



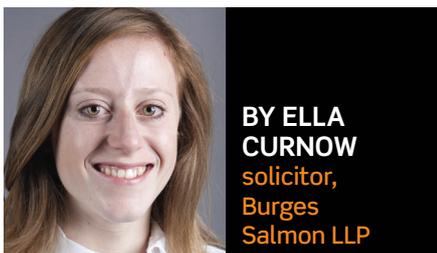
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Minimum energy efficiency standard for commercial  
buildings: issues for landlords and tenants

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# Minimum energy efficiency standard for commercial buildings: issues for landlords and tenants



THE GOVERNMENT IS EXPECTED TO produce draft regulations to introduce a new minimum energy efficiency standard for non-domestic and domestic rented buildings.

The draft regulations will, if adopted, mark a major policy shift in the regulation of the energy efficiency of buildings in England and Wales. The draft regulations are anticipated to be called the Private Rented Sector Minimum Energy Efficiency Standard (Non-Domestic) (England and Wales) Regulations, and abbreviated to the 'Minimum Standard Regulations'.

Currently, there are no direct legal requirements on landlords to ensure that buildings rented in the private sector for commercial use meet any minimum energy efficiency requirements. The policy to date has been to impose energy efficiency standards at the construction stage only and then, in order to comply with EU Directives, require the disclosure of energy efficiency information through an Energy Performance Certificate on the sale or grant of a lease so that purchasers and tenants can make an informed choice on energy performance.

The Minimum Standard Regulations would impose new requirements on landlords to ensure their buildings meet a minimum energy efficiency standard before they can be rented out. However, the practical implications of the detailed requirements set out in the government's proposals may not be as far reaching and onerous as landlords may have feared. Tenants, on the other hand, may consider that the proposals do not go far enough and may be concerned that the costs of improving buildings will fall on them.

We examine below the current regime and the new Minimum Standard Regulations proposed by government. We also consider some of the opportunities and threats likely to be created for landlords, tenants and the energy improvement industry by the introduction of the Minimum Standard Regulations regime in 2018.

## **CURRENT REGIME: CONSTRUCTION REQUIREMENTS AND DISCLOSURE OF ENERGY EFFICIENCY INFORMATION**

### **Construction requirements**

The policy in relation to the construction of buildings has been implemented through

the building regulations regime. For new buildings, and for changes to existing buildings, there are requirements in the Buildings Regulations 2010 relating to energy efficiency and ventilation. The current building regulations have existed in various forms and across a number of legislative instruments since 1984. However, although the energy efficiency requirements have changed over time, the building regulations do not have retrospective application so existing buildings are not caught by the changes.

### **Disclosure of energy efficiency information**

The policy in relation to disclosure of energy efficiency information has been implemented through the Energy Performance Certificate (EPC) regime. Since 2007, under the Energy Performance of Buildings (Certificates and Inspections) (England and Wales) Regulations 2007, it has been a requirement to obtain an EPC when a non-domestic building (with some exceptions) is offered for sale or rent.

An EPC is a certificate containing information about the energy efficiency of a building including an asset rating for energy performance (usually referred to as the energy efficiency rating) to indicate energy performance and an environmental impact rating to indicate carbon emissions performance. The energy efficiency rating and environmental impact ratings are based on the building's fabric and its services and are calculated using standardised energy usage patterns (simplified building energy model methodology for commercial buildings). The asset rating is expressed on a scale from A to G: A rating indicates that the building is very energy efficient and G is the lowest rating.

An EPC must also contain a recommendation report setting out technically feasible suggestions for the improvement of the energy performance of the building. Since 1 January 2013, in accordance with the Energy Performance of Buildings (England and Wales) Regulations 2012, Regulation 4, the recommendation report must distinguish between improvements which would require a major renovation of the building envelope or the technical building services and improvements which could be carried out to individual building elements without requiring a major renovation.

## 'The Minimum Standard Regulations would impose new requirements on landlords to ensure their buildings meet a minimum energy efficiency standard before they can be rented out.'

The EPC regime helps tenants to make informed energy performance decisions when choosing a building to rent but the regime does not overcome what the government has identified as a key barrier to improvements: the fact that the incentives are split for rented property:

'... the costs of energy efficiency improvements are borne by landlords, while the benefits (lower energy bills) accrue to current or future tenants'.

