

Impact of the minimum efficiency standard

Elisabeth Jeffries weighs up the implications of the 2018 ban on letting buildings with a poor EPC rating.

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The landlord of an office in the Thames valley ran into trouble when the building was threatened with obsolescence. It had been let from 1993 for 15 years, but when the lease was due to expire it was clear the building needed a great deal of work. Retrofit measures and repairs were estimated to cost almost twice the annual rent, and this meant the building's commercial letting potential was under threat. The outcome was that the landlord renewed the existing tenant's lease at a much reduced rent. At the end of this lease, the landlord may well be left with an obsolete building in need of significant refurbishment or redevelopment.

Thus reports commercial property consultancy Lambert Smith Hampton, warning of the risks of cutting corners on building maintenance and repairs. Increasingly, building obsolescence (the inability to let the property before the end of its life) is attributed to poor energy performance as well as general building condition – although the two are clearly related. Creeping energy legislation, most notably the Energy Act 2011, means the poorest-performing buildings could be threatened with obsolescence by 2018. In April that year, the ban on letting properties that fail to meet the minimum energy-efficiency standard comes into force.

As a result of the Act, owners of properties with an F or G Energy Performance Certificate (EPC) rating will have to bring this up to an E or higher if they want to let them out. According to a report by property consultancy WSP published in May 2013, nearly one-fifth (17%) of the UK commercial property market is affected.

"By 2018 – five years away, which is a typical property investment horizon – you will find that if you want to sell your [lower-rated] building you will be stuck at that point unless it's been refurbished," says Daniel Grandage, associate director of sustainability & energy at WSP Environment & Energy. "Most of our clients are at the high end of the market, like pension fund investments which have strong corporate governance requirements, but I suspect this hasn't filtered through to smaller and medium-sized-property owners."

WEAKNESSES IN EPCs

The worst-performing buildings tend to be located outside London and the South East, in places where capital expenditure costs are not always matched by

premium letting rates. Typical examples of buildings that may not be performing well include warehouses in rural parts of Britain or some leased retail outlets, pubs and hotels.

However, the picture is confused by a major anomaly in the UK property market, which means the framework for judging buildings is inaccurate. EPC ratings are not transparent, as a study by property management firm Jones Lang LaSalle remarked. Its 2012 report, *A tale of two buildings*, conducted with the Better Buildings Partnership, demonstrated how one building with a low EPC rating was actually more energy efficient than a higher-rated one.

Ropemaker Place in London EC1 had a B rating. It was compared to 10 Exchange Square in London EC2, which had an E rating. The research found that the latter building was 66% more efficient in terms of actual energy consumption. These discrepancies have created a pattern across the whole capital and are explained by the fact that EPCs are based on theoretical or potential, rather than actual, energy performance. They take into account the type of asset, generalised across different buildings. "The building assessment is based on different standard elements but not the individual actual operating performance such as computer data centres or other equipment running in the building. It's about the building fabric. Yet we already know that 10% of energy improvements can quickly be made using operational measures rather than capital expenditure," explains Emma Hoskyn, associate director of upstream sustainability services at Jones Lang LaSalle.

Landlords, property managers and occupiers therefore need to take EPCs with a pinch of salt. Building management rules set by the property owner can play a more important part in how efficiently energy is consumed than a score on a piece of paper. "I suspect the minimum performance standard legislation is the best of a bad lot because the EPCs don't reflect how buildings perform in practice," comments Justin Snoxall, head of the business group at British Land.

GOVERNMENT U-TURN?

Quite apart from the flaws in the EPC rating, which undermine the meaning and effectiveness of the legislation, justifiable doubts are sometimes expressed over whether the ban on letting poorly performing buildings will really go ahead. A history of regulatory u-turns and political uncertainty underlies this scepticism. "There is recognition that, as it covers

a lot of ground, the Energy Act is the one piece of legislation that has got people's attention. But does it mean it will automatically work? I am not sure," points out Richard Francis, an expert at property and construction consultancy Gardiner & Theobald, and chairman of the Environmental Sustainability Group at the British Council for Offices (BCO).

