www.falcolegaltraining.co.uk/blog

The effect on commercial leases of the Minimum Energy Efficiency Standard – Part 2

1 September 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

In Part 1 of this article, published on 27 August 2015, I started to consider the effect on commercial leases of the Minimum Energy Efficiency Standard, which I shall term MEES.

I looked at seven different aspects of commercial leases, and concluded that in relation to MEES, typical lease provisions will make it relatively difficult for landlords to pass on the costs to their tenants. So for future lettings, might landlords want to alter the wording of typical leases so that they are more in their favour? I will consider this question under the same seven headings.

As in Part 1 of this article, everything that I am talking about relates to commercial lettings. I don't know enough about residential lettings to be able to talk sensibly about what is likely to happen.

Also as in Part 1 of this article, this is only a very quick summary of some of the key issues. I have not carried out any detailed research into the cases.

Again, 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).

1. Service charges

Assume that a lease allows a landlord to recover via a service charge the cost of operating and maintaining a building, but not improving it, which is a good baseline (some leases may allow landlords the cost of improvements, in which case those landlords need not read any further). In Part 1 of this article, I concluded that landlords may well be able to recover the costs of replacing plant by more energy-efficient versions from their tenants where this entails replacing kit that is life-expired. But where the current system is in working order and is only being replaced because the landlord needs to obtain a better EPC rating, the cost of replacement is likely to fall on the landlord rather than the tenant.

So landlords may wish to ensure that they are expressly permitted to include in the service charge the cost of replacing kit that is still in working order in order to improve the building's energy efficiency. There are various ways of saying this, depending upon how obvious the landlord wants to make it.

By way of example, the Model Commercial Lease already contains a provision that allows the landlord to include in the service charge:

"Auditing the Environmental Performance of the Building and, where reasonable and cost-effective to do so, implementing the recommendations of any environmental management plan the Landlord has for the Building from time to time"

This looks pretty innocuous, so many tenants will overlook it. Furthermore, a tenant who does see it may well be prepared to accept it given that the landlord cannot take advantage of this provision unless it is reasonable and cost-effective to carry out the improvement works.

2. Yielding up

In Part 1 of this article, I concluded that a standard yielding-up provision does not require a tenant to bring the property up to a minimum E rating at the end of the term.

The suggestion I have heard is that the wording of the yielding-up provision should therefore be amended so that it requires tenants to ensure that, at the end of the term, the EPC rating of a building is no less than the minimum required under MEES, or perhaps even the same rating (or at least the same rating) as existed when the property was first let.

This seems unfair to tenants. The basic position has always been that they should deliver the premises back to the landlord at the end of the term in a good state of repair – which might be a better state of repair than when they took it, but at least it is the same property. Requiring a particular level of EPC rating might well involve handing back an improved property, which is more than a repairing covenant would normally require. This was discussed in the seminal case of Ravenseft Properties Ltd v Davstone (Holdings) Ltd [1980] QB 12. The key question, of course, is one of fact: is the tenant being asked to hand back something different from what was originally demised? In that case the court held that a property with effective expansion joints in the exterior stonework was effectively the same property as had been demised (but with faulty expansion joints).

In passing, it is worth pointing out that it is possible that the criteria for obtaining a particular EPC rating may tighten over time, if the requirements of the Building Regulations change. So a property that is rated D today may be rated E in five years' time. I have to say that this is something that I have heard many times, but I have no idea whether it is correct. The workings of the algorithm inside the EPC software for commercial properties (SBEM – Simplified Building Energy Model) is a mystery not just to me but to everyone else I have spoken to about it.

If this is correct, then a tenant who agrees to hand back a property with at least the same EPC rating could be taking on a commitment potentially to hand back a different property at the end of the term. Tenants would be ill-advised to accept such a provision, in case this argument is correct.

3. Statutory compliance

In Part 1 of this article, I concluded (tentatively) that a tenant that agrees to comply with statute in respect of the property does not become liable to ensure that the property has a minimum E rating, or to pay the costs of work necessary to achieve it. I cannot see landlords trying to change that situation.

In fact, perhaps tenants should be asking for a specific carve-out to this provision to make it clear that tenants are not liable to carry out any works that are required directly as a result of MEES (although from a landlord's point of view, this is not desirable, as it may not be possible to ascertain whether particular works would or would not fall within such a carve-out).

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

It is relatively rare for leases to govern how, and when, a tenant obtains an EPC, but this is likely to change pretty quickly.

There are a number of reasons why landlords may be concerned about this.

First, there is a perception (unproven, I hasten to add) that some EPC assessors "mark higher" than others, and landlords may have their favourite assessor, and may not want the tenant to use any other assessor.

Also, a later EPC supersedes an earlier one, so a landlord will not want a tenant inadvertently to reduce the rating of the property by obtaining its own EPC rating that turns out to be lower than the current one (not impossible – rating a complex building seems to be as much an art as a science). It is still unclear what effect a later EPC of part of a building will have on an EPC of the whole. Possibly it will supersede the earlier EPC to the extent of the part of the building to which it relates (it is thought unlikely that it will supersede the EPC in relation to the whole building). In any event, this is an area that a landlord will want to stay well clear of.