The government believes that Minimum Standard Regulations, alongside the Green Deal, will help to tackle this split

and create an impetus to improve the worst performing buildings.

The diagrams below show the traditional lease arrangement, with a split between the interests of the landlords and those of tenants, as compared to a 'green lease', in which the environmental and energy interests of landlords and tenants are aligned. The government's proposals are aimed at steering the leasehold market in the direction of green leases.

### NEW PROPOSALS FOR MINIMUM ENERGY EFFICIENCY STANDARDS

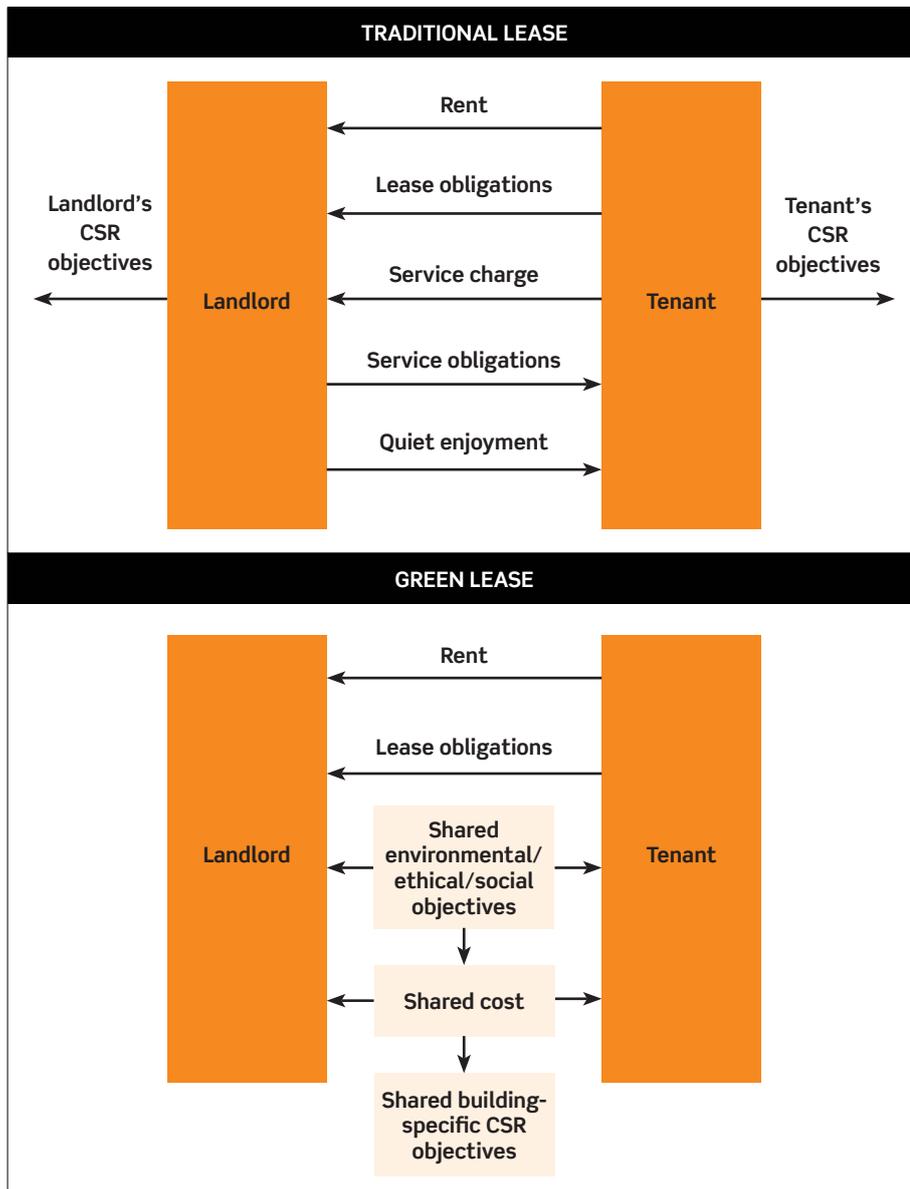
The proposals are derived from a duty in the Energy Act 2011, s49 for the government to introduce regulations by 1 April 2018 to require all eligible properties in England and Wales in the private sector to be improved to a specified standard. Scottish Ministers have a similar duty under the Climate Change (Scotland) Act 2009, s63.

