The Carbon Challenge

How emission reduction schemes may affect property lenders

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Commercial property is now subject to a range of EU-wide and UK domestic law aimed at reducing carbon emissions. These laws raise important questions for those lending against property.

- Could certain properties become less attractive to target tenants?
- Will properties require costly energy efficiency upgrade works?
- Could property sales therefore become more complicated and costly (whether pre- or post-insolvency)?

All of these issues may have an impact on value, and on the adequacy of a property as security throughout the life of a loan facility.

Metaphorically, carbon reduction legislation takes the form of both carrots and sticks. Lenders are more likely to be concerned with the latter than the former. In this note we therefore focus on three schemes that may bring unavoidable costs for certain owners and users of property: Energy Performance Certificates (see paragraph 1), the CRC Energy Efficiency Scheme (see paragraph 2) and the Energy Savings Opportunity Scheme (see paragraph 3). For completeness, we have also provided much briefer details of the key voluntary schemes which the government has introduced to encourage low carbon activities (see paragraph 4).

Key legislation

At European level, the key legislative drivers are the Renewable Energy Directive 2009/28/EC (RED) and the Energy Efficiency Directive 2012/27/EU (EED). The RED requires Member States in the EU collectively to increase the proportion of energy consumed from renewable sources to 20% by 2020. The EED requires collective final energy savings of 20% by the same date.

In the UK, the government has implemented the RED requirements through various schemes, such as the Renewables Obligation, the Feed-In Tariff, the Contract for Difference and the Renewable Heat Incentive. These regimes aim to support and enhance the price of renewable electricity generation to encourage new capacity to be installed.

In addition, the UK has introduced various measures to encourage greater energy efficiency, such as the CRC Energy Efficiency Scheme and the Energy Savings Opportunity Scheme. These and other measures should help the UK to meet its savings target under the EED.

1. Energy Performance Certificates (EPCs)

What are the legal requirements?

EPCs are required whenever a domestic or commercial property is built, sold or rented. This has been the case for many years now without being a major issue for owners or funders. However, focus has returned to EPCs because of the recent introduction of a minimum efficiency level for commercially let property.

Background on EPCs

An EPC provides information on how energy-efficient a building is, giving it a rating from A (very efficient) to G (inefficient). It also provides information on the likely carbon dioxide emissions from a building and what that building's energy efficiency rating could be if suggested improvements were made.

Where a building, or a self-contained part of a building, is to be sold or let, the seller or landlord must ensure that an EPC has been commissioned before marketing the premises and make available a copy of the EPC to any prospective buyer or tenant.

The relevant legislation is:

- Energy Performance of Buildings (England and Wales) Regulations 2012, and various Department for Communities and Local Government (DCLG) guidance notes; and
- Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015.

An EPC must be issued by an accredited energy assessor and must have been issued no more than 10 years before the date on which it is made available. EPCs must be filed on the register held by the DCLG. The information is available to the public unless the EPC holder opts out of having its information publicly available.

Exemptions

Certain buildings and transactions are exempted from the requirement to have an EPC on sale or letting. For example, no EPC is required:

- on the grant of a licence (as opposed to a tenancy), lease renewal, lease surrender, compulsory purchase or share sale;
- for buildings intended for demolition; or
- for buildings protected as part of a designated environment or because of their special architectural or historical merit, where compliance with certain minimum energy performance requirements would unacceptably alter the character or appearance of the building.

Minimum Energy Efficiency Standards

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 (the Regulations) will prevent landlords from granting new leases or renewing existing leases for properties with an EPC rating of F or G. The new restrictions will apply in stages:

- to **new lets and renewals of tenancies** from 1 April 2018;
- to **all existing tenancies for domestic properties** from 1 April 2020; and
- to **all existing tenancies for non-domestic properties** from 1 April 2023.

It will be unlawful to let a property which does not have a minimum E rating, unless there is an applicable exemption.

The Regulations are made under Chapter 2 of Part 1 of the Energy Act 2011 which requires the government to implement measures to improve the energy efficiency of buildings in the domestic and non-domestic private rented sector in England and Wales.

Key points to note

- Properties let on short-term tenancies (less than six months) (provided the tenant has not already occupied the property for more than 12 months or the tenancy agreement does not provide for extensions beyond six months) are excluded.

- Properties let on long term-tenancies (99 years or more) are also excluded.

- In some cases landlords have a six month "grace period" to cure a breach, for example where the tenancy arises by operation of law, or because of insolvency.

- The legislation refers to properties below an E rating as being "sub-standard". If this term becomes widely used when referring to properties with an F or G rated EPC, it may have a negative "blight" effect, reducing the asset value of these properties.

- Where a landlord lets "sub-standard" domestic or non-domestic property in breach of the Regulations, that breach does not affect the validity or enforceability of the tenancy. The breach could however lead to enforcement action by a regulator and a financial penalty.

