Briefing

RadcliffesLeBrasseur

Minimum Energy Efficiency Standards (MEES)

MEES now in force in relation to commercial property

Background

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 (2015 SI No. 962) were put in place to meet obligations to improve energy efficiency under the Energy Act 2011, and to meet the UK's targets for CO^2 reduction.

These rules were brought in to implement an EU Directive. It seems likely that MEES will stay if and when the UK leaves the EU. Under the Climate Change Act 2008 and various subsequent EU initiatives, the UK Government is committed to making significant reductions to emissions. The Clean Growth Strategy issued in October 2017 suggested that this drive to improve energy efficiency may only increase.

MEES will affect an estimated 20% of non-domestic properties within England and Wales.

Application

Landlords need to satisfy MEES from 1 April 2018 for new lettings or will need to satisfy MEES by 1 April 2023 for existing lettings.

Not all commercial properties are affected: buying and selling commercial properties will not trigger landlords' obligations under MEES. Neither will licences to occupy, assuming they are genuinely licences and not leases. MEES do not apply to owner-occupied properties.

MEES are not only relevant to landlords but also to tenants who want to sub-let. Sub-letting will be caught by the MEES regulations.

Landlords must make appropriate, permissible and cost-effective improvements. Before a new letting is granted, landlords should either carry out any "relevant energy efficiency improvements" and/or register an exemption, if one is available.

The "relevant energy efficiency improvements" will have been identified as a recommended improvement for that property in a recommendation report attached to an Energy Performance Certificate ("EPC") or a report prepared by a surveyor.

The landlord can be required to carry out works to a commercial property if they will pay for themselves within seven years or less regardless of whether that landlord has the means of funding them.

There is a formula in the MEES regulations for calculating whether the cost will be less than the projected energy cost savings.

Energy Performance Certificates

A landlord will now commit a criminal offence if it grants or renews a lease of a property with an EPC rating lower than 'E'.

Financing or re-financing does not trigger any requirement for an EPC but lenders may be concerned to check the energy performance position because of the potential impact of the MEES regulations. Lenders may require an EPC rating higher than 'E' to future-proof their security.

If an EPC exists, one can find it online by searching for "EPC register commercial".

Early EPCs are reaching the end of their ten-year validity. There is increasing evidence that older EPCs are inaccurate and many properties with ratings of 'E' or better are being downgraded to 'F' or 'G' ratings on reassessment.

As the industry matured, assessments became more closely regulated, the software used to produce EPCs evolved and concurrently the Building Regulations have tightened to make it more difficult to achieve the minimum 'E' rating.

A landlord may want to restrict a tenant's ability to commission its own EPC in the lease, as a new EPC invalidates an old one. It is not clear at this point whether a clause that prohibits tenants from commissioning EPCs will be ineffective.

Alternatively, the lease may prohibit the tenant from commissioning an EPC without the consent of the landlord. Prohibiting an EPC from being commissioned from any assessor other than the one designated by the landlord may ensure that the EPC will be done by someone competent.

Another option would be for the lease to prohibit the tenant from commissioning an EPC but instead agree that the landlord will commission and pay for an EPC at the tenant's request.

Exemptions

If a property is caught by the MEES regulations, the landlord may still let it if an exemption applies, such as when the recommended energy improvements do not pay for themselves in energy savings over a seven year period.

The legislation envisaged that this would be achieved by way of one or more of a Green Deal finance plan, the Energy Company Obligation ("ECO") or a local authority grant. However, the Green Deal failed to gain traction and the government ended public investment in it in 2015.

The supplier obligation funding, such as the ECO, will not be sufficient to bridge the funding gap and the ECO is not scheduled to continue beyond 2022.

Other exemptions apply if:

- The landlord has completed all cost-effective improvements, but the rating remains 'F' or 'G'.
- The landlord has failed to obtain a third party's consent which is needed for the works despite using reasonable efforts to do so, or consent has been given subject to conditions with which the landlord cannot reasonably comply. This would include the consent of a tenant, a superior landlord, a mortgagee, or the local planning authority.

