



Investment
Property Forum

Commercial Property Investment:

Towards Net Zero Leasing

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Introduction

Property as part of the multi-asset investment portfolio

Over the last 30+ years, commercial (non-domestic) property has become a key asset class for investors using its returns profile within their diversification strategies to optimise the performance of their multi-asset portfolios¹.

Investment returns from property comprise rental (income) returns, which have been fairly consistent over the long term², and capital returns that may fluctuate quite dramatically depending on the state of the economy, supply and occupier demand of investment grade buildings, availability of debt/equity finance etc. Income returns have been underpinned by the traditional 'institutional lease', which provides the investor with the certainty of a specified rent with the tenant being responsible for operating and building costs for the duration of the term.

Impact of climate change commitments

The UK Government commitment in 2019 to set 'net zero target' for carbon emissions by 2050 is having a major impact on multi-asset investment strategies. Commercial (non-domestic) property is part of this re-evaluation, not least because the illiquidity of property compared with other asset classes, such as equities and gilts, increases the risk of investors being stuck with obsolete (also known as 'stranded') assets that they are unable to let and/or sell.

Many of the institutions who invest in commercial (non-domestic) property are making their own net zero commitments³ in support of the commitments to limit global warming to the levels agreed in Paris at COP 21⁴. The challenge will be for these institutions to meet their commitments within the constraints of current legal and market practices in the property sector. The remainder of this paper, written by the Investment Property Forum (IPF) ESG Special Interest Group (see back page for the list of members of the Group), outlines these barriers to adopting net zero carbon targets and makes recommendations for change.

¹ The major research report, Real Estate's Role in the Mixed Asset Portfolio: A Re-examination (papers 1-4), published by the IPF Research Programme, found that for longer-term investors property certainly offers clear diversification benefits when placed alongside equities in a mixed-asset portfolio.

² Source: MSCI Global Intel.

³ For instance, Aviva Investors aims to reach net zero emissions across the whole of its £47.3bn real assets platform by 2040.

⁴ <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>

In June 2019, the UK became the first major economy to legislate to bring all greenhouse gas emissions to ‘net zero’ by 2050⁵. Net zero as defined by the UK Government means any remaining greenhouse gas emissions would be balanced by schemes to offset an equivalent amount of greenhouse gases from the atmosphere through initiatives such as planting trees or using technology like carbon capture and storage.

The World Green Building Council (WorldGBC) Net Zero Carbon Buildings Commitment invites developers, landlords, occupiers and regional authorities to commit to all buildings in their direct control achieving net zero carbon for operational energy by 2030⁶. This may be ambitious, but it does signal the direction of travel that the leading players in the property industry will be following. The UK Green Building Council (UKGBC) has in turn published a Framework Definition for Net Zero Carbon Buildings⁷ developed by an industry-led task group of businesses, trade associations and non-profit organisations. It provides guidance on the definition of net zero carbon buildings – both residential and non-domestic – and a way to demonstrate how a building has achieved net zero carbon status.

In the last two years, the UK Government has increased its focus on the buildings sector in relation to carbon emission targets⁸. A UK Government consultation on the trajectory for Minimum Energy Efficiency Standards (MEES)⁹ in relation to non-domestic private rented sector was launched in October 2019¹⁰. Its preferred trajectory was that all non-domestic private rented buildings achieve an Energy Performance Certificate (EPC) rating Band B by 1 April 2030, provided the measure or package of measures are cost effective¹¹.

In the Energy White Paper¹², published in December 2020, it was confirmed that this preferred trajectory would be followed¹³. The UK Government has estimated that the EPC B trajectory will require investment of approximately £5bn to be made by 2030. It also has estimated that the return on that investment would be substantial, with an average payback time of 4-5 years. The UK Government’s modelling suggests bill savings to business in 2030 would be £1bn and would generate an overall net present value of £6.1bn to the UK economy.

5 Greenhouse gas emissions are equated to carbon emissions for the purposes of net zero targets by applying global warming potential factors to such emissions so references to net zero carbon are technically to net zero carbon equivalent greenhouse gases.

6 <https://www.worldgbc.org/thecommitment>

For net zero carbon – operational energy, the boundary (or energy scope) is defined as all areas under operational control or influence where a net zero carbon balance has been achieved on an annual basis.

