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## Chapter 4

### Energy upgrades in commercial property: Minimum Energy Efficiency Standards, compliance pathways, and leases in the UK

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#### Abstract

Improving the energy performance of the commercial built environment presents significant opportunities for meeting the UK's carbon reduction targets, but also significant challenges, particularly where space is rented. The UK Government has passed Regulations introducing statutory minimum energy efficiency standards (MEES) designed both to tackle the split incentive and to provide a regulatory impetus to make improvements for the most energy inefficient rented buildings. These will prohibit the letting of sub-standard properties from April 2018 unless an exemption applies.

This chapter explores the interaction between MEES and leases, and potential effects for energy efficiency upgrades. Drawing on industry interviews and document analysis from the UK-based 'WICKED' project, it defines three approaches - active, protective, and avoidant - in managing compliance with the MEES Regulations, and looks at the role of leases within

these approaches. While the active and protective approaches are in keeping with the intended effects of the Regulations, the avoidant approach could exacerbate tenant/landlord tensions and create a secondary market in sub-standard properties.

## **4.0 Introduction**

Meeting the UK's carbon reduction targets will require significant improvements to the energy performance of the commercial built environment (DECC 2011). For rented properties, the "split incentive" has been highlighted as a particular challenge, as the misalignment of investment costs and financial savings can mean neither landlords (building owners) nor tenants (building occupiers and energy bill payers) have sufficient incentives to invest in energy efficiency improvements (e.g. DECC 2012). UK leases tend to reinforce the split incentive, in particular by not allowing landlords to recover the costs of energy efficiency improvements from occupiers, and by giving landlords only limited rights of access to tenant premises to carry out improvements (e.g. Bright 2008).

The UK Government has passed Regulations introducing statutory minimum energy efficiency standards for rented commercial buildings (MEES) to overcome some of these challenges, with the aim of securing improvements to the least efficient buildings (Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015: hereafter the MEES Regulations).

This chapter explores how industry actors in the UK - including lawyers, landlords, tenants, and property managers - perceive that the MEES Regulations interact with lease clauses and energy efficiency upgrades. Drawing on interviews and document analysis from the UK-

based “WICKED” project<sup>1</sup>, it examines the potential contribution of lease clauses to managing compliance with the MEES Regulations in the commercial sector, and the extent to which the interaction between the MEES Regulations and leases may support or undermine the objectives of MEES to secure energy upgrades to the UK’s least efficient properties.

The chapter starts by providing an overview of the relevant literature on energy efficiency upgrades, MEES, and leases. It goes on to describe the research approach briefly. Key findings from industry participants are then presented and discussed, including three “compliance pathways” to MEES - active, protective and avoidant. These varying approaches have different impacts on how MEES may manifest in practice, including some unintended consequences. The final section concludes by suggesting implications for industry participants and policy makers, within the UK and beyond.

## **4.1 Background: energy efficiency and commercial buildings**

This section begins with a brief discussion of the literature on energy efficient renovations in the commercial sector. Next it describes MEES, before going on to consider the interaction of MEES and leases.

### **4.1.1 Energy efficiency opportunities and challenges in commercial buildings**

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<sup>1</sup> The Oxford University-based, RCUK Energy Programme-funded “WICKED” project (Working with Infrastructure, Creation of Knowledge and Energy Strategy Development) is an interdisciplinary investigation of energy management practices and issues across the UK retail sector. Part of this project set out to investigate the role and impact of leases in relation to energy management. See [www.energy.ox.ac/wicked](http://www.energy.ox.ac/wicked) , Janda et al (2016) and Patrick & Bright (forthcoming, Conveyancer).

Improving the energy efficiency of existing rented commercial buildings is an important element of – and opportunity for - meeting the UK’s carbon reduction targets (DECC 2014a). About 12% of the UK’s emissions are attributed to energy used for non-domestic buildings (DECC 2011) and estimates suggest that around 60% of today’s non-domestic buildings will exist in 2050 (Carbon Trust 2009). Moreover, in the retail sector (the focus of the WICKED project), whilst energy management is considered a particularly complex challenge, it is also seen as a significant opportunity (BRC 2014; BCSC and CBRE 2015).

The general need for energy efficiency investment in the building stock is thus recognised at a national level, both by the UK Government and by industry bodies. However, views on building and portfolio-level opportunities and drivers for energy efficiency investments differ. A recent industry report by the British Council of Shopping Centres and CBRE (an international commercial property consulting and management firm) suggests there is a compelling business case for energy efficiency upgrades in shopping centres, whilst recognising a number of barriers including availability of capital, limited awareness of costs and benefits, and the role of fixed service charges (BCSC and CBRE 2015). Conversely, Elliot et al. (2015) suggest that the *lack* of a compelling business case is the “*primary barrier*” to energy efficiency investments (Elliot et al. 2015: 667). At the same time, some have argued that risk avoidance, in particular avoiding the future risk of obsolescence, can or should drive investment decisions (e.g. JLL 2013; Sayce et al. 2007). BCSC and CBRE (2015: 3) suggest that “*the extent to which a centre does or does not possess optimal energy using equipment is a useful gauge of its susceptibility to value erosion or price-chipping by prospective acquirers*”. They argue that “*ultimately it is prospective enhancement in asset value that is most likely to drive change*” (BCSC and CBRE 2015: 4). Elliot et al’s 2015 study of investment decisions in this context, however, did not find any evidence that these considerations were in practice driving more sustainable commercial property investments. Others have

suggested that such investment decisions go beyond mere financial considerations and are driven instead by a range of strategic considerations, of which risk is one (Cooremans 2011).

