Between you and MEES

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Jen Lemen-Hogarth outlines the essentials of the Minimum Energy Efficiency Standards and explains how retail property owners can mitigate the risks as the 1 April deadline approaches

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The Minimum Energy Efficiency Standards (MEES) were introduced by the Energy Act 2011 , followed by the Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 . The key implications for retail assets under the scope of MEES are:

- from 1 April 2018, new leases or lease renewals cannot be granted on buildings with an energy rating of F or G
- from 1 April 2023, F- or G-rated buildings cannot continue to be let on existing leases.

Therefore, the aim of the MEES is to direct attention towards the least efficient stock, which comprises around 18% of all British buildings according to the UK Green Building Council (UKGBC). But with a total annual energy spend of more than ?3bn, the UK retail sector stands to benefit considerably from savings in energy efficiency.

Exceptions and exemptions

Buildings will fall outside the scope of MEES if an energy performance certificate (EPC) is not required, as is the case for places of worship, industrial sites or workshops with low energy demand and non-residential agricultural buildings; for properties where the EPC is more than 10 years old, or there is none; and for premises where the tenancy is less than 6 months with no security of tenure, or is more than 99 years.

In other cases, compliance will not be required and buildings will become exempt where the EPC rating cannot be improved to E or above even when all possible improvements with a payback of 7 years or sooner have been made. Another case for exemption can be devaluation, where improvements would reduce the market value of a property by more than 5%. Finally, where third-party consent from a tenant, superior landlord or planning authority for improvements is refused or conditionality cannot be reasonably met by the landlord, properties are also exempt. These exemptions last for 5 years and cannot be transferred on sale.

Non-compliance penalties

The penalties for non-compliance are up to ?150,000 per breach per property. Non-compliance will also be made public knowledge, so it could damage the reputations of some of the UK?s largest retail asset owners. Equally, the financial impact on smaller retail investors could be substantial.

However, the landlords of retail properties also face a range of other issues.

- **Costs of compliance:** these are reported in a UKGBC blog to be between ?1 and ?9 per square foot. The affordability of compliance will depend on the ratio of proposed costs to rental income and on capital availability and liquidity.
- **Landlord?s ability to pay:** no account is taken of this when considering improvements made in order to increase EPC ratings.
- **Tenant?s willingness to contribute:** no account is taken of this either, particularly where the works are considered to be improvements rather than maintenance costs relating to service charge recoverability.
- **Voluntary contributions:** as tenants will benefit directly from improved energy efficiency, early engagement should canvass contributions from them. The Carbon Trust reports that a 20% reduction in energy costs represents a bottom-line benefit comparable to a 5% increase in sales (http://bit.ly/1tplwv9).
- **Tenant engagement:** this will depend on many factors. National retailers, for instance, are more likely to be aware of and understand the implications of MEES, whereas smaller occupiers facing unforeseen costs may run the risk of business failure if these costs narrow their margins.
- **Dilapidations:** early advice should be sought on this issue, as pursuing timely interim or terminal claims could enhance the EPC rating, or at least allow works to be carried out at the same time to take advantage of economies of scale and reduce void periods.
- **Rent review:** an inability to let space that is F- or G-rated could lead to the argument at rent review that value is depressed. In these situations, negotiations are likely to become increasingly polarised, leading to third-party proceedings with high associated costs.
- **Lease renewal:** at lease renewals under the Landlord and Tenant Act 1954 , there is likely to be an impact on value, particularly in relation to section 34 . This is because tenant?s improvements undertaken pursuant to an obligation to the landlord will not be disregarded for renewal purposes. Equally, if a landlord undertakes the works they may argue that the rent should be determined on the basis of the improved premises. Renewals outside the act may be affected to a lesser extent given unbalanced negotiating power and depending on market conditions. The risk is greater at renewal than rent review given the difference in hypothetical lease terms.
- **Capital values:** depressed rental values may affect capital values, so owners of F- and G-rated retail assets should take early action to avoid breaching lending criteria and ensure that residual values are not detrimentally reduced. An F- or G-rated building may also have a limited market and restricted exit value, reducing liquidity.
- **Finance:** funding for acquisitions that are F- and G-rated may become difficult or impossible as lenders seek to avoid risk. For example, Lloyds Bank introduced an EPC review for new loan applications in March 2017.