7 UK GBC Framework addresses scope 1 and 2 emissions only (i.e., those within its control as opposed to third-party occupied areas where the energy use is controlled by the occupier) for operational energy use:

<https://www.ukgbc.org/wp-content/uploads/2019/04/Net-Zero-Carbon-Buildings-A-framework-definition.pdf>.

8 Business and Industry are responsible for over 25% of UK emissions, a significant proportion of which are created through businesses’ demand for energy. Of this, typically just over 50% is used in maintaining the non-domestic building stock.

9 The MEES regulations (PRS Regulations) were introduced in 2015. From April 2018, landlords of non-domestic private rented sector properties have not been permitted to grant a new tenancy or to extend or renew an existing tenancy if their property had an EPC rating of an F or G. From 1 April 2023, this prohibition on leasing applies to continuing with an existing lease so all non-domestic private rented properties will need to be at least EPC E.

10 <https://www.gov.uk/government/consultations/non-domestic-private-rented-sector-minimum-energy-efficiency-standards-future-trajectory-to-2030>.

11 Where the expected value of savings on energy bills that the relevant energy efficiency improvement is expected to achieve over 7 years (starting with the date the installation is completed) is the same as, or greater than, the calculated repayment cost, worked out on the basis of a prescribed methodology.

12 <https://www.gov.uk/government/publications/energy-white-paper-powering-our-net-zero-future>.

13 A consultation on the implementation of this trajectory has now been published: <https://www.gov.uk/government/consultations/non-domestic-private-rented-sector-minimum-energy-efficiency-standards-epc-b-implementation>.

B BARRIERS TO LANDLORD & TENANT CO-OPERATION

1. Aspects of the 'institutional' lease

The institutional lease is the market standard lease for the non-domestic rental market in the UK¹⁴. In the 1980s and 1990s, it generally took the form of a 25-year lease with upward only rent reviews, privity of contract between the landlord and tenant for the duration of the original term (regardless of whether the lease was subsequently assigned by the tenant and its successors) and no rights for a tenant to break.

Since then, there have been some changes, which include the ending of the continuing liability of the original tenant to a lease by virtue of privity of contract under the Landlord and Tenant (Covenants) Act 1995 and the move in the property market to much shorter leases, often containing rights to break for the tenant. However, certain core principles and deficiencies in policy and practice remain that present difficulties in effecting energy efficiency improvements, as outlined below.

a. Lack of incentive to reduce building operational costs

A basic non-negotiable principle of an institutional lease is that it generates a 'clear rent'. This means that the rent is a payment for occupation of premises by a tenant and is clear of all deductions by way of the operating costs of the premises themselves and the building of which they form part. The tenant of a multi-let building is liable, therefore, to pay rent and utility costs for the premises it occupies and, via the service charge, a share of the utility costs for the common areas within a building, e.g. a shopping centre. However, the landlord controls the expenditure incurred on the common areas and, where there is 100% recovery of shared utility costs via the service charge, may have little incentive to look at ways to reduce these costs. This lack of alignment between the control over, and responsibility for, shared energy costs is termed the 'split incentive' problem.

The introduction of MEES exacerbated this problem when a policy decision was made that the landlord should, in all circumstances, be responsible for the making of the energy efficiency improvements that would result in any improved EPC¹⁵ rating for the property. When MEES was first proposed¹⁶, the split incentive was to be addressed by means of 'Green Deal Finance' (GDF), which would have enabled the cost of the energy efficiency improvement to become cost neutral by adding an increment to utility costs that would be offset by reduced energy costs. This was never implemented in relation to non-domestic properties as no private funding entity was willing to sign up to be the scheme provider.

The split incentive, therefore, remains an obstacle but one that may be ameliorated at least in part by:

• Changing market conditions

The increasing number of vacant retail and leisure units, whether due to the impact of online shopping and/or streaming, corporate failure or restructuring etc., together with the impact of the Covid-19 pandemic, has left landlords without full recovery of service charges from their tenants. Utility cost management is now a greater priority for both landlord and tenant.