The complexity of energy efficiency renovation is magnified in rented buildings, which make up over half of the UK's commercial buildings sector (PIA 2015). Here, landlord and tenant interests, and split incentives, create an additional layer of problems. The problem of the split incentive is well known (e.g. DECC 2012; EC 2011). It is highlighted as a particular barrier in the Government's consultation on the MEES Regulations, where it is defined as a situation where *"the costs of energy efficiency improvements are borne by landlords, while the benefits (lower energy bills) accrue to current or future tenants"* (DECC 2014b: 18). The Government's impact assessment in relation to the MEES Regulations explains: *"In principle, in a well-functioning market, rent levels should fully reflect differences in a property's energy efficiency thus overcoming this split incentive issue. However, [in] the presence of other market failures, such as imperfect information on the costs and benefits associated with energy efficiency measures, rents may not fully reflect differences in energy efficiency. This leaves landlords with little incentive to make energy efficiency improvements."* (DECC 2015a: 15).

#### 4.1.2 Policy Context: MEES

Against this background, MEES are being introduced *"to tackle the very least energy efficient properties"* (DECC 2014b: 10) and *"drive improvements in the energy efficiency of buildings in the non-domestic sector"* (DECC 2014b: 11). The focus of MEES is only on rental property and the MEES Regulations provide a regulatory impetus for landlords to implement energy efficiency upgrades. Operating alongside a range of other government measures (DECC

2014a), MEES is the first government initiative to address explicitly issues associated with rented commercial properties including split incentives between landlord and tenants.

The MEES Regulations will make it unlawful, from April 2018, to let non-domestic properties (including lease renewals or extensions) that fall below the minimum standard of an “E” Energy Performance Certificate (EPC) rating, unless all relevant energy efficiency improvements (broadly, those recommended by a surveyor with a payback period of seven years or less) have been carried out (*Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015*). EPCs rate properties across seven categories, from A (best performing) to G (worst performing), based on age, size and fabric of the building and are required when buildings are constructed, let or sold (DECC 2014a). Landlords will be exempted from the prohibition on letting where tenants or third parties have refused consent to relevant energy efficiency improvements (the consent exemption), or where such an improvement would adversely affect the value of the relevant property by more than 5% (the devaluation exemption). From 2023, the prohibition and related provisions will not just apply to properties that are newly let, but also those that continue to be let. Importantly, the EPC ratings are an “asset rating” (an estimate of what amount of energy a building *should* use based on a model of its fabric and equipment), rather than an “operational rating” (based on actual metered energy use). This focus provides an impetus for physical renovation rather than encouraging advances in energy management and control strategies. It has been suggested that improving EPC ratings, therefore, is only one part of the picture and does not necessarily lead to reduced energy consumption (JLL and BBP 2012).

Almost a fifth of UK commercial properties are rated F or G (DECC 2014b) and will be affected by the MEES Regulations. For these properties to continue to be let, the Regulations result in an indirect requirement to carry out improvements unless an exemption applies. A

further 19% of properties currently carry an E rating (Cushman and Wakefield 2016). As ongoing changes to the EPC methodology could mean that a current E falls to F or G (BPF 2014), and the regulatory standard may be raised going forward, landlords may also need to consider whether improvements are needed for these E-rated properties.

In the original consultation on MEES, the Government envisaged the operation of a green financing arrangement as a key mechanism for facilitating improvements (DECC 2014b). This would mean no upfront costs to the landlord (*“to ensure that any regulations do not impose disproportionate burdens on business”* (DECC 2014b: 12)) and payback through energy savings over time, creating *“a win-win opportunity for both landlords and tenants”* with energy savings for the bill payer and an improved building for the landlord (DECC 2014b: 4). In practice, this green financing deal has to date failed to materialise due, it has been suggested, to a lack of financial backing (UKGBC 2016). Instead, therefore, the Regulations refer to a seven year payback period as the alternative *“financial arrangement”* (Regulation 28; Energy Act 2011, section 49(4)(b)). This means, broadly, that landlords are only required to carry out improvements that would pay for themselves through energy cost savings after seven years or less. No alternative mechanism is suggested for ensuring landlords do not have to bear upfront costs.

More broadly, it has been suggested that MEES may help to reinforce links between the sustainability of buildings – as expressed through EPCs – and asset value. In preparation for the start of MEES in April 2018, according to BCSC and CBRE (2015: 20), commercial landlords are reviewing portfolios *“to determine their risks and investment required to mitigate them”*. BCSC and CBRE (2015: 20) go on to say: *“As would be expected, the lettable or otherwise, of a building has a significant impact on its value. We are seeing valuers building in allowances for improvement works in their appraisals and purchasers*

*proposing price chips during acquisition negotiations*". It has also been suggested that MEES will add weight to obsolescence risk as a driver (JLL 2013). The BCSC and CBRE (2015: 19) suggest: *"Depending on the fabric and systems, and the extent of work required to meet minimum standards, some buildings could be considered obsolete if improvements cannot be made cost effectively"*. In other words, MEES provides a clear benchmark for which buildings may be considered "obsolete" in the future.

