for privately rented property by April 2018 (which we refer to throughout this report as 'MEPS'). MEPS have the potential to be transformational in respect of the existing commercial building stock, provided they are implemented in a way which is sensitive to the rights and responsibilities of owners and occupiers, but a number of issues remain to be addressed, which are set out over the course of this document.
- The intention of this report, therefore, is to provide guidance to the Government on the key issues to be considered when drafting the Regulations for MEPS, and to identify key issues which the Working Group thinks could require further work or form part of the Consultation. The Working Group hopes that consultation will proceed quickly in order to permit the industry sufficient lead-in time to respond to the market signals that MEPS will send (and to some extent, are already being sent).
- In **Chapter 2** the Group sets out the context and challenges that might explain why energy efficiency standards in many existing commercial buildings have not naturally risen over time at a rate which one might have expected. Conventionally, it is understood that many energy efficiency measures repay their investment in energy savings, but in rented properties the benefits often accrue to the tenant whereas the landlord pays the costs. There are also a number of conventions in leases which have been designed without environmental performance improvement in mind. In this Chapter we conclude that MEPS could be transformational in that it would reinforce current trends of thought around regulatory obsolescence of assets, and consequent risk to value, but the energy efficiency benefits will need to be weighed against other concerns, such as return on investment for property owners, rights of occupiers and wider environmental concerns such as water and waste. The

⁷ <http://www.bpf.org.uk>

⁸ <http://www.deloitte.com/uk/realestate>

introduction of MEPS should also be handled in a way which avoids uncertainty for investors, as ensuring confidence in the sector is vital to the wider UK economy.

- In **Chapter 3** we explore the options for an appropriate tool on which to base MEPS. Energy Performance Certificates (EPCs) which provide an energy rating from A to G, where A is very efficient and G is the least efficient, are required on construction, sale or letting of a building. Where an EPC has previously been provided it must be displayed in commercial buildings which are over 500m² and frequently visited by the public. The Working Group therefore believes EPCs to be an appropriate choice as the basis for MEPS. However, there is a market view that EPC compliance among building owners could be improved, through more rigorous enforcement, and the quality of the rating assessment will become all the more important if EPCs are to be used as a determinant for regulatory action.
- **Chapter 3** also reports our finding that the quality and consistency of EPC ratings and anomalies in their underlying methodology should be addressed ahead of the introduction of MEPS. To do so would not only ensure a level playing field for MEPS, but also boost confidence in the rating.
- **Chapter 4** explores the implications of introducing MEPS at a rating of E on the EPC scale, as has been suggested by the Government. The Working Group concludes that MEPS should be introduced at a level of E rating, since this is now the wide market expectation.
- In **Chapter 5** the Report details the findings of the Working Group in respect of the timing of the introduction of MEPS. A key challenge for the Government is to set a standard which achieves an acceptable rate of retrofit of existing commercial properties, whilst also respecting the rights and responsibilities of owners and occupiers. The Chapter concludes that there are some legal and technical challenges associated with upgrading a building while tenants are in situ, which means that building upgrades are often easier and more affordable when they are vacant. The Group compared options for the introduction of MEPS, and determined that the option which showed the most promise for further investigation consisted of a requirement to upgrade the property at the first eligible lease event following the date of introduction of MEPS, subject to relevant consents and cost-effectiveness tests set out in **Chapter 4**. Recognising that this could lead to the persistence of F and G rated properties, the Working Group has recommended that the Government should explore the use of secondary backstop dates by which time all properties would have to comply with MEPS.
- MEPS are only intended by the Government at present to cover lettings of property. **Chapter 6** considers who should comply with MEPS and the point at which they should comply in a lease transaction.
- In most cases, it was thought that the party with a duty to comply should be the landlord. The exception to this case is the tenant in the case of sub-lettings, although the tenant should only be liable to comply in respect of parts of the building it controls.
- In respect of the point of compliance, **Chapter 6** suggests that, in view of the fact that most tenants will wish to design their own fit-out when taking a lease of a property,

the landlord should be able to continue to market for letting a property which fails to meet MEPS. This will help to ensure that the landlord is able to gauge whether there is interest in the property at the rent required to make improvement works cost-effective, but it will also help to ensure that any improvement works (and in particular those that concern the tenant's fit-out) meet the tenant's requirements. The *quid pro quo* for this arrangement is that the landlord would be required to provide additional information alongside the EPC to indicate what works are required to bring the building within compliance with MEPS, which would inform both the landlord and the tenant during their lease negotiations.

- **Chapter 7** makes recommendations for improving the current levels of compliance with EPC requirements ahead of the introduction of MEPS, which include providing more resourcing to enforcement bodies, potentially including MEPS compliance as a check within SDLT returns, and increasing the openness and transparency of the EPC Energy Performance of Buildings Register. This Chapter also considers the role professionals are currently playing (as the market is already preparing for the introduction of MEPS) and will play in the future. The Working Group has suggested that professionals such as agents and lawyers will have a role to play in advising clients of a risk of non-compliance with MEPS, although it would remain the client's responsibility to comply.
- **Chapter 8** sets out scenarios where there might be legitimate reasons for an exemption from MEPS. These include:
 - Where the landlord has been unable to obtain necessary permissions or consents to carry out the relevant energy efficiency improvements to the property
 - Where the relevant energy efficiency improvements are likely to have a negative effect on the value of the property
 - Where the relevant energy efficiency improvements are not financeable via the Green Deal.

This is in addition to complete exclusions from scope of the Regulations, where the building or transaction type is not one to which the Regulations should apply.

The Working Group agreed that any exemption which is based on an economic test (the second and third sub-bullets above) should last only until a change of occupier, renewal of a lease (with the possible exception of those within the scope of the Landlord and Tenant Act 1954) or five years since the exemption was granted, whichever is the earliest.

The Working Group considers that, although lease renewals currently do not trigger a requirement for an EPC, that the Government should consider their inclusion within the MEPS regime, as there is concern that otherwise landlords may opt to extend leases indefinitely in order to avoid MEPS. Legal experts represented on the group thought that the 1954 Landlord and Tenant Act may require special treatment, since such renewals are granted on a non-voluntary basis by the landlord.

- **Chapter 9** considers the ways in which the costs of compliance with MEPS might be funded, and on whom these costs could fall. It is thought by the Working Group that in most cases the costs will fall on the landlord. The Working Group also observes

that it is important to understand the associated costs of retrofit in complex commercial buildings (e.g. compensation due to tenant disturbance, project management, legal due diligence) as this could affect the cost effectiveness of energy efficiency measures.

- In **Chapter 10**, the Working Group has examined how MEPS might be subject to future tightening, if the built environment is to deliver its apportioned share of an 80 per cent reduction in UK greenhouse gas emissions by 2050. The Working Group considers it important that if further tightening of MEPS is envisaged by the Government, it is important to set out this trajectory as soon as possible, to give market certainty and also to encourage those who are improving properties to consider whether they are able to achieve higher standards in order to further delay the risk of obsolescence.

KEY RECOMMENDATIONS

- **Energy Performance Certificates (EPCs)** – EPCs should be the basis of MEPS, as they are comparatively well understood in the market and are already required in sales and letting transactions. However, there are industry concerns around the quality and consistency of EPC Assessments. The Working Group thought that if the industry perceived there to be issues with the implementation of EPCs, then it should provide evidence of issues being experienced in the market to Government (see Chapter 3, Section aiii).
- **Setting the standard** – the market is preparing for an E EPC rating as the level of MEPS, and subject to caveats outlined in this report, the Government should not seek to apply a different threshold
- **Timetable for the introduction of MEPS** – MEPS should be introduced in April 2018, and apply to the first letting transactions (save those with a valid exemption) which occur following that date. Recognising overarching emissions reduction targets, some members of the Working Group suggested the introduction of energy efficiency backstops, such that all F and G EPC-rated properties would have to be upgraded by a certain date. There was consensus that the full impacts of the introduction of backstops would need to be understood ahead of their introduction and merited further consideration by the Government and industry.
- **Point of compliance** – landlords should be able to market an F or G EPC-rated property on the basis that the property is compliant before a tenant occupies, at which point a compliant fit-out must be agreed between the landlord and the tenant which will result in the achievement of at least an E-rated EPC to comply with MEPS.
- **Enforcement** – Trading Standards Officers, who will enforce MEPS, will need support and resourcing, and all avenues for gathering information and monitoring should be explored.
- **Exemptions** – exemptions should be limited in scope, and where they do apply, time-limited.

- **Paying costs** – the Government should assess how the costs of compliance with MEPS will be split between landlords and tenants, and design policy so as not to unfairly prejudice the interests of one or other party.
- **Future trajectory** – if the MEPS compliance level is to be increased over time, the Government should announce a clear trajectory well in advance. This should be linked to clear evidence and objectives, to enable industry to prepare and make appropriate investment decisions

Chapter 2: Context and Challenges

SECTION A: COMMERCIAL PROPERTY AND VALUE

Much can be done from a technical building perspective to improve the performance of existing buildings, and many energy efficiency interventions can be shown to repay their investment in energy cost savings over the course of their useful life. This being the case, one might question the need for Minimum Building Energy Performance Standards (MEPS) to be introduced at all.

There are valid legal and practical reasons why property owners and occupiers have not, as yet, made as much progress as they might have in making their buildings more energy efficient. Understanding the reasons why this has been the case should be a critical consideration when designing future policy interventions, such as MEPS, as this will likely inform effective policy development.

A large proportion of the commercial property stock is occupied by someone other than its owner⁹. While that should have a relatively modest impact on how emissions might be reduced solely from the way buildings are used, it has a huge impact on how emissions can be reduced by changing the buildings themselves. That impact is greatest in the context of multi-tenanted buildings such as shopping centres or office blocks, but in general it flows from the fact that while technical improvements are readily achievable, leases and relevant legislation governing the relationship between landlords and tenants are generally framed without environmental improvements in mind. This results in:

- **Operational issues** – the disruption caused to occupiers while buildings are changed;
- **Commercial issues** – varied and uneven distribution as between landlord and tenant of the costs and benefits of, and control over, energy use and changes in buildings or behaviours designed to reduce it;
- **Legal issues** – constraints within leases on how costs and benefits associated with energy reduction initiatives and related expenditure or behaviour can be allocated as between landlords and tenants.
- **Information-related issues** – unavailability, or poor transfer of, information relating to energy use between landlords and tenants;

Such issues manifest themselves in a list of complications that have traditionally meant that large-scale energy efficient retrofit has not been the norm:

- terms in leases, or the general law, will often require landlords to compensate tenants who are subject to disruption, which can discourage mid-lease renovations to improve the building's energy performance;
- leases restrict the landlord's access to the tenant's demise during their term, save for access for maintenance and repair. Such rights of access do not extend to access for the purposes of alteration, so that the parts of a building demised to the tenant cease to

⁹ 66% of commercial property by value is rented, BPF & IPD 2012 Annual Data report
http://www.bpf.org.uk/en/files/reita_files/property_data/BPF_Property_Data_booklet_2013_spreads_web.pdf

be within the landlord's control, unless the tenant specifically authorises the landlord to enter;

- leases very rarely require the exchange of data between landlord and tenant concerning utilities data (e.g. energy, water, waste data). As a result, low-cost and no-cost improvements to performance arising from better management or use of resources can lie hidden and unexploited;
- where a landlord has let an entire building to a single tenant, the lease will state that it is the tenant's responsibility (not the landlord's) to keep the building, and its plant and equipment, in good repair and condition. This is often termed a Full Repairing and Insuring (FRI) lease. In such a case, the tenant is unlikely to be happy to allow the landlord to have access in order to carry out works to improve the energy efficiency of the building owing to the disruption that this will cause. Any such works ought properly to be carried out by the tenant, since it is the tenant's building for the duration of the lease;
- the lease normally sets out the precise circumstances in which the costs of improvements to a building's performance can be recouped from the tenant. Most leases will not permit the recovery by the landlord from the tenant of the cost of energy efficiency improvements. This is because typically an improvement to an existing item of kit is deemed to be an 'improvement' which is a landlord cost, whereas a like-for-like replacement of an item of kit due to wear and tear is deemed to be a tenant cost. Improvements to a building's performance often have limited or no effect on the value of the asset, and if the cost of the improvement cannot be recouped via the service charge, there will be no incentive for the landlord to make the investment;
- with shortening lease lengths (in 2010/11, the average lease length for commercial property was 4.8 years¹⁰ and 4.1 years for SMEs), the ability to recoup investment monies over a single lease period could be challenging for energy efficiency measures with a longer term payback¹¹;
- the Landlord and Tenant Act 1954 effectively allows most tenants of non-domestic property to require the landlord to grant them a new lease at the end of the term of an existing lease, on the same terms and at market rent. This makes it very difficult for landlords to obtain vacant possession of their buildings when a lease expires, particularly where there are several tenants whose leases are not coterminous. However, the Group thought that on balance, if improvements were contingent upon tenant consent, this might not be as significant an issue as first appeared. Nevertheless, it warranted further examination by Government and industry;
- there are also challenges in enforcing 'green' clauses¹². This is because where they are found to be within the lease itself, they often do not carry with them the ultimate sanction of forfeiture for non-compliance, and where they are found within a memorandum of understanding which sits alongside the lease, they are not legally binding; and

¹⁰ BPF/IPD Annual Lease Review 2012

¹¹ Although it should be noted that a Green Deal is not limited by lease periods/length of tenant occupation

¹² <http://www.betterbuildingspartnership.co.uk/working-groups/green-leases/green-lease-toolkit/>

- under the Landlord and Tenant Act 1927, at the end of a lease, under certain conditions a tenant leaving an energy efficiency improvement in situ can be entitled to compensation from the landlord. Currently, the Landlord and Tenant Act 1927 would appear not to offer a means for the landlord and tenant to waive this. This can often lead to the landlord requesting that the premises are returned to the fit-out originally supplied by the landlord, at the tenant's expense. .