• More operational-style leases/licences

The institutional lease remains the norm. However, many investors seeking higher returns are increasingly targeting more operational property investment assets such as purpose-built student accommodation, build-to-rent residential and hotels where the lease is more of a financial instrument and the institutional lease model is generally less applicable. Similarly, the growing amount of office space that offers businesses flexible

¹⁴ This paper will refer broadly to the UK for the sake of brevity but the comments specifically relate to England & Wales. It is acknowledged that different letting practices may well be the norm in Scotland and Northern Ireland.

¹⁵ Energy Performance Certificate. For further information see: <https://www.gov.uk/energy-performance-certificate-commercial-property>.

¹⁶ See the Energy Act 2011.

space on a monthly or longer-term basis is let on an all-inclusive rent or membership fee. In retail, there is an expectation that more units will be let on short leases with turnover, rather than fixed, rents.

These new leasing/licencing arrangements require greater landlord and tenant engagement, with the former being incentivised to achieve energy efficiency savings.

- **Increasing requirements to report energy use and GHG emissions**

Financial reporting on so-called ESG issues for both landlords and tenants should start to align the interests of landlords and tenants on improving energy efficiency in the rented sector, but this is likely to take some time.

b. Costs of improvements generally fall to landlords

As mentioned above, the service charge provisions within an institutional lease of non-domestic premises enable the landlord to recover all operating expenses associated with the management of the building. However, this recovery does not generally extend to the cost of carrying out improvements to a building or the plant and machinery within the building. The rationale for this is that any improvement is a capital cost and, therefore, should fall upon the landlord. The principle of 'spend to save' has not caught up with the non-domestic property rental market.

As regards the cost of works to improve the environmental performance of a building, the RICS 2018 Professional Statement on service charges¹⁷ in commercial property does recommend that a fair and reasonable approach to the carrying out of such works should be encouraged and the costs be shared between the landlord and tenant on a fair and equitable basis. However, it is not clear how many landlords have even adapted the service charge provisions of their leases to enable energy efficiency improvements to be carried out. Additionally, few – if any – institutional leases have addressed the basis on which the cost of carrying out energy efficiency improvements during their term should be apportioned between the landlord and the tenant. In the absence of such provisions, the cost will fall on the landlord and the tenant will recoup the energy savings benefits.

This lack of progress may be an indication that there has not to date been a sufficient imperative to carry out energy efficiency improvements during the term of a lease of non-domestic premises because MEES will only apply to existing leases of such premises as from 1 April 2023.

c. Right of the tenant to refuse entry

As stated above MEES will apply to non-domestic privately-rented properties that are currently let from 1 April 2023. Where the premises are subject to existing leases these are unlikely to have reserved a specific right for the landlord to enter the premises to carry out energy improvement works. Where no such right exists, the tenant is perfectly entitled to refuse to give consent to the carrying out of such works. Tenants may have no incentive to give their consent, save for the prospect of gaining any resulting energy saving, and may well be justified in not doing so from a business continuity perspective.

The PRS Regulations do, of course, grant landlords an exemption from compliance with MEES where the consent of a tenant to the carrying out of the relevant energy efficiency improvement has been refused despite the landlord having made reasonable efforts to obtain the same. Nevertheless, this is not a satisfactory resolution of this problem in that it leaves the landlord with a sub-standard property even though the landlord is not in breach of MEES.

d. Tenant cannot be forced to carry out energy efficiency improvements

Institutional leases oblige the tenant to be responsible for the repair of all parts of the premises which fall within its demise. The ambit of 'repair' does not extend to include an 'improvement' so the tenant will not be obliged to carry out any improvements unless it is under a statutory obligation to do so. As stated above, the

¹⁷ <https://www.rics.org/uk/upholding-professional-standards/sector-standards/real-estate/service-charges-in-commercial-property-1st-edition>.

PRS Regulations imposed the burden of complying with MEES solely on the landlord. Where the premises comprise a whole building or self-contained unit, the landlord will have no right to alter anything that falls within the tenant's demise, including upgrading elements such as windows or lighting equipment to improve their energy efficiency. The tenant will also be concerned by the prospect of taking over responsibility for any new items of plant and machinery, which will have been installed by the landlord, under its repairing obligations without appropriate product guarantees or warranties.