The government consulted on its proposals from 22 July to 2 September 2014 and is expected to publish a response and produce draft Minimum Standard Regulations in early 2015.

The key proposals in the consultation are summarised below.

#### Which rented buildings will be caught?

The Minimum Standard Regulations would apply to all buildings (that are not dwellings) which are required to have an EPC in



MINIMUM STANDARD REGULATIONS TIMETABLE	
Energy Act 2011	18 October 2011
Minimum Standard Regulations for non-domestic and domestic properties consultation	22 July 2014- 2 September 2014
Draft regulations expected	Early 2015
New lease extensions and lease renewals caught	1 April 2018
All leases caught	1 April 2023

accordance with The Energy Performance of Buildings (England and Wales) Regulations 2012. This means that buildings due for demolition, some listed buildings and some religious buildings would fall outside the Minimum Standard Regulations.

The current proposals provide that any length of lease would be caught. The government is, however, considering whether this should be refined to exclude very short flexible leases, in order to protect SME occupiers, or very long leases akin to a freehold interest.

#### **What will landlords be required to do?**

The key restriction introduced by the Minimum Standard Regulations is that landlords will not be able to rent out a building which has an EPC energy efficiency rating lower than an E. The government estimates that properties with ratings F and G make up 18% of the total building stock in the sector. It is this 18% that is the target of the Minimum Standard Regulations.

However, there are a number of exclusions in the government's proposals which considerably water down this restriction and these are likely to provide some reassurance to landlords.

#### **Will the landlord have to pay for energy efficiency improvement measures?**

The Minimum Standard Regulations will not require landlords to achieve an E rating if the landlord can show that, under a 'green deal' finance arrangement, the annual repayments for the installation of the improvement measures would exceed the annual bill savings estimate.

What is a 'green deal'? In a green deal, business energy bill payers are able to obtain finance to pay the upfront costs for certain energy efficiency improvement measures. Bill payers then repay those costs through a charge on their energy bills. A green deal will only be available where an improvement measure fulfils the golden rule: over the course of its life, the savings made through the improvement measures (based on likely energy prices for the first year) must always be equal to or exceed the cost of the improvement measures.

What this is likely to mean, for the Minimum Standard Regulations, is that a landlord

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would not have to install an energy efficiency measure if the entire installation cost could not be covered by a green deal – ie if a further upfront cost would have to be paid by the landlord. In this situation, a landlord would only have to install those measures, if any, which meet the golden rule. Where the landlord uses a green deal it would be the tenant, as the energy bill payer, and not the landlord, who would in fact pay for the installation of the improvement measures.

The onus will be on landlords to show that they are not required to meet the EPC E rating by obtaining a non-domestic green deal advice report. The report will set out a recommended package of improvement measures and their expected energy bill savings. The expected energy bill savings form the cost 'cap' for the golden rule. The landlord will then have to obtain quotes from installers to ascertain whether improvement measures can be installed within the cost cap. The landlord will need to keep the quotes and the report as evidence that the correct rating for the property has been reached.

#### **Are there any other exclusions?**

A landlord will not be required to install improvement measures where the landlord has been denied consent to do so. This could include refusal of planning permission, consent of a lender, consent of a freeholder or higher landlord and the consent of an occupying tenant.

In addition, the government is considering an exemption where the improvement measures are considered to be likely to result in a net material decrease in the property's capital or rental value. The calculation would be carried out by an accredited surveyor based on set criteria. The threshold for 'material' has not yet been determined. The government thinking on this point is that a net material decrease is unlikely to occur because the golden rule

means that the tenant would not be paying more for their energy bills.

All the above exclusions would not apply indefinitely. The landlord would have to show that the relevant exemption still applies at the end of a certain period (the current proposal is for five years) or earlier if the objecting tenant moves out before the expiry of that period.

#### **How will this be enforced and what are the penalties?**

The government's proposals on enforcement and penalties are not yet very detailed. The Minimum Standard Regulations are likely to be enforced by Trading Standards officers with penalties for offences calculated by reference to the rateable value of the property.

