MEES

White paper report

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Overview

This paper was put together following the CBx evening event in April 2015, to show how the Minimum Energy Efficiency Standards will affect landlords and tenants alike. The regulations are already having the biggest impact of any energy regulation on the commercial property market with price chipping a key risk for any transaction. They will require all eligible domestic and non-domestic private rented properties in the sector to be improved to a specified minimum standard which is proposed at an Energy Performance Certificate (EPC) rating 'E'. Our panel of experts presented an early examination and clarification on the details of MEES implementation and discussed the role of EPCs in the regulations.

With special thanks to our fantastic panel of experts; Polly Plunket-Checkemian of Cushman & Wakefield, Professor Paul Ruyssevelt of UCL Energy Institute, Patrick Brown of British Property Federation, Dan Grandage of Aberdeen Asset Management PLC and Philippa Gill of Tishman Speyer (January 2007 to January 2015).

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Important Notice

INTRODUCTION

The Committee on Climate Change (CCC) is an independent, statutory body established under the Climate Change Act (2008). It advises the UK Government and Devolved Administrations on emissions targets and reports to Parliament on the progress made in reducing greenhouse gas (GHG) emissions and preparing for climate change.

In 2008, the CCC suggested that all non-residential buildings should achieve at least an F-rated EPC by 2020. The (2009) Carbon Trust report, 'Building the Future Today', reaffirmed this recommendation whilst including a cost-effectiveness caveat. The proposal would also act as an insurance policy for Green Deal uptake by creating demand for the mechanism. With the agreement of DECC, two working groups were convened: residential and non-domestic. Their purpose was to investigate how the application of a minimum performance rating should work in practice.

> ***"The idea of a Minimum Energy Efficiency Standards (MEES) Policy was first discussed in the 2009 progress report; one year after EPCs had been introduced"***

On 26th March 2015 the Energy Efficiency (Private Rented Sector) (England and Wales) Regulations were passed, bringing into effect MEES in the residential and commercial private rented sector. The MEES regulations will make it unlawful from 1st April 2018 to let out eligible buildings in England and Wales that do not have a minimum EPC rating of an 'E'.

ELIGIBILITY

Buildings subject to MEES are those that require an EPC rating under current regulations. MEES applies to commercial properties where leases are granted for more than six months and less than 99 years. This may exclude certain agricultural buildings, listed buildings and ecclesiastical buildings. For residential property, MEES applies to all types of tenancy agreements. For buildings eligible under these criteria, there are a further three exemptions which allow landlords to let out the building even if they do not achieve the minimum EPC rating: cost effectiveness, third party consent and property devaluation.

1) Cost Effectiveness

All energy efficiency measures are subject to a cost effectiveness test – a similar calculation as the Green Deal. An exemption applies if the improvements identified by an independent installer of energy efficiency measures would not be cost effective after seven years. The resulting mechanism is essentially a form of energy performance contract where technology or measures are purchased upfront and are repaid via savings on the energy bill. However, as a non-domestic version of the Green Deal financing never came to fruition, an alternative cost-effectiveness calculation was introduced based on the menu of measures taken from the Building Regulations Part L2B and subjecting each package of measures to a seven year payback rule. For domestic properties, exemptions would have applied if improvements were not covered by the Green Deal. However, with the scrapping of the Green Deal in July 2015, it looks unlikely whether there will be a replacement funding mechanism in place for when MEES comes into force in 2018. The Green Deal was to play a central part for the regulations, allowing for landlords to implement energy efficiency measures with no upfront costs. This would have satisfied the Green Deal's 'Golden Rule' where energy efficiency improvements would pay for themselves over their expected lifetime. Without the Green Deal, there may be little financial support for landlords, which provides a bleak future for MEES for domestic properties.

2) Third Party Consent

Consent must be acquired from a lender, tenant or superior landlord before any energy efficiency improvements can be made. Where consent has not been obtained and all "reasonable endeavours" have been exhausted, then the exemption applies. The legal terminology of "reasonable endeavours" has yet to be established by the courts. However, the policy indicates that this exemption should not be exploited as a deliberate means to avoid taking action.

3) Property Devaluation

The final exemption of MEES is where a property is shown to decrease in value as a result of implementing energy efficiency measures. An independent surveyor must report, in writing, that the market value would decrease by five percent or more. There is also a specific exemption on internal wall insulation where it can be proven that the proposed improvements are not appropriate due to the potential negative impact on the building fabric or structure of the building.

4) Recently Becoming a Landlord

The regulations acknowledge that there are some circumstances where a person recently became a landlord and accepts it would be inappropriate or unreasonable for them to comply with the regulations immediately. In such cases, an exemption may be registered for six months. After six months, the exemption would expire and the property must either have an EPC rating of at least an 'E' or another valid exemption if they are to continue letting.

All exemptions must be registered and property owners can be fined if they are found to have falsified information. Exemptions are valid for five years or until the incumbent tenant leaves and cannot be novated to new owners. As a result, MEES has a de facto effect on the sale of property.