These issues are not addressed in institutional leases as the possible need for a landlord to make alterations to the premises during the term of a lease is simply not within the contemplation of the parties. Tenants, on the other hand, are generally under institutional leases entitled with the consent of the landlord to make improvements to their premises and the PRS Regulations did give tenants the right to carry out energy efficiency improvements. It was expected that tenants would be willing to do this utilising GDF (as referred to above) but this of course did not materialise for non-domestic properties. However, few tenants have been willing to undertake energy efficiency improvements voluntarily.

e. Dilapidations, reinstatement and environmental improvements

The institutional lease generally binds the tenant to hand back the demised premises to the landlord in good repair and with the tenant's alterations removed. These provisions can be nonsensical in that landlords will rarely actually want the premises back in their original condition absent any works that have been carried out by the tenant. This is compounded where the tenant has carried out environmental improvements that the landlord should be seeking to retain.

The most recent RICS Code for Leasing Business Premises, England and Wales 2020¹⁸, which came into effect on 1 September 2020, does attempt to pivot the established leasing approach from a tenant being liable to reinstate *unless* the landlord otherwise requires to the tenant not being bound to do *unless* the landlord reasonably otherwise requires. This is, however, only a statement of good practice and is not a mandatory requirement.

Generally, tenants do not actually reinstate their premises in accordance with the strict terms of their lease and simply pay a sum by way of compensation to the landlord in lieu of fulfilling this obligation. Section 18 of the Landlord and Tenant Act 1927 provides a statutory limit on damages a landlord can claim in respect of breaches of tenants' repairing obligations, which is by reference to the amount, if any, of any diminution in value of the landlord's reversion.

Section 18 does not apply to the reinstatement of tenants' alterations, but the common law measure of damages will usually achieve the same result where the landlord has no genuine intention to carry out the reinstatement of alterations or where it would be unreasonable to do so. Where reinstatement of alterations would adversely affect the energy efficiency of the premises or where any works of reinstatement would be superseded by works required to improve the energy efficiency of the premises, there must be real doubt as to the strength of any claim by landlords for damages for failure to reinstate tenants' alterations.

Landlords serious about protecting the environment and the conservation of resources may wish to review their approach to claims for dilapidations, not least by considering whether environmental improvements that a tenant may make to its premises should be excluded from the ambit of the reinstatement principle.

¹⁸ <https://www.rics.org/uk/upholding-professional-standards/sector-standards/real-estate/code-for-leasing-business-premises-1st-edition>.

2. Lack of energy performance management obligations

A missing ingredient in the UK Government's approach to the energy performance of non-domestic buildings is any regulatory tool to compel landlords or tenants to reduce actual energy use within their premises¹⁹. MEES is only concerned with the achieved EPC rating of premises, which is a function of the designed fabric and services within the premises, and the application of a modelling tool that predicts the likely energy use.

On 17 March 2021, the Government issued a consultation on a performance-based policy framework for large commercial and industrial buildings in England and Wales²⁰. Whilst this is targeted at buildings larger than 1,000m², and many of these buildings will not be privately-rented, it does signal a new direction of travel for UK Government regulation. However, the consultation is suggesting that the rating framework follows the National Australian Built Environment Rating System (NABERS)²¹ approach insofar as there will initially be no regulatory obligation to improve ratings. The Better Buildings Partnership (BBP) has launched a NABERS UK rating for new office developments and refurbishments, which aims to overcome the performance gap between the design performance and the operational performance. A similar regime will be required for other types of non-domestic property such as retail, leisure and industrial property.

In terms of reducing energy consumption and carbon emissions, the UK Government estimates that, as an average across each sector, private non-domestic buildings over 1,000m² will need to be using approximately 30% less energy in 2030 than they were in 2015. That level of reduction is consistent with the UK Government's Carbon Budgets (CB), which will need to be met if the country is to remain on track to deliver net-zero by 2050.

The absence of any energy performance management obligations in the institutional lease – such as obligations to collect and share data on energy consumption and to adopt strategies to reduce such energy consumption – will hinder the effectiveness of any UK Government regulations that are specifically aimed at reducing energy consumption within non-domestic rented premises.

19 Note that the Carbon Reduction Commitment Scheme (CRC), which was introduced on 1 April 2010 was designed to encourage non-intensive energy users but, being large businesses, still substantial energy users (i.e. those who consumed over 6,000 Mwh of qualifying electricity in the qualifying year 2008) to become more energy efficient and reduce their carbon emissions. The idea was to provide an incentive for these businesses to look at their operations and the associated energy use, with a key part of this being the energy used in the buildings from which they operated. These operations were estimated to be contributing 10% of the GHGs in the UK.