#### 4.1.3 The interaction of MEES and leases

As noted above, the legal arrangements between landlords and tenants, as set out in the lease, commonly reflect – and arguably reinforce – the split incentive problems (see e.g. DECC 2015a; Dixon et al. 2014; Bright 2008). In response, in the UK the industry-led Better Buildings Partnership (BBP) and its members have sought to address the role of leases in energy (and broader environmental) performance by promoting the use of "green" clauses and developing a "Green Lease Toolkit". Building on the concept of "green" leases first proposed in Australia in 2006 (Woodford 2007), the Green Lease Toolkit identifies the *"split responsibility/incentive ... in the procurement, control and use of resources"* as a *"key barrier to the improved Environmental Performance of commercial buildings"* and includes model clauses and guidance to *"help overcome this challenge by providing a framework for engagement on environmental issues"* (BBP 2013: 2; Janda et al. 2016). More recently, the concept of green clauses has been reflected more widely across the industry with the development of the "Model Commercial Lease" (MCL 2016).

The introduction of the MEES Regulations is prompting debates about the interaction between MEES and lease clauses, in terms of how existing lease clauses help or hinder MEES

compliance, and how new lease clauses might do so, for example whether they allow landlord access to carry out improvements (e.g. Farnell 2015; BSDR 2014; Patrick et al. 2015). Indeed, both the BBP and Model Commercial Lease are considering whether changes should be introduced to their model clauses in light of MEES (personal communication with Chris Botten, Programme Manager, BBP, 8 March 2016; MCL 2015).

Williams (2015) has written on the potential implications of MEES for new lease clauses from a practitioner's perspective. Table 1 summarises the key points, which provide a useful overview of the potential implications of MEES in relation to seven different types of lease clauses.

**Table 1: Potential implications of MEES for new lease clauses** (based on Williams 2015)

<b>Type of lease clause</b>	<b>Potential implications of MEES for new clauses</b>
<b>Service charges</b> Typically these cover repair and maintenance but not improvements	Landlords may wish to include provisions that expressly allow them to recover the costs of energy efficiency improvements
<b>Yielding-up</b> (or reinstatement) Typically this relates to tenant's repairing obligations at the end of the lease	There have been suggestions that provisions could require tenants to ensure the EPC rating at yield up is the minimum required under MEES, or no lower than at the start of the term. It is suggested that this might in practice require improvements and therefore be unfair to tenants.
<b>Statutory compliance</b> Typically this requires tenants to comply with statutory obligations in relation to demised premises	Tenants may wish to seek a specific carve-out from these provisions in relation to MEES.
<b>EPC production</b> Although currently rare, some leases provide for how and when a tenant obtains an EPC	It is expected that landlords will in future seek to include provisions that control when and how an EPC is produced, including requiring tenants to use the landlord's choice of assessor or asking the landlord to obtain EPCs on their behalf.
<b>Alterations</b> Typically this allows tenants to make non-structural alterations with landlord consent	Landlords may wish to prevent alterations that could adversely affect a building's environmental performance or EPC rating.

<b>Landlord's right of access to carry out works</b> Lease provisions are likely to vary, but improvements (rather than maintenance) are typically excluded	On the one hand landlords may wish to include rights of access to carry out improvement works; on the other hand they may seek to restrict their rights of access in order to be able to rely on the consent exemption under MEES.
<b>Rent review</b> Typically these assume a notional letting on the date of review based on certain assumptions e.g. the property is fit for occupation, or may lawfully be used	It remains unclear whether any additional provisions will be needed to ensure MEES does not adversely affect rent review for landlords.

This overview focuses largely on the landlord's perspective, although it identifies a particular implication for tenants in relation to statutory compliance provisions, suggesting tenants may in future seek to exclude any MEES-related obligations or costs from this provision. Moreover, BCSC and CBRE (2015:30) have reported that retailers have *"requested during negotiations that clauses be included that exclude works to improve a centre's EPC rating from service charges"*. BCSC and CBRE (2015:30) suggest that these types of leasing responses *"may further emphasise the split incentive between owner and retailer, reinforcing the industry stalemate."*

## 4.2 Research approach and methods

MEES arose in the UK with a public consultation in July 2014 and a response to the consultation published in February 2015 (DECC 2014b; DECC 2015b). The emergence of MEES coincided almost exactly with the two-year period of the WICKED project's funding (July 2014 - June 2016). One of the WICKED project's research streams addresses organisational energy management practices (e.g. Janda 2016), and this stream includes a focus on the role and impact of leases in relation to energy management (e.g. Janda et al. 2016, Patrick and Bright (forthcoming, Conveyancer)). WICKED project researchers in this

area carried out semi-structured interviews with industry experts and participants between January and November 2015, which were well-timed to capture initial industry thinking about the introduction of MEES with respect to leasing. The sampling of interviewees is best described as a snowball sample reflecting a number of influences: a socio-technical model of participants in the retail sector (Janda et al. 2014); the need to synthesise with other WICKED project research themes investigating portfolio-wide energy and building data sets (e.g. Janda et al. 2015); and convenience and accessibility. The research team carried out 29 interviews with 38 representatives of 25 different organisations, including retailers (3), property owners (3), letting and property management companies (4), law firms and legal experts (11, including 5 that typically act for BBP members, 4 that typically act for retailers and/ or non-BBP property companies, and 2 independent experts with a broad view of the market), and industry intermediaries and experts (4). Although the inclusion of lawyers as interviewees provided an opportunity, in some cases, to capture experience amongst SMEs as well as larger companies, and lettings in the secondary market, overall respondents tended to represent, or have insights into, larger organisations with national or international portfolios of prime properties.