  Government guidance suggests this may mean making several attempts to obtain the consent. More than just a token effort will be required.

  The MEES guidance states that the exemption for lack of tenant consent only remains valid so long as that tenant remains the tenant. So if the tenant assigns the lease the landlord would have to seek fresh consent from the new tenant. However, this is not reflected in the MEES regulations and the guidance is not legally binding.

  It may be preferable for landlords not to reserve an express right to carry out energy improvements, assuming they would rather have the option of postponing such works.

  Tenants might also be concerned about the possible disruption that could be caused to their business if they consented, so may wish to limit such a right in some way and/or argue for the rent to be wholly or partly suspended for the duration of recommended energy improvement works.
- The landlord has obtained a report by an independent surveyor which says that making the energy improvements:
  - Would reduce the property's value by more than 5%; or
  - Would have a negative impact on the fabric or structure of the property.

Exemptions last for five years and can be applied for again on expiry of the five year period.

The landlord must register its exemption on a central online register, which has already been open for registration for over a year. If they fail to register the exemption, it will be ineffective. This amounts to non-compliance with the MEES regulations. Registration involves administrative and other costs to provide the required information to demonstrate that the exemption applies.

To protect itself from enforcement action, the landlord will need to register a new exemption before the original one expires. The availability of a new exemption is not guaranteed because circumstances may have changed since the previous exemption was registered.

MEES compliance should become part of landlords' planned maintenance and refurbishment programmes. Tenants cannot rely on any exemptions registered by their landlord and will have to register their own exemptions if they wish to sub-let.

If the landlord sells the property, the new owner must apply for a fresh exemption. Exemptions are not transferable to a new landlord. MEES compliance will, therefore, need to be factored into due diligence on investment acquisitions.

Temporary exemptions

There are some temporary exemptions available for six months where:

- The landlord has bought a property which is subject to an existing lease;
- The lease has been renewed pursuant to the Landlord and Tenant Act 1954;
- The lease has been granted pursuant to a contractual obligation.

  There is no exception for leases granted after 1 April 2018 pursuant to agreements for lease which exchanged before that date. Therefore, if completion occurs on or after 1 April 2018, the MEES regulations will apply regardless of whether there was a prior agreement for lease.

  However, where the lease is granted pursuant to a contractual obligation, such as in an agreement for lease, it may be possible for the landlord to benefit from the above temporary exemption in order to make the letting lawful.

  Whilst on a literal interpretation of the MEES regulations this would apply to both existing and new landlords, there is a suggestion in the government's guidance that this exemption would only be available to those landlords who inherit a contractual obligation to grant a lease, for example, by buying a property which is already subject to an agreement for lease or that this exemption was only meant to cover contractual obligations in agreements for a lease entered into before April 2018. However, the legislation is not drafted that way and appears to cover any agreement for lease.

  A landlord and tenant are allowed to enter into an agreement for lease of 'F' or 'G' rated properties. It is only granting the lease itself that is prohibited.

Temporary exemptions apply to guarantors who become the tenant's landlord following the tenant's insolvency, the landlord having been a guarantor or former tenant who exercised the right to an overriding lease under section 19 of the Landlord and Tenant (Covenants) Act 1995 and on the deemed creation of a new lease by operation of law.

These temporary exemptions must also be registered on the central register.

When the six months have expired, the landlord must either carry out the necessary energy improvements, or register a full exemption.

Properties not caught by MEES

Commercial leases are not captured by the provisions:

- Where an EPC is not required, for example:
  - Listed buildings, but only where compliance unacceptably alters character or appearance. While the Historic England website stated on 1 November 2017 that "since January 2013 listed buildings had been exempted from the need to have an EPC", this is not what the EPC regulations say. It is not clear which buildings qualify.