Thirdly, where a building does not yet have an EPC, a landlord may wish to prevent a tenant obtaining one, except where the tenant is legally bound to obtain one (ie in advance of a proposed assignment or sub-letting). This is to try to ensure that the building is not brought within MEES as from April 2023 when it would otherwise be outside MEES because it does not have an EPC at all. (However it may be too late to worry about that now, since any lease granted now will require an EPC to be obtained in any case. So it is only relevant to leases that were granted before 2007 and that will still exist in 2023. There probably are not too many of those. Although that is of course assuming that landlords obtained EPCs when they were meant to obtain them, which might not be the case.)

So for all these reasons, there may be provisions in new leases about EPCs. It is thought that it is unrealistic for a landlord to stipulate in a lease that a tenant must not obtain its own EPC, given that there are occasions when the tenant is under a legal obligation to pass a copy on (to a potential assignee or sub-tenant).

However, a landlord may wish a tenant not to obtain its own EPC when there is already an EPC in place for the building. Where there is no EPC, landlords might wish tenants to use the landlord's choice of EPC assessor. The landlord might even wish the tenant to ask the landlord to obtain an EPC where the tenant needs one, where there is no EPC in place already. The fact that the tenant would not then have to pay for the EPC may be sufficiently attractive for the tenant to accept such a provision.

It is worth mentioning that if the tenant breaches such a covenant against obtaining its own EPC, the landlord is going to be unable to do much about it. The tenant's EPC will exist and cannot be made to unexist.

5. Alterations

Currently alterations covenants do not mention environmental performance. I have heard it suggested that landlords might wish to be able to prevent tenants carrying out alterations that would (or perhaps merely might) have an adverse effect on the building's environmental performance, or perhaps on the EPC rating.

Tenants would be nervous about accepting such a restriction. It could interfere with their normal use of the property for their business. A change of use of part of the property to, for example, a server room could worsen the EPC rating. Or at least a landlord could raise that argument, and leave the tenant to try to refute it.

As an alternative, it has been suggested that landlords might be prepared to let tenants carry out whatever alterations they are permitted to carry out under the lease, without regard to any effect those alterations might have on the EPC rating, on condition that the tenant returns the property at the end of the term with an EPC rating at least as good as when the lease was granted. That would only be appropriate in a letting of whole, where it would be clear that it was the tenant that was responsible for the drop in the EPC rating during the term (this would not be the case in a multi-occupied building).

For the reasons explained in the "yielding up" section above, tenants should be wary of agreeing to such provisions. In addition, one cannot be certain that a property that is rated X today will be rated X in ten years' time, such is the complexity of obtaining an EPC for a commercial building.

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

Landlords may wish to include in new leases a right to enter to carry out energy-efficiency improvement works during the term of the lease. Tenants will probably not be keen on this, but some may agree. They might want to limit the type of works that are permitted: would a tenant be happy to see a complete recladding exercise carried out, while it was in occupation? It happens occasionally when (for example) defective panes of glass need to be replaced, but tenants would not want it to become the norm.

However, as mentioned in Part 1 of this article, landlords might be better off by not having such a provision in the lease, as it would deprive them of one of the exemptions within MEES – that works required after April 2023 cannot be carried out because the tenant will not give its consent.

7. Rent review

Rent reviews present the most difficult area. 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 property requires works to be carried out in order to comply with MEES (because it has only an F or G rating), the tenant could argue that a letting would be unlawful and so the rental value of the property would be zero. In a standard upward-only rent review, that would mean no rent increase for the landlord.

It is quite likely that one or more of the existing assumptions in a typical rent review clause will already cover the point, such as the assumption in the Model Commercial Lease's rent review schedule that "the Premises may lawfully be let to and used for the Permitted Use by any person throughout the term of the Hypothetical Lease".

But would it be sensible to include an additional assumption to deal with the point? Something along the lines of "assuming that the landlord would carry out (at its own cost) any works to the Premises [or the Building] that would be required by the [MEES regulations] before the landlord grants the notional lease of the Premises".

Inclusion of such words could be criticised on the basis that it is creating a false assumption – and might perhaps require the third party to ascertain exactly what notional works the landlord would have carried out. Another viewpoint (which I think I favour) is that its inclusion is simply to ensure that the tenant cannot argue that the notional letting envisaged by the rent review machinery cannot take place. Time will tell whether landlords and tenants feel it necessary to adopt wording of this nature. My mind is not yet made up one way or the other.

IN CONCLUSION

I am pretty sure that we can expect to see some changes to typical leases in the coming months, with a view to enabling landlords to recover from tenants the costs of complying with MEES, and of improving their buildings' energy efficiency generally. This is not necessarily a bad thing, in theory, since tenants ought to benefit from lower energy bills. The devil will be in the detail, as usual, and rent review looks like the issue that is going to cause the most difficulties.