Interviews were recorded and transcribed and responses were coded (using NVivo software) and analysed thematically. Thematic analysis of interview transcripts was supplemented by document analysis of company strategy reports, green lease clauses in company templates, and model green lease clauses promoted by industry partnerships, and a review of policy documents and industry reports. Given the relatively small samples within each category of respondent, and the different capacities in which respondents answered questions (at times drawing on their own experience, at other times commenting on wider market practice), the views captured cannot be considered necessarily representative or comprehensive, but they

nevertheless reflect a range of different industry views and responses on newly emerging industry and policy issues.

### 4.3 Industry insights

This section summarises interview responses from the WICKED project relating to MEES, in particular the link between leases and MEES, the role of lease clauses in helping to manage compliance with the MEES Regulations, and the extent to which this interaction may promote or hinder the objectives of MEES to secure energy efficiency improvements to the UK's least efficient properties.

Many interviewees commented on how MEES is now causing landlords, tenants and their advisers to consider the role of leases in relation to compliance and to environmental improvements more generally. As one in-house lawyer commented, *"there's MEES out there, but there's also the lease provisions and you've got to read the two together"* (Interviewee 28).

Overall, interviewees identified broadly three responses, and corresponding potential roles for lease clauses (which are not mutually exclusive):

- (1) Active: from a landlord's point of view, an active approach sets out to identify action necessary to improve F and G rated properties (i.e. the worst performing properties, below the minimum standard set by the MEES Regulations). This approach most directly works to meet the Government's objectives under MEES, in terms of securing improvements to the least efficient buildings.

- (2) Protective: from a landlord's point of view, the protective approach seeks to preserve the asset rating of properties that already comply with MEES through requiring tenants to maintain (or not worsen), the environmental performance or rating of their premises. The protective approach seeks to ensure that currently compliant buildings do not add to the stock of "least efficient" buildings by falling below the minimum standard.
- (3) Avoidant: for both landlords and tenants, an avoidant approach seeks to avoid or delay action and/ or associated exposure to costs in relation to MEES compliance. This approach secures technical compliance with the MEES Regulations at the portfolio level, but risks preventing or delaying improvements to sub-standard properties in the building stock.

Interview findings in relation to these three categories are described further below and are summarised in Table 2 (the summary not necessarily reflecting the full range of nuances expressed by different interviewees).

#### **4.3.1 Active approach to MEES**

Respondents who described an active approach to MEES (typically representing larger property companies operating in the prime market) highlighted ways of using leases and other mechanisms to support landlord action to carry out energy efficiency improvements to comply with MEES, to ensure that F and G rated properties are improved to meet the minimum standard.

First, a number of interviewees highlighted the potential role of MEES in reinforcing economic drivers of energy efficiency, in particular the link between MEES compliance and preserving asset value. Amongst these, most seemed uncertain about the link with some suggesting that value implications would depend on market dynamics, e.g. the relative bargaining positions of landlords and tenants. Two interviewees suggested that sub-standard properties were likely to attract a “brown discount” under MEES, suggesting this is one driver of an active approach. This link was explained by one lawyer as follows:

*“some landlords are now saying it’s worth investing in stock, not because this necessarily makes it more valuable, but because it is less likely to reduce in value. MEES in particular are driving this as an issue and are ‘chipping off the price”*  
(Interviewee 23)

An active approach to MEES may, therefore, be important to preserve asset value, depending on market circumstances. Views on the role of the lease in facilitating such an approach are, however, mixed.

One view was that landlords adopting an active approach may seek greater rights of access to enable them to carry out improvements during a lease (thus avoiding the need to plan a void in order to do the works). One lawyer explained: *“...with MEES coming in ... there might well be a driver now much more for the landlord to make improvements to the building and have access to the tenant areas to do that”* (Interviewee 32).

The same lawyer suggested, however, that increased rights of access might not mean very much on their own, without dealing with the issues of cost allocation and potential disruption to the tenant’s business:

*“As soon as there is a clause which allows landlords to carry out improvements, the tenant will go straight to the service charge schedule and make sure there’s a specific exclusion or will definitely come out in the negotiation as to who is paying for this. There are also cases that we can give the landlord right of access but the tenant will say ‘when reasonable’.. ‘not affect quiet enjoyment’. And if you’re talking about major improvement works, the landlord will have to get in and disrupt the tenant. We can explain to the landlord there can be a right of access but whether you can go in there and carry out these improvements is another matter; because tenants will not want to be disrupted to a major extent .. and if these works are expensive then a right of access in the lease may not mean much at the end of the day.”* (Interviewee 32).

Related to this, respondents suggested that landlords might increasingly attempt to recover costs for the energy efficiency improvements needed under MEES, either through existing lease provisions or through new, explicit lease clauses. One legal expert (with an overview of the wider market) commented that cost recovery is *“going to come into sharper focus because of MEES”* (Interviewee 34).