    If EPCs are not required for listed buildings, the MEES regulation will not apply to listed buildings. If the government's intention was that MEES should apply to listed buildings except where energy efficiency improvement works "would unacceptably alter their character or appearance" it could have said so, but this is not what the MEES regulations say;
  - Places of worship;
  - Temporary buildings with a planned life of two years or less;
  - Certain industrial or agricultural buildings with low energy demand; or
  - Small demises of less than 50m².

  If a "voluntary EPC" is obtained for such premises it would not bring them within the MEES regulations. It has been suggested that a "voluntary EPC" is never an EPC for the purposes of the MEES regulations because the property was not "required to have an EPC" at the time when the EPC was obtained. Some comments in the MEES guidance seem to support this, but are ambiguous.
- Where the property does not in fact have a valid EPC. To be valid, an EPC must be no more than ten years old and be the most recent EPC for the property.
- If they are for a short term of six months or less (unless there is a right of renewal beyond six months, or at the time of the grant of the lease, the tenant has already been in occupation for more than twelve months); or
- If they are for a term of 99 years or more.

Penalties

The penalties for non-compliance vary depending on how long the landlord has been letting out the property in breach of the MEES regulations. Penalties are between £5,000 and £150,000 per three month period of infringement.

Where the landlord has remained in breach for less than three months after service of the penalty notice, the penalty will be the greater of £5,000 and 10% of the rateable value of the property up to a maximum of £50,000.

Where the landlord has remained in breach for three months or more, the penalty is the greater of £10,000 and 20% of the rateable value of the property up to a maximum of £150,000. On multi-let properties these penalties will mount up.

The landlord's details will also be put on a "name and shame" register. Publication penalties will be registered on a publicly accessible part of the exemption register for at least twelve months. This can include the landlord's address (where not an individual), the property's address and any financial penalty imposed.

No penalties will be payable by the tenant. The lease will remain valid and the tenant will still be liable to pay the rent and observe the lease covenants. Although a letting granted in breach of the MEES regulations will have been granted unlawfully, it will still be valid and legally enforceable.

MEES will be enforced by local authorities, but it is not yet clear if they will be allowed to keep the cash raised by penalties, rather than return them to central government. If they are, local authorities may be more rigorous in pursuing breaches.

The MEES regulations enable the enforcement authority to serve a compliance notice where the landlord appears to be, or to have been at any time in the last twelve months, in breach. The compliance notice may request that the landlord produce the EPC valid when the property was let, the current tenancy agreement or any qualifying assessment in relation to the premises within a minimum of one month from the date of service. If the local authority is satisfied that the landlord is, or has been at any time in the preceding 18 months, in breach it can serve a penalty notice imposing a financial penalty, a publication penalty or both.

Landlords will have the opportunity to review the penalty and ask the enforcement authority to reconsider. Landlords may also appeal to the First-tier Tribunal, which may quash or affirm the penalty notice. Unpaid financial penalties can be recovered as a debt but proceedings for recovery cannot be commenced pending review or appeal.

Service charges

Some, all or indeed none of the costs for the energy improvement works could be recoverable under the lease, which is why both landlords and tenants need to be alert about the implications of MEES.

The wording of service charge provisions and repairing covenants are, therefore, key.

MEES imposes obligations on landlords, not tenants. So a landlord will not be able to pass these obligations onto a tenant under the standard tenant's covenant to comply with statute.

For a full repairing and insuring lease of a whole building, the landlord will not be able to recover MEES-related costs from the tenant unless the lease contains a specific clause to that effect, which many tenants may resist.

For a lease of part, the landlord may be able to recover some MEES costs through the service charge, but this depends on the exact wording of the tenancy. Works are unlikely to fall within the scope of a general repair covenant, as they will tend to be improvements, not repairs. They are also unlikely to fall within obligations to comply with statute, as the MEES regulations do not actually impose any obligation to carry out works. The landlords may argue that the tenant will benefit from reduced energy bills. However, the tenant's view is likely to be that the landlord is improving the value of its investment, so should pay for the improvements.