Complying with MEES

There are a number of ways to ensure properties comply with MEES.

Design guides

Tenant fit-outs can have a substantial impact on a unit?s EPC rating, so you should ensure that design guides reflect MEES requirements and are rolled out consistently across all projects, with inspections after completion to confirm compliance. Although design guides may be primarily intended to support corporate social responsibility, they may also provide helpful guidelines to improve energy performance. Inspections post completion will be key to ensure compliance with design guides.

Hammerson, the joint owner of multiple retail assets such as Bicester Village, Brent Cross, Bullring and Cabot Circus, includes sustainability guidance in its tenants? handbook and retail delivery design guides. It also liaises with retailers through its retailer forum to ensure collaboration on initiatives.

The Crown Estate also publishes sustainable fit-out guidelines , including advice on energy-efficient lighting, waste management, water-efficient sanitary equipment and material procurement decisions based on lifecycle costs and impacts.

Reviewing EPCs

Asset owners must check that existing EPCs are fit for purpose and reflect current physical condition to meet the requirements of MEES without substantial capital outlay. Remember that ratings can go up or down ? in particular, properties with EPCs more than 5 years old may show higher ratings than would be assessed today due to standards being raised in the interim. In all circumstances, expert advice will be needed to model potential impacts.

The UKGBC has reported that by reviewing the EPC ratings of 75,000 buildings, two-thirds of F- and G-rated units were improved to E or above while British Land undertook a MEES risk analysis of 2,355 leased demises and found that 5% of total rental income was at risk due to F- and G-rated units. Compared to the national average of 18%, this reflects British Land?s proactive planned asset management and the modern, efficient nature of its retail stock.

Acquisitions

By following the principles outlined in the Better Buildings Partnership Acquisitions Sustainability Toolkit , it may be easier to identify MEES risks by, for instance, reviewing EPC ratings, energy spend and third-party sustainability ratings. Due diligence and early advice will ensure the right price is paid and that any opportunities to add value are identified.

Lease wording

The wording of leases should be carefully considered to define clearly which party is responsible for MEES compliance, with costs passed on in service charges where equitable. Green lease clauses should also be considered. Such clauses may include:

- requiring tenant cooperation to produce an EPC
- ensuring that no tenant alterations reduce the EPC rating
- managing metering, recycling, water and waste
- balancing energy improvement costs acceptably between the parties
- arranging meetings to agree energy targets
- use of sustainable materials.

Marks & Spencer has been a key proponent of green leases and has memoranda of understanding for more than 80 UK stores, through a partnership with the Better Buildings Partnership. Retail asset owners involved include British Land, Canary Wharf Group, Hammerson, Hermes Real Estate, Henderson Global Investors and Land Securities.

Clem Constantine, Director of Property at M&S, commented:

> 'Currently, it can be difficult for landlords and tenants to work together when it comes to a building?s environmental performance, particularly under older leases. There?s often no structure for measurement, incentives or sharing of goals.
>
> 'Green leasing changes this situation as it provides the framework within which both can

work together. And both will benefit: a store with a reduced environmental impact and lower costs is more marketable for landlords and more cost-effective for tenants to occupy.'

Finance

Schemes exist to help finance energy-efficiency improvements, which retail asset owners may wish to use to avoid direct capital expenditure, such as those provided by the Carbon Trust . Improvement works may also attract Enhanced Capital Allowances (ECAs), providing invaluable tax relief.

Timely advice

Retail asset owners should engage early with tenants, during the life cycle of a lease and at lease trigger events. Identifying the risks and seeking timely professional advice will help mitigate the risks and reduce the costs of compliance with MEES.

Although the 1 April deadline looms ever closer, the 2023 deadline is perhaps a greater risk because it also covers existing leases and will involve disrupted trade. Landlord and tenant relationships are often contentious, and this could add more fuel to the fire.

While the general market sentiment is that the larger property companies are mostly well prepared to deal with MEES, the legislation may take smaller investors by surprise and have substantial time and cost implications. Smart investors will also undertake additional MEES due diligence and adjust pricing accordingly on asset acquisitions, as well as finding opportunities in some instances to add value.

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Further information

- Related competencies include Landlord and tenant , Property management , Sustainability
- This feature is taken from the RICS Property journal (December 2017/January 2018)
- Related categories: Commercial EPCs