Some leading property owners and occupiers have sought to address the above issues by employing green leases and green memoranda of understanding to provide a rubric for collaboration on energy efficiency and carbon management¹³. However, a number of the above issues, particularly around waiving the requirement to reinstate, may require a change in the law.

SECTION B: SUSTAINABILITY, VALUE AND WORTH

There has been little convincing market evidence that a more sustainable non-domestic building, all other things being equal, commands a higher rent or capital value than its non-sustainable counterparts. The World Green Building Council's 'Case for Green Building'¹⁴ established that academic studies had identified there to be a value premium for more sustainable buildings, particularly within the United States and Australia, but more recently from the UK¹⁵, Ireland¹⁶, Denmark¹⁷ and across Europe¹⁸. Such studies have made the case that some buildings carrying sustainability certification may attain higher rental and capital values than those that do not (i.e. there is a difference in the value of buildings which have sustainability performance ratings and those which do not).

However, leading valuation experts expect that property owners who fail to mitigate environmental risk may find that their buildings are likely to become subject to higher rates of regulatory obsolescence faster than those of property owners who actively manage this risk (see Fig 1). This relationship is currently being explored by a number of industry initiatives such as the Global Real Estate Sustainability Benchmark¹⁹ and the RICS/Investment Property Databank's ECOPAS survey²⁰. It is important to note, however, that valuers following RICS practice are 'score takers' and not 'score makers' and as such must rely on sound evidence and agreed denominators of performance when valuing. This means that the expectations of academic studies will not find their way into market valuations until a critical weight of evidence has built up.

¹³ <http://www.betterbuildingspartnership.co.uk/working-groups/green-leases/green-lease-toolkit/>

¹⁴ <http://www.worldgbc.org/activities/business-case/>

¹⁵ <https://www.gov.uk/government/news/energy-saving-measures-boost-house-prices>

¹⁶ The value of domestic building energy efficiency – evidence from Ireland, <http://www.economics.ox.ac.uk/materials/papers/12042/paper614.pdf>

¹⁷ Sammenhæng mellem energimærkning og salgspris, Netværk for energirenovering <http://www.sbi.dk/miljo-og-energi/energibesparelser/bedre-energimaerkning-bedre-pris.-netvaerk-for-energirenoveringole-michael> - English translation: Correlation between energy efficiency and selling price. Network for energy retrofit

¹⁸ http://ec.europa.eu/energy/efficiency/buildings/doc/20130619-energy_performance_certificates_in_buildings.pdf & DTZ, European Sustainability Guide, April 2013

¹⁹ <http://gresb.com/>

²⁰ <http://www1.ipd.com/Pages/DNNPage.aspx?DestUrl=http%3A//www.ipd.com/sharepoint.aspx%3Ftabid%3D2215>

A number of leading advisors acting for both owners and occupiers are now tending to speak in terms of 'value' and 'worth.' Value has been mentioned above, but worth can encompass features and characteristics of buildings which, while they do not impact on the rent or capital value of the asset in a discernible way, make the building more attractive to an occupier. This can include evidence of increased workplace health and productivity, reduced risk of exposure to future energy prices, extreme weather events and emissions taxation and increasingly demanding standards for consequential improvements to non-domestic buildings when ancillary works are undertaken²¹. The problem is that such market thinking is not yet normative. However, RICS has recently updated and strengthened guidance to valuers encouraging them to build sustainability into their inspection, analysis and reporting systems²².

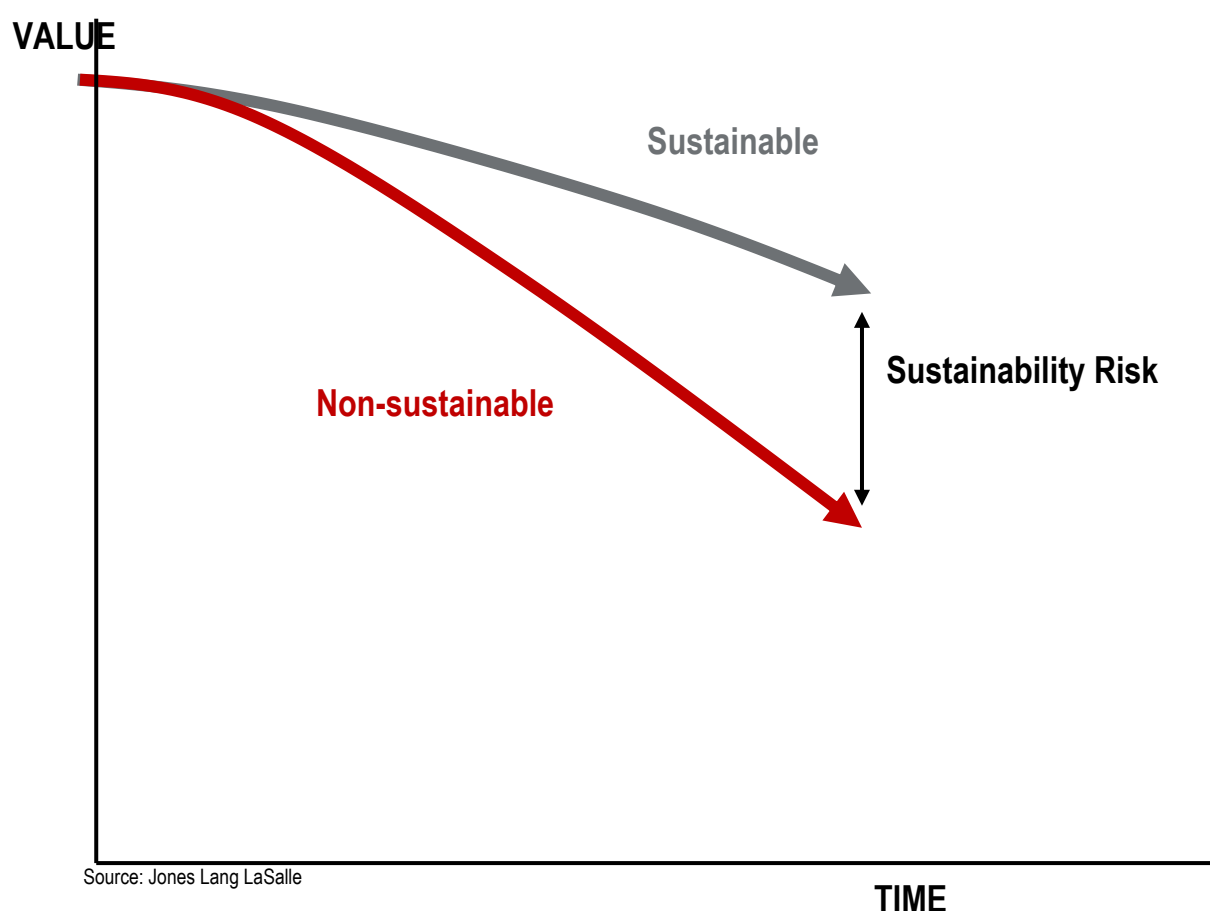


Figure 1: Anticipated Future Relationship Between Value and Sustainability

The above issues do not preclude the introduction of MEPS and in fact support the need for a disruptive intervention to encourage building upgrades. MEPS could reinforce current trends around regulatory obsolescence of assets, but the energy efficiency benefits will need to be weighed appropriately with other concerns, such as return on investment for property owners and the rights of property occupiers. The Working Group considers that MEPS, if

²¹ <http://www.worldgbc.org/activities/business-case/> <http://www.worldgbc.org/activities/business-case/>

²² <https://consultations.rics.org/consult.ti/sustainability/view?objectId=879796>

implemented correctly, could help overcome some of the key barriers that have so far held back significant levels of investment into energy efficiency improvements across the existing rented building stock. Above all though the introduction needs to be handled in a way that avoids uncertainty for investors, as ensuring confidence in the sector is vital to the wider UK economy.

SECTION C: MEPS AND SALES TRANSACTIONS

The Regulations which will implement MEPS will only apply to rented property.

However, it is worth pointing out that MEPS could have an effect on the sale and purchase of commercial property that is held as an investment. This is because advisors to prospective owners advise their clients of any risks in the acquisition particularly those which may affect the economic viability of the asset. Similarly, businesses purchasing property for owner occupation will almost certainly have an eye to the possibility that they may wish to let some or all of the building to somebody else in the future in order to realise an income stream or to sell that building to someone who will wish to do the same.

In practical terms, there is likely to be an adverse effect on the saleability of tenanted property that falls below the MEPS threshold. Any potential buyer will be aware that property with a rating of F or G will need to be improved before it can be let, which is bound to reduce its attractiveness compared to other similar property that does not need such work doing, even if the costs of such work are paid for through the Green Deal.

Chapter 3: Making EPCs an Effective Basis for MEPS

RECOMMENDATIONS

1. EPCs should be used as the basis for MEPS, given their complementary role in raising awareness and understanding of energy performance in buildings.
2. There is, however, a need for the EPC calculation methodology to be improved and the quality and consistency of EPCs to be addressed through improved assessor training and potentially professional membership requirements.
3. Anomalies reported by some group members in the EPC methodology, such as the treatment of shell and core developments, should also be addressed. It is recognised that this may have an impact on assessment costs. Industry should assist Government to address these issues with evidence and case studies where possible.
4. There is a need to ensure that property owners and occupiers are aware that the calculation methodologies used to generate EPCs change over time to improve accuracy and to update energy cost information. Both Government and industry have a role to play in raising awareness concerning how EPC ratings are generated, and how amendments to the calculation methodology may impact future ratings for the same building.
5. The way in which buildings are managed and used can have a pronounced effect upon their actual energy performance, and asset ratings can usefully be supported by operational measurement and data exchange between owners and occupiers.

SECTION A: CHOOSING AN APPROPRIATE TOOL FOR MEPS

i. Introduction

The Working Group considered issues related to using EPCs, as defined in the Energy Performance of Buildings Regulations, as the basis for MEPS.

ii. The case for using the EPC as currently defined as the basis for MEPS

There are several advantages to the use of EPCs as the basis of MEPS:

- **Market Liquidity** - Where a building is being traded to another owner or occupier, the theoretical use of the space measured via the EPC methodology would be most relevant to all parties. An existing owner would be unwilling to countenance a transaction being held up because the previous tenant's use of the space or the landlord's management of it was inefficient or more intensive than the typical benchmark values, as might be the result if a measurement framework based on actual energy use were to be used instead.
- **Compliance costs** - The EPC is already used in the market, and is produced on construction, sale or letting of a building. Compliance costs would be lower if EPCs were used as the basis for MEPS, compared to an approach which relied on a bespoke or alternative tool for demonstrating compliance (i.e. EPCs are required on transaction in any case).

- **Profile** - EPC ratings are currently required to be displayed in properties over 500m² frequently visited by the public (falling to a 250m² threshold in 2015), where a valid EPC has been procured. The asset rating is also currently required to be displayed in property advertisements. These public display requirements, if adequately policed, could assist compliance with MEPS. We return to the issue of enforcement later in this report.

iii. Improving the EPC

In order for the existing system of EPCs to be used in support of MEPS, the Group has identified a number of reported issues which should be investigated:

- **Quality and consistency of EPCs:** the quality and consistency of EPC ratings has improved since their introduction, but there remains evidence of inconsistency and variability. A number of industry advisors to property owners have informed the Working Group that, in carrying out portfolio analysis for leading property owners, in their opinion, a number of quality issues with EPC ratings have been identified. Moreover, as EPCs are valid for ten years, poorer quality ratings can continue to be used. It was alleged that this arises because assessors have not conducted sufficiently rigorous inspections and have used default values in the software and that this has meant that advisors reassessing properties using the software as intended, and following the correct conventions. It is claimed that assessors have been able to improve or worsen a building's rating without energy efficiency improvements having been carried out. It may be however that as the market responds to MEPS by placing a heavier emphasis on quality assessments, as landlords and tenants will want to ensure they have as accurate an assessment as possible for their property to ensure certainty as to whether the building is in risk of non-compliance.
- **Shifting grades:** with periodic reviews of the National Calculation Model, and revisions of the treatment of the assumptions within the methodology concerning heating, lighting and ventilation performance, it may be that EPC ratings may increase or downgrade over time, all other things being equal. The Group thought that it could be helpful to advise the industry of future changes in layman's terms, and to restrict changes to the National Calculation Methodology to 1-2 commencement dates each year to maximise certainty.
- **Anomalies:** from a technical perspective, some members of the group raised that the treatment of certain aspects of building energy performance under the EPC are possibly counterintuitive. For example:
 - the treatment of properties stripped back to shell and core under the EPC methodology is understood differently by different assessors which leads to uncertainty for owners and occupiers²³.
 - typically, lighting controls in the methodology are not deemed to provide energy efficiencies of an order one would expect (e.g. in the case of LED lighting)

²³ However DCLG guidance is available to assessors in relation to shell and core.