The scheme worked by effectively applying a charge on the amount of energy used as those who were caught by the scheme were required to purchase, and then surrender, 'allowances' equivalent to the carbon dioxide emissions from their energy consumption. The scheme did therefore set a price for carbon, which through the life of the scheme rose from £15.60 to £18.30 for each equivalent tonne of carbon.

The CRC scheme was criticised for its complexity and undoubted administrative burden, and it was abolished in April 2019, but it did lead to many businesses looking at, and collecting data, as to their energy consumption and taking steps to reduce that consumption, at least the low hanging fruit. Additionally, it encouraged organisations to develop energy management strategies to gain a better understanding of energy usage. It also resulted in complicated drafting in leases but, rather than working together, much of the drafting was to enable the landlords to pass not only the cost of the allowances, but also their administrative costs in complying with the scheme, to their tenants as opposed to resulting in sensible discussions as to how to reduce consumption and be more energy efficient for the benefit of all.

Part of the scheme requirements involved an annual report being produced and this showed that total energy use reported for 2018 to 2019 was 98,065,845 megawatt hours (MWh), reduced from 103,806,596 MWh in 2017 to 2018, and that total reported emissions for 2018 to 2019 were 25,732,096 tonnes of carbon dioxide (tCO₂) reduced from 31,967,178 tCO₂ reported in 2017 to 2018.

The scheme also included, at its inception, the publication of a Performance League Table (PLT) showing how participants had fared against other businesses – the idea being that change would be driven by increased public scrutiny of corporate emissions, albeit that the table had many flaws and did not compare apples with apples. The PLT was unexpectedly abandoned following the Autumn Statement in 2012.

20 <https://www.gov.uk/government/consultations/introducing-a-performance-based-policy-framework-in-large-commercial-and-industrial-buildings>.

21 This has generated significant savings despite only requiring disclosure of energy consumption and not mandating energy savings. Since the beginning of the scheme, office buildings have seen their energy use per m² reduce by 38%, including a 34% reduction over the last decade, based on office buildings with 13 consecutive NABERS (whole and base building) ratings. Source: Peter Mallaburn et al, 2020. See: <https://nabers.info/annual-report/2019-2020>.

3. Landlord and Tenant Act 1954

When granting a new lease, the ability to change the terms in the existing lease with regard to climate change mitigation is essential to meet the Government's net zero agenda. Given this, it is not helpful that the provisions of section 35 of the Landlord and Tenant Act 1954 provide that in determining the terms of the new tenancy the court is only to have regard to "the terms of the current tenancy and other relevant circumstances".

The leading case on this provision is the O'May²² decision in which the then House of Lords forum decided that the provisions of the existing lease are the appropriate starting point for any renewal negotiations, that the burden of persuading the court to impose a change of terms against the will of one party should lie with the party seeking that change and the change should be fair and reasonable in all the circumstances. However, the court also recognised that it should not seek to petrify the terms of a lease and where they were obsolete or deficient there may be grounds for new terms.

²² O'May v City of London Real Property Co. Ltd [1983] 2 AC 726. See also the recent case of WH Smith Retail Holdings Limited v Commerz Real Investmentgesellschaft MBH [2021] as an illustration of the difficulties faced by a landlord trying to introduce energy efficiency provisions into a renewal lease.

There is much in terms of carbon emission and energy use reduction that the property industry can achieve by adopting best environmental practice in relation to the letting and management of non-domestic premises. The procurement of renewable sources of energy and sourcing of recycled materials or materials with low embodied carbon will generate significant savings in the whole-life carbon footprint of those premises. The November 2020 launch of the NABERS UK scheme, led by the BBP, is a welcome development. It is an entirely voluntary scheme but it should deliver carbon and energy savings amongst the BBP's membership and, hopefully, across the wider property industry.

The net zero challenge for non-domestic buildings is a complex one which requires a number of practical and policy interventions and changes to be implemented. MEES and the forthcoming energy performance metric regulations will undoubtedly start to have a real impact but on their own may not be sufficient to change the landscape that currently fetters the efforts of the property industry to respond to the climate emergency. This will need to build on the discussions on green leases²³ that have taken place over the last decade but which have not as yet been fully embraced by the UK property industry.