ENFORCEMENT & ESCALATION

The enforcement body for this regulation is likely to be Trading Standards, with Local Authorities collecting any fines.

> ***"If a landlord is suspected of breaching the regulations then the enforcement body may serve a compliance notice requesting further information"***

If the notice is not actioned, or the information supplied does not satisfy the enforcement body, a penalty notice may be issued. This may be a financial penalty and/or a publication penalty i.e. company published as non-compliant which may lead to reputational damage.

Penalties range in order of severity. For breaches of less than three months' duration, the fine will be:

- 10% rateable value (minimum £5,000 and a maximum of £50,000) for commercial buildings
- £2,000 for residential buildings

Where a breach is more than three months' duration, the penalties may be:

- 20% rateable value (minimum £10,000 and a maximum £150,000) for commercial buildings
- £4,000 for residential buildings

IMPORTANT DATES

- From 1st April 2018, landlords will be unable to grant new leases (including renewals and extensions of existing leases) for property which falls below the minimum 'E' rating; and
- From 1 April 2023, landlords will be unable to continue letting property under existing leases if the EPC rating for the property falls below the minimum 'E' rating.

THE ROLE OF THE EPC

EPCs define the scope of the MEES regulation. EPCs are a rating of the energy performance of a building against the calculated energy requirement of a typical building of the same size, operational characteristics and also include a set of generated improvement measures that can be administered to the building to improve its energy efficiency rating.

Information required to produce an EPC includes the floor area of the building, the nature of the building fabric and construction, and the building services that are present. However, obtaining accurate data to produce an EPC is not necessarily easy. For example, it may not always be possible to calculate the wall thickness and what insulation is used. The composition of a wall is not always consistent with other walls of the same thickness. U-values are a measure of how well the fabric functions as an insulator; the lower the value, the less heat is lost through the fabric of the building. The methodology used to calculate the U-value of walls was originally intended to be used for sizing heating systems and is therefore quite conservative. The assumed U-values of solid walls can have a major impact on the final EPC rating of a building.

> ***"17% of existing buildings with a U-value of 2.1 would move from an 'F' to an 'E' EPC rating if a U-value of 1.7 was assumed and 45% would move up with an assumed U-value of 1.4"***

In the domestic setting, this can lead to houses on the same street having very different EPC ratings. Another example where properties of a similar build quality may vary is through heating controls, such as thermostatic room controls. Higher scores are given for various heating controls and lower scores where they are less salient. However, some buildings do not use heating or rely on technology where controls are not widely used (e.g. heat pumps). This can be unintuitive as more environmentally-friendly technologies may be penalised.

EPCs are offered at a price that does not cover the cost of producing a well-researched, accurate assessment. This traditional holistic approach to assessing a building's energy performance does not account for the effects a building's occupants may have. As a result, a complete forensic evaluation of a building's energy profile is unlikely to be achieved through an EPC. Research has shown that there can be large differences between the modelled and actual energy use of buildings (Ryna & Sanquist, 2012). Therefore, a review into the current validation methods to assess building energy models may be needed if MEES is to be successful in reducing building energy consumption and paving the way towards a more sustainable future.

There is scope to use a combination of methodologies that incorporates building performance against actual performance. For example, the inclusion of Display Energy Certificates (DECs) could be used alongside EPCs to provide greater accuracy in energy reporting. DECs are measured on actual metered energy consumption thus will include energy consumption from modifications an occupier has made (e.g. additional cooling or servers within the building). Therefore, the occupancy habits and modifications have a key role in determining the level of energy consumption. A combination of the two methodologies may lead to more accurate reporting that will save real energy instead of theoretical energy. However, even this method cannot be relied upon because there is such variability in how buildings operate. Furthermore, would the market pay for an increased level of detail that a forensic investigation can supply?

IMPACTS ON TENANTS

The MEES regulations may be the first piece of legislation that forces asset managers and fund managers to pay attention to sustainability because it actually affects the value of a building. If no improvements are made, there is a real possibility that buildings may become vacant thus gaining no rental income. As a result, many landlords would be considering an energy efficiency improvement plan to make good use of the time now so they can continue to lease after the deadlines have passed. Landlords will also be reviewing existing lease arrangements and working on their approach for compliance with MEES. These strategies may impact the tenants.

> ***"Savvier tenants are beginning to ask for previous three years of energy bills"***

Tenants with existing leases or prospective tenants considering new lettings will be affected by MEES. Tenants should be aware of a property that has a low EPC rating (an 'E' or less) and of any energy efficiency improvement work and expenditure the landlord may be taking to meet the regulations. Areas of particular concern include the disruption that may be caused by improvement works and whether the landlord will pass the bill on. This will depend largely on the precise wording of the contracts between tenants and landlords.