- commercial refrigeration within the methodology is thought to be as energy efficient as domestic refrigeration which is not the case.
- Traditional building methods and materials are not attributed their correct energy performance characteristics by the methodology, and modern energy efficiency measures installed in traditional buildings are often assessed using over-optimistic performance assumptions.
- **Enforcement** – There is a perception within industry that rates of compliance with Energy Performance Certificates on building transactions are low. It is important to set a level playing field across industry, and thus rates of compliance should be backed by credible penalties and well-resourced TSOs (see Chapter 7).

SECTION B: AREAS OF CONCERN

A number of commentators have observed the need to tackle the performance gap between how buildings are designed and how they operate in practice²⁴. The Group therefore concludes that in order to meet the UK's binding emissions reduction targets by 2050, MEPS may be insufficient in isolation to encourage efficient management and use of buildings (as opposed to stimulating upgrades of their fabric and fittings which MEPS is primarily intended to achieve).

Efforts are under way by the industry to promote the voluntary adoption of Display Energy Certificates for rented commercial buildings. In the experience of some of the Group's members, savings of between 5 and 40% can be achieved through simple management and behavioural changes. Although some owners and occupiers are capitalising upon these opportunities, there is a clear need to make such practices mainstream. DEC's can be seen as a simple way to understand where opportunities lie for improving building performance at no or low cost, and ensuring that investments in energy-efficient kit deliver on their savings.

In this context, the Group welcomes the recognition in the Energy Saving Opportunities Scheme consultation of DEC's as a potential means to comply (in respect of building-related energy) with the requirements of Article 8 of the Energy Efficiency Directive, whilst allowing a carve-out for large organisations which have energy management plans to recognised European standards.

²⁴ <http://www.betterbuildingspartnership.co.uk/download/bbp-jll---a-tale-of-two-buildings-2012.pdf>

Chapter 4: Setting the Required Minimum Building Energy Performance Level

RECOMMENDATIONS

1. Any future trajectory for increasing the baseline standard for MEPS should be based on an evidence-based assessment.
2. The Working Group recommends that MEPS should be set at a starting point of E, given that this is the basis on which the industry has been preparing for their introduction. As a result of the Government's initial announcement on MEPS, the market widely expects MEPS to be introduced at a rating of E (so that F and G rated buildings would be unable to be let), and this is the basis on which the market is preparing. The Government should be sensitive if the level of MEPS is going to be different from E EPC rating. Industry should assist government address these issues with evidence and case studies where possible.
3. The industry should build upon work undertaken by Sweett Group and the Investment Property Forum to determine the costs of upgrading properties to higher EPC ratings and subject it to a wider sample. The findings should be shared with the Government and used to support the setting of the future MEPS trajectory.
4. The 'negative value' based carve-out within the primary legislation holds the possibility of being used subjectively in order to avoid compliance. The Government should restrict the value-based carve-out to a number of valid, but specific, circumstances in which the value of a property might be diminished by MEPS compliance. Suggestions for the circumstances, and the means by which each test could be validated, are set out at Annex B.

SECTION A: SETTING THE LEVEL OF ENERGY PERFORMANCE FOR MEPS

i. Introduction

The Government has stated its intention to set MEPS at an EPC rating of E for both domestic and non-domestic property.

Since the Energy Act 2011 received Royal Assent, leading property owners and investors have been seeking to understand the potential impact of the introduction of MEPS upon the assets they own and in which they invest. The intention is that MEPS will be introduced at an EPC rating of E. As this is the basis on which the industry has been preparing, there is likely to be benefit in the Government proceeding on this basis. In Chapter 10, we have set out the case for the Government to plan to tighten MEPS over time.

Further issues to be considered in setting the standard are:

ii. *What is the quantum of the stock to which MEPS will apply if it is set at a rating of E?*

According to the Energy Performance of Buildings Register (where EPCs, Air Conditioning Inspections and DEC's for non-domestic buildings are lodged), F and G rated properties account for 18 per cent of the entire non-domestic stock. The table below displays the breakdown of EPC ratings by grade for England and Wales correct as at June 2013²⁵:

Energy Performance Asset Rating Band	Number of non-domestic properties	Proportion
A+	84	0.020
A	2257	0.53
B	31693	7.41
C	115929	27.098
D	126313	29.53
E	71718	16.76
F	36358	8.50
G	43462	10.16

However, it is important to note that many leading property owners obtained EPCs for their entire portfolios at the time of their introduction in 2008. This could mean that the non-domestic Energy Performance of Buildings Register could be weighted toward the prime end of the market, which the group would expect on the whole to perform better, weighting the data in favour of higher rated properties. It is therefore difficult to say as to whether the breakdown of EPC ratings is representative of the wider (unassessed) stock.

iii. *The costs associated with upgrading a property from EPC rated F or G to E or above*

There has not been much research specifically on the costs involved in upgrading the EPC rating of commercial properties. A report by Sweett Group²⁶, commissioned by the Investment Property Forum in 2012, suggests that where a market refurbishment is undertaken (when a property is vacant, and typically once every ten years), there are only marginal costs involved in upgrading the building beyond a 'typical market refurbishment' (which would be compliant with the prevailing consequential improvement requirements of Part L where the total useful floor area of the building is over 1000m²). The table overleaf reproduces the key findings of the report.

²⁵ http://www.theccc.org.uk/wp-content/uploads/2013/06/CCC-Prog-Rep-Book_singles_web_1.pdf

²⁶

<http://www.sweettgroup.com/viewfile.cfm?id=306&h=F22723A632B9FBB77AA6AF91DE66E47D54429008441BFFBEB345EB77F402C791>

			Marginal percentage cost increase of improving building to each EPC grade over and above market refurbishment EPC grade				
Building Archetype	Baseline EPC Grade	Market Refurbishment EPC Grade	E	D	C	B	A
Office 1: Mid-town and West End Office type (period, dating from pre-1940, non-air-conditioned and heated only)	E	D	N/A	N/A	0.8%	14.1%	40.0%
Office 2: Partly glazed air-conditioned early 1990s, narrow plan office, compliant with 1990 Part L Building Regulations	G	F	0.3%	1.7%	14.6%	37.3%	N/A
Office 3: Fully-glazed, deep plan, air-conditioned office, compliant with Part L 2002 Building Regulations	F	F	1.0%	1.9%	12.6%	44.7%	N/A
Office 4: As Office 3 but compliant with 2006 Part L Building Regulations	E	E ²⁷	N/A	1.0%	12.8%	45.7%	N/A
Retail: Single storey with lighting, heating and air conditioning. Office and warehouse space included. Compliant with 1990 Part L Building Regulations	D	C	N/A	N/A	N/A	2.6%	N/A
Industrial/Warehouse: Single storey with lighting and heating. Limited windows or rooflights. Offices included. Compliant with Part L 1990 Building Regulations	F	B	N/A	N/A	N/A	N/A	20.7%

²⁷ A market refurbishment would not be carried out on a building that is less than 10 years old, hence no improvement in the EPC rating

The figures suggest that, as the group will see in the following chapter on the timeline for the introduction of MEPS, there are small marginal costs involved in improving the EPC rating of buildings when properties are undergoing renovation anyway.

The IPF study identified a number of quick wins across a range of building types that are considered low cost to implement and have a measurable impact on the EPC rating:

- Boilers (95% efficiency)
- Daylight controls
- Improved air tightness
- Variable speed heating and cooling pumps
- Heating controls
- Power factor correction (>0.95%)
- High-efficiency chillers
- T5 lighting
- Heat recovery; and
- DC drive fan coil units

These 'quick wins', the IPF/Sweett Group Report found, can either form part of a general refurbishment during a period of vacant possession or a 'one off' improvement when a building is wholly or partly occupied (through phased, or overnight/weekend/holiday upgrades when the property is not in occupation). This is an important consideration when a planned refurbishment is some years away, and one or more leases are due to expire, in the context of MEPS as these quick wins could make the difference between lettability and obsolescence in properties which are on the border of an E and an F rating.

While the results of the IPF Report are encouraging, it should be recognised that its findings are based on a limited sample of buildings. It would be of enormous benefit to both industry and Government if an extension of the study could be conducted, using a larger representative sample of stock, in order to verify its findings. Such a study would be valuable in determining any future trajectory for tightening of MEPS (as well as for wider policy development around building energy efficiency).

The Group is aware that further work, commissioned by the Green Construction Board, is currently being undertaken and the results when known should be taken into account, to help establish the progression towards tightening requirements moving forward.

SECTION B: AREAS OF CONCERN

One of the potential unintended consequences of MEPS is the risk of accelerated obsolescence. Where older properties are nearing the end of their useful life and sites are being assembled for redevelopment, short leases may be currently available on flexible terms to small and medium sized enterprises. Unless taken into account, MEPS may prevent such low cost arrangements, since there will be no business case for making the required improvements. This could lead to an increase in the number of unoccupied properties.

Chapter 5: Timetable for introducing MEPS

RECOMMENDATIONS

1. Given the legal complexities and technical challenges associated with upgrading a building when it is occupied, the Working Group recommends that a soft start is employed, with a backstop date. This would mean that all properties that are let or re-let post-2018 are subject to MEPS, and all leased properties, whether or not they have been transacted since 2018, would be required to comply with MEPS by the backstop date.
2. The group did not reach a consensus on when the backstop should apply; however 2023 was suggested and was widely supported as it provides enough time for the average lease to have turned over following the introduction of MEPS in 2018. Any future trajectory of MEPS should be set out ahead of introduction, and be well-evidenced.

SECTION A: WHAT SHOULD THE TIMING OF INTRODUCTION FOR MEPS BE FROM APRIL 2018?

i. Introduction

Aside from the energy performance threshold that will be used to determine which properties are required to be upgraded under MEPS, MEPS may start to take effect through variants of a 'hard' or 'soft' start.

It is necessary to define the terms the Group will be using throughout this chapter (these are not terms of art):

- A 'comprehensive hard start' means that as from 1st April 2018, a property owner's non-domestic property will need to be compliant with MEPS where there is a lease in place on 1st April 2018, regardless as to whether the need for an EPC has been triggered previously by a transaction under Energy Performance of Buildings requirements (i.e. Government would require all owners of privately rented commercial buildings to obtain an EPC in advance of 2018). In such a scenario, the Government might nevertheless choose to permit certain exceptions within the Regulations implementing MEPS.
- A 'hard start' means that as from 1st April 2018, a property owner's non-domestic property will need to be compliant with MEPS where there is a lease in place on 1st April 2018, but only where there is an EPC for the building (again, subject to any other exceptions in the Regulations).
- A 'soft start' means that MEPS applies only to new leases (excluding leases being renewed under the Landlord and Tenant Act 1954) granted on or after 1st April 2018 (again, subject to any other exceptions in the Regulations)

Under each option, the Government has suggested that requirements to upgrade properties would be subject to obtaining the necessary consents where relevant.

The Working Group believes that a full hard start is not possible under the current primary legislation. For a comprehensive hard start to work, every privately rented commercial building would require an EPC, regardless as to whether under existing legislation they are

required to have one. The Working Group understands additional primary legislation would be necessary to require all privately rented commercial buildings to have an EPC by April 2018. Instead a 'hard start' or a 'soft start' is considered possible to be implemented without the need for further primary legislation. The Working Group has set out below some of the pros and cons of the different start options. Hard starts have been included within this, despite the understanding of the Working Group identified above.

ii. Pros and cons of the different start options

A hard start might send a strong signal to the market to take action now (a key anti-avoidance measure). Supporters argue that it would:

- reduce the scope for property owners to strategically manage lease events in order to avoid compliance.
- lead to a faster rate of retrofit than other methods of MEPS introduction. This is because property owners and occupiers would be acting unlawfully if they continued to let space which failed to meet the minimum standard, posing economic risk for both parties.
- be more beneficial for the green economy, as it would provide a key driver for the production and sale of green services and goods as property owners and occupiers worked to bring the properties they own and occupy up to the required standard. At the time of writing, although the Green Deal for domestic properties is in place, its non-domestic counterpart is taking longer to come to market.

A focussed hard start would have similar benefits to the comprehensive hard start, although it would not catch as many properties. The Group thought that the legislation may also need to distinguish between those EPCs held voluntarily, and those that are required, to avoid discouraging voluntary take up of EPCs, but was of the view that it would be difficult to identify a simple mechanism for doing so.

It would seem reasonable to assume that a hard start would lead to better environmental outcomes, through tackling anti-avoidance. Although large property investors and owners and corporate tenants are aware of the MEPS requirements, many owners and occupiers in the long tail of the market may be unaware of these requirements and communication with that section of the market will be very important (an area where the Government and industry should hold joint responsibilities), and indeed the possibility of the application to existing leases has not been widely appreciated until recently.

Whether a hard or soft start is undertaken, it is clear that property owners will wish to know whether or not their property, as it currently performs, will meet MEPS or not. Clarity and advance notice of EPC software changes would assist in this regard.

iii. Legal implications

As set out in Chapter 2, section A, leases entitle tenants to quiet enjoyment of their premises, excluding all others. Where an FRI lease is in place, landlords have the right to enter to *repair* building services which are within the tenant's premises, but not an automatic right of entry to *alter or improve* them. Tenants also have rights to compensation if the agreed levels of service within the lease are disturbed. This means that a tenant's permission is likely to be required before an upgrade can be carried out within their demise.