Some changes to letting practice in the UK (including the institutional lease) and a couple of amendments to the PRS Regulations are required in order to enable the net zero target to be achieved. Below is a list of recommendations for change.

Recommendations

a. Fitting out practice

The property industry needs to undertake a wider audit of the way in which non-domestic premises are fitted out²⁴ for each tenant in a bespoke manner and greater re-use²⁵ and standardisation of works, materials and equipment should be captured by the Building Regulations.

It is noted that, in the recent consultation on achieving the future trajectory of EPC B under MEES, the practical difficulties associated with the letting of non-domestic premises on a shell-and-core basis by landlords is proposed to be addressed by the UK Government by creating a six-month compliance window from the date of letting to enable the tenant's fitting out works to be completed. At present, the landlord often has to obtain an EPC of the premises in a shell-and-core condition and usually this results in a very low EPC rating²⁶.

b. Landlord's right to make energy efficiency improvements

Tenants should be obliged under the PRS Regulations to permit the carrying out by the landlord of the necessary energy efficiency improvements to the property, provided that such works cause no material disruption to the tenant's occupation of the property and when complete do not adversely affect the tenant's beneficial use and occupation of the property. Conversely, landlords carrying out works should be obliged to do so in a manner which causes no material disruption to the tenant and do not adversely affect the tenant's beneficial use and occupation of the property.

²³ The BBP's Model Green Lease Toolkit, (which was first published in 2011), contains a number of clauses that could and should be incorporated in institutional leases particularly if the institutions and other property owners who adopt the same are serious in their ambitions to achieve net zero carbon emissions across their managed estates. Green leases of the type backed by the Better Buildings Partnership contain provisions that encourage co-operation between landlords and tenants but rarely impose specific carbon reduction commitments on the parties to such leases: <https://www.betterbuildingspartnership.co.uk/green-lease-toolkit>.

²⁴ The industry should adopt a rating tool such as the Ska rating system to raise standards in relation to fit-outs.

²⁵ See the commitments being made to adopting circular economy principles and reduction of embodied carbon in the net zero pathways that are now being published by property companies such as the Canary Wharf Group: <https://group.canarywharf.com/wp-content/uploads/sites/2/2020/12/canary-wharf-corporate-responsibility-net-zero-carbon-pathway-dec-2020.pdf>.

²⁶ The Government has not, however, taken up its own suggestion that landlords should be able to transfer liability to comply with MEES to the tenant where the tenant is carrying out significant fitting out works.

This could be achieved by a simple amendment to the PRS Regulations and the effect of such would be to reduce the scope of the consent exemption, which could otherwise be utilised by the landlord where a tenant's consent to the carrying out of requisite energy efficiency improvement works cannot be obtained. It is considered that this exemption unnecessarily frustrates the policy aims of MEEs and its scope should, so far as possible, be curtailed by providing a statutory right to carry out such works to the landlord as against the tenant (subject to the caveats mentioned above). The consent exemption could also be restricted to exclude mortgagees, who should in any event be aligned with the objective of such works being carried out.

A specific right for the landlord to carry out energy efficiency improvements to parts of the property that fall within the tenant's demise should also be conferred upon the landlord. This would enable the landlord to carry out works to such items as lighting and air-conditioning that may have been installed by the tenant. These works would need to be approved by the tenant, but the tenant would only be entitled to object to any works that cause material disruption or have an adverse effect on the use and occupation of the property by a tenant not adequately compensated by the landlord.

c. Tenant's obligation to contribute towards the cost of energy efficiency improvements

When the PRS Regulations were first introduced they were expected to be underpinned by the Green Deal that would ensure that energy efficiency improvements would be carried out at no cost to the landlord via GDF. As previously mentioned, GDF did not materialise for the non-domestic rented sector but the 'pay-back test' that was a central feature of GDF remained in the PRS Regulations. Hence, the seven-year pay-back test now applies in relation to the non-domestic PRS sector so that any energy efficiency improvements that fail to generate sufficient energy savings over a seven-year period to repay the capital cost and notional interest (based on a technical formula) do not qualify as relevant energy efficiency improvements under the PRS Regulations.

