DENTONS

The Carbon Challenge

How emission reduction schemes may affect property lenders

July 2014

Introduction

Commercial property has become subject in recent years to a range of evolving 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 unavoidable, and potentially costly, energy efficiency work? 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 two schemes that for certain owners and users of property may potentially bring unavoidable costs: Energy Performance Certificates (see paragraph 1) and the CRC Energy Efficiency Scheme (see paragraph 2). For completeness, we have also provided much briefer details of the key voluntary schemes which have been introduced to incentivise carbon emission reduction (see paragraph 3).

Overview of the 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 RED requirements have been implemented by a range of legislative mechanisms, such as the Renewables Obligation, the Feed-In Tariff, the Contract for Difference and the Renewable Heat Incentive. These regimes are designed to support and enhance the price of renewable electricity generation to encourage new capacity to be installed.

In addition, in the UK there has been a great deal of legislative activity designed to encourage greater energy efficiency in terms of energy consumption. Key initiatives include the CRC Energy Efficiency Scheme and the Green Deal. 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 a number of years now without being a major issue for owners or funders. However, focus is returning to EPCs as a result of the proposed introduction of a minimum efficiency level for commercially let property.

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.

Requirements relating to EPCs are contained in the Energy Performance of Buildings (England and Wales) Regulations 2012, which is accompanied by various Department for Communities and Local Government (**DCLG**) guidance notes revised in 2012. Previously, EPC requirements were set out in the Energy Performance of Buildings (Certificates and Inspectors) (England and Wales) Regulations 2007 (amended a number of times and now repealed), which implemented parts of the Energy Performance of Buildings Directive 2002 (which was recast in 2010).

Where a building, or a self-contained part of a building, is to be sold or let, the seller or landlord must (amongst other things) 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 at the earliest opportunity.

Certain buildings and transactions are excepted from the requirement to have an EPC upon sale or letting. For example, an EPC is not required upon the grant of a licence (as opposed to a tenancy), lease renewal, lease surrender, compulsory purchase or share sale. Exemptions also apply for buildings intended for demolition or 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 (commonly interpreted to include listed buildings).

An EPC must be issued by an energy assessor (who must be a member of an approved accreditation scheme) and must have been issued no more than 10 years before the date on which it is made available. Where there is more than one EPC for a particular building, only the most recent will be valid. EPCs must be filed on the register held by the Department for Communities and Local Government. The information is available to the public unless the EPC holder opts out of having its information publicly available.

A public authority, or other institution providing public services, occupying a building frequently visited by large numbers of the public with a total useful floor area of 500 square metres or more must hold an advisory report issued by an energy assessor, and display at all times a "display energy certificate" (**DEC**). The floor area threshold will be reduced to 250 square metres on 9 July 2015. DECs must be registered on the register held by the DCLG.

Local authorities, usually through their trading standards departments, are responsible for enforcing the requirement to have an EPC. Failure to provide an EPC when required by the regulations may result in the issuance of a civil penalty charge notice. 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. Certain defences are available.

Points to note

- The requirement to have an EPC carries a cost implication, but equally it provides owners and occupiers with information to help them consider energy efficiency and fuel costs as part of their investment.

- The Energy Act 2011 includes a provision for the Secretary of State to make regulations requiring a landlord to achieve a certain level of energy efficiency for a property before it can be let or a lease renewed.

- The required rating is expected to be an "E" rating, as shown on the EPC for the property (unless all possible Green Deal measures have been carried out and it has still not been possible to attain the required rating) and the regulations will apply to all private sector lettings (both residential and commercial, but excluding social housing). The regulations are currently anticipated to come into force no later than 1 April 2018.

The lender perspective

- The key issue for a lender is the risk that a property will fall below the minimum efficiency level (when it is introduced). 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.

- Even before the minimum level is introduced, 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:

a) 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);

b) prepare and submit an annual report each year, including details of all electricity and gas supplies consumed; and

c) purchase and then surrender an amount of CRC allowances equivalent to annual emissions (one allowance per tonne of CO_2). The cost per allowance is set by HMRC and is currently £12/tCO_2, rising to £16 next year. Unused allowances may be sold in the open market or surrendered back to the scheme.

Points to note for owners

- 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 which 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.

- CRC is a relatively new and untested regime and the law is not clear on how CRC obligations and liabilities should be treated in an insolvency.

- 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 the 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.

3. Voluntary Schemes

Green Deal

The Green Deal is a Government scheme, introduced by the Energy Act 2011 and officially launched in January 2013, through which electricity bill payers can obtain funding to carry out energy efficiency improvements to their premises.

There are two options to fund improvements: Green Deal finance and (available very shortly) the Green Deal Home Improvement Fund (GDHIF). Although most of the publicity for the scheme has focused on residential premises, Green Deal finance is also available for non-domestic properties. Uptake of Green Deal finance has been slow, so the impact of this scheme on the property market remains to be seen.

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 has recently announced a shift in policy away from large solar farms and towards rooftop solar.

The Government provides financial support to drive the deployment of solar PV. There are two options for generators: the Renewables Obligation (which will be replaced with Contracts for Difference) and Feed-In Tariffs (**FITs**). Of these, the FITs scheme is targeted at small-scale generators, which would include most rooftop solar generation.

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 of which have different tariffs, joining conditions, rules and application processes. Both schemes are administered by Ofgem and 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

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