All this has tended to mean that, traditionally, property owners have preferred for reasons of efficacy and economy to undertake improvements (including energy efficiency

improvements) to a property when it is vacant (and the costs related in the IPF/Sweett Group Report cited in Chapter 4 confirm the economic case for this). Such an approach enables more invasive and expensive works to be undertaken in complementary packages and avoids the need to pay compensation or move tenants in view of the disruption caused.

The legal issues under the lease surrounding building upgrades when properties are occupied, and the findings of the IPF/Sweett Group report mentioned in Chapter 4, suggest that a soft start would be more practical for landlords to implement. This is because it would enable building upgrades to be undertaken at appropriate lease breaks, although there would remain issues in multi-let buildings where not all leases will end at the same time.

iv. Compliance implications

Those in favour of a comprehensive hard start or a hard start argue that a soft start would enable property owners to gear their leasing strategies toward avoidance of risk of compliance (for example, such as granting long leases in 2017). However it was also argued that trends in recent years, shown in the British Property Federation/Investment Property Databank Annual Lease Review²⁸, have been toward granting tenants greater flexibility of terms, and tenants are therefore unlikely to agree to terms that are simply for the benefit of the owner. An owner who fails to offer competitive terms is likely to fail to compete with owners offering similar space for let. Furthermore, tenants are likely to be wary of signing long leases on properties falling below MEPS as it could impact their ability to sub-let in the future.

We have mentioned in Chapter 6 that, according to the current Government guidance, lease renewals in England and Wales do not currently require an EPC. On balance the Working Group thought that lease renewals should require an EPC on the basis that to do otherwise could lead to avoidance, with property owners structuring their lettings in order to avoid compliance (by avoiding the need to obtain an EPC or by changing a negotiating stance at lease end).

Enforcement and monitoring could be argued to have a bearing on the speed of progress on retrofit. While a hard start may appear to be simpler to enforce, *prima facie*, since it applies as a blanket requirement, in fact this simplicity is confounded by the intended cost effectiveness test provided by the Green Deal and the value trigger, and that any compliance with MEPS is subject to the owner receiving all relevant consents (e.g. tenant consent, and relevant regulatory consents such as planning and building control where relevant). Additionally, a hard start would not only require the identification of properties being rented as would be required under a hard start, but also those that have an EPC and would therefore be within scope. Complexities around identifying and certifying whether an exemption has been triggered would also accompany a soft start. Therefore the Working Group believes that a comprehensive hard, hard and soft start all pose equally complex questions for the purposes of monitoring and enforcement.

²⁸ http://www.bpf.org.uk/en/files/bpf_documents/commercial/BPF_IPD_Annual_Lease_Review_2012.pdf

v. *Speed of progress*

In 1999, the average lease length for comparison purposes was 8.7 years. In 2011/12, the average lease length for commercial properties was 4.8 years, with 4.1 years favoured among SMEs²⁹. The reducing length of lease terms suggests that progress under a soft start would not be constrained since lease expiry would generate turnover of retrofit at an acceptable rate, for both property owners and occupiers and wider civil society. However, although *average* lease lengths are now shorter, the average masks considerable variation. Many secondary properties, which are those most likely to fall below MEPS, are also most likely to have short leases – but also fail the Green Deal's Golden Rule. Those on the cusp of compliance could well have longer leases.

The question remains whether the Government will choose to ratchet MEPS requirements over time, such that higher ratings must be achieved in years after 2018. If this is the Government's intention, then it would be beneficial for this to be a stated objective as soon as possible, with clear links made with any backstop introduced and for the trajectory to be set out in advance. This issue is explored in further detail in Chapter 10.

Some members of the Group thought that energy efficiency backstops should be explored as a mechanism to ensure that the letting of buildings with the lowest ratings is definitely phased out by a certain date, recognising that 2018 might be too early a date for this to occur, with 2023 being a possible date for the introduction of the first backstop. This is an issue that merits further consideration.

SECTION B: IMPLICATION ON MARKET CAPACITY TO FURNISH THE REQUIRED EPCS

The Working Group explored the ability of Energy Assessors to deliver a marked increase in the rate of EPC assessments. The concern was that the downturn in the property market had led to a climate of decreased rates of transaction, which might have constrained the growth in the number of energy assessors. Some research was conducted to establish whether MEPS compliance would be constrained by a lack of availability of assessors, or not.

The Investment Property Databank gathers impartial information on the financial performance of the property sector. Each year, the Investment Property Databank and the British Property Federation conduct a review of the characteristics (e.g. length, number, conditions granted) of leases granted in the previous year.

The table below shows the trends in leases granted in all properties (with further sub-categorised data for how retail, office and industrial property transactions contributed to the whole) from 1999-2001 up to 2011. It can be seen that there has been a pronounced decline in the number of leases granted following the downturn in 2008³⁰, which coincided with the downturn in the wider economy and in particular the property market. In 2008, EPCs were introduced via a phased introduction, starting with the largest buildings.

²⁹ http://www.bpf.org.uk/en/files/bpf_documents/commercial/BPF_IPD_Annual_Lease_Review_2012.pdf

³⁰ The authors are aware that the data for prior to 2008 is combined into rolling three year periods, but even if the figures for the early years are prorated, there is still a pronounced downturn following 2008.

Number of leases granted

	99-01	02-04	05-07	2008	2009	2010	2011	All Leases
All Retail	9,432	11,205	12,294	4,456	5,162	5,159	4,560	52,268
All Office	4,945	5,132	6,375	1,769	2,104	2,282	1,880	24,487
All Industrial	5,143	7,538	9,731	2,569	2,341	2,572	3,612	33,506
All Properties	19,876	24,152	28,884	8,995	9,718	10,236	10,316	112,177

According to a freedom of information request from 2012, recent energy assessor levels for non-domestic buildings have been as follows:

	Inactive	Registered	Struck Off	Suspended
Level 3 Assessors	1590	3681	64	255
Level 4 Assessors	941	2365	36	157
Level 5 Assessors	88	291	1	11

The figures suggest that, if the percentage of the non-domestic stock which is F and G EPC-rated is as the Energy Performance of Buildings Register suggests around 18 per cent, there is likely to be a sufficiency of energy assessors equipped to provide ratings on demand.

Given that level 5 assessors use Dynamic Simulation Modelling³¹ to conduct assessments, and the Green Deal assessment is a variant of SBEM, currently buildings requiring a Level 5 EPC assessment are not able to have a Green Deal assessment conducted using the same model.

At present, the Working Group finds, therefore, that assessor levels and capacity are likely to be sufficient for either a hard or a soft start. The Working Group was not able to assess the level of Green Deal Assessors likely to be available in 2018. This is important to understand since should only GoldenRule-compliant energy efficiency measures be required pursuant to compliance with MEPS, there will likely be significant demand for the expertise of such assessors in the run up and during the implementation of MEPS.

³¹ DSM is a more accurate means of modelling energy performance and is favoured by leading consultancies. Strictly speaking DSM is used for complex buildings such as those with large atria. However, we find that increasingly because of its accuracy DSM is being used for simpler buildings.

Chapter 6: Identifying the Point of Compliance in a Lease Transaction

RECOMMENDATIONS

1. The Government should introduce MEPS in such a way that a property owner (or a tenant in the event of a sub-letting) can market their property even if it does not meet the minimum standard, provided that when a new occupier is found, an agreement is reached on the fit-out that either the landlord or the tenant will carry out the energy efficiency works.
2. The Government should consider who is liable for failure to meet MEPS, particularly when a building has been sub-let.

SECTION A: OBJECTIVES

i. Introduction

This chapter considers at what point a landlord should have to comply with the MEPS requirements.

All parties to a letting transaction, together with those responsible for enforcement, need to have certainty about whether the MEPS requirements apply to the transaction and, if so, when they apply.

SECTION B: LEGAL OBLIGATIONS IN DIFFERENT OWNERSHIP STRUCTURES

In the normal case of a landlord granting a lease to a tenant, it was suggested that the MEPS requirements will need to be complied with by the landlord. In the case of a tenant granting a sub-lease to a sub-tenant, the MEPS requirements will need to be complied with by the tenant.

However, there are two potential issues to be considered in the case of a sub-letting:

- (1) The landlord may not grant consent to the tenant under its lease to carry out the works that are required to bring the property up to the minimum MEPS standard; and
- (2) The tenant may not have control of the parts of the building that need to be upgraded to meet the minimum MEPS standard. For example, if the tenant occupies one floor of a building, the exterior and windows of the building will not be included in the lease. Control over these elements will normally have been retained by the landlord, and only the landlord is able to carry out upgrading works.

This is discussed in paragraph (d) in Annex C. The suggested solution is that the tenant should not be liable to carry out works to parts of the building that are not within the premises that have been let to it.

SECTION C: APPLICATION POINT AT DIFFERENT STAGES OF A LEASE

This section looks at how the MEPS requirements can be applied at different stages of a lease.

It looks at the following possibilities:

- Simple grant of lease
- Works to be carried out by landlord or tenant before the lease is granted

Issues arising in relation to leases that are in place at 1st April 2018 when the MEPS requirements take effect are considered in Chapter 5.

i. Simple grant of lease

In normal circumstances, the property will be marketed and an EPC will need to be available as part of the marketing information, as required by the Energy Performance of Buildings Regulations.

If the property is below the minimum standard required by the MEPS requirements, this will be apparent from the EPC. In such a case, the regulations should state that the MEPS requirements should apply at the date of the grant of the lease, not the date when the marketing of the property starts.

In other words, a landlord should be permitted to market a property that has a rating below the minimum MEPS standard. This is because bringing the property up to the minimum MEPS standard may be expensive (should the landlord opt to undertake improvements outside of the Green Deal), and the landlord needs to be able to establish if there is any demand for the property at the rent required to make the works cost-effective. Indeed, it may make more sense to wait until negotiations have begun with an interested tenant so that the improvement works can be adapted to suit the tenant's particular requirements.

However, the landlord should still retain an obligation. It is suggested that where a property is being marketed with an EPC rating below the MEPS minimum standard, the landlord should provide information (ideally in the form of an investment grade audit or a valid Green Deal Assessment) as to what works are required to bring the property up to the minimum standard. This will inform both the landlord and the tenant during negotiations. It is important under such arrangements that the parties recognise that, for compliance to be achieved, works must be undertaken prior to execution of the lease, assuming no further works are in contemplation. The situation if they are is considered below.

ii. Works to be carried out by landlord or tenant before the lease is granted

It makes sense to permit a procedure under which either the landlord carries out the energy efficiency works at the same time as other works that it is planning to carry out, or the tenant carries out the energy efficiency works as part of its fitting-out works. This should be permitted, so long as the parties are able to show that there is a binding contract that one or other of the parties has agreed to carry out the works.

This will fit well into the existing agreement for lease structure. Where either the landlord or the tenant is to carry out works to a building before a lease is concluded, it is usual for the parties to enter into an agreement to bind both parties to complete the transaction. The works are then carried out and, after they are completed, the lease is granted.

In this case, the Working Group recommends that the parties be permitted to enter into an agreement for lease before the minimum EPC rating has been reached, so long as this agreement contains a binding commitment by either the landlord or the tenant to carry out the works, and agree that the lease will not be granted until those works have been completed. The Working Group was not able to arrive at a suitable option for monitoring compliance with this requirement and the issue merits further consideration.

It should follow that where a tenant is seeking to sub-let their space, they should be allowed to market the space even if it does not meet MEPS requirements at that point, and that an agreement for lease should be signed between the tenant and sub-tenant as to what works will be undertaken by them. Under standard lease terms, the landlord must not unreasonably withhold consent to a sub-letting and also must not withhold consent unreasonably to alterations to the leased space, which should ensure that the landlord will have some influence.

It will also be necessary to consider against whom any enforcement should be taken in the case of the tenant agreeing to carry out the works as part of its fitting out works and then failing to do so. Currently the legislation makes obligations upon the landlord alone. There is no legal provision for enforcement action to be taken against the tenant. Therefore landlords would need to take steps to ensure that tenants do not bring them into non-compliance through terms in their leases.

In operating a regime whereby a property which falls below the MEPS requirement can be marketed for let, it is necessary to consider how enforcement might operate where the landlord agrees to carry out the works and the tenant takes possession in the meantime (before the lease has been granted). This has not yet been considered in detail.

Chapter 7: Monitoring and Enforcement

RECOMMENDATIONS

1. Trading Standard Officers (TSOs) require greater support to carry out their role of enforcing EPC compliance and provide credible sanctions for those who do not comply (EPB follows civil sanction guidelines). TSOs would benefit from information and assistance in identifying rented properties and their EPC ratings. SDLT returns would be one avenue by which additional information about rented properties that ought to have an EPC could be provided to TSOs.
2. Consideration should be given as to whether it would be practical for an EPC to state whether a building is compliant with MEPS or exempt and if exempt, how long the exemption should last for. Attention would need to be paid to implications for property in the owner-occupied sector where such information would be irrelevant.
3. Industry-leading owners and occupiers should help to build the case for the benefits of better performing buildings, and industry trade bodies and the Government should promote them, in order to encourage EPC and MEPS compliance among SMEs.
4. Advisors to clients (whether owners or occupiers) have an important role to play in flagging risk of non-compliance with MEPS to their clients during the conveyancing process. Compliance should remain the liability of the client.
5. As compliance with MEPS can only apply to those buildings where there is an EPC, there is a risk that this creates a perverse incentive to not acquire one, and might discourage property owners from voluntarily obtaining an EPC. Government should take steps to mitigate this risk through credible penalties and more resourcing devoted to enforcement.