There are many areas a tenant should be aware of within their contracts. Service charges should be checked to see if the landlord can recover the costs for improvements or replacements. Landlords aiming to improve their efficiency may look to change their HVAC systems first, which can be costly. Tenants should also check their 'repair' obligations to the landlord as landlords may charge tenants to 'repair' their premises to an improved EPC rating standard. Tenants may also choose to seek out the extent of the landlord's right to enter the premises to carry out works. This can impact both the tenant and landlord as it is stipulated in the regulations as an exemption.

There are several potential implications for tenants looking for new leases, but it is not yet clear how landlords will adapt to the MEES regulations. It is widely believed that landlords may look into changing the provisions in their contracts with tenants. They may explore the potential of limiting tenants to making alterations within the building which may have a negative impact on efficiency. This may well be a game changer for retail leases. Traditionally, landlords would provide the retailer with an empty space that could then be altered to the retailer's requirements. With MEES, landlords may want to limit the types of alterations that a tenant may make. For example, landlords may limit the amount or type of lighting a retailer could use if it could lower the existing EPC rating for the premises. Landlords may also include clauses into their tenancy contracts where the tenant is obligated to 'repair' the property up to a specific EPC rating. The total cost of occupation is beginning to factor in the operational energy of a building.

MEES will require tenants to be more mindful of energy efficiency and what the regulation's potential impacts are to tenancy agreements and landlord obligations. There are, of course, benefits for tenants to potentially reduce their overall energy expenditure under the MEES regulations. MEES could also be used as a negotiating tool for tenants and landlords alike. Tenants could use the regulation to negotiate lower leases or service charges if the property is perceived low in energy efficiency. Likewise, landlords could use MEES to their advantage to persuade prospective new tenants to sign a lease if the rented space is shown to be more energy efficient than their competitors. This does not necessarily factor in as rental value but it does increase attractiveness of a property.

THE FUTURE OF THE POLICY

The Energy Performance of Buildings Directive (EPBD) is undergoing a review this year. Any amendments to EPCs, as a result of changes in Brussels, are likely to have knock-on effects for the basis on which MEES rests. There may still be a development of a Green Deal for non-domestic buildings. Higher end non-domestic landlords are less likely to utilise this as historically they did not qualify for such funding. The MEES policy is up for review in the UK in 2018.

> ***"It is anticipated that the Minimum Standards will be raised progressively up the EPC ratings scale although no trajectory has been issued"***

Cost-effectiveness takes many forms across the various rental sectors, and to this end, a seven year payback will look very different in each. The Green Construction Board's (2014) 'Value and Demand' working group have produced a report that examines the magnitude of obligation across the sectors. The document concludes that, across the case study buildings, particularly those that were naturally ventilated, cost effective improvements will be adequate to meet the minimum standard and that where this is the case, these costs should be absorbed by the market. However, older air conditioned units and some industrials buildings will struggle to develop a package that would meet the 'Golden Rule'. The report calls for a clear statement from Government on the future evolution of the policy with a timescale for any incremental changes to help reduce uncertainty in this area.

Many F and G rated buildings are reaching obsolescence and any refurbishment may also result in an improvement in energy efficiency. However, many buildings have limited potential to add sufficient value from these activities, and therefore MEES can be considered a necessary regulatory driver to speed up investment. In the retail sector, where re-letting is often accompanied by a new fit-out, there is more opportunity for upgrade and compliance with MEES.

The Department of Energy and Climate Change (DECC) has produced a Draft MEES Guidance for stakeholders with a final version anticipated to be released Summer 2016. DECC's 'Private Rented Sector Minimum Energy Efficiency Standard Regulations (Non-Domestic)' document states that the Government will be required to review the operation and effect of the regulations at five yearly intervals and that it intends that the first review will be carried out in 2020. The implication up until now is that we will not see a planned trajectory until this time.

> ***"Anecdotally, the general feeling expressed at the CBx event and others is that this will come far too late to provide any certainty or facilitate proper incorporation into the Planned Preventative Maintenance cycles"***

This is particularly relevant following announcements by the Treasury to shelve both the Allowable Solutions Scheme and the Zero Carbon Buildings regulations in a 'red tape cutting' exercise following which the construction industry is understandably twitchy about making such investments.

The European Commission is watching what is happening in the UK with some interest, particularly the Brexit referendum happening in June 2016. If Britain were to leave the EU, would the UK replace EU policy with similar national policies? After all, the UK did ratify legally binding targets to combat global warming set out during the December 2015 Paris Agreement. Frans Timmermans, current Vice President of the European Commission, says of the EPBD that the commission went too far and drilled too deeply into how governments would individually manage their energy performance and that a more light-touch regulatory framework from Brussels may have been more suitable.

Interestingly, in the Netherlands, Dutch social housing must have a 'B' rating and private housing must reach a 'C' rating by 2020. Therefore, we are likely to see even more aggressive standards coming out of Europe in the next few years. How this will affect UK policy will become clearer after June 2016.

Whilst MEES and its methodologies are not perfect, it does have an important role in improving energy efficiency in some of the most inefficient and oldest building stocks in Europe.

RESOURCES

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