There is no reason why cost sharing between landlords and tenants should impose an additional burden or cost on the landlord given that the energy efficiency improvement is likely to generate energy cost savings. The cost savings that effectively repay the cost of the improvement will not necessarily be contemporaneous with the term of the lease so it may be unfair to require the tenant fully to repay the cost of the improvement in such circumstances. However, it could be argued that a fair contribution by the tenant would be equivalent to the expected energy savings generated and received by the tenant from the improvement during the term of its lease. Clearly the drafting of such provisions would need careful thought but hopefully industry standard provisions could soon emerge.

At this stage, it would be unhelpful to make cost sharing provisions a mandatory legal requirement as it would be almost impossible to craft a statutory obligation that could be applied universally, given the number of different energy responsibility scenarios that will apply across the non-domestic private-rented sector. This would also conflict with the more flexible leasing models being developed by the industry, where energy costs are included in the cost of the space.

d. Duty to co-operate with energy management and data sharing

The improvement of the operational energy performance of privately-rented buildings will not be possible without the active engagement of landlord and their tenants in this endeavour. A duty on the tenant (and the landlord) to co-operate in collecting and sharing data in relation to energy consumption is an essential component of any green lease and should be an essential component of any lease of non-domestic premises²⁷.

²⁷ See the co-operation clauses that were included in the Model Commercial Lease (MCL) suite of documents commissioned by the British Property Federation (BPF), which were drafted by a working group comprising representatives from large law firms, major landlords and trade organisations: <https://modelcommerciallease.co.uk>.

e. Tenant's obligation to reduce energy intensity

It is accepted that many institutional landlords will be reluctant to interfere with the operation of areas of their buildings that are controlled by their tenants. However, as is being recognised by some of the property industry's leading players²⁸, truly net zero carbon buildings cannot be achieved without the inclusion of these areas in the overall calculation of the carbon emissions of those buildings. This requires tenant engagement and co-operation so at first the targets can be modest and the sanctions gentle, but these targets can become meaningful over time and the sanctions or tariffs can be used to fund further energy efficiency investments and carbon offsets.

It may well be the case that many business tenants will be adopting their own net zero pathways and so will be very willing to accept obligations to reduce their energy use. Government regulation or incentives clearly would be helpful in the case of tenants who are less inclined to positive action²⁹.

f. Tenant's alterations

It should be provided in any institutional lease that any tenant's alterations will not adversely affect the energy efficiency of the property and should conform to the same sustainable principles as should apply to the tenant's fitting out works as mentioned above.

In addition, the mandatory requirement of reinstatement of tenants' alterations should be reconsidered. Reinstatement that adversely affects energy efficiency, increases GHG emissions and/or is superseded by the need for relevant improvements will rarely if ever be reasonable.

g. Tenant's repairs and dilapidations

Sustainability principles should apply to the approach to tenants' repairing obligations and obligations to decorate at certain prescribed intervals should be resisted. Where repairs and decorative works do genuinely need to be undertaken then provision should be made for environmentally responsible and sourced materials and methods of working.

The requirements of the MEEs regulations are likely to mean that improvement works will be required to the fabric of the plant and equipment in the premises and should bring the statutory cap on damages into play thus reducing claims for end of term dilapidations. Further, where tenants' repairing obligations require them to replace equipment which is no longer capable of repair, then the tenant should not be obliged to install in the premises new versions of outdated landlords' fixtures and fittings during or at the end of the term of the lease.

h. Landlord's services and service charges

The institutional lease should be adapted to enable the landlord to carry out energy efficiency improvements in accordance with an energy performance plan that has clear targets in terms of energy intensity and carbon reduction. The plan should reflect a net zero trajectory in line with achieving the Paris Accord of maintaining global warming to significantly below 2°C, be independently costed and identify the projected energy savings. The landlord and the tenant should agree to co-operate and co-ordinate their efforts to implement the plan. The landlord would then be entitled to make energy efficiency improvements and fund these at least in part through the service charge with tenants' contributions equivalent to any energy savings resulting from such improvements.

The landlord should, of course, be required to provide all usual building services in accordance with sustainable principles with targets to reduce waste to landfill, water consumption and increase use of recycled materials.