SECTION A: DELIVERING COMPLIANCE

i. Current levels of compliance with EPC requirements

There is a perception among industry that compliance with EPC requirements is low. Whilst it is regrettable that a high level of non-compliance is presumed in respect of EPCs as a market tool, it is far more of an issue when EPC ratings are used as a condition of granting a lease.

It has been noted in chapter 2 that the possession of an EPC is a precondition of being within the scope of MEPS.

It is highly likely that larger corporate landlords will fully comply with requirements for EPCs now and in the future, whereas owners of one or two property investments and smaller corporate landlords may either not be fully aware of their responsibilities or may risk fines rather than comply.

Introduction of MEPS without concerted action to encourage and incentivise compliance and to better enforce EPCs risks creating a disproportionate burden on the law-abiding participants in the property sector. This would be a perverse, unfair and unacceptable outcome. It would also not achieve change of the scale required, as it would significantly

impact on the penetration of the measure among the existing stock that is most likely to require upgrade.

SECTION B: CURRENT ENFORCEMENT ARRANGEMENTS

The legal basis for MEPS is set out in the Energy Act 2011, section 49, as follows:

- (1) The Secretary of State must make regulations for the purpose of securing that a landlord of a non-domestic PR property—*
- (a) which is of such description of non-domestic PR property as is provided for by the regulations,*
- (b) in relation to which there is an energy performance certificate, and*
- (c) which falls below such level of energy efficiency (as demonstrated by the energy performance certificate) as is provided for by the regulations,*
- may not let the property until the landlord has complied with the obligation mentioned in subsection [\(2\)](#).*
- (2) The obligation is to make to the property such relevant energy efficiency improvements as are provided for by the regulations.*

Section 51 provides for sanctions, identifies ‘local weights and measures authorities’ (TSOs) as the enforcement body, and enables civil penalties in the event of non-compliance or provision of false information about compliance. It also requires provision for appeals.

No definitive figures are available but it is thought that there have been few cases of enforcement of the existing EPB Regulations by TSOs against non-compliant property owners. Even in cases where fines are levied, they are capped at a value of between £500 and £5000 dependent on the rateable value of the building.

It would appear that where a property offered for rent does not have an EPC (legally or illegally), it will not have to comply with section 49. This has particular relevance to the discussion about hard or soft starts. It appears that where a property has not been let since the introduction of EPCs and has not been let since that time, it is not within the scope of a ‘hard start’, since it does not have an EPC and neither the Energy Act nor the EPB Regulations provide powers to require one unless the property is sold or let.

Current levels of compliance are perceived by industry to be unsatisfactory. The Group presumes that the Government would welcome an approach that boosted compliance. However, in a climate of constrained resources, a combination of regulation and market mechanisms may be a more pragmatic and equally effective approach. We have set out below a number of proposals for the Government to consider.

SECTION C: RAISING COMPLIANCE THROUGH EFFECTIVE ENFORCEMENT

i. Ensuring compliance with Energy Performance of Buildings Regulations requirements

We have suggested in Chapter 3 that the basis for MEPS should be an improved EPC, supported by a more robust methodology and improved assessor training.

Reference has been made above to the deficiencies in compliance monitoring and use of sanctions in order to ensure EPCs are obtained when required. Whereas compliance levels

should be higher today, while the EPC is solely a market information tool, compliance monitoring becomes even more important if EPCs form the basis of a regulatory regime.

The Working Group believes that compliance with EPC requirements has historically been low due to the under-resourcing of local TSOs, who consequently lack the means to enforce compliance. There appears also to be a view outside the “premier league” of the property sector that it is worth taking the risk of not complying, and paying the fine if challenged by a TSO. If having an EPC brings the property within scope of MEPS, this creates a much bigger incentive to avoid obtaining an EPC in the first place. A first step to ensuring appropriate MEPS compliance would be to ensure that EPCs are being commissioned, on transaction.

The Working Group believes that TSOs would be unlikely to be able to assist in MEPS compliance beyond these roles – i.e. to make sure that the market has the information it needs at its disposal. TSOs will not, for example, be sufficiently resourced or knowledgeable in building services and financing acumen to determine whether the value or Green Deal economic tests (see Chapter 4) have been satisfied or failed, and to determine on that basis whether a property owner or occupier is in breach of MEPS. For this reason in Chapter 8, we have set out a regime and identified individuals who might check whether compliance with MEPS has been met, or whether an exemption is valid (**Annex B**).

TSOs should perhaps also be empowered to enforce requirements for the display of EPCs by property owners within buildings frequently visited by the public, and in property advertisements, so that there is a credible risk for those property owners who fail to comply.

The Government may also wish to explore whether there is a role for HMRC. Given that SDLT is charged on lease transactions, this might be a way to monitor and enforce compliance with MEPS.

The Working Group suggests that if TSOs were better resourced to enforce EPC requirements, including the requirement to have a prominent display of EPCs in qualifying property and energy ratings in property advertisements, they would be more effective. Further, this could help to give the EPC the prominence it requires in order to propagate awareness of MEPS. However, even if enhanced and better financed, TSOs will not be sufficient to enforce the entire MEPS compliance process. As we have set out in Chapter 8 (and Annex B), a variety of individuals would need to contribute toward an expert view as to whether compliance has been reached, depending on a property owner’s circumstances and features of the building in question. Part of the challenge will lie in the fact that an F or G rated EPC on a building is not necessarily an indication of non-compliance.

In terms of fines, for many commercial property owners (and occupiers in the case of sub-lettings), a £500 to £5000 fine is relatively modest, and not proportionate to the costs avoided through non-compliance. Fines for breach of the Energy Performance of Buildings Regulations could perhaps continue to be on a sliding scale related to the capital value of the property (as they are now), but perhaps should be increased. Some local weighting may be necessary.

As we move toward the introduction of MEPS, auditing of the quality of MEPS will be critical to ensure that assessors, commissioned by property owners to conduct assessments, are not pressured to grant compliant ratings to properties where these are not correct.

Another difficulty is that EPCs are able to be granted for parts of buildings and for whole buildings. It is even currently possible for an EPC for a single demise within a building and an EPC for the whole building to be concurrent. Given the confusion which could arise in such circumstances, the Government's EPC guidance could provide advice as to whether the EPC for the whole building or the EPC for the individual demise should have primacy.

ii. Increasing the visibility of energy performance

Since 2008 individual non-domestic EPC records have been available free of charge from the Energy Performance of Buildings Register. From April 2012 register data has been publicly accessible via bulk data requests made by authorised recipients. The Working Group recommends that Government should investigate whether EPCs could show that a building is compliant with MEPS within the official format of the certificate. Such a change to the EPC would take time to implement and therefore the Group recommends that this should be initiated soon. The Government could also make it a more straightforward process to obtain this data – making the data available to valuers, agents, rent review experts could help to accelerate research into the effect of energy performance on the financial performance of assets, tenant preferences and so forth.

Further, article 12(2) of the recast EPBD clearly requires a copy of the EPC to be handed over to the buyer or tenant³². Article 12 (4) clearly requires Member States to legislate for the energy rating to be disclosed in any commercial media³³. To encourage compliance, there should be far greater promotion of this requirement to the property sector, including professional advisors and agents and lawyers. Compliance with MEPS could also be required on the advertisement, so that if not apparent the clear inference is that the building does not meet MEPS.

Combining all this leads to the recommendation that as disclosure of the energy rating is required on advertising a building, that information should be publicly accessible via the relevant national database (Energy Performance of Buildings Register or VOA), and professionals should be firmly steered by their professional or representative bodies to use those registers to obtain the ratings when placing property on the market or when viewing details.

iii. Professionals

The measures the Group have proposed so far have been geared towards compliance through credible sanctions, and raising awareness and increasing understanding of EPCs. However, it is equally important to ensure that there are appropriate checks throughout the

³² Member States shall require that, when buildings or building units are constructed, sold or rented out, the energy performance certificate or a copy thereof is shown to the prospective new tenant or buyer and handed over to the buyer or new tenant.

³³ Member States shall require that when:

- buildings having an energy performance certificate,
- building units in a building having an energy performance certificate, and
- building units having an energy performance certificate,

are offered for sale or for rent, the energy performance indicator of the energy performance certificate of the building or the building unit, as applicable, is stated in the advertisements in commercial media.

transaction process to ensure that the EPC is present, and that clients are made fully aware of any environmental or legal risk they are accepting.

Professional advisors such as lettings agents, surveyors and lawyers (as well as building control officers in respect of alterations) could play a role in flagging to clients (whether owners or occupiers) that the property is compliant or deficient in respect of MEPS. However, they should not have any legal responsibility for ensuring that their clients comply with their obligations in relation to MEPS.

In respect of lawyers, it may be possible to work with the legal profession to provide standard enquiries that seek information during a transaction as to the property's compliance with MEPS. This should include a valid EPC, requests for documentation demonstrating applicability of any exemptions, records of works completed and so forth. The lawyer can then advise the client whether or not the property is compliant, but nonetheless it would be the client that would bear liability for non-compliance.

Market-leading transactional agents, particularly when advising blue chip occupiers, will tend to seek to include information as to the 'total occupational cost' of occupying the building. Should this practice percolate throughout the industry, not only would notice of the energy performance of buildings feature more prominently in the concerns of occupiers but also, by extension, owners. One way to encourage wider adoption of such practice may be through working with the RICS to refine guidance on the consideration of sustainability matters in valuations. The RICS have reviewed and upgraded their extant advice to valuers (Valuation Information Paper 13 on Sustainability and Commercial Property Valuation³⁴) and this gives a strong steer to valuers to investigate and collect sustainability data more comprehensively for analysis and valuation purposes. This will include EPC data, where appropriate. However, as with lawyers, the Group does not propose that agents would acquire liabilities for compliance with MEPS – the Group believe that this belongs with the client, but a better advised client is more likely to comply.

MEPS compliance may also be assisted through efforts by market-leading owners and occupiers to set out what the potential benefits of better performing buildings are to the wider market. Industry trade associations representing owners and occupiers will have a key role to play in cascading awareness of such materials to their SME members.

³⁴ http://www.joinricsineurope.eu/uploads/files/sustainabilityandcommercialvaluation_2.pdf

Chapter 8: Exclusions and Temporary Exemptions

RECOMMENDATIONS

1. The number of exemptions from MEPS should be as few and specific as possible in order to present a clearly intelligible policy to the market. The assumption should be that all buildings and all lettings in which an EPC is required for a transaction should be subject to MEPS requirements, unless there is some provision to the contrary. Such provisions should be evidence based. We have set out our rationale for some exclusions and exemptions, the majority of which will apply only in uncommon and specific circumstances, in this Chapter.
2. The Government should ensure that it can exempt from MEPS any properties where an EPC was not required for a transaction but which has an EPC because it was obtained voluntarily.
3. In the case of exemptions triggered by a financing or a negative value safeguard (i.e. where all works possible through a Green Deal have been undertaken or where the energy efficiency measures would demonstrably reduce the property's value), the property should remain exempt until a change of occupier, renewal of a lease, the expiry of the EPC or five years since the exemption was triggered, whichever is the earliest. At that point the property would have to reach the minimum standard or demonstrate a further exemption.
4. In relation to consents from the tenant for the purposes of MEPS compliance, the evidence which a landlord should be required to produce should be such evidence as would enable the landlord to show that:
 - it has taken reasonable steps to obtain the relevant consent and/or
 - the consent was being withheld unreasonably or given subject to unreasonable conditions.

The burden should be placed on the landlord to prove that the exemption applies on the balance of probabilities. This evidence might consist of letters and other communications which have taken place between the landlord and the tenant.
5. In relation to lease renewals, the Working Group was unable to reach agreement on whether lease renewals should be covered by the MEPS requirements and recommend that this issue is consider further.

SECTION A: GUIDING PRINCIPLES

MEPS should complement existing requirements to obtain and display EPCs, and therefore all buildings and all lettings in which an EPC is required for a transaction should also be subject to the MEPS requirements, unless there is some other provision to the contrary.

This Chapter considers types of transactions to which the Group recommend the MEPS requirements should not apply (which the Group call 'exclusions') or specific situations where the MEPS requirements should temporarily not apply (which the Group call 'temporary exemptions').

There are three types of exemptions which are set out in the primary legislation:

- The landlord has been unable to obtain necessary permissions or consents to carry out the relevant energy efficiency improvements to the property;
- The relevant energy efficiency improvements are likely to have a negative impact on the value of the property; and
- The improvement is not financeable via the Green Deal or other description of financial arrangement yet to be announced.

There are two further types of exemption which the Working Group considered may be justifiably necessary, and should be the subject of consideration by the Government:

- The building is not one to which the Regulations should apply; and
- The type of lease transaction is not one to which the Regulations should apply.

The last is a particularly complicated area legally, because of the need to accommodate the extremely complex manner in which landlord and tenant law operates. It is also important to take into account the multitude of different ways in which commercial property transactions are structured.

