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A TUFFIN FERRABY TAYLOR GUIDANCE NOTE

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MINIMUM ENERGY EFFICIENCY STANDARDS:
A CHANGING DILAPIDATIONS LANDSCAPE?

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DILAPIDATIONS

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From 1 April 2018, it will be unlawful to grant a lease of a property with an Energy Performance Certificate (EPC) rating of F or G, unless it meets certain exemptions or the transaction falls outside of the requirement for an EPC. A lease commencing before 1 April 2018 must comply from 1 April 2023. Financial penalties for non-compliance range from £5,000 up to £150,000.

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 were made on 26 March 2015 having passed through both Houses of Parliament. The Regulations introduce a mechanism for implementing and enforcing Minimum Energy Efficiency Standards (MEES) in accordance with the Energy Act 2011. This represents a significant step forward by the Government to make commercial (and residential) private rented properties more energy efficient, and address a general market reluctance to fund 'green' improvements when the benefits of lower energy bills typically accrue to tenants rather than those footing the capital cost.

Approximately 19% of commercial properties requiring an EPC currently fall below the minimum F rating[1] and will be captured by the MEES regulations. Whilst significant, this figure does not tell the whole story. It is thought that 17% of those are commercial properties[1] are E-rated and the interdependent relationship between EPC assessments and Part L of the Building Regulations means that an EPC granted in 2008 would be substantially lower if re-accessed now, even if the building remains unchanged.

The implications for the commercial sector are wide reaching and pose some interesting questions about how landlord and tenant matters should be approached in the lead up to, and after 2018.

WHY IS THE BUILDING F OR G RATED?

It is necessary to ascertain exactly why a building has the EPC rating is does in order to make strategic decisions. Of course, inherent inefficiencies due to outdated technology or design are often to blame; whilst there is a clear interrelationship between large areas of glazing and poor EPCs, mechanical and electrical services are most impactful on non-domestic ratings.

Tenants' aging air conditioning or heating systems will often worsen an EPC rating and, assuming a typical lease reinstatement covenant, removal is likely to improve the EPC. However, there are exceptions to this common sense approach. If energy will be used to condition an indoor climate (once the heating / cooling system has been removed), the EPC software will automatically factor in a generic heating system; in some cases this may be worse than what the tenant had installed (for example, where there is no gas supply), thereby adversely affecting the EPC rating.

Similarly, if a tenant has carried out energy efficiency improvements, strict enforcement of the reinstatement covenant could worsen the EPC rating. If reinstatement would result in an F or G rating, it would be prudent for the landlord to retain the alterations (for example, low energy T5 or LED luminaries often enhance the rating). Comprehensive EPC modelling is required to identify what the resultant rating will be once the tenant's alterations have been removed.

Concerns about the accuracy of some EPC ratings have abounded in the industry for some time now. An intensely competitive market and clients procuring surveys on a lowest cost basis means that sufficiently detailed assessments of complex building systems are sometimes lacking, leading to an overreliance on default settings within the software.

This is where expert (i.e. Level 5) assessors can add value and it is not uncommon for an EPC rating to improve, simply by re-running the correct figures.

Whether you are a landlord or tenant, you would be well advised to verify EPCs on the approach to lease expiry in order to

[1]The study for the Green Construction Board had access to circa 400,000 records taken from the Landmark non-domestic EPC database in Spring 2013.

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flush out inaccurate ratings and formulate a strategic approach to properties within, or on the boarder of F or G banding.

MID-TERM ISSUES

The Regulations are set to affect existing leases from 1 April 2023. Whilst there are various exemptions including a get-out clause if tenants refuse access to implement energy enhancements, landlords will have to make reasonable efforts to implement improvements. Logistical issues will be plentiful (wholesale replacement of plant with a tenant in-situ is never easy), as will contractual and legal obstacles.

Mortgage security could be affected if capital values of F and G stock are reduced. It is conceivable that landlords will have to complete works mid-term to prevent loan to value (LTV) defaults and tenant buy-in will be necessary to do so. There may be an angle here for bullish tenants to negotiate improvements or waive future dilapidations obligations.

Whilst most modern leases contain a Jervis v Harris clause which gives landlords powers to carry out repairs when the tenant fails to do so, MEES Regulations place obligations on landlords, not tenants. Entry under such a clause or a claim under Leasehold Property (Repairs) Act 1938 is unlikely to be lawful even if works are immediately required to comply with the Regulations.

One would hope that this will prompt increased take-up of collaborative 'green' lease provisions to facilitate access for MEES improvements in order to share the benefits. However, there has been a proliferation of service charge clauses excluding any liability for energy enhancements to minimise financial exposure. This is understandable but perhaps counterproductive in the long run as energy bills may be higher as a consequence. Tenants should also be mindful of potential business interruption before agreeing to take F or G stock through this period transitional period. This further supports the need for Technical Due Diligence at the pre-occupation stage.

SUPERSESSION

When a poor EPC is found to relate to inherent issues with the base-build, the question of supersession will inevitably arise if, at lease end, a landlord needs to implement extensive works to bring the building up to MEES compliance standard. Wholesale replacement of mechanical or electrical equipment due to poor energy efficiency rather than disrepair will fall outside of a typical repairing obligation.

There is the knock-on effect to consider, too: replacing plant within ceiling voids will damage ceilings and naturally form part of a larger refurbishment exercise. Taking this idea to its extreme, a significant portion of a dilapidations claim could be extinguished.

SUMMARY

As ever, dilapidations matters must be considered on a case by case basis with regard to the lease documents and issues thrown up by the specific property. Whilst MEES do not fundamentally change standard dilapidations procedures, energy enhancement works both mid-term and at term end will surely increase in prevalence and the impact of such improvements must be considered.

Landlords need to identify cost effective improvements early on and put in place strategic plans for implementing such works in advance of the 2018 and 2023 deadlines.

Conversely, tenants must be wise to the mid-term risk that improvement works could cause business interruption and be alert to a supersession based terminal dilapidations defence when it can be proven that improvements are required to comply with MEES, not the repairing covenant.

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