In terms of the role of the lease in cost recovery, there were different views about whether improvement costs could be recovered under typical service charge provisions. One professional support lawyer suggested: *“actually when we look at our leases... because they’re drafted quite widely in what landlords can put through the service charge, you think actually it’s wide enough already”* (Interviewee 26). By contrast, one retailer in-house lawyer expressed a different view: *“Normally you can install new things where it’s not economic and viable to repair but generally it shouldn’t be improvements”* (Interviewee 28). An alternative view was that in practice, sometimes landlords may include improvement

costs in service charges irrespective of what the lease says. One lawyer mentioned: *“managing agents I’ve spoken to will put stuff through the service charge without bothering to check whether it’s chargeable”* (Interviewee 34). Going forward, there were some suggestions that landlords are increasingly attempting to insert explicit environmental improvement cost recovery clauses into new leases, although whether tenants would accept these was uncertain. These views suggest that leases *may* – one way or another – have a role in supporting an active approach.

Overall the responses suggest that increased landlord attempts to recover costs – possibly facilitated through lease provisions - could enable energy efficiency improvements that might otherwise not happen and thereby help deliver MEES objectives.

There was also a different view that the lease is not a helpful tool in facilitating positive energy efficiency improvements and that these are more effectively dealt with outside the lease, even under MEES. One property company representative explained:

*“Even in relation to MEES, opportunities can happen outside the lease. As soon as it’s in the lease, lawyers argue over it.”* (Interviewee 16)

One lawyer put it slightly differently:

*“With MEES, parties would rather take a light touch approach – you don’t want to spend hours negotiating these provisions and then finding that it does not work in practice. It is a difficult balance and until MEES settles down we’ll see very light touch on documents. I think that’s probably right because I don’t think the lease can cater for all of this. It will probably have to sit outside the lease so it can be a bit more free-*

*flowing and fluid, and you don't then have to spend time varying the lease when things change."* (Interviewee 32)

Some interviewees presented yet another perspective, suggesting that cost recovery during the term of a lease might be less of an issue, and that the likely landlord response to sub-standard properties under MEES would be to carry out improvements following the end of a lease, and possibly recover costs through charging a higher rent to the incoming tenant. Others suggested certain landlords may want to pay for improvements themselves to show leadership, or because they perceived clear benefits from investment in terms of higher tenant retention, shorter voids and preserving the value of their portfolio.

#### 4.3.2 Protective approach to MEES

Alongside the "active" approach, a number of respondents (again, typically representing larger property companies) saw MEES acting as a driver to protect existing asset ratings. As one lawyer put it, *"With MEES it's around EPCs...Changes to leases will focus very much on preserving an asset rating"* (Interviewee 32).

Maintaining EPC ratings was generally discussed in relation to tenant action, and seen in terms of both preventing actions that would reduce environmental performance, and ensuring investment to improve environmental performance where this would be necessary to maintain the minimum rating of E, given the likely shifting thresholds in the calculation of EPC ratings. One property company representative commented: *"what we can say around maintaining an EPC rating and what that actually means on a practical level and a legal level as well is becoming increasingly important"* (Interviewee 11).

In relation to alterations, respondents (commenting typically from a landlord's perspective) were concerned that the lease should prevent tenants from carrying out alterations that adversely affect either the property's EPC rating, or more generally environmental performance of the property. One lawyer described a need to *"beef up what the lease says about the tenant carrying out alterations, so that the tenant is prevented from doing things that would have a detrimental impact"* (Interviewee 23). Other lawyers highlighted a possible view that alterations clauses commonly require landlords reasonable consent in any event, and there was an argument that withholding consent would not be considered unreasonable where proposed alterations would adversely affect environmental performance.

In relation to yield up, respondents seemed uncertain about what provisions might be needed to protect against non-compliance with MEES. The representative of a property management company explained:

*"One [link between leases and energy management] that's come up recently is this Minimum Energy Performance Standard [now generally referred to as MEES] and the cost of dilapidation when whoever it is vacates. So if when we get to 2018, it's the law that you can't let an F or a G, who does that cost lie with and what part does the lease play in that? I think that's something that the industry's not really clear on."*

(Interviewee 4).

Another area where landlords were considering the role of lease clauses was in relation to the production and quality of EPCs. It was suggested that landlords were increasingly including clauses to control when and how EPCs are produced, e.g. preventing tenants from

obtaining EPCs unless legally required to do so (for example on a subletting); and requiring tenants to use the landlord's choice of EPC assessor, or to let the landlord carry out the EPC for them. This trend is likely to continue. The position was summed up by one lawyer as follows:

*"I think the way it feeds into leases .. there has been a recognition that EPCs are sometimes good and sometimes bad... If the tenants do something that changes the EPC rating or might do, then they, the landlord, want to control that process. They want to be able to step in and do the EPC even if it's a tenant sale or letting that's triggered the requirement." (Interviewee 38).*

#### 4.3.3 Avoidant approach to MEES

Respondents also highlighted a more risk-averse approach, seemingly concerned not with improving the environmental performance of buildings – as envisaged under the MEES Regulations – or preserving it, but with ensuring compliance whilst minimising exposure to MEES and associated costs, thus avoiding or delaying investments in building improvements.

As mentioned above, in response to MEES some landlords may increasingly seek to use lease clauses to recover improvement costs. In itself, this might be considered helpful in enabling improvements and thereby achieving the objectives of MEES. However, interviewees also suggested that MEES would cause *tenants* to consider more explicitly what happens to the costs of energy improvements, resulting in increased tension between landlords and tenants: landlords aiming to recoup costs, and tenants simultaneously aiming to exclude these. It was suggested that this could potentially undermine attempts to create a more

collaborative approach between landlords and tenants, and also create additional legal barriers to improvements, making tenants less likely to agree informally to minor improvements. Interviewees gave different examples of improvements that had been agreed between landlords and tenants in this way, including those that could be recovered by the landlord within the annual service charge budget (suggesting relatively low capital outlay), those with a payback of two years or less, and those with a payback of five years or less, where the cost charged to tenants was spread over the payback period.