The Working Group discussed the issues that follow at length. This was one of the particular areas where it was agreed that care needed to be taken to ensure that the commercial property market is not adversely affected by the introduction of MEPS, while ensuring at the same time that loopholes are not created and that the policy is readily intelligible to the market.

The Working Group thought that in the case of economic tests (i.e. negative value, Green Deal), the exemption should last until a change of occupier, renewal of a lease (outside of the 1954 Act potentially – see Chapter 8 section F), or five years since the exemption was triggered, whichever is the earliest. The landlord would then have to prove that the exemption was still valid for the property, a new exemption was available, or comply with MEPS.

SECTION C: EXEMPTIONS BASED ON OBTAINING THE NECESSARY PERMISSIONS OR CONSENTS

i. Background

There are three types of consent that may need to be obtained in order to undertake relevant energy efficiency improvements:

- consent of another person with an interest in the building where consent is required to the carrying out of the relevant energy efficiency improvements (N.B. this could include a superior landlord or mortgagee);
- consent of another person with an interest in the building where consent is required to the taking out of Green Deal finance; and
- planning permission or other consent which may need to be obtained from a public authority.

ii. *Obtaining Consent from a Tenant or a Superior Landlord*

The Energy Act 2011 makes provision for the secondary legislation to determine, among other things, exemptions relating to any necessary permissions or consents required in order to carry out relevant energy efficiency improvements.

It seems reasonable to the Working Group that in order to activate an exemption under the Regulations a landlord should take reasonable steps to obtain any necessary permissions or consents. Accordingly, the Regulations could provide that a landlord can obtain an exemption where, having taken reasonable steps to obtain any necessary permissions or consents, he has been unable to do so. Therefore where a superior landlord or a tenant has refused consent to improvement works and/or a Green Deal charge, a landlord should be required to produce such evidence as would enable the landlord to show that:

- it has taken reasonable steps to obtain the relevant consent and/or
- the consent was being withheld unreasonably or given subject to unreasonable conditions.

The burden should be placed on the letting party to prove that the exemption applies on the balance of probabilities. This evidence might consist of letters and other communications which have taken place between the landlord and the superior landlord or tenant.

There is a considerable body of case law on the nature of 'reasonableness' and the Group believes it would be best left to the courts to decide in disputes whether a landlord has acted reasonably. This would ensure that a landlord would not have to meet any terms that were imposed by the superior landlord or tenant on the giving of consent where the tenant's terms were unreasonable (such as a request for a payment or benefit from the landlord). Existing safeguards within the lease would ensure that a tenant's rights were protected.

It is likely that the Regulations will stipulate certain reasons when it is reasonable for a party to refuse consent. For example, the Equality Act 2010 (Disability) Regulations 2010 (made under the Equality Act 2010) set out circumstances in which a landlord's withholding of consent to alterations is reasonable and when it is not reasonable.

It may be possible for a similar structure to be adopted in relation to the regulations that will implement the MEPS requirement. This is relevant in the following way. A landlord will often have to seek consent from existing tenants to carry out alterations. In this context, it is important to appreciate that tenants will have two distinct concerns when a landlord asks for consent to carry out improvement works under the Green Deal:

- **the physical impact of the works** – what works are to be carried out, how they will affect the tenant's use of the premises, and how much disruption will be caused to the tenant's business while the works are being carried out; and
- **the financial impact of the works** – if the tenant is being asked to consent to the landlord entering into a Green Deal, this will have a financial impact upon the tenant, who will be required to pay the repayments as part of payment of the electricity bill. A tenant may be reluctant to consent to this, as there is no guarantee that the Green Deal repayments will be covered by the reduction in energy costs. In theory, this should only be relevant as an issue under a hard or comprehensive hard start, since under a soft start, landlords would seek to introduce lease clauses which obliged the tenant to contribute to the Green Deal charge. Of course, there is the possibility that the tenant

may refuse to accept such clauses – this will depend upon the relative bargaining power of the landlord and the tenant in each case.

iii. Obtaining Consent where Beneficial and Legal Ownership are Split

This issue was not considered by the Working Group in detail, and merits further consideration. In short, in some circumstances, the legal title and the beneficial ownership of properties are split. This may be to permit a number of parties to share the risk and reward of ownership of a property, among other reasons.

Commonly, the legal owner will have the responsibility of sanctioning requests from tenants to assign or sub-let, and to carry out alterations to their property. Ordinarily, the legal owner will be aware of what the scope of their authority is in this regard, but consent to Green Deal Finance may be something that has not been the matter of previous discussions between the legal owner and the beneficial owner(s). It is therefore pertinent to examine how MEPS will function where the legal and beneficial ownership of properties is split.

iv. Obtaining Consent from Relevant Authorities (Planning and Building Control)

This requirement will only apply to energy efficiency improvements which require the consent of relevant authorities. The Group presumes that the landlord would be required to obtain the burden of proof pursuant to an exemption, but that a letter from Building Control or a Planning Authority should be sufficient to demonstrate where consent has been withheld.

It would be important that the landlord should demonstrate, when taking advantage of a whole or partial exemption, that the measures he/she planned to undertake were the only way the building could reasonably (or cost effectively according to a Green Deal Assessment) have been uprated.

v. Obtaining consent from a landlord's lender

Lenders were not represented on the Working Group and therefore this issue was not discussed. It therefore is appropriate for the Government to further explore the issue.

SECTION D: FINANCING AND NEGATIVE VALUE EXEMPTIONS

i. Background

The Act says that the regulations may include 'provision about exemptions from any requirement imposed by or under the regulations' and specifically refers to a possible exemption 'relating to the likely negative impact on the value of a property of complying with a requirement imposed by or under the regulations, which, under the Energy Act 2011, are those which can be 'wholly paid for pursuant to a Green Deal plan' or 'financed by such other description of financial arrangement as the regulations provide'. The latter has not been the subject of Working Group discussion and the Group concentrate in this section on the former.

ii. Green Deal Exemption

The Group understands the Green Deal financing exemption to work on the principle that all measures identified under a Green Deal Assessment for the property that conform to the 'Golden Rule' must be made to the property (subject to other exemptions provided to the landlord) prior to the grant of any exemption under MEPS.

The Group believes that in this case, the burden of proof should again belong with the landlord. The landlord should be required to demonstrate that either a) a Green Deal has been undertaken on the property, and that all measures which were financeable via a Green Deal, and met the Golden Rule, were undertaken or b) provide evidence to suggest that a Green Deal Assessment has been undertaken and that no measures meeting the Golden Rule are appropriate for that property. At present, the Green Deal Assessment does not provide quotes for the installation of improvements or Green Deal finance, and therefore a Green Deal Assessment which identified no cost-effective improvements would alone not be sufficient as proof of compliance. It would be necessary for the Government to determine a mechanism for the Landlord to show that he has complied in such cases.

The Group understands that the Green Deal is likely to be means-tested, but it is unclear at this point what the eligibility test would be for commercial enterprises seeking non-domestic Green Deal Finance. In other words, the question which should be answered is should the exemption apply where Green Deal Finance is available in theory, but is not obtainable by that particular landlord in fact?

The Group raised that some landlords may not wish to take forward Green Deal finance, and therefore there may be merit in exploring offering an additional way of demonstrating reasonable improvements had been undertaken, outside the Green Deal Golden Rule calculation.

iii. Exemptions based on any negative effect on the value of the property

The Group has set out in Chapter 2, Section B, that there could be benefits to be obtained in terms of investment worth for those property owners who have improved their properties, and the anticipation that a more energy efficient building in the future may suffer less risk to its yield than a building that is less efficient.. Pending the development of the latter, the Group recommends below a number of value-based exemptions which are designed to ensure that, in very specific circumstances where a property owner is likely to harm the income potential of his/her asset, MEPS compliance is subject to an exemption:

- **General Diminution** - There is an obvious risk to value if there are qualifying improvements that, for some reason, diminish the overall quality, character or appeal of a building. For example, energy efficiency improvements that reduce the net lettable floor area (NLA) of a building would have a direct and measurable impact on the amount of rent receivable and therefore the capital value. The diminution would be relatively easy to calculate with a "before" and "after" valuation. Value could also be diminished if the market does not trust the installed technology to perform.
- Energy efficiency improvements which simply make a building less attractive would be more difficult to prove as this is more subjective. A possible way to arbitrate whether an exemption is warranted could be to require an independent valuation to be conducted,

relying on a valuer's expertise and market knowledge. A RICS valuer will have to establish whether the increase in potential rental income from a better EPC-rated building will outweigh the loss of rental income from a decrease in floor area. To avoid potential abuse of this provision, the working group proposes that the negative value must be material; interpretation of 'material' being ultimately for the courts to decide.

- **Accelerated costs** - there may be instances where the required improvements can be achieved more effectively and/or at a lower cost at a later date than MEPS would first apply (for example, when the whole building is vacant). The later date could be specified, and the lower costs proven via an independent development appraisal. For example:
 - It is generally assumed that the cost of works will be significantly lower when a building is vacant, and that a number of effective improvement measures cannot be installed whilst a building is in use.
 - Works which would raise the EPC rating above the minimum threshold might have to be deferred due to tenant occupation, leaving landlords with an obligation to undertake less cost-effective improvements in the meantime in order to meet MEPS regulations.
 - If the deferred works involve the removal or significant alteration of the compliance-motivated works, presumably the compliance-motivated works would not qualify for a Green Deal as the short lifetime of the improvement would make it hard for the works to pass the 'Golden Rule' test. If there is no overlap between the two sets of works, the overall energy efficiency of the property would be improved but less cost-effectively, especially in comparison with other properties where the required works can be achieved at a lower cost through undertaking all qualifying works simultaneously. These higher costs may have a detrimental impact on value.
- The Working Group considered whether the regulations should allow landlords to defer their obligation to comply with MEPS for a limited period if they are able to prove that the improvements can be achieved significantly more cost-effectively at a specified future date or that more significant improvements will be achieved by deferring the works. They concluded that, given the potential relationship between consideration of postponement of works so that compliance can be packaged with wider upgrades, and the feasibility test for consequential improvements under Part L of the Building Regulations³⁵, it should be recommended that property owners could obtain temporary, time-limited waivers from TSOs granting them the ability to continue to let the property. In the event that a property with a time-limited waiver is sold to a new owner, the liability to comply with MEPS should transfer to the new owner along with the temporary exemption.
- **Shortfall in cost recovery** - There is a further risk to value if there is any disconnection between the party making the loan repayments and the party getting the benefit of the reduced energy costs. The normal arrangement is for the tenant to pay for electricity,

³⁵ Such requirements under Part L only apply to buildings larger than 1,000 m² and where the building's carbon footprint is being increased

either direct to the supplier, through a service charge or by reimbursing the landlord 'on demand'. There could be a problem in multi-tenanted buildings if the wording of leases does not allow the landlord to recover Green Deal repayments but obliges landlords to pass on energy charges 'at cost' (since it is generally thought that Green Deal repayments are not 'energy charges' in themselves). Given that the Green Deal charge applies to the electricity meter, there is a further complication if the measures reduce heating demand and therefore reduce the gas bill rather than the electricity bill.

- There is no disconnection if the landlord charges an all-inclusive rent, as the landlord is the party paying the costs and receiving the savings, or if the tenant pays directly to a supplier as the tenant pays the cost and receives the savings. However, few landlords favour inclusive rents as they give no incentive to the tenant to reduce consumption.
- In some circumstances landlords may be compensated for non-recoverable costs through enhanced letting terms (higher rents, better tenants, longer leases etc) but this is not guaranteed, being dependent on prevailing market conditions, and the type and location of the property.
- The Working Group does not recommend the inclusion of a specific exemption where Green Deal costs cannot be passed through to occupiers. This would risk creating a loophole and a perverse incentive not to seek arrangements whereby Green Deal charges may be passed through (as not having an avenue would provide an exemption). Furthermore it can be expected that as the Green Deal market develops, leases will be drawn up with provisions that state how Green Deal charges are to be treated. Should a soft start apply the issue of pass-through of Green Deal costs would be less pronounced as arrangements can be agreed before a tenant occupies. However if some types of lease *renewals* are included in due course, the situation would arise (see section G of this chapter).
- **Interrupted benefits** - there is another risk to value – which probably will be the most common – which will arise where there is a significant discrepancy between the length of a Green Deal loan and the period during which a building is in use, for example void periods between lettings when the landlord will have to make the repayments but is not benefitting from any energy savings. This may particularly be the case where demand for the asset has declined, with the current high vacancy rates among town centre retail units and secondary provincial offices providing very stark examples.
- In many cases, the amounts will be relatively insignificant and short term, but in others it could be more material and, for some properties, may undermine the viability of lettings, which in some locations could be damaging for the local economy.
- Unless loan repayments can be suspended during void periods (which probably is not practical), there ought to be a feasibility test that has regard to the length of leases, frequency and duration of voids and gives an exemption when the negative effect on net cashflow is 'material'. The non-domestic Green Deal methodology is capable of calculating historic voids to adjust the Golden Rule, so there are mechanisms already in place within the methodology to consider issues such as interrupted benefits.