Francis's doubts arise from the track record of other buildings policy instruments such as the Code for Sustainable Homes (CSH) and the Carbon Reduction Commitment (CRC). Government definitions of "zero carbon" were revised in March 2011, attracting widespread criticism. The changes meant energy produced by mobile appliances such as phones and televisions were excluded from the zero-carbon definition, so that this only covered heating and lighting. Thus, the target for zero carbon was ratcheted down one notch to CSH Level 5 rather than 6 – the most stringent standard. More recently, the government has scrapped the CRC performance league table (see article on p.20).

"People who watch regulation in the property sector are aware it does change ... if it's very difficult or unpopular, it can be modified," remarks Francis. Comments such as these, frequent among property experts, suggest further political horse trading and tampering with the minimum energy-performance standard may well surface before 2018.

IMPACT ON BUILDING VALUE

However it is rated, the status of an energy-efficient building has begun to improve in grass-roots business transactions. This in turn affects its value as a rentable property. Francis perceives an undercurrent of savvy negotiating over energy performance, which is affecting some final deals. "The smart observer in this market has been asking for two years about energy performance by price, and that tells the tenants whether they are dealing with a sustainable building. So people are bypassing regulations because the source data [such as utility bills] is more reliable," he says.

Francis's argument points to how market leaders could eventually drive change more effectively than the legislation. If energy awareness continues to spread, he suggests, energy-efficiency data will send out signals to potential tenants. This in turn will have an impact on energy performance and eventually perhaps the EPC framework. But the two need to work together.

It is quite a complex picture. The impact of energy efficiency on value in the UK market is already visible to a limited extent, as Daniel Grandage of WSP points out. "It was originally expected that a premium would be attached to green property," he says. "Instead, you still get the usual market value for a normal building but if it is a particularly poorly performing building in terms of energy efficiency, you can get a 'brown discount'. More energy-efficient properties don't get above the market value, but it does protect their value."

Location and building function will nearly always take first place when choosing a property but energy efficiency can be an indicator of quality. Says Richard Francis: "Energy as a proportion of cost in running a building is always fairly low. But this is not about cost but about 'cost plus'" – the added value that occupiers get from high-performing buildings.

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Francis indicates that the UK market has already changed, and will continue to do so, with energy efficiency acting as an increasingly strong cue in negotiations since energy disclosure has become commonplace over the past five years. To some extent, the accuracy of the disclosure is less important at this stage than the willingness to disclose. Legislators have set the ball rolling but the market leaders are picking up that ball and running with it. "What the regulator has done is to flag up the issue," explains Francis. "Having received the signal, let's see what matters to the occupants. That means it is not just about compliance but excellence," he says.

PRICE OF POOR PERFORMANCE

So owners of lower-rated buildings should take note: even if EPC grades are faulty, energy-efficiency considerations continue to rise up the agenda; and the poorest-performing buildings may see the greatest financial rewards from retrofitting, so investment may well be particularly worthwhile. This was shown in a 2011 report by consultancy Sweett. Its investigations suggested that only the most inefficient buildings might be eligible for the Green Deal if the Golden Rule (through which the cost of the improvements must be covered by the savings they produce) was strictly applied. Even if Green Deal loans are not involved, it makes sense that the greatest savings are likely to be gained from improving the worst buildings.

If BCO indications are correct, failing to improve the buildings could still create problems for owners, regardless of the EPC rating. In a 2012 report on obsolescence, the organisation observed: "Assets with poor energy efficiency, and particularly current [class] A buildings, will see significant depreciation in future. This suggests that investors will need to take a back-to-basics approach, where asset quality fundamentals (including sustainability factors) become as important as income and covenant. Due diligence processes and informed in-house views on asset quality and value will be vital."

What is more, new energy legislation will also eventually make an impact. This includes the EU Energy Efficiency Directive, which came into force in December 2012. This introduces binding energy-efficiency measures on the public sector and industry, covering the entire cycle from generation to end use.

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