- The current energy efficiency requirement is an EPC rating of E – however, this could be increased in the future.

Exemptions

Certain exemptions apply to the minimum energy efficiency requirements. However, an exemption can only be relied upon if it is registered on the PRS (Private Rented Sector) Exemptions Register. The Department of Energy & Climate Change will set up the Register, which will be available from 2016.

A landlord can claim an exemption in any of the following circumstances:

- all possible energy-saving improvements have been made in respect of which the consequential expected energy bill savings exceed or equal the cost (including the cost of finance) of the work (this is the "golden rule" that would qualify an improvement for funding under the government's Green Deal scheme);

- (in the case of a non-domestic property) all possible energy-saving improvements have been made that would achieve a "payback" of seven years or less (that is, the expected energy bill savings over seven years exceed or equal the cost (including the cost of finance) of the work);

- (in the case of a domestic property) all possible energy-saving improvements have been made that can be wholly financed by other means, but at no cost to the landlord;

- the landlord cannot carry out the necessary work because the consent of a third party (for example, a tenant, a lender, a superior landlord, the planning authority) is required and that consent has been denied (or has been granted subject to unreasonable conditions); or

- the works would result in a reduction of more than 5% in the market value of the property, or of the building of which it forms part (this will need to be verified by an independent surveyor).

Wall insulation work is exempt if it will have a negative impact on the fabric or structure of the building.

An exemption lasts only for five years from the registration date. After that the landlord must either demonstrate that the relevant exemption still applies or carry out the work.

Temporary exemptions

A temporary exemption of six months applies for anyone buying a property subject to an existing, non-complying tenancy. The buyer has six months to either comply with the Regulations or establish a fresh exemption.

There are also temporary exemptions of six months where a lease is granted:

- under a contractual obligation (for example, the exercise of an option to renew);
- on a tenant's insolvency, by virtue of the landlord having been the tenant's guarantor;
- under the (rarely used) overriding lease provisions of section 19 of the Landlord and Tenant (Covenants) Act 1995;
- by operation of law (for example, by way of a surrender and regrant);
- under the 1954 Act lease renewal procedure; or
- by court order.

Enforcement and breach

Local authorities, usually through their trading standards departments, are responsible for enforcing the requirements relating to EPCs. may result in a civil penalty charge notice.

If a regulator suspects non-compliance, it may serve a compliance notice on the landlord requesting further information. If that is not provided, or is not sufficient to prove compliance, then the regulator may issue a penalty notice.

Penalties for breach are civil, not criminal, and enforcement will be through a combination of compliance notices, financial penalties and publication penalties.

A publication penalty involves publication on the PRS Exemptions Register, including the name of the company in breach, the property address and the amount of any financial penalty imposed. The information will be published for a minimum of 12 months – potentially for longer at the regulator's discretion. A publication penalty can be applied in all cases, either with or without a financial penalty. This results in potential reputational risk for companies found to be in breach.

The financial penalties are set out in the table below.

Breach	**Financial penalty**
Failure to provide an EPC when required by the regulations	For non-residential buildings, the penalty is 12.5% of the rateable value of the building, with a default penalty of £750 where the formula cannot be applied. The minimum penalty is £500. The maximum is £5,000. For dwellings, the penalty is £200.
Providing false or misleading information to the PRS Exemptions Register	Up to £5,000.
Failing to comply with a compliance notice	Up to £5,000.
Renting out a non-compliant domestic property	For non-compliance lasting less than three months, up to £2,000. For non-compliance lasting three months or more, up to £4,000.
Renting out a non-compliant commercial property	For non-compliance lasting less than three months – a penalty of 10% of rateable value (minimum £5,000 and a maximum of £50,000). For non-compliance lasting three months or more – a penalty of 20% of rateable value (minimum £10,000 and a maximum of £150,000).

Domestic tenants – right to carry out energy efficiency works

Under Part 2 of the Regulations, the government has made it more difficult for landlords to withhold consent to domestic tenants making energy efficiency improvements to their properties. Part 2 comes into force on 1 April 2016.

Even if a domestic tenancy agreement prohibits alterations, the landlord must not unreasonably withhold consent to the tenant carrying out energy efficiency works that:

- result in expected energy bill savings where the golden rule applies (see above); or
- can be wholly financed by other means, at no cost to the landlord.

The landlord can make a counter-proposal of a similar package of energy efficiency measures.

Part 2 applies regardless of the property's EPC rating and whether or not an EPC has actually been produced for the property.