Included at **Annex B** is a schedule with each of the above risks to value, and potential feasibility tests to determine whether or not a value-based exemption should apply. The set of definitions for what may qualify for a value-based exemption should reflect the value risks

identified above, accompanied by a set of economic tests relevant to each type of value risk which would have to be satisfied in each case. The definitions must be tightly drafted to avoid loopholes that could undermine the policy.

SECTION E: BUILDINGS THAT COULD BE EXCLUDED FROM MEPS

i. Buildings that do not require EPCs

Two specific issues need to be considered:

- The Working Group considered whether a building should be within MEPS where it is a type of building where an EPC was not required to be obtained but where an EPC has in fact been obtained (such as a building within the exemption for religious buildings or where a property owner has for portfolio analysis purposes obtained EPCs for the majority of their portfolio ahead of any formal requirement). The Working Group's view was that the fact that an EPC has been obtained voluntarily should not bring MEPS into operation for that building.
- The Working Group indicated that industry would welcome scenarios to support guidance on the precise circumstances in which heritage properties do not require an EPC, as provided for in the Directive, whereby an exemption is given to "buildings and monuments officially protected as part of designated environment or because of their special architectural or historic merit, where compliance with the requirements would unacceptably alter their character or appearance."

ii. Buildings that are about to be demolished

A building that has been granted planning consent for demolition should not be required to meet MEPS (as is set out in the Non-Domestic EPC Guidance). It would be a waste of resources to bring up to E standard a building that is about to be demolished. Buildings that are to be demolished are currently exempt from having to obtain an EPC and this exemption should be carried through to MEPS.

iii. Buildings below a certain size or value

In relation to size thresholds, currently there are no size thresholds for the EPC requirement, except that standalone buildings under 50m² are exempt from the need for an EPC. There seems no reason to introduce any other size threshold to MEPS than what is already required for obtaining an EPC.

The Working Group considered the merits of including a value threshold for MEPS but concluded that the difficulty of ascertaining accurate values for buildings means that this is not desirable. Moreover, values of commercial properties differ across the UK and it would not be practicable to choose a particular value under which buildings are exempt from the MEPS requirements.

iv. Buildings below a certain energy consumption

Apart from an exemption for buildings that are 'low energy use' in the EPC regulations, all buildings need an EPC. It is not logical to exempt any other buildings that are below a certain level of energy consumption for the purposes of MEPS.

SECTION F: LETTING TRANSACTIONS THAT COULD BE EXCLUDED FROM MEPS

There are some types of lettings transactions that may merit consideration for a complete exclusion from MEPS, taking into account the need to ensure the regulations are as effective as possible, whilst also ensuring that only appropriate lettings are within scope.

Exclusion of generic letting transactions may appear to be against the spirit of MEPS, but leases are used in a large number of different ways in the property industry and there are logical reasons why exclusion is being suggested in certain cases. In practice this may not exclude many individual transactions but this does not mean that they are unimportant.

Care needs to be taken that these suggested exclusions are not capable of being used to avoid the operation of MEPS entirely. The Group has suggested how this could be done in certain cases within Annex B.

In summary, the suggested categories for potential consideration are:

- (a) where the landlord has no choice over granting the lease, either because it is required to grant the lease by a pre-existing agreement between the parties, or is required by law to grant the lease to the tenant (please see Annex C and Section G below for more detail on the types of transaction in question).
- (b) where the letting is for a very short term (perhaps six months or less), since the cost to the landlord of complying with the MEPS requirements is likely to exceed the landlord's return from granting the lease, and landlords would therefore be dissuaded from granting leases for short terms
- (c) where the transaction is more akin to a sale than a letting, although it is being accomplished through the grant of a lease for reasons connected with landlord and tenant law.
- (d) sub-lettings of parts of buildings in circumstances where the tenant does not have control of the whole of the building

Annex C contains further details of the reasons for these suggested exemptions, and examples falling within each of these different categories of exemptions.

SECTION G: LEASE RENEWALS AND RE-GEARS

Lease renewals and re-gears are a difficult area in relation to MEPS, for the reasons that appear below. Members of the Working Group were not able to reach agreement on how lease renewals and re-gears should be treated under MEPS. Accordingly this is an area recommended for further consideration. The Group has set out the main issues below:

(A) According to the Government's guide on EPCs for commercial buildings, no EPC is needed for a lease renewal³⁶. On that basis, all renewals of leases where a building does not already have an EPC will be outside the scope of MEPS entirely. On balance the Working Group thought that lease renewals should require an EPC (see chapter 5, section A, part iv)

(B) The Landlord and Tenant Act 1954 gives most tenants of business premises a statutory right to be granted a new lease at the expiry of their existing lease, so the landlord has no choice over whether to grant a lease or not. If the landlord will not grant the new lease by agreement, the tenant can ask the court to order the landlord to grant it, and the court has power to fix the terms of the new lease and the rent the tenant has to pay.

Some members of the Working Group therefore considered that leases where the tenant has the protection of the Landlord and Tenant Act 1954 (which we call "1954 Act Leases") should be excluded from the MEPS requirements, since the landlord has no choice but to grant the new lease. If such a lease were not excluded, the landlord would be under a legal obligation not only to grant the new lease to the tenant, but also to bring F and G rated buildings up to the minimum standard before granting the lease.

Those members of the Working Group also considered that this exclusion should apply to any renewal of a 1954 Act Lease even if the parties voluntarily agree the terms of the new lease between themselves without resorting to the court. Very few cases of lease renewal actually reach the court. The fact that the court has power to order a new lease to be granted if the parties cannot reach agreement is normally enough to persuade the parties to reach agreement.

Other members of the Working Group believed that renewal of 1954 Act Leases should not be entirely excluded from the MEPS requirements. They believed that the landlord should be required to ask the tenant for consent to carry out the necessary works (as explained in Section B of this chapter, above). This would involve the landlord asking the tenant to consent both to the physical works being carried out by the landlord within the tenant's premises (while the tenant is still carrying on its business in the premises), and to the landlord entering into a Green Deal plan (which would require the tenant to repay the Green Deal loan through the levy on the electricity bill). If the tenant does not give its consent, then the landlord would not be under any obligation to meet the MEPS requirements.

(C) Even where a lease is being renewed that is not a 1954 Act Lease (so that the tenant does not have a statutory right to a new lease), the tenant will be in occupation of the premises carrying out its business, and will not wish its business to be disrupted by the landlord carrying out works to comply with the MEPS requirements.

It might therefore be equally logical to exclude leases that are being renewed where the lease is not a 1954 Act lease (usually called a 'contracted-out lease').

On the other hand, however, many leases are renewed several times and if voluntary lease renewal transactions were to be excluded, it could delay implementation of the energy efficiency improvements for many years. A solution would be as above – to require the

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/50268/A_guide_to_energy_performance_certificates_for_the_construction_sale_and_let_of_non-dwellings.pdf

landlord to ask the tenant for consent to carry out the necessary works (again meaning consent to the works and consent to the Green Deal plan). If the tenant does not give its consent, then the landlord would not be under any obligation to meet the MEPS requirements.

A third option, in the case of leases that are not 1954 Act Leases, would be to require the landlord to comply fully with the MEPS requirements, which would be likely to disrupt the tenant's business.

In summary, there are a number of different options and they differ depending whether the lease is a 1954 Act Lease or not.

For renewals of 1954 Act Leases (where the landlord is legally bound by the Landlord and Tenant Act 1954 to grant a new lease)

- Excluded from MEPS requirements entirely; OR
- The landlord is required to ask the tenant for consent to carry out improvement works and to enter into a Green Deal plan, but if the tenant will not consent then the landlord is not required to carry out any works

For renewals of leases that are not 1954 Act Leases (where the landlord is not legally bound to grant a new lease)

- Excluded from MEPS requirements entirely; OR
- The landlord is required to ask the tenant for consent to carry out improvement works and to enter into a Green Deal plan, but if the tenant will not consent then the landlord is not required to carry out any works; OR
- The landlord is subject to MEPS requirements and therefore the tenant will need to put up with any disruption that the landlord's improvement works cause to its business

The Government is recommended to consider the merits of the above proposals.

(D) The issue of lease re-gears may also need to be explored. A lease re-gear takes place where the landlord and the tenant agree to replace the existing lease with a new lease, before the expiry of the existing lease. This normally gives the tenant either a longer term, or a lower rent (or both). Lease re-gears should perhaps be treated in the same manner as renewals of leases that are not 1954 Act Leases.

Chapter 9: Paying for Energy Efficiency Improvements and Associated Costs

RECOMMENDATIONS

1. Given the potential limitations on a landlord to recover the full cost of required energy efficiency improvements it is most important that the impact assessment for MEPS in the non-domestic sector is evidence-based, and assesses the costs of meeting requirements under the regulations. Industry is encouraged to assist government with the provision of evidence on typical costs relating to energy efficiency upgrades and regulatory compliance to aid this process.

SECTION A: WHO IS LIKELY TO BEAR THE COST OF COMPLIANCE?

This chapter considers two separate issues under the general heading of costs. First, who in practice is likely to bear the cost of making energy efficiency improvements in order to comply with the MEPS regulations. Secondly, whether there are any ancillary costs that will be borne by landlords other than the direct costs of making energy efficiency improvements.

Where MEPS applies to new lettings it is expected that the division of costs (whether through an on-going Green Deal repayment liability, or other funding arrangement) would form part of the lease negotiation process. However it is important to recognise that the issues raised below would need to be considered where MEPS applies to situations where there is a sitting tenant (in the case of a comprehensive hard start, hard start or where there is a backstop date).

Cost of energy efficiency improvements

Where landlords carry out energy efficiency improvements to a building, the costs may be capable of being recouped from the occupying tenants of the building, where these are replacements of kit due to wear and tear and on a like-for-like basis, but improved kit is likely to be a cost borne by the landlord.

i. Landlord funds the works itself or borrows the money

Where a landlord uses its own money to improve the building, or borrows the money, the landlord would not expect to be able to recoup the cost from the tenants. Tenants (whether in the building at the time of the carrying out of the improvements, or occupying the building at a later time) normally pay for maintenance, repair and replacement at end of life of a building fabric and services, but not the cost of improvements unless by agreement with the tenant through a separate and prior arrangement.

So a landlord that carries out improvement works without prior agreement with the tenant will only be able to recoup its investment by being able to charge a higher rent for the property when it is next re-let, and (possibly) by an increase in the capital value of the building.

ii. Landlord uses the Green Deal to fund the works

The position may be different, however, where Green Deal finance is used to fund the energy efficiency improvements. In that case, the cost of the repayments will be included within the electricity bill relating to the relevant property:

- where the improvements relate to the whole of the building and the tenant takes a lease of the whole of the building, the repayments will be included in the tenant's electricity bill; but
- where the improvements relate only to the common parts of the building (e.g. air conditioning equipment), or where the tenant is taking a lease of only part of the building, the repayments will probably be included in the landlord's electricity bill. Whether the landlord can collect the repayments from the tenant depends upon the terms of the lease (see below); and
- Where the improvements relate to some tenant areas, the repayments may still be included within the landlord's electricity bill (if there is only one incoming main meter) and whether the landlord can collect the repayments from the tenant for which the improvements relate depends upon the terms of the lease.

iii. Occasions on which the landlord cannot recoup its expenditure from the tenant

Even where the landlord has used green deal finance, there are still two occasions where the landlord may be left bearing the cost of the repayments.

- Where the terms of the lease do not permit the landlord to pass the costs to the tenant. Whether the landlord can collect the Green Deal repayments from the tenant (when the Green Deal repayments are payable by the landlord) will depend upon the terms of the lease between the landlord and the tenant. Some leases will allow the landlord to recoup the money from the tenants (especially more modern leases) whereas others will not. A lease typically contains a list of items towards which a tenant is expected to contribute, and "Green Deal repayments" is unlikely to feature in any leases apart from those granted very recently (and in many cases it will not be mentioned in even those granted very recently). So if the service charge schedule does not mention Green Deal repayments, the landlord will not be able to charge these to the tenants (unless the tenant expressly agrees otherwise).
- Where the property is unoccupied but there are still Green Deal payments to be made (i.e. where the repayment period was longer than the term of the lease, or the first date on which one of the parties could terminate the lease). Where there is no tenant in occupation of the property (for example one tenant has left and the landlord has not yet found a new tenant to take its place), the cost of making the Green Deal repayments will revert to the landlord.

Associated costs

Apart from the direct costs of making energy efficiency improvements to their buildings, landlords are likely to incur some or all of the following indirect costs of complying with the MEPS regulations:

- The loss of income while energy efficiency works are being carried out

- Empty property rates while the building has been empty (facilitating works) for at least 3 months³⁷
- Internal management time
- Potential compensation to the tenant on disturbance
- Legal due diligence
- Project management in the case of major works
- Potential unforeseen additional works required to correct hidden defects which are uncovered by works pursuant to a Green Deal Package/MEPS compliance
- Making good following installation of energy efficiency measures
- Fees for health and safety compliance, including any inspection fees

Whether the above would apply, and the exact size and nature of the cost, would depend on a number of factors. It is therefore difficult to quantify the scale and proportionality of these in any meaningful way.

