SPOTLIGHT
Savills Research

UK Rural - September 2021

Rural Homes Energy Challenge

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Prioritising efficiency ● Implications for landlords ● Funding upgrades

89%
of PRS homes could be brought up to an EER band C or above

2028
The year by which improvements must be achieved on all tenancies

Prioritising energy efficiency

The drive for residential energy efficiency will affect the entire private rented sector, but rural landlords are likely to feel the impact more than their urban counterparts

The residential sector will be the largest consumer of energy by 2040, according to the latest government projections. The proportion of that demand being provided by renewable energy sources is forecast to rise marginally to 30%, assuming no intervention, meaning the majority will still be derived from polluting sources. On its current course, residential energy consumption will remain bound to carbon emissions and all the negative implications therein.

With a legally binding commitment to cut greenhouse gas emissions to at least 100% below 1990 levels by 2050, government policy-makers have naturally decided to address the residential energy problem. Taking the view that greater efficiency is both needed and possible, policy will push landlords to upgrade as