From the landlord's perspective, it may be preferable for the lease to be silent on the costs of complying with MEES. If a landlord tries to add a clause saying MEES costs can be recovered through the service charge, this may simply prompt the tenant to amend this to the opposite.

For a tenant's point of view, it would be worth seeking an express exemption in relation to all MEES-related costs.

Tenants' improvements

Express covenants against tenants carrying out alterations which adversely affect energy efficiency, whatever the current rating of the building are likely to become more common. Such restrictions could cause problems for tenants such as retailers, because lighting and window displays make them high users of energy. If the works are sufficiently extensive to trigger the issue of a new EPC, this will supersede the EPC held by the landlord.

There could still be potential arguments about whether the proposed works will or will not have an adverse effect, and the tenant may have rights under the Landlord and Tenant Act 1927 to carry out the works regardless of a prohibition.

Dilapidations

In relation to dilapidations claims, well-advised tenants are likely to seek to show that non-compliance will render a landlord's dilapidations claim subject to supersession due to required energy efficiency improvement works. If the property is below standard, the landlord may need to carry out works to improve the EPC rating after the end of the term, which could make any repair works by the outgoing tenant unnecessary. Tenants could argue a landlord's requested dilapidations work will still leave the property 'unlettable' and, therefore, that works is rendered valueless.

If the tenant has carried out works to improve the EPC rating during the term, the landlord may want to benefit from the improved EPC rating. Reinstatement may not, therefore, be required.

Lease renewal

It is common practice not to provide an EPC on a lease renewal. This is in line with current government guidance, which states that lease renewals are not considered to be sale or letting to which the duty to provide an EPC applies. This practice may need to change. It is not clear whether the landlord remains outside the scope of the MEES regulations until an EPC is commissioned. It would be prudent for landlords to provide EPCs on lease renewal.

The exemption runs for six months from the date on which the renewal lease is granted. However, to rely on this temporary exemption, the landlord must register it on the exemption register.

Rent reviews

There is an argument that could be run in relation to buildings with an 'E' or 'F' rating – that it is not lawful to grant the hypothetical lease, so the market rent should be zero, even though the actual lease was entered into before 2018.

Tenants could obtain new EPCs in advance of review in the hope of reducing the rating to help the tenant argue for a nil increase.

One way for a landlord to counter this argument would be to establish the availability of an exception to the hypothetical landlord, if that is possible. This may require the landlord to produce additional evidence.

One possibility for landlords would be to invoke the classic presumption of reality principle. In the real world, the actual letting will not be unlawful, because it will have been affected before the date on which the MEES regulations prevented lettings to premises rated 'E' or 'F'. This assumption should, therefore, arguably be made in relation to the hypothetical letting.

Restrictive drafting to deal with MEES, such as prohibiting certain tenant works, may rebound on landlords at rent review. However, if restrictions on works which adversely affect an EPC rating become standard their impact on rent review will diminish.

Landlords may consider introducing:

- An assumption that the hypothetical premises at review will have an EPC rating that is the same as the rating which the premises actually had at the start of the lease.

  This should mean that any actual lower EPC rating awarded on a new EPC at the date of the review will be ignored. This has the downside of stopping a landlord from improving the rating on review, preventing it from taking advantage of any consequential rise in rental value. This could be a big problem if the assumed rating is 'D' and the benchmark applied by the MEES regulations is raised to include 'D' as well as 'E' and 'F'.

- A disregard of the effect on rent of any lower EPC rating shown on a new EPC or of the adverse effect of any tenant works.

  The latter may not be necessary if the rent review clause already disregards tenant's alterations or assumes no works have been carried out which reduce rental value.

- An assumption that the hypothetical premises may be lawfully let.

  This more general wording may avoid some of the problems of assumed ratings and allow the rent to take into account the condition of the building, including any low energy rating, but there may be problems finding comparable evidence in the future.

Tenants are likely to resist such new drafting.

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