³⁷ <https://www.gov.uk/apply-for-business-rate-relief/exempted-buildings-and-empty-buildings-relief>

Chapter 10: Plan beyond 2018

RECOMMENDATIONS

The Working Group agreed that if it is the intention of the Government to ratchet up MEPS in the future, the Government should set out a clear trajectory in advance. In the light of the issues outlined above, it was agreed that this trajectory should:

1. **Be linked to Government's wider energy and carbon saving objectives** – the chosen trajectory should reflect the contribution that the sector can cost-effectively make to the UK's carbon targets as well as the impacts of other policies on the sector.
2. **Take into account any changes that could effect EPC calculations** – changes to the EPC methodology or EPC software tools can affect the carbon benchmark which underlies the headline A to G rating. Government should ensure that changes are known in advance wherever possible to avoid any unanticipated changes to building ratings, not relating to physical building alterations.
3. **Harmonise with other energy efficiency policies to avoid conflicting requirements** – the commercial property sector is impacted by a plethora of energy and carbon regulations. In developing the MEPS regime, Government must ensure that it is aligned with existing policies, in particular the Energy Saving Opportunities Scheme, or ESOS (i.e. as an ESOS assessment determines cost-effective improvements, it may be an appropriate alternative to the Green Deal test to determine which measures must be undertaken to improve the property).
4. **Provide sufficient warning of tightening of standards for industry and the supply chain to prepare** – work to set the trajectory should be undertaken as soon as possible so that the wider industry can make timely preparations. This, in itself, is likely to stimulate earlier and deeper retrofit, since there will be technical and cost benefits in making one significant intervention rather than several piecemeal refurbishments.
5. **Be clear and easily understood by the whole industry, including smaller owners and occupiers.** – as discussed in Chapter 7, significant efforts should be made to ensure that the chosen trajectory is pro-actively communicated to the industry, with particular attention given to smaller organisations that may otherwise be caught unawares.

SECTION A: THE CASE FOR A TRAJECTORY

The Carbon Trust Report 'Building the Future Today'³⁸ suggested that in order for the non-domestic built environment to deliver its apportionment of the 2050 target, the average building rating according to the Display Energy Certificate methodology would have to be four grades higher than it was at the time of writing. While this report was based on a 'best guess' model which made a number of reasonable assumptions, there is the possibility that further targets will be required post-2018 in order to encourage the non-domestic stock (barring some exemptions) toward overall higher ratings.

If further targets are to be introduced by the Government, property owners should be allowed to make informed and timely investment decisions that will minimise costs and risks, and maximise beneficial outcomes. As such, the Working Group members frequently cited the long-term trajectory for MEPS regulations as being amongst the most important elements of the legislation.

If MEPS are to be tightened over time, and progressively better ratings are to be enjoyed in the Privately Rented Commercial Sector (PRS), this begs the question as to whether owner occupiers will make progress at the same rate. It may be necessary, in order to ensure that the owner occupied stock does not lag behind the PRS, to introduce further measures or MEPS outside the PRS. To do otherwise could also restrict the flexibility of the market for owner occupier, where, should they wish to let part of their excess floor space, they may find that they are unable to do so until building upgrades are completed.

SECTION B: OBJECTIVES FOR SETTING OUT PLANS BEYOND 2018

Putting in place a credible plan for MEPS beyond 2018 is critical to industry certainty, and will provide the basis for cost-effective compliance strategies. It is also essential to the supply side to enable it to plan appropriately to provide the capacity to deliver large-scale building refurbishment. Importantly, with clarity over the long-term challenge they face, there is the potential for organisations to voluntarily go beyond whatever minimum standard is chosen as a starting point as a means of minimising costs and mitigating risks, including taking a longer-term investment horizon.

One critical benefit of setting a clear trajectory is that doing so can help to reduce complexity, and experience shows that such long term clarity and certainty can often be more important to industry than creating a policy that works perfectly for everyone in all situations. For example, the choice over a more or less 'soft' start (see Chapter 6) may arguably be less important if those that are initially exempted are, nonetheless, encouraged to take action knowing that any delay may leave them facing a steeper hill to climb in the future. The same may apply in the case of some of the other (temporary) exemptions [and may even reduce the need for those exemptions in the first place].

In setting a trajectory, Government can also ensure that the sector is making an appropriate contribution to the UK's legally binding carbon targets. Insofar as it would encourage early

³⁸ <http://www.carbontrust.com/resources/reports/technology/building-the-future>

action, an appropriately ambitious trajectory could also serve to reduce the demands placed on other areas of the economy, and to ensure that overall national targets are achieved more cost-effectively.

SECTION C: THE PROCESS FOR SETTING A TRAJECTORY

As with the initial minimum standard, it is expected that any proposed trajectory would be set following a robust impact assessment. Complexities will arise due to the unknown nature of future changes to building regulations, and their consequent impact on EPC ratings. However, it should be possible to start with an assessment of the contribution that the sector can reasonably make to the achievement of 2050 targets, and to work backwards from that point in developing the steps on the trajectory. A similar process to this has already been followed in respect of zero carbon homes.

By taking real care in the initial trajectory-setting exercise, Government can also avoid later adjustments that may undermine confidence in the industry and add to compliance costs.

SECTION D: KEY AREAS OF CONCERN

In reaching these conclusions, the group identified a number of areas of concern that should be taken into account.

- **Linking the timetable to lease lengths** – it may be helpful to ensure that steps in the MEPS trajectory are not shorter than typical lease lengths. In doing so, Government would make it easier for landlords to undertake retrofit work during breaks between tenancies, reducing associated costs.
- **Lease renewals:** – it is important to consider the implications for lease renewals of their inclusion within the scope of a future timetable (see Chapters 5 and 6).
- **Hard or soft steps?** – when designing and communicating the trajectory it should be made clear whether steps are ‘hard’ or ‘soft’ (i.e. whether they apply to all leases at that point in time, or only to new leases after that point). Hard steps (post 2018) would be more acceptable to industry if the trajectory is sufficiently clear and published suitably far in advance to allow organisations to plan accordingly, and if there is seen to be an effective compliance mechanism so that the policy is effectively delivered across the sector, and not just by the leading edge.
- **Co-ordinating MEPS steps with adjustments to the EPC methodology** – it may be necessary to ensure that changes to the EPC methodology are co-ordinated with step changes in the MEPS trajectory. This would help to ensure landlords have confidence that an EPC rating is valid for the duration of a MEPS phase. However, this has implications for the management of building regulations.

Annex A – Acknowledgements

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Annex B - Schedule of Potential Risks to Value to be Covered by An Exemptions Regime, and Methods of Arbitration

The Group identified the following potential risks to value in complying with MEPS, listed in the left column of the table below.

The Government may wish to consider further the following options, striking a balance between risk of “loop-holes” undermining the effectiveness of the regulations, administrative simplicity and cost when approaching exemptions.

Risk to Value	Scenario	Feasibility Test	Challenges to implementation
General Diminution	That the energy efficiency improvements materially reduce rental and/or capital values e.g. through reducing the net lettable floor area	‘Before’ and ‘After’ valuation by an accredited RICS valuer	Does any diminution qualify or is it restricted to ‘significant loss’ of value? In which case, how to define ‘significant’?
Accelerated costs	That the improvements would be more extensive or cost less if deferred	An assessment proving enhanced saving or cost reduction through deferring the works	The date of deferred works must be known (e.g. guaranteed vacant possession of a building) and evidenced but should there be a maximum period of permitted deferral?
	The qualifying works will be superseded by subsequent events (e.g. the refurbishment of the building)	An assessment of the expected lifespan of the improvements having proper regard to known future events as well as the physical lifespan of the works	The exact timing of some future events will be unknown at the time of the Green Deal assessment. What evidence would be needed to prove that the lifespan of an improvement will be shorter than its general durability?

Annex C – Types of Transactions for Which There are Valid Reasons for Exclusion from the Scope of MEPS

This annex contains examples of letting transactions that it is suggested could be considered as potentially being excluded from MEPS (see chapter 8, section E)

The four categories of letting transactions that it is suggested could be excluded from MEPS requirements are:

- (a) where the landlord has no choice over granting the lease
- (b) where the transaction is short-term only
- (c) where the transaction is more akin to a sale than a letting, although it is being accomplished through the grant of a lease for reasons connected with landlord and tenant law
- (d) sub-lettings of parts of buildings

Examples of each are provided below.

(a) where the landlord has no choice over granting the lease

The Working Group proposed that these lettings should be outside the scope of MEPS because the landlord has no choice over granting the lease to the tenant.

(1) **Existing contractual arrangements** – a lease granted under a contractual obligation to grant it that had been entered into before the MEPS requirements came into force. This is a standard exclusion for virtually all new legislation.

(2) **Lease granted to a guarantor following the insolvency of the tenant** – a lease granted in circumstances where a tenant has become insolvent and (as previously agreed) the tenant's guarantor is taking over responsibility for the lease obligations. Technically this is achieved by the grant of a new lease to the guarantor for the balance of the original lease term.

(3) **Statutory overriding lease** – a lease granted under section 19 Landlord and Tenant (Covenants) Act 1995 where the current tenant has defaulted and the landlord has a statutory obligation to grant a new lease to a previous tenant if the previous tenant calls for it. The previous tenant is entitled to call for a new lease to be granted if it resumes paying rent for the premises.

(4) **A lease granted by order of the court.**

(5) **A lease granted by operation of law.** On occasions English law deems a new lease to be entered into between the parties even if they did not intend to do so (eg where the extent of the premises is being enlarged). It would be impossible to require the MEPS requirements to apply in such a case as the parties are not aware that they are entering into a new lease.

(6) **A lease being renewed under the Landlord and Tenant Act 1954.** Some members of the Working Group believed that this exclusion should apply regardless of whether the court orders a new lease to be granted or whether the parties agree the terms of the new lease without the need to involve the court, whereas others disagreed. This has been covered in

detail in Chapter 8 section G above. The question as to whether lease renewals (within the scope of the 1954 Act or otherwise) required further consideration.

(7) **Renewal of a periodic tenancy.** A periodic tenancy is one that continues until one party stops it. Effectively it 'rolls over' at the end of each period (normally monthly or three-monthly) until one party (normally the tenant) says it does not want it to continue. As a new lease arises automatically at the end of each expired period, it would not be possible to require the landlord to comply with the MEPS requirements before granting it.

(8) **Extension of an existing tenancy.** Technically where the term of a lease is being extended (eg from five years to ten years), this has to involve the grant of a new tenancy.

(b) where the transaction is short-term only

The Working Group considered that short-term lettings should be excluded since the cost to the landlord of complying with the MEPS requirements is likely to exceed the landlord's return from granting the lease, and landlords would therefore be dissuaded from granting leases for short terms. For certain types of property users, particularly SMEs, short leases can be beneficial as they are preferable to a commitment to a long-term financial overhead.

(1) **A tenancy at will.** This is a personal arrangement between the parties which can be ended at any time by either party.

(2) **Meanwhile leases** – which are leases granted for short periods for socially beneficial purposes.

(3) **Very short-term lets (perhaps six months or less).** Very short-term lets could perhaps be excluded, to ensure that landlords are not dissuaded from keeping buildings in use. To ensure that this is not used as an anti-avoidance method, this would only apply where the tenant has not been in occupation of the building before the letting takes place.

(c) where the transaction is more akin to a sale than a letting, although it is being accomplished through the grant of a lease for reasons connected with landlord and tenant law

It is often necessary to structure a transaction as a lease even where the underlying financial effect is a sale. For legal reasons one cannot sell a horizontal slice of a property (e.g. a flat or one floor of an office building), so these are generally disposed of by granting a new lease. This will normally be for a period of 99 years or 999 years. Although this is structured as a lease, it is more akin to a sale.

Similarly one cannot split up a building into parts, so the sale of (say) one-half of a building is accomplished by the grant of a long lease (perhaps 99 years or 999 years) that entitles the tenant to one-half of the rents of the building. Sales of parts of buildings are quite frequent. Modern buildings are so large that often large numbers of investors have to club together to buy them jointly.

A similar example is an "overriding lease". This is where a lease is granted of a building that already contains tenants. In such a case the landlord is not granting a lease of vacant premises and therefore is not in a position to carry out improvement works on the building since tenants are already in occupation. Although an overriding lease is (in legal terms) a letting transaction, it is more in the nature of a property investment transaction. As such the Working Group considered that it should be excluded from the MEPS requirements.

(d) sub-lettings of parts of buildings

The Working Group spent a great deal of time discussing sub-lettings, as this is a very tricky area. The three relevant parties are L (the landlord), T (the tenant) and S-T (the proposed sub-tenant). When a sub-lease is being granted, T is the landlord under the sub-lease and S-T is the tenant under the sub-lease. L is not a party to the sub-lease and is not subject to the MEPS requirements at all in relation to the grant of the sub-lease.

Where T is the tenant of a whole building, it will be responsible for its repair and maintenance. Therefore if T wishes to grant a sub-lease of a building with a rating of F or G, it will be able to improve the building in accordance with the MEPS requirements.

However if T's tenancy is only of part of a building (eg one floor in an office block), T will have no right to make alterations to parts of the building outside its tenancy. These excluded areas will include the entrance area, lifts and stairwells, heating and air conditioning systems, external walls and roof. These parts will remain the responsibility of the landlord.

Our suggestion is that a sub-letting should be subject to MEPS only to the extent that the tenant has control of the elements of the part of the premises to be sub-let. So where T has a lease of one floor of the office building, it should only be required to carry out works to the parts of the building within its lease, even if that does not bring the building up to an E rating.