The effect on commercial leases of the Minimum Energy Efficiency Standard – Part 1

27 August 2015

This is a very long article. I have therefore prepared a PDF version of it, to make it easier to read and print out.

PDF version of this article

I have been giving some thought (and I know I am not alone) to the effect on commercial leases of the Minimum Energy Efficiency Standard, which I shall term MEES for this article.

Curiously, although there have been two recent articles in Estates Gazette about MEES (in addition to my two articles), there has not yet been an article on the effect of MEES on existing leases, or on changes that are likely to be made on new lettings. So I will start the ball rolling with this article. I am grateful to Charles Woollam of Sustainable Investment & Asset Management (SIAM) for commenting on the initial draft of this article (but of course the views in it are my own).

Everything that I am talking about in this article relates to commercial lettings. I don't know enough about residential lettings to be able to talk sensibly about what is likely to happen.

The regulations to implement MEES are now in place – the Private Rented Sector (Energy Efficiency) (England and Wales) Regulations 2015. The reference to "private rented sector" is irrelevant in relation to commercial lettings, by the way. The regulations apply to lettings of commercial (and other non-domestic) properties by public authorities as well as by private landlords. The term derives from the language of residential lettings and is seriously misleading.

Two questions need to be asked. First, how will MEES affect existing leases? Secondly, what changes need to be made to typical forms of lease for new lettings? I will look at the first question in this article and at the second question in a separate article next week.

None of this is easy, for at least two reasons. First, this is all new territory, and secondly we do not yet have a full understanding of how MEES is likely to operate in practice. DECC has promised us some (non-statutory) guidance but nothing has appeared yet.

It seems pretty clear (to me at least) that the Government expected landlords to pay the cost of improving properties to satisfy MEES. Whether or not it expected those landlords to be able to extract a higher rent from the property as a result is less clear. In theory, that depends on the local market. If all the buildings around you are D rated, you are not going to get a higher rent for your property that has just been improved from a G rating to a D rating merely because you have just spent a shedload of money on it.

But in practice what seems to be happening (or being talked about, at least) is that landlords are expecting to recoup as much of the cost of this exercise from tenants as possible, and if they cannot get it back in higher rent, then they are looking at the other provisions in leases. For example, I have heard of landlords who are expecting tenants under existing leases to return the property at the end of the term with an E rating or above (which is misconceived, as explained below).

It isn't all bad news, of course. The only works that MEES requires to be carried out are ones that pay for themselves through energy savings. Landlords may – with some justification – argue that the primary reason for making these improvements is for the benefit

of the tenants. It will reduce their costs, and enable them to sublet, and on that basis tenants may be happy to contribute towards the costs of improving a building. But there will need to be a pretty quick pay-back. Perhaps seven years will be thought appropriate – the same period as in the MEES test (but tenants whose leases expire earlier than seven years may feel differently). And tenants need to consider what should happen if they are persuaded to contribute towards capital costs by the promise of lower energy bills, and the bills never do get lower. In relation to residential properties, that was apparently one of the reasons for the failure of the Green Deal.

EFFECT OF MEES ON EXISTING COMMERCIAL LEASES

What follows is a very quick summary of some of the key issues. I have not carried out any detailed research into the individual issues yet.

1. Service charges

In the case of a multi-occupied building with a rating of F or G, landlords are likely to be sorely tempted by the idea of recovering costs of compliance with MEES through a building's service charge, so as to be able to let any vacant areas from 2018 onwards.

Currently there is a fairly clear distinction (in theory, if not in practice) between the costs of repair and maintenance (for which tenants expect to pay through a service charge) and the cost of improvements (for which tenants would not expect to pay). This was demonstrated by the case of Fluor Daniel Properties Ltd v Shortlands Investments Ltd [2001] EWHC 705 (Ch). The High Court ruled in that case that the landlords were not entitled to recover through the service charge the cost of replacing air conditioning kit that was still in working order.

However, the distinction between improvements and repairs is not quite as easy to draw as this makes it sound. Replacement of subsidiary parts of a building that need replacement because they can no longer be repaired (or where it is not cost-effective to repair them) is treated as repair – in which case it is likely that landlords will be able to recover the costs. Replacing the boiler will often be a simple way of improving a building's EPC rating, and may well constitute repair rather than improvement, where it is nearing the end of its life.

The RICS Service Charge Code (third edition), which has no legal status of course, mentions the point in its introduction, where it says:

> "Service charge costs do not generally include … any improvement costs above the costs of normal maintenance, repair or replacement. Service charge costs may include enhancement of the fabric, plant or equipment, where such expenditure can be justified following an analysis of reasonable options and alternatives, and with regard to a cost-benefit analysis over the term of the occupiers' leases."

2. Yielding-up

As I mentioned above, some landlords have expressed the view that under a typical yielding up provision in a lease, the tenant is required to bring the property up to a minimum E rating at the end of the term.

This is nothing more than wishful thinking, in my view. There is no connection between a tenant's repairing obligations (to which the yielding-up provision is related) and the property's EPC rating.