One lawyer (who does not typically act for BBP members or large property companies) explained the avoidant approach as follows:

*“There have been more comments and questions from clients since MEES. They’re not asking how they can sort this out. Landlords are saying ‘how can I get tenants to pay?’; the tenant is saying ‘how can I stop landlords charging me?’ ... All are jockeying for position to make sure whatever happens, they’re not paying for it”* (Interviewee 26).

Similarly, the in-house lawyer for a retailer took the view: *“We want to protect against having to update a landlord’s property, at our expense”* (Interviewee 28).

In this context interviewees referred both to service charges and to statutory compliance provisions as potential battlegrounds for cost recovery. For example, one property management company representative commented:

*“the landlords will argue that most leases now will have a clause that says the landlord is entitled to charge the tenant the cost for any works that are required to*

*meet a statutory requirement. On the flipside, in general, leases tend to say that any improvements to a property that enhance the asset value are the responsibility of the landlord and the landlord pays". (Interviewee 24).*

Other lawyers commented:

*"you've then got who picks up the cost.. and we are seeing landlords put in they can recover the costs of environmental improvements. Whether a tenant can strike this out or not depends on how strong a tenant they are." (Interviewee 31).*

*"MEES is the driver that would mean that landlords would be able to negotiate that [cost recovery] in. Whether landlords try to get that in through the back door by defining improvements quite widely... it remains to be seen how easy it is to negotiate that into the lease... With MEES landlords will argue more heavily that they have to carry out these improvements and that the tenants will benefit from the energy efficiency savings as a result of these improvements. ... As soon as there is a clause which allows landlords to carry out improvements, the tenant will go straight to the service charge schedule and make sure there's a specific exclusion or will definitely come out in the negotiation as to who is paying for this." (Interviewee 32).*

All of these views seem to paint a picture of a mutual desire by landlords and tenants to avoid the costs of any improvements necessary to comply with MEES.

Similarly, it was suggested by lawyers and one landlord that landlords may seek to limit their access rights – making their right of access to carry out improvements subject to tenant consent – in order to be able to rely on the statutory exemption from MEES, under which

landlords are not prohibited from renting out sub-standard properties where tenants have refused consent to relevant energy efficiency improvements. One lawyer explained, “... you see landlords’ minds working... ‘how can I get myself into an exemption up to until the premises are vacant’” (Interviewee 32). Another lawyer commented, “We’ve been considering from a landlord’s perspective how this will interface with MEES. Whether if the landlord has that right they’ll be able to rely on the consent exemption... One way to deal with this is to temper it so the landlord only has right of access to deal with improvements that have been consented to by the tenant and the tenant has absolute discretion” (Interviewee 31).

It was suggested that fundamentally, in relation to cost recovery, there would be “two camps” (Interviewee 32, lawyer):

*“There are two views. There are some landlords that will wish to carry out those improvements and will wish to recover the cost from the tenant; or there are some better informed landlords who accept that if they have to make improvements to the building that they should pay for those. And therefore there will be two camps. The landlords looking to use the exemption in the regulation that allow them not to carry out improvements if they can’t get consent. And those that accept if they want to carry out improvements they should pay for those.”*

Overall, whilst interviewees highlighted a range of approaches, one view was that in practice MEES compliance might involve a mix of approaches. As one lawyer explained:

*“So I suspect we will see provisions requiring tenants not to do anything which might impact EPCs, we might see ability for landlord to go in and carry out improvements; the tenant will counter that by saying, you can only have access to the premises*

*when I say and in terms of cost I'm not paying for any improvements and there will be some arguments – the landlord arguing that if there are any benefits the tenant should pay.” (Interviewee 32).*

The same lawyer also commented that the issues may be magnified from 2023, when MEES apply to existing lets as well as new (and renewal) ones:

*“I suspect landlords will just have to take it on the chin and improve the building and pay for it. The problems are going to be when we come to 2023 when it's all leases and you have to start targeting existing leases, that's when we're going to have problems and arguments are going to start.” (Interviewee 32).*

#### 4.3.4 Other MEES issues

A complete description of the interview responses is beyond the scope of this chapter. However, we note that interviewees raised a range of other issues related to MEES including:

- the role of fit-out as a key opportunity for engaging with tenants to respond to MEES;
- the risk that sub-standard properties are off-loaded, possibly to those with less capacity to deal with MEES and energy management generally;
- questions about how MEES will be enforced;
- the consequences of landlords' inability to access upfront cash to fund improvements;
- the challenges of EPC methodology and logistics to monitor ongoing compliance with MEES.

The issues are picked up further, where relevant, in the discussion and conclusions below.

