

LANDLORDS V'S TENANTS – FUTURE MEES CONFLICTS



The pressure on Landlords is growing. Cushman & Wakefield are seeing evidence that investors are reducing purchase offers accounting for the capital expenditure required to meet Minimum energy efficiency standards.

A landlord is likely to or must be considering improving the premises to meet Minimum Energy Efficiency Standards (MEES) 2030 and incremental increases to the EPC rating requirements in 2027. Whilst not yet law, the Government has confirmed in their **energy white paper**, that the future trajectory for MEES in relation to commercial property will be EPC band B by 2030.

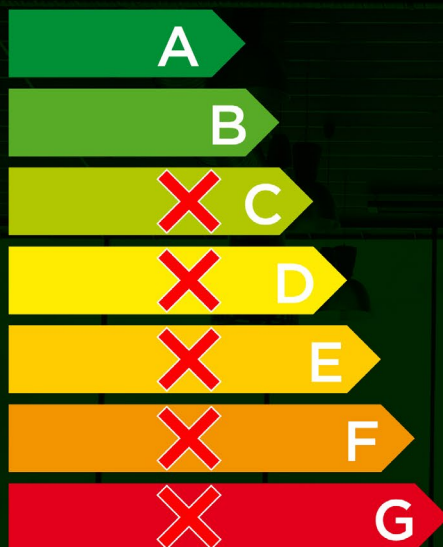
Future tenants are demanding improvements, as ESG credentials are important to their own brand, and they will factor in choices of one property over another. Investors must react.

On the other hand, existing tenants with leases terminating within the next five years before 2030 will not want to pay for improvements that would benefit the property beyond their lease.

Outgoing tenants are not liable for improvements and will argue supersession reducing the dilapidations claim accordingly. Landlords are likely to explore disrepair as a reason for needing to replace equipment. Either way, MEES is likely to become a contentious issue in future dilapidation negotiations.

There are many questions arising, to which industry currently have little in the way of answers at present. There is a need to explore these now, as ESG / MEES conflicts between landlords and tenants are already arising.

Energy Efficiency Ratings



The Government's stated future trajectory for the non-domestic minimum energy efficiency standards (MEES) will be EPC B by 2030, and it will be an offence to let a property below this rating without exemption.



EPCS

- EPCs last for ten years unless superseded by a requirement to renew it earlier. Generally, they are only an indication of the rating on the day of the assessment and no account is made of regular calculation methodology amendments in software and utility carbon factors. How many had the foresight to predict that the government would meet its target to reduce the carbon factor of electricity, to the extent that it is now on a par with natural gas and forecast to drop a further 50% by 2030?
- How often do clients review the EPC to ensure it has been prepared in sufficient detail to trigger the highest rating possible. For instance, algorithms behind EPC calculations utilise default data rather than specific detailed data if that cannot be found at the time of the assessment.
- Will an EPC assessor care whether the landlord or tenant has carried out works? They just assess the site irrespective. When is a good time to undertake an EPC? Is it before the tenant carries out a fit out? Does the lease require the tenant not to affect the EPC rating? Retail shop displays, lighting, warm air curtains, etc, will all impact the EPC rating, so is the best time to undertake one before a fit out or more practically after?
- A landlord may interpret increases in EPC ratings differently to a tenant in that improvements may be reached by carrying out different works. For instance, improving insulation versus replacing air conditioning, or improving lighting. Is there a legal argument here to state that landlord's costs are excessive and benefitting the value of the property more than the existing tenant's own interest?



INTERIM DILAPIDATIONS

- Where a tenant has full repairing liability, they are in control of interpreting the extent of works required to comply with the lease covenant. However, a landlord could serve an interim schedule of dilapidations listing items of lease liability which a tenant has purportedly failed to undertake during the lease term.
- Lease obligations include compliance with statutory requirements. It is therefore conceivable that a landlord may serve an interim schedule including items required to comply with MEES. A landlord will argue that failing to comply with MEES will impact the value of the property. This issue will predominantly relate to existing leases, as drafting new leases creates an opportunity to negotiate a compromise position at the start of the lease.
- Can a landlord serve an interim schedule of dilapidations against a tenant whose fit out has apparently deteriorated an EPC rating? This is particularly relevant where leases state that the tenant must not carry out any alterations which reduce an EPC rating.



END OF TERM DILAPIDATIONS

- Can a landlord require improvements from the tenant as part of a dilapidations claim, justifying that they are unable to let the property because the EPC rating falls below the standard required? A landlord would need to prove that the improvements are justified to comply with statute.
- Will a landlord increase the cost of a claim to ensure dilapidations works are undertaken more sustainably, such as waste disposal, which adds to time, logistics and costs?
- Conversely, could a tenant insist that the landlord undertakes dilapidations works at the end of the term more sustainably accepting the increased cost?



SERVICE CHARGE CONFLICTS

- Where tenants have internal liability only, can a landlord carry out MEES improvements and pass costs back to the tenant through the service charge? Clearly drafting of the lease terms will dictate whether this is possible. The tenant would expect the landlord to carry out works in compliance with latest legislation such as Part L.
- Can a tenant defend against landlord improvements using the "Return on investment is beyond 7 years" argument? For example, if a landlord is proceeding with works and expecting the tenant to pay through service charge, can a tenant use this defence on the basis that it is now a landlord's choice, not a strict legal compliance requirement? Conversely, this argument works both ways and a landlord may use this to support the improvements.
- Who pays? There is a clear conflict here where each party has a vested interest to argue that the other pays. A good example is where a gas boiler has been replaced by the tenant in the last two years and the landlord is intending to change it to a heat pump system before 2030 to reach the EPC target. Gas boilers have a life expectancy of 15-20 years and so the tenant would not have had the benefit they paid for. They will therefore argue the landlord should pay. On the other hand, a landlord will argue this should be paid by the tenant, as the property may be unlettable unless the replacement is made.
- In the run up to a minimum EPC rating of E by April 1st 2023 we have seen landlords foot the bill for EPC improvements in order to secure lease renewals. In many cases this has included renewing tenant installed plant. The costs required to reach minimum B EPC ratings are likely to drive higher rental premiums.



TENANT'S FUTURE LEASE STRATEGY

What strategy / actions can a tenant take to protect themselves from future exposure?

- Operate breaks in return for more favourable lease terms / protecting from areas of conflict.
- Pre-empt requirements in new leases by varying terms as appropriate.
- Implement a robust strategy around alterations, ensuring these meet MEES, EPC and lease obligations.
- Negotiate financial caps on service charge liability.



LANDLORD'S FUTURE LEASE STRATEGY

Understand what they need to do to protect themselves from future exposure.

- Assess their building's ability to achieve future MEES requirements and tenants net zero carbon goals. Creating a roadmap and supporting evidence to reach net zero will prove useful during tenant lease negotiations.
- Ensure leases have clauses that protect them from the tenant making changes that reduce the EPC rating.
- In the short term ensure that plant replacement projects will not negatively impact later EPC assessments.



Whilst there are many unanswered questions, we are already seeing evidence that these conflicts are arising, as the pressure builds on landlords to protect their investment by carrying out improvements to meet MEES. Landlords are preparing their strategy, and therefore Tenant's should be reacting to counter any rising costs from service charge and dilapidations

"Forewarned is Forearmed"



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