3. Statutory compliance

Could a landlord require a tenant to pay the costs of upgrading a property to an E rating through the covenant to comply with statutory obligations in relation to the demised premises? If this was possible, it could apply to both single-let buildings and the demised parts of multi-let buildings.

This seems once again to be wishful thinking. Between 2018 and 2023, there is no requirement within MEES on the landlord to carry out any works. The regulations merely require a minimum EPC rating before a letting.

The position will change from 2023, as owners that are already landlords after that date, in buildings that are F or G rated, will need to carry out works to improve energy efficiency (unless one or more of the exemptions applies). However, this is an obligation on the landlord as the person who is letting the property (meaning "continuing to let" the property). It is not related to the tenant's use or occupation of the property (other than the fact that the property is let, which is what brings it within MEES in the first place). My current view is that landlords are unlikely to be able to use the statutory compliance provision to pass on to tenants the responsibility of bringing a property up to an E rating, or the costs of so doing, whether before or after the 2023 date. But that won't stop landlords from trying, I'm sure.

4. Governing how, and when, a tenant obtains an EPC

There are some leases that contain provisions governing how, and when, a tenant obtains an EPC. I imagine this will work as intended. I am mentioning the point here as I will be covering possible new lease clauses in a second article and this is a likely area where landlords may want additional controls.

5. Alterations

To what extent, if at all, can a landlord bring environmental issues into play in relation to its control over a tenant's alterations? Probably not very much, on the basis of typical alterations provisions. In a lease of part, these normally provide that tenants can make non-structural alterations with landlord's consent, and structural alterations are not permitted at all. A tenant of a single building may be permitted to carry out structural alterations with landlord's consent. Given the flexibility of the concept of "reasonableness", it may already be possible for a landlord to take into account the effect of the tenant's alterations on the building's EPC rating when considering whether to give consent to those works, although I have never considered the point before. But that issue may become clearer in leases in the future, as I will discuss in the second part of this article.

6. Landlord's right to carry out works to improve energy performance

Landlords typically reserve extensive rights when granting leases. In leases of whole buildings, they will often be limited to rights necessary for maintaining adjoining buildings. In leases of part, they will also allow entry in connection with maintaining the remainder of the building or centre. Some leases allow the landlord to enter in connection with improvement works being carried out to adjoining properties but a well-advised tenant will try to resist this.

Would these provisions allow a landlord to enter premises to carry out works to improve energy performance, either of the premises or the building as a whole ? That is too broad a question to be able to answer with a generic answer, but – as in the comments under "service charges" above – the answer is more likely to be No than Yes. Improving energy performance is likely to be considered to be improvement rather than maintenance, and therefore likely to be outside the scope of what the landlord is entitled to do. I stress again that this is only the broadest of approaches, and each lease would need to be considered individually.

Curiously, landlords might wish to claim that they do not have the right to enter to carry out improvement works, which is the opposite of what one might expect. This is because the MEES regulations contain an exemption under which a landlord does not need to carry out works to improve energy-efficiency (from 2023) if tenant's consent is needed and cannot be obtained. This exemption lasts for only five years, and it means that the property has to be included on the exemptions register, which may possibly carry a stigma. But landlords may still be happy to take advantage of it.

7. Rent review

The impact of MEES on rent reviews is currently a mystery, although I am not certain how important it is going to be in practice.

A rent review provision assumes a notional letting of the actual property to a notional tenant on the rent review date. If – at a rent review after April 2018 – the landlord is required to carry out works in order to comply with MEES (because it has only an F or G rating), the tenant (it is said) could argue that the notional letting would be unlawful and so the rental value of the property would be zero.

This is not a very convincing argument. In practice, if a property was going to be let and needed works doing, the landlord would have to carry out the works, at its own cost. So the argument that the rental value of the property would be zero is fallacious. It would still have a value.

It is also arguable that one or more of the typical assumptions in a rent review provision would mean that the MEES argument fell away – perhaps that there is a willing landlord and a willing tenant, or that the property is fit for occupation and use, or that the property may lawfully be used for the purpose for which it is being let. There is an article there waiting to be written (but I don't want to be the one to have to write it).

Or perhaps it is arguable that MEES does not actually prevent a letting, since a letting in breach still creates a valid lease. In that case, the problem goes away.

We must not forget that the purpose of a rent review is to ascertain a rent for a lease that is already in existence, and avoid the sorts of rent review arguments that clogged up the courts in the 1970s and 1980s, all of which look pretty misguided now. The worst of them (in my

view) was the once-held view that “ignoring rent” meant also ignoring the rent review provision, so that the hypothetical lease contained no rent review provisions at all, resulting in the tenant paying a much higher rent than the market rent. (The classic example of this was National Westminster Bank plc v Arthur Young McClelland Moores & Co [1985] 1 WLR 1123). Yet the most recent Supreme Court case on interpretation, Arnold v Britton [2015] UKSC 36, demonstrated that where there is no obvious ambiguity, a provision in a lease (or elsewhere) has to be interpreted to mean what it says, so there is plenty of room left for argument on this sort of point.

So that is a very brief look at existing lease provisions – which seem to be pretty much in tenants' favour. In the second part of the article, to be published next week, I will consider how a typical lease precedent might be altered so as to favour the landlord more.