The lender perspective

- If a property falls below the minimum efficiency level, it may be "unlettable" in practical terms. If a landlord is in financial difficulty it may not be able to take the measures necessary to bring the property's energy efficiency up to the minimum required level.
- This is likely to affect the value of inefficient properties: potential purchasers will increasingly factor the cost of future efficiency upgrades into the price they are prepared to pay.
- Before lending against a property that is currently below or on the threshold of the anticipated minimum efficiency level, lenders should ensure they understand how the owner proposes to address this, and how it will fund any necessary work.

2. CRC Energy Efficiency Scheme

What are the legal requirements?

The CRC Energy Efficiency Scheme is a mandatory emissions reduction scheme. It requires companies to monitor and report on energy consumption across all operations within their corporate group. It applies to large energy users (public and private sector), for example retailers, shopping centres, supermarkets, hospitals, hotel chains, and other large office occupiers such as banks, accountants, law firms and data centres.

The key obligations are to:

- register with the Environment Agency as a participant in the scheme where the company uses more than 6,000 megawatt hours per year of energy (electricity or, unless below 2% of its energy use, gas for heating purposes);
- prepare and submit an annual report each year, including details of all electricity and gas supplies consumed; and
- purchase and then surrender an amount of CRC allowances equivalent to annual emissions (one allowance per tonne of CO2). The cost per allowance is set by HMRC and currently ranges from £15.60/tCO2 to 16.90/tCO2 for 2015. Unused allowances may be sold in the open market or surrendered back to the scheme.

Points to note

- CRC gives rise to an annual compliance cost which can be significant (for example, £500,000 per year for a large retailer with a portfolio of shops). This figure will rise every year until 2020.
- All companies within a group have joint and several liability under the CRC legislation. It is now common in sale and purchase agreements to include specific drafting to deal with CRC liabilities in transactions.

- Usually, liability for CRC rests with the end user that is responsible for paying for the electricity/gas. There are some exceptions – and particular complexities when dealing with franchise operations, joint ventures and private equity structures.

- The position for landlords and tenants is complex. The "bill payer" is usually the end user – this could be the landlord or the tenant. A landlord contracting with an electricity company for the supply of electricity to a building will be accountable under the scheme even if the tenants reimburse the landlord for the energy used through a service charge or as assessed by sub-meters. Tenants are accountable under the scheme only to the extent that they contract directly with an energy company for their supply. Large commercial property companies have found that they are liable for CRC for some properties and not others. Leases typically do not anticipate CRC, and so landlords are in some cases finding it difficult to recover the costs from tenants. Where possible the lease should include express reference to the tenants reimbursing any carbon allowances costs which are charged to the landlord.

- As a general rule, residential property is excluded from the scheme.

The lender perspective

- Usually tenants have the primary obligation to pay energy bills. However the landlord will need to be mindful of its obligations under the scheme where the landlord is the party contracting with the energy supplier.

- On that basis, if a property is already fully let on long-term leases, CRC may be of less concern to lenders funding landlord vehicles. While the payment obligations under CRC can be significant, they are unlikely to affect the overall creditworthiness of an existing tenant.

- What if a lender is proposing to lend against a property that is unlet, partially let, or subject to short-term leases? If the property is suitable for, and likely to attract, businesses that use large amounts of office space, it is possible that the energy efficiency of the property (compared to likely alternatives) could affect how attractive it is to those businesses. An inefficient building is likely to lead to higher CRC costs as well as higher energy bills. This could affect rental values and in turn the value of the property as a whole. Lenders should consider with their valuers whether this is likely to be relevant for any particular property.

- Although CRC is less likely to be relevant for groups focusing purely on ownership of commercially let property, lenders should at least consider the nature of the group of which its "Obligors" are a part. In most real estate finance transactions, the property-owning companies are special purpose vehicles. The intention is to ring-fence them from the liabilities of the wider group. However, if they are part of a group subject to CRC, they will have a joint and several obligation to comply with it, regardless of their own energy consumption. This can complicate matters, particularly upon any enforcement of security.

Warning: Changes to the CRC Energy Efficiency Scheme

The CRC Scheme was reviewed by the government as part of the July 2015 Budget. Further to this, in September 2015, HM Treasury and the Department of Energy & Climate Change published a consultation on reforming the business energy efficiency tax landscape. This consultation proposed to:

- abolish the CRC Scheme (as well as the climate change levy) and replace it with a single new tax; and
- draw together the most effective elements of the current energy efficiency and carbon reduction reporting schemes into a single reporting framework based on the Energy Savings Opportunity Scheme (outlined in paragraph 3 below).

The government expects to publish its response to this consultation in the 2016 Budget. Lenders should note that, although the CRC Scheme still applies today, there is a chance that it will shortly be abolished, and replaced with a new framework based on the Energy Savings Opportunity Scheme.

3. The Energy Savings Opportunity Scheme

What are the legal requirements?

