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The new minimum energy efficiency standards:
implications for real estate in England and Wales

The transition to a low carbon economy in the UK will see a significant move towards energy efficient, sustainable infrastructure combined with the creation and development of intelligent, smart cities. The pace of change is ever accelerating—the continued introduction of more stringent legislative requirements, carbon taxes and green incentives are all factors affecting the focus on low carbon propositions.

As a result of recent regulatory changes the energy efficiency implications for those involved in the real estate rental market are significant and early action will undoubtedly help to 'smooth' the transition to a low carbon environment.

The Regulations

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 (the Regulations) were made on 26 March 2015 and will apply to private rented property in England and Wales only.

The Regulations apply to both residential and commercial property, but for the purpose of this briefing note we have focused on the Regulations as they affect commercial property only.

Those Regulations which affect commercial real estate will come into force on 1 October 2016, and allow a period until either 1 April 2018 (for new leases) or 1 April 2023 (for existing leases) in which to carry out any required works to improve the energy efficiency of the building in question.

Why is the change significant?

The Regulations will apply to all buildings which are required to have an Energy Performance Certificate (EPC), and which fail to meet the 'minimum standard' rating of E or higher. If the property has a rating of F or G, the landlord will be required to install energy efficiency measures to bring the EPC rating up to E, unless an exemption applies.

It is currently estimated that nearly 20 per cent of non-domestic properties and 7 per cent of domestic properties in England and Wales will be classed as sub-standard, fail to meet the minimum energy efficiency standard introduced by the Regulations and will therefore require expenditure in order to ensure compliance.

Failure to comply with the Regulations could have significant implications on business continuity as landlords will not only be prevented from granting new leases (including renewal leases), but will also face financial penalties and any breaches will be published in a public register.

New Leases & Renewals – 1 April 2018

Unless an exemption applies, with effect from and including 1 April 2018, the owner of a property with an

EPC rating of F or G must not grant a new lease or renew an existing lease of that property until works have been carried out to improve the energy efficiency to a rating of E or above.

All Leases & Buildings: 1 April 2023

Unless an exemption applies, with effect from 1 April 2023, the owner of a property with an EPC rating of F or G must not continue to let out that property until works have been carried out to improve the energy efficiency to a rating of E or above.

Failure to comply with this Regulation will not affect the validity or enforceability of the lease(s). However, the landlord will be considered in breach of the regulations and subject to the sanctions and penalties commented on below.

Implications for Owners, Investors and Funders

For property owners the Regulations will require landlords to have a greater focus on the energy efficiency standards of a building and will result in some landlords having to make significant upgrades to their assets to ensure that they remain rentable, and capital value is not affected.

For funders and investors there will be a greater emphasis on borrowers actively managing their real estate portfolios to ensure compliance with the Regulations and that any required action is taken early or promptly to prevent a void in rental income or to mitigate any impact on market value (and consequently covenant compliance). Many funders are including specific representations and undertakings in this regard.

Borrowers may seek additional finance from funders and investors to meet the costs of any necessary works: the question of course is how achievable that is if the property in question has a significant amount of debt secured against it.

Exemptions

There are some exemptions to the Regulations, where a landlord of a sub-standard property (with an EPC rating of F or G) will be permitted to proceed to let or continue to let the property without undertaking the required energy efficiency improvements. The Regulations do not apply if:

- **Lease Term:** Where the lease term is less than 6 months (unless the tenant has been in occupation for 12 months previously) or over 99 years.

- **Consents:** Where the consent of the occupational tenant is required to carry out the works and the tenant has refused to provide that consent, or the consent of any third party is required, but despite reasonable efforts by the landlord to obtain that consent it has been refused or granted subject to unreasonable conditions.

- **Economic Efficiency:** If the energy efficiency works proposed will not deliver a simple payback within seven years (meaning that the savings in energy costs over seven years will be less than the cost of carrying out the works).

- **Reduction in Capital Value:** If the landlord obtains a report by an independent surveyor stating that the energy saving improvements if made would reduce the capital value of the property by 5% or more.

- **Negative Impact on the Fabric:** If the landlord obtains a report by an independent installer of energy improvement works advising that the proposed work(s) in question are not appropriate due to the potential negative impact on the fabric of the building.

- **EPC Exempt:** Properties exempt from the requirement to obtain an EPC, e.g. buildings about to be demolished, listed buildings.

- **Temporary Exemption:** The purchaser of any sub-standard building which is let, will have a grace period of 6 months in which to carry out the works necessary to bring the building up to the required E rating.

Exemptions Register

In order to rely on any exemption, the landlord must register details of the exemption with the supporting information.

The Regulations provide for an Exemptions Register to be set up, to hold details of the property, the landlord, the exemption relied upon, the EPC and the date of registration.

A registered exemption will remain valid for five years (or until the end of the current tenancy).

Enforcement and Penalties

The Regulations will be enforced by a local weights and measures authority, anticipated to be Trading Standards. If the enforcement body suspects a landlord has breached the Regulations at any time in the preceding 12 months, a compliance notice will be served on the landlord requesting further information. If the notice is not complied with, or the information provided doesn't satisfy the enforcement body that an exemption applies, a penalty notice may be issued.

The penalties may be financial or 'publication' in nature, or both. A publication penalty is a notice in the Exemptions Register that a breach has occurred. The financial penalties imposed are set out below:

Infringement	Penalty
Providing false or misleading information in respect to a claimed exemption.	£5,000
Failing to respond to compliance notice	£5,000
Non-compliance < 3 months	Greater of £5,000 and 10% of rateable value (subject to a maximum of £50,000)
Non-compliance > 3 months	Greater of £10,000 and 20% of rateable value (subject to a maximum of £150,000)

If a property does not have a rateable value then a substitute figure is calculated using a standard formula.

Next Steps

It is less than 3 years until 1 April 2018, and landlords are recommended to plan ahead to reduce any void letting periods or exposure to financial penalties. Many clients are considering:

- an audit to identify 'at risk' properties currently sitting within the F and G rating band including assessing the accuracy of existing EPCs and perhaps updating;
- a 3-5 year plan for retrofitting and energy efficiency improvements to ensure void letting periods and reductions in capital value are minimised;
- the potential cost of compliance with the Regulations, where the funding for the improvements works will be sourced and any cash flow implications;
- additional due diligence on any purchase or funding to identify potential cost of compliance.

It is clear that all landlords will potentially be affected by the Regulations, irrespective of the size and nature of their portfolios and early action is advised to mitigate the impact of the Regulations. Similarly for funders and investors in real estate, attention should be paid to the potential consequences of the Regulations in terms of void rental periods, financial penalties and the capital value of their real estate portfolios.

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