**Table 2: Summary of issues raised by interviewees: responses to the introduction of MEES and the role of leases**

Types of responses	Summary of interviewee views
<p><b>Active approach</b> (improving sub-standard properties)</p>	<p><b>Landlord perspective</b> (typically larger companies in the prime market)</p> <ul style="list-style-type: none"> <li>- MEES may reinforce economic driver to preserve asset value, depending on market dynamics.</li> <li>- Landlords may seek greater rights of access to tenant premises to carry out improvements</li> <li>- Landlords may increasingly seek to recover costs of improvements, which may involve more explicit cost recovery clauses in leases.</li> <li>- Alternatively, landlords may deal with improvements and related cost recovery outside the lease, or at the end of a lease term, and/ or may accept that they should pay for improvements.</li> <li>- The extent to which landlords will be able to recover costs from tenants either through the service charge or rent is uncertain.</li> </ul>
<p><b>Protective approach</b> (preserving minimum standards)</p>	<p><b>Landlord perspective</b></p> <ul style="list-style-type: none"> <li>- Landlords will seek to prevent tenant alterations that reduce environmental performance and/ or EPC ratings through appropriate lease clauses.</li> <li>- In relation to yield up/ reinstatement, landlords may similarly wish to secure a certain level of environmental performance, possibly through the lease, but whether and how this would work is unclear.</li> <li>- Preserving minimum EPC ratings may involve investment to <i>improve</i> environmental performance due to changing ratings thresholds.</li> <li>- Landlords are increasingly including lease clauses to control when and how EPCs are produced by tenants.</li> </ul>
<p><b>Avoidant approach</b> (ensuring compliance whilst avoiding improvements and/ or associated costs)</p>	<p><b>Landlord perspective</b> (typically the wider market, possibly not including larger landlords)</p> <ul style="list-style-type: none"> <li>- Landlords may increasingly seek to recover the cost of improvements, including through more explicit lease provisions.</li> <li>- Landlords may seek to limit their rights of access to tenant premises under the lease, to rely on the MEES exemption where tenants refuse consent to improvements.</li> </ul> <p><b>Tenant perspective</b></p> <ul style="list-style-type: none"> <li>- Tenants may increasingly seek to exclude explicitly the cost of improvements, including from service charge provisions and/ or statutory compliance provisions.</li> </ul> <p>Whether landlords are able to recover costs will depend on market dynamics. These avoidant approaches may undermine attempts to create a more collaborative approach. Tensions may be magnified from 2023, when MEES will apply to existing lets.</p>

<b>Types of responses</b>	<b>Summary of interviewee views</b>
<b>Other issues</b>	<ul style="list-style-type: none"><li>- Fit-out arrangements (before the start of the lease) may present an important opportunity for engaging with tenants to comply with MEES.</li><li>- There is a risk that sub-standard properties may be off-loaded, possibly to those with less capacity to deal with MEES and energy management generally.</li><li>- There are questions about how MEES will be enforced.</li><li>- It is not clear what the consequences will be where landlords are unable to access upfront cash to fund improvements.</li><li>- There are a number of issues related to EPC methodology and logistics which will make monitoring ongoing compliance with MEES challenging.</li></ul>

#### 4.4 Discussion

The findings describe a variety of industry views on MEES and the roles of leases in relation to MEES. This section summarises and discusses these roles, as well as their implication for energy efficiency improvements of sub-standard buildings and the prospects of meeting the objectives of the MEES Regulations.

In summary, interview responses highlighted three broad responses to the MEES Regulations and three corresponding – potentially conflicting – roles for lease clauses. MEES are causing some – typically larger - landlords to adopt an active approach, to seek improvements to F and G rated buildings. At the same time, MEES has focused attention of these landlords on the need to protect ratings and the environmental performance of assets, both through preventing detrimental activity and through encouraging positive improvements by tenants. Lease clauses are seen as playing an existing or potential role to enable these two approaches although other mechanisms, such as fit out, may also need to play a role. To what extent these approaches will involve cost recovery (or more cost

recovery than at present) or whether landlords will have to “*take it on the chin*” (Interviewee 32, lawyer) remains to be seen.

On the other hand, there are suggestions that MEES may reinforce tensions between landlords and tenants around cost allocation for improvements, with both seeking to avoid exposure under MEES. In this context, lease provisions may serve to clarify cost allocations more explicitly, with both landlords and tenants seeking to pass on or avoid exposure to costs, and they may restrict landlord access to carry out improvements. These developments may reduce the likelihood of energy efficiency upgrades within the lease, and they may make informal collaboration and arrangements to support improvements outside the lease less likely.

In terms of the role of lease clauses, it was noticeable that when discussing MEES interviewees tended to focus on the allocation of responsibility and cost between landlords and tenants, and on the prevention of certain activity. Other clauses that are typically referred to in the context of green leases – such as cooperation and general sustainability clauses, data sharing, and regular landlord-tenant meetings (Janda et al. 2016) – did not seem to be seen by respondents as relevant to MEES. Failure to associate these broader green clauses with MEES may partly reflect the asset-based (rather than operational) focus of EPCs which are used as the measure for MEES. However, for those property owners that adopt an active approach, cooperation with their tenants and data sharing may assume new significance, for example, to enable identification of “relevant improvements” under MEES, including those with payback periods of seven years or less. Collaboration may also be needed to deal with the technical and logistical challenges of assessing actual and potential EPC ratings, for example related to proposed alterations, and in particular in relation to E-rated properties. Moreover, tenants for whom subletting is a possibility may take an active

interest in MEES compliance as they themselves would be caught by the MEES prohibition in the event of subletting a sub-standard property.

