

# The stick that became a carrot

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## With the Minimum Energy Efficiency Standards newly in effect, Daniel Montlake and Sivan Gelb examine their potential impact on the market

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The [Minimum Energy Efficiency Standards \(MEES\)](#) were devised to improve inefficient and substandard buildings, and therefore reducing carbon emissions as well as energy demand and consumption.

With the [Private Rented Sector Energy Efficiency Regulations \(Non-Domestic\)](#) having come into force on 1 April, landlords of private rented non-domestic properties are now prohibited from granting a tenancy to new or existing tenants if these properties have an energy performance certificate (EPC) rating of band F or G, subject to certain exemptions. A much firmer stance will be taken from 1 April 2023, when landlords must not continue letting a non-domestic property if it is rated in these bands.

The penalty for failure to comply with MEES is a statutory fine of up to ?150,000 and being named on a register of non-compliance. However, although the financial penalty can be quite severe, we believe that compliance will largely be self-regulated. Landlords will not want to see their property breach the minimum standards given the impact this will have on the value of their asset.

Any attempt to circumvent the regulations will in the first instance be enforced by the landlord's professional advisors. Solicitors must not act on transactions that breach the regulations, and other professional advisors such as surveyors and property managers will want to ensure that they have correctly advised their clients for fear of negligence claims if the landlord is prevented from letting the premises.

## Erroneous expectations

?It's fine, I have a C rating on my EPC, so I'm not concerned about the regulations,? says Landlord X. This is at best a naive view. EPC assessments between 2008 and 2012 should be considered for re-evaluation as the rating may be inaccurate, and indeed recent reviews of older certificates have shown C ratings falling to F or G. For example, [Core Sustainability](#) recently reviewed a large office building in Euston that was downgraded from band C to G, even though certain energy efficiency upgrades had been carried out since the original EPC was awarded. This discrepancy was largely a result of various updates in EPC software and [Building Regulations](#) .

From our experience, EPCs awarded before 2012 have on average been downgraded by 2 bands on reassessment ? which is quite worrying when you are dealing with certificates that will require re-rating when they expire over the next few years. We always advise our clients not to rely on certificates that are more than 5 years old, and property investors should also instruct an energy assessor as part of their professional team.

Many property stakeholders have little knowledge of how an EPC is calculated. We are often informed by clients that a building will perform well or badly on assessment, usually because of their visual perception of it rather than an identification of the key systems such as lighting or heating that affect the rating. It is now imperative that landlords understand how each element of the EPC affects the rating, and how they can protect that rating.

### *A multi-tier market could emerge*

Tenants' fit-out works and alterations should be carefully monitored, for instance, and advice taken from an energy assessor before consent for them is granted. The cost of instructing an energy assessor to advise on a tenant's proposed works should be recoverable under the terms of most leases and, in our opinion, it will be reasonable in many circumstances for the landlord to refuse its consent for works that reduce the energy rating.

## **The commercial case**

We foresee buildings of varying EPC ratings attracting differing levels of rent and calibres of tenant. Therefore, the landlord may have an incentive not to apply for exemptions, so it can compete with other properties on the market. We strongly advise owners and agents to undertake simulations of improvement strategies and their costings from a substandard level to E or above.

Inevitably, landlords will want to pass on any costs to their tenants, but we believe that landlords have little ammunition in respect of existing leases unless this arrangement has been expressly agreed. Some have argued that a landlord may seek to recover the costs under the compliance with laws clause of their lease, which would typically require the tenant to comply with all laws relating to the property and its use. In our view this is a misconception: regulations 23 and 27 impose an obligation on the landlords not to let or continue to let the property in the event that it has an F or G rating, rather than placing a duty on the tenants regarding their occupation.

The landlord is also unlikely to be able to recover any costs through the repairing covenants or service charge, as works required to increase a property's energy efficiency rating constitute an improvement to the property rather than a repair. If the landlord wants the tenants to contribute towards the costs of the works then this must be expressly stated, either in the service charge or the repair covenant.

## **MEES tactics**

One of the most interesting aspects of the regulations is how landlords and tenants will seek to use the legislation tactically for their own advantage. Rent review is an area where we foresee problems for both parties (see [?There may be trouble ahead ?](#)).

Take a review clause providing for the open market rent to be the higher of the current rent or ?an open market rent at which the property could reasonably be expected to be let?. If the energy rating is substandard but the lease was granted before April 2018 then the letting would be lawful, as it predates the MEES coming into effect. However, what would be the position at rent review? Could a tenant argue that a property with a substandard EPC rating cannot be let on the open market and therefore no rent increase is appropriate?

It is difficult to prejudge the court's decision in such circumstances. While the courts have tended to base their judgments on a presumption in favour of reality, they are reluctant to rewrite a clause that is commercially unrealistic if the drafting is unambiguous, as was the case in [Earl Cadogan v Escada AG \[2006\] EWHC 78 \(Ch\)](#). We have held many seminars throughout England, and the majority of rent review surveyors have indicated that they would agree with the tenant's argument that there should be no increase in these circumstances. Much depends on the wording of each lease, and some precedents have been changed to deal with this. However, it does highlight some of the uncertainties and ambiguities that could arise as a result of MEES.

A landlord or tenant could also use the ambiguity for its own commercial gain. For example, if there is no prohibition in the lease, there is nothing to stop a tenant from undertaking a new EPC if they believe that their current rating would be downgraded to a substandard one. This would then cause the landlord significant problems on rent review. It is therefore vital that landlords know the true ratings of their properties and that leases provide for them to retain control over when an EPC can be commissioned.

Even for properties that comply, the EPC rating could affect rent review. When looking at comparable evidence, should surveyors consider the difference between similar properties with different EPC ratings? A landlord would surely be justified in pointing out that their property is more energy-efficient than the neighbouring comparable property.

## Summary

Paradoxically, although the purpose of the regulations is to ensure that underperforming properties are brought up to a minimum standard, the unintended consequence could be that even landlords of compliant properties seek to achieve a gold standard, given the benefits this may offer.

*Many property stakeholders have little knowledge of how an EPC is calculated*

We expect the prime rental market to notice the introduction of MEES in the short to medium term. Tenants will now have another choice to make, and a multi-tier market could emerge with more energy-efficient stock achieving higher rents. Market competition will in effect cause self-conformity, and we will see improvements throughout the different sectors. We are led to believe that the minimum rating will be increased over time and this will further stimulate growth and opportunities in this exciting market.

As this process becomes more established, energy efficiency will become central to property professions. Then, as the market responds, landlords may undertake further energy audits to enable their tenants to gain a full insight into their usage of the building, their demands and the costs of occupancy. As part of this, elite energy assessors will join the professional team alongside lawyers and surveyors.

Regulations that were intended to act as a stick to beat inefficient properties may well have created a carrot to reward those that perform best. The ripples from MEES will be felt throughout the whole property market, lifting the efficiency of all commercial property from lettings and sales through to rent reviews and valuations: we are about to embark on a sustainability revolution.

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## Further information

- Related competencies include [Leasing/letting](#) , [Sustainability](#)
- This feature is taken from the [RICS Property journal](#) (May/June 2018)
- Related categories: [Commercial EPCs](#) ; [Landlord and tenant](#)