There may be trouble ahead

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Commercial property rental rates could be at risk when the Minimum Energy Efficiency Standards come into effect in April. Claire Das Bhaumik summarises a recent white paper on the possible effects

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As of 1 April, landlords will be prohibited from letting substandard properties, which are defined as those with an energy performance certificate (EPC) rating of F or G under the Minimum Energy Efficiency Standards (MEES).

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 place a requirement on landlords to ensure their properties comply, and these apply to new lettings, including sublettings, as well as lease renewals and extensions where the property has an EPC. From 1 April 2023, MEES will apply to all non-domestic property where there is an EPC, unless they are exempt.

Building energy simulation company arbnco has recently produced a white paper, *MEES: The implications for rent reviews, lease renewals and valuation*, quantifying the risk for commercial property and the knock-on effects on valuations, and including a case study.

The current expectation is that the incoming regulations may suppress rental levels at rent review and lease renewal. If rental growth is suppressed, then ? with all other things being equal ? growth in capital values will likewise be suppressed.

Furthermore, if evidence emerges that MEES affect rental values and the property in question is thought to be at risk in a future rent review or lease renewal, then the yield could be adjusted for an investment sale. This could also potentially suppress capital values further. Anticipated rental suppression could manifest itself through both the complexities and nuances of rent review and lease renewal negotiations, or through transactional evidence that shows MEES-compliant buildings achieving higher rents or sale prices than those that do not comply.

Summary of findings

The white paper concludes that MEES-related risks are real. Valuers will mount polarised arguments during rent negotiations depending on whether they are appointed by the landlord or tenant.

Tenant fit-out can play an important part in complying with the regulations

The effect of MEES on value is likely to range from a sum slightly more than the cost of relevant energy efficiency improvements to one considerably in excess of this, potentially leading to a reduction of more than 10% in the building?s capital value.

The UK government?s Green Construction Board reported in 2014 that 19% of all commercial property in England and Wales is in danger of failing to comply with MEES. As the size of the UK property market is estimated to be ?883bn , this means that as much as ?16.77bn could be wiped off the value of the UK?s commercial property portfolio.

It is unlikely that leases covered by the Landlord and Tenant Act 1954 will escape MEES? impact on value. However, the main impacts will tend to follow statutory lease renewals, and leases might only be affected at rent reviews if transactional evidence proves there is a rental discount. Central to the debate on value impacts are typical lease covenants relating to hypothetical lets, and the provisions of section 34 of the 1954 Act relating to rent under new tenancy.

Effects on rents

Rent reviews are typically undertaken using the assumption of a hypothetical letting and include a number of factors that affect valuation. Among these are the length of the lease to be valued, whether a rent-free period needs to be accounted for, and whether a tenant?s improvements should be disregarded.

It is impossible for a property to get a good EPC rating without having energy-efficient building services. However, it is in many cases currently possible to get an E rating or better with efficient building services but relatively poor building fabric. Tenant fit-out can therefore play an important part in complying with the regulations, and the way in which a fit-out is treated in the context of the lease can thus affect property valuation.

Where the tenant is responsible for fitting-out, there is a risk that disregarding their improvements will mean this hypothetical property cannot be let. In such cases, the cost of the relevant energy efficiency improvements could be amortised over a period of time to arrive at what is effectively a reduced net rent, but doing so is generally only possible where it has had the landlord?s formal consent.

Whether or not such disregards become generally accepted could depend on existing case law, and the extent to which any precedents can be extended to include MEES. The assumption that premises are fit and available for immediate occupation and use is a typical provision in most leases.

Valuers will mount polarised arguments during rent negotiations

As such, this raises the issue of whether this would also include the possession of the required EPC rating. For statutory lease renewal pursuant to the 1954 Act, there is no assumption of compliance with covenants or that the premises are fit and available for immediate use.

Valuation considerations

Clearly, the effect of MEES on valuation is not yet known, and will ultimately be determined by market forces, case law and legislation. However, while it may not be possible to provide a precise assessment of the impact, the potential effects of MEES on rent and capital values can be considered by examining the impact of the various arguments that might be raised at rent reviews or lease renewals.

The following arguments assume that tenants have made improvements that increase the EPC rating from G to E with the landlord?s consent; greater detail and a costed example are included in the white paper itself.

Potential arguments from tenants

- At rent review, tenants? advisors may argue that the improvements should be disregarded. This would mean that the letting could not go ahead at the review date because the EPC rating without the improvements was below E.
- Given this, the tenants could argue that to comply with the MEES the landlord would have to undertake the required works at their own cost. This would mean disruption for the tenant and, as such, they would require a rent-free period to cover the time in which the works were carried out.
- The tenants could also attempt to negotiate a rental reduction to reflect the fact they would not be able to occupy the offices from the start of the lease. They would have to make alternative arrangements and thus lose business or incur costs, which would require compensation by way of a rent reduction.
- Since the works were paid for by the tenants and the rent review clause in each lease disregards any increase in rental value attributable to tenants? improvements, the tenants would also argue that the cost of the improvements should be amortised over the period of the remaining lease term.

Potential arguments from landlords

- At rent review, landlords may argue that for the premises to be assumed fit and available for immediate occupation, they must have a minimum EPC rating of E. As such, they would argue that this requires the parties to assume that it has that rating, meaning that the tenant will not be rewarded with a discounted rent for making improvements.
- The landlord may be prepared to agree a rental reduction to reflect the amortised cost of the works. However, the benefit to the landlord would be longer than the remaining lease term, and therefore, the period over which the costs should be amortised would be longer.
- If the landlord?s consent had not been given for improvements, they could argue that the tenant has not complied with their lease conditions so the works should not be disregarded and the offices should be valued at the full rate.
- At lease renewal, the rent will be reviewed in accordance with section 34 of the 1954 Act . The landlord could argue that, even though this contains no provision enabling them to assume an E rating, it would in fact achieve an E as the works have been completed.

The potential effects of the above arguments on values could range from negligible to profound. This introduces uncertainty into the valuation process, increasing property risk. It therefore remains to be seen how the market is affected.

It is important to note that the regulations place a great deal of importance on the EPC rating. As such, holding an inaccurate EPC could have serious and expensive consequences for the landlord.

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Further information

- See the white paper: MEES: The implications for rent reviews, lease renewals and valuation
- Related competencies include Sustainability , Valuation
- This feature is taken from the RICS *Property journal* (March/April 2018)
- Related categories: Commercial EPCs , Property management