A key question is how Trading Standards officers will identify rented buildings from owned buildings, in light of the limited requirements for registration of leasehold interests. One suggestion in the consultation is to rely on the public EPC register maintained by Landmark and give Trading Standards officers powers to require landlords to provide information. At the other end of the scale is a proposal that local authorities operate a mandatory certifying service for exemptions, which could effectively require all landlords to supply an EPC certificate with an E or higher rating or a certified exemption whenever they sought to put a property on the rental market.

#### **When would this come into effect?**

The Energy Act 2011 requires regulations to be in place by 1 April 2018. The current proposals favour a 'soft introduction' whereby the Minimum Standard Regulations would apply to tenancies granted, renewed or extended after 1 April 2018 and then to all tenancies from 1 April 2023.

## ‘The Minimum Standard Regulations are likely to present a massive opportunity for installers, assessors and all levels of the supply chain involved in the energy efficiency industry.’

It should be noted that extensions and renewals of leases do not currently trigger the requirement for the production and disclosure of an EPC. The current proposals do not appear to advocate an extension of the EPC regime, although this could conceivably be a necessary change to enable the Minimum Standard Regulations to be implemented.

### OPPORTUNITIES AND THREATS

#### The energy improvements industry

The Minimum Standard Regulations are likely to present a massive opportunity for installers, assessors and all levels of the supply chain involved in the energy efficiency industry. Where landlords are not installing measures, they will still need to obtain green deal advice reports and quotes in order to qualify for the golden rule exemption.

A threat to this potential increase in improvement measures, however, is the current lack of funding for non-domestic green deals from The Green Deal Finance Company (TGDFC). Each green deal is organised by a green deal provider. For domestic green deals, the long-term funding is provided by TGDFC. TGDFC's current policy is that it does not finance non-domestic green deals, so if a green deal provider wishes to organise a green deal for a business, it must carry the full risk that the business will become insolvent or otherwise be unable to repay the loan. It is not clear to what extent green deal providers have the appetite to take on the risk of such deals without help from TGDFC.

#### Landlords

A key threat and opportunity for landlords will be satisfying the requirements for

the golden rule exemption. The Minimum Standard Regulations take the rather unusual step of defining the scope of landlord's statutory obligations, at least in part, by reference to market forces. Landlords may be able to show that the golden rule exemption applies by deliberately going to the most expensive installers for quotes. There could also be huge variations across the country in the price for installation, prejudicing some landlords and benefitting others. One threat will be that landlords are likely to have to pay for quotes that they obtain, creating an immediate cost of compliance before any money is spent on the improvement measures themselves.

In light of the difficulties which landlords may face in obtaining green deals, the government has consulted on whether other finance options should be open to landlords. Many landlords may prefer to pay for the measures themselves and then recoup their costs in charging a higher rent. Another threat to landlords posed by the green deal is that, when there is no tenant to pay the energy bills, the landlord will have to pay the green deal repayments.

One of the things that the government has given some consideration to is how landlords might need to change their leases to enable them to comply with the Minimum Standard Regulations. The consultation suggests that landlords may wish to include provisions to restrict the tenant removing elements of the property that may reduce the EPC energy efficiency rating and providing rights for the landlord to carry out energy efficiency related works. This

would bring leases closer to the 'green lease' model. However, landlords may also decide not to include such rights deliberately so that they can benefit from the denied consent exemption.

#### Tenants

Some tenants may see the Minimum Standard Regulations as an opportunity to compel their landlord to improve the energy efficiency of the building that they occupy. Some tenants, on the other hand, may view a green deal as a requirement on them to pay the short-term costs for the long-term improvement of a building which they do not own. Tenants may wish to ensure that, if they are paying for a green deal, they occupy the building for long enough to see the real benefits – ie once the green deal loan has been paid for and the energy bills are much lower due to the improvement measures.

Another potential threat or opportunity for tenants is aligning the Minimum Standard Regulations with the raft of other energy-related requirements currently imposed on businesses. It is not yet clear how the Minimum Standard Regulations will interact, for example, with the Energy Savings Opportunity Scheme (ESOS), the Carbon Reduction Commitment (CRC) or even with the EPC recommendation reports.

A final factor to consider, in the opportunity/threat balance, for industry, for landlords and for tenants, is the price of energy and carbon over the coming years. Probably more than any other factor, it will be the cost of heating buildings, and the money that landlords and tenants stand to save, which will dictate the perceived success or failure of the Minimum Standard Regulations.

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