The Energy Savings Opportunity Scheme (ESOS) implements Article 8(4) of EED, requiring larger companies and non-public sector organisations in the UK to carry out mandatory energy-saving assessments. Such large companies or "undertakings" are those that (i) employ 250 people or more or (ii) have an annual turnover over €50 million and an annual balance sheet total over €43 million. Participants must calculate their total energy consumption, carry out energy audits and identify where energy savings can be made. ESOS came into force in the UK on 17 July 2014, and the first compliance date is 5 December 2015.

The key obligation of ESOS is to carry out an ESOS assessment, requiring participants to:

- measure their total energy consumption over a 12-month reference period (total energy consumption consists of energy supplied to participants and consumed by the assets they hold and the activities they undertake, including energy consumption in buildings, transport and industrial processes);
- carry out energy audits of at least 90% of their energy consumption and ensure the audits are carried out or reviewed by a qualified assessor; and
- identify cost-effective recommendations to improve energy efficiency in their energy audits.

Participants must provide certain information to the Environment Agency, as scheme administrator, to show that they have complied with the scheme.

Points to note

- Where several undertakings are part of a corporate group, they must comply with ESOS as a single participant. However, undertakings have the choice to disaggregate from the group so that they can comply with ESOS separately. Normally, relevant undertakings will participate in ESOS through their highest parent group (i.e. the highest member of the group that has no parent undertaking).
- ESOS runs in a series of compliance periods or phases. The initial compliance period runs from 17 July 2014 to 5 December 2015, with subsequent periods lasting four years, starting with 6 December 2015. For each phase there is a:
    - qualification date – date at which relevant undertakings must decide if they qualify for ESOS. The first qualification date of 31 December 2014 has already passed, with the next qualification date being 31 December 2018.
    - compliance date – date by which the ESOS assessments must be completed and compliance notified to the EA. The first compliance date is 5 December 2015, with subsequent compliance dates every four years after that.
- The Environment Agency can impose civil penalties of up to £50,000 for non-compliance with ESOS.

The lender perspective

- As is the case with other schemes, where a building is let to a tenant (or multiple tenants), the decision as to whether energy should be included in an organisation's total energy consumption is determined by whether the participant (i) is supplied with the energy; and (ii) consumes the energy through its activities or assets.
- Environment Agency guidance clarifies that, where a landlord supplies energy to the tenant under an agreement, the landlord does not need to include that energy in calculating its total energy consumption under ESOS, provided that the amount of energy is measured (e.g. by a sub-meter) or can reasonably be estimated. If it is not measured, landlords will need to include this energy in their ESOS calculation.
- The landlord and tenant should decide between themselves who is accountable for the energy in the particular conditions of the lease. However, energy provided by landlords to common or shared areas in buildings should be included in calculating their own total energy consumption.

- Although there is no obligation to carry out the recommendations in an energy audit, many of the recommendations may be required as a result of other property lender requirements, such as the energy efficiency standards already mentioned above.

4. Voluntary schemes

Rooftop Solar

The government is legally committed under the RED to sourcing 15% of the UK's energy consumption from renewable sources by 2020 and has identified solar photovoltaic generation (solar PV) as a key part of the future energy mix.

The government currently provides various forms of financial support to drive the deployment of solar PV. Of these, Feed-In Tariffs (FITs), designed for small-scale generators, have historically been seen as most suitable for rooftop solar generation (as distinct from free-standing "solar parks", which have benefited from subsidies under the Renewables Obligation as well, and may in the future benefit from Contracts for Difference, the new subsidy mechanism for projects above 5 MW). However, the government is concerned about the affordability of solar subsidies, and has proposed deep cuts in the rate of FITs. In the future, rooftop solar may be attractive primarily to avoid the costs of buying power in from the grid.

Renewable Heat Incentive (RHI)

The RHI is a financial incentive programme designed to increase the use of renewable heat technologies and help the UK meet its targets under the RED to source 15% of its energy from renewable sources by 2020.

Under the RHI, organisations and individuals can receive payments for set periods for installing eligible renewable heating systems or for injecting biomethane into the gas grid. The RHI covers both the domestic and non-domestic sectors and a wide range of technologies, each having different tariffs, joining conditions, rules and application processes. Ofgem administers both schemes. The government plans to keep the schemes open to new installations until at least 2020.

Contacts

Sam Boileau
Partner
D +44 20 7320 6803
sam.boileau@dentons.com

James Irvine
Partner
D +44 20 7246 7356
james.irvine@dentons.com

Simon Masri
Partner
D +44 20 7246 7138
simon.masri@dentons.com

Helen Bowdren
Senior Associate
D +44 20 7246 4866
helen.bowdren@dentons.com

Adam Brown
Senior Associate
D +44 20 7246 7014
adam.brown@dentons.com

Christopher Foxall
Managing Associate
D +44 20 7246 7301
christopher.foxall@dentons.com