THE VALUE PROPOSITION

Engineers should be excited by the Energy Act 2011 because it has the potential to embed their work in property valuation – a key driver for the commercial property retrofit market, says **Andrew Cooper**

Until recently, many asset managers regarded building services as merely an operational function of a building. Whether services worked efficiently or not was often irrelevant, because operational and energy costs were passed on to tenants through service charges or direct billing/recharging. These costs do not form part of valuation calculations, so it is difficult to work out a value differential between an efficient building and a less efficient one. The incentive to make buildings more energy-saving has been stymied by valuation techniques and the way the UK leasing market operates.

However, there has been a seismic change in fund and asset management strategy within the larger UK property funds and real estate investment trusts (REITs). Managers are beginning to take energy efficiency very seriously – in particular, a building's energy performance certificate (EPC).

This is largely a result of the Energy Act 2011, and its requirement for minimum energy efficiency standards – known in the property market as MEPs (minimum energy performance standards) – which are tied to a building's EPC. In July this year, the government released its consultation on the implementation of the legislation and its energy efficiency regulations of the non-domestic private rented sector in England and Wales. The consultation has reaffirmed the likelihood of an MEPs threshold of an E-rated EPC.

The proposal is that rental properties that require an EPC under the EU Energy Performance of Buildings Directive will also be subject to MEPs. From 1 April 2018, all new lettings would be subject to minimum standards, and – from 1 April 2023 – a regulatory backstop would apply, meaning all let properties must comply with legislation.

The Act introduces a mechanism for identifying qualifying energy conservation measures – known as the Golden Rule – and mandates their installation. The Golden Rule is that repayments for improvements, including any interest charges, must be the same or less than the expected energy bill savings in the first year.

Properties rated F or G that are captured by the legislation will need to undergo a due process linked to this rule. If, afterwards, they remain F or G rated, only then may they be let.

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INVESTMENT POTENTIAL
COST OF IMPROVING EPC E+ RATED BUILDINGS: £29BN
ANNUAL REDUCTION IN RUNNING COSTS: £3.9BN

If a property cannot be let, rental income will be lost until it is compliant. Because of the way rent reviews and lease renewals operate, there is also a risk of reduced rent if an E+ rated EPC is the result of an occupier's fit out, rather than the landlords'. The Energy Act 2011, therefore, introduces a market dynamic with the potential to affect value and/or the amount of finance secured against an asset – be this directly, or indirectly through utility bills.

There is already evidence of transactions being affected by EPC ratings at the fund and REIT level. If this continues, and is replicated across the market, a clear value differential based on comparable evidence – a central tenet of UK valuation techniques – is likely to emerge.

There are concerns over the proposals – particularly the link to the Green Deal, and the fact that Green Deal Finance is not yet available for non-domestic properties. But the consultation document provides investors with a degree of certainty that an investment in energy efficiency is a priority.

Such sentiment is supported by Deloitte Real Estate's research document *Carbon Penalties and Incentives*, commissioned by the Green Property Alliance and the Green Construction Board. Miles Keeping, a partner at Deloitte Real Estate, says investors welcome moves to create certainty in the marketplace because it enables them to plan risk management. 'Investors want to see a sensible and robust framework for the managed reduction of carbon emissions,' he said.

The potential rewards for the UK economy are enormous. Research by CO_2 Estates estimates the cost of improvement works to F, G and the worst-performing E-rated properties to be £29bn, resulting in an estimated £3.9bn per year reduction in running costs – and at the heart of all of this will be the building services engineer.

● **ANDREW COOPER** is an independent commercial property and energy consultant