In terms of the broader landlord-tenant relationship, the issue of cost recovery – who should pay for improvements – featured strongly in the interviews and is at the heart of the split incentive problem. It is clear from the early policy documents that the UK Government initially intended MEES to tackle this split incentive. In practice, however, policy shifted and the MEES Regulations do not address the underlying misalignment of fiscal incentives. The WICKED interviews revealed the continuing misalignment of incentives in ongoing uncertainty about the link between environmental performance and rental and capital values, and the tensions surrounding cost recovery. It may be that as questions around the link between value and building performance become more settled within the commercial property industry, the underlying split incentive will be reduced and the lease will assume a clearer role in supporting positive compliance, preserving asset value and avoiding obsolescence (cp. Elliot et al. 2015). In the meantime, however, MEES may inadvertently put extra pressure on the historically adversarial landlord-tenant relationship and undermine moves to encourage more collaborative approaches.

Ultimately, where parties adopt an avoidant approach this may of course serve only to delay improvements to sub-standard properties; as existing leases come to and end, landlords are unlikely to be able to rely on the consent exemption to avoid improvements, and would have to bear the costs of such improvements before being able to re-let. Whether such costs could be recouped through higher asset or rental values – or whether some landlords may choose to off-load sub-standard properties and/ or re-let sub-standard properties in contravention of the MEES Regulations - remains to be seen.

To the extent that landlords are simply unable to access the cash needed for relevant improvements and tenants refuse to share the costs, it is unclear what the implications under MEES are – including how Government will be able to enforce compliance in these circumstances. In the absence of a workable finance arrangement (Green Deal or otherwise), the Government has arguably failed in its promise to ensure landlords do not face upfront costs (DECC 2014b). Offloading sub-standard properties at a discount to property owners that do have the cash to fund improvements may be one way that improvements are ultimately achieved; although if offloading results in a secondary, sub-standard market, it may further hamper the successful delivery of MEES objectives.

By mandating minimum standards, the MEES Regulations may well result in active compliance, the harnessing of leases as an active compliance tool, and resulting improvements to much of today's sub-standard commercial building stock. However, MEES only go so far (see also Elliot et al. 2015): upgrading the UK's commercial building stock to meet the UK's carbon reduction targets will require companies to go beyond compliance and, of course, the application of MEES is confined to commercial properties that are "let" and does not affect owner-occupied buildings that are sold, for example. In addition, the lease's role in supporting energy efficiency improvements may be limited, even if it is used for active compliance. As many interviewees suggested, positive, pro-active, informal and creative collaboration between landlords and tenants outside the lease will be needed to lift standards across the commercial built environment as a whole. Finally, reductions in energy consumption will require improved operational strategies and management in addition to improvements to the fabric of buildings (JLL and BBP 2012).

## 4.5 Conclusions

Throughout the WICKED project, the role of leases in relation to energy management and energy efficiency has been questioned by industry participants, including retailers (tenants), property owners (landlords), letting and property management companies, law firms and legal experts, and industry intermediaries and experts. However, MEES are creating an arena that demands consideration of the implications of lease clauses from a regulatory compliance perspective. MEES have highlighted the diverse roles of leases clauses and their potential to support active, protective, and avoidant approaches to compliance. There are many detailed questions that have yet to be explored further in relation to MEES: for example, how will MEES in 2023 affect buildings let on long leases pre-dating MEES; what are the implications of MEES for rent review and statutory lease renewals (cp. CO2 Estates 2015); and how will MEES interact with 'reasonable consent' clauses in leases. The UK Department of Energy and Climate Change will need to consider some of the issues and questions raised, in particular what MEES will mean for property owners that lack access to upfront cash to carry out improvements.

The implications for individual property owners will vary across different types of company, buildings, and landlord-tenant relationships. However, the findings discussed here suggest that there is a good case for an active approach which seeks to plan for improvements combined with a protective approach which prevents the deterioration of assets' environmental performance, provided that investments in energy efficiency are reflected in the avoidance of obsolescence or – perhaps less dramatically – a price differential or “brown discount”. Property companies and their occupiers may find this a more compelling proposition if value questions are further clarified across the industry. Professional valuers

and industry bodies such as the Royal Institution of Chartered Surveyors (RICS) have a key role here, and further guidance from BBP will also be welcome.

Beyond the UK, barriers to energy efficiency investments including split incentives, and appropriate regulatory and market responses, have been recognised and discussed widely, including across the EU, Australia and the US (e.g. EC 2011; Coalition for Energy Savings 2015; CAEPB 2016; Australian Government 2015; McKinsey&Company 2009). Most policy responses, however, take the form of focusing on minimum standards when building, maintenance or refurbishment occurs (e.g. Coalition for Energy Savings 2015; CAEPB 2016; LEAF 2016) or on mandatory disclosure requirements (eg the Building Energy Efficiency Certificate (BEEC) in Australia required under the Building Energy Efficiency Disclosure Act 2010). Only the UK and Ireland are – it would appear - introducing minimum standards specifically for *rented* properties (Coalition for Energy Savings 2015), in the UK's case making it unlawful to let sub-standard properties. The wide range of measures and responses across different countries suggests that many of the challenges outlined in this chapter are not UK-specific, and that much further work by governments, companies and industry bodies will be needed to enable improvements to the commercial building stock across the EU and worldwide. The UK's pioneering approach, tying the requirement for minimum standards to the letting of property and thereby creating clear trigger points for improvements, will no doubt be followed with interest by industry and policy makers across the globe.

## Note

The Department of Energy and Climate Change is expected to publish non-statutory guidance on MEES, which may provide clarification on some of the issues described here. At the time of writing this had not yet been issued.

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