²⁸ The BBP Climate Commitment (to which many of the industry's leading players are signatories) requires the inclusion of Scope 3 emissions (including tenant energy consumption) in their net zero carbon pathways – a full list of the 26 signatories with links to their net zero carbon pathways can be found here: <https://www.betterbuildingspartnership.co.uk/node/877>.

²⁹ The Government is considering amending the PRS Regulations to give tenants of non-domestic properties some duties regarding compliance with MEEs rules, and to add consequent duties of cooperation for both landlord and tenant that they must work together to reach compliance. New primary legislation would be required to place such legal obligations on tenants under the PRS Regulations.

i. Clean energy obligations

Many large landlords are already purchasing renewable electricity and exploring options for on-site generation. Clearly this may not be practicable for all landlords – let alone their tenants – but commitments should be made by landlords and tenants of non-domestic privately-rented properties to purchase and/or generate energy from renewable sources so far as practicable and cost-effective³⁰. Currently less than 5% of energy used for heating buildings in the UK comes from low-carbon sources. The Committee on Climate Change (CCC) has recommended that by 2030 37% of heat demand in commercial and public buildings should be met by low-carbon sources³¹. The property industry should support these objectives.

j. Transition funds and carbon offsets

Whilst the emphasis remains firmly on reducing emissions as a priority step, there is wide recognition that carbon offsets will need to play a critical role in the transition towards a state of net zero emissions if we are to achieve it at sufficient pace³². The UK GBC has recommended the use of a transition fund as the leadership approach in recognition that most sectors will need to reduce emissions close to zero without offsetting to meet the UK's net zero target³³.

In either case, a carbon price should be allocated to the emissions that have not been eliminated and the landlord and tenant will need to agree to set aside funds either to pay for on-site energy efficiency investments or, where offsets are being bought, off-site measures. It is likely that these funds can be raised by borrowing as green finance providers are beginning to emerge³⁴. Whilst these may be matters that will be dealt with entirely by the landlord initially, it is likely that tenants, especially those who have their own net zero ambitions, will wish to play an active part in these initiatives and accordingly these matters will start to be documented in commercial leases. At this stage it is difficult to prescribe the terms upon which the parties will be prepared to do so but these issues will soon need to be actively considered in lease negotiations³⁵.

30 See: <https://www.ukgbc.org/wp-content/uploads/2021/03/Renewable-Energy-Procurement-Carbon-Offsetting-Guidance-for-Net-Zero-Carbon-Buildings.pdf>.

31 In the CCC's Balanced Net Zero Pathway for buildings which accompanied its advice report to Government on the Sixth Carbon Budget (which covers the period 2033-37) the CCC forecast that of this low-carbon heat demand 65% will be met by heat pumps, 32% district heating and 3% biomass. By 2050 it recommended that all heat demand should be met by low-carbon sources of which 52% will be heat pumps, 42% district heat, 5% hydrogen boilers and around 1% new direct electric heating: <https://www.theccc.org.uk/wp-content/uploads/2020/12/Sector-summary-Buildings.pdf>.

32 As an example of such a scheme it is useful to remember the 'Allowable Solutions' that were developed as part of the Government's Zero Carbon New Homes initiative back in 2011. This concept looked at housing developers being required to offset carbon emissions to reach the carbon compliance target required for new homes, firstly by near site solutions and as a last resort off-site. There was a lot of commentary over what was meant by off-site, i.e., how far away would be permitted. Sadly, the Government abandoned the whole Zero Carbon New Homes policy in July 2015 and along with that of course the concept of Allowable Solutions. It will be interesting to see if this hierarchy of allowable offsetting may now be reintroduced. The UKGBC Net Zero Carbon Buildings: A Framework Definition indeed includes reference in its framework to any remaining carbon being offset using a recognised offsetting framework.

33 See the UKGBC guidance cited in footnote 30 above.

34 There are some examples already emerging from within the industry. Derwent London, Land Securities, GPE and British Land have all set internal prices of carbon and some are utilising revolving credit facilities (RCF) linked to sustainability performance and are also using internal prices of carbon to set up decarbonisation funds.

35 Clearly there is a role for educational bodies such as RICS and the IPF to play in developing understanding of these mechanisms.

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The IPF's mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and derivatives, for its members and other interested parties, including government, by:

- undertaking research and special projects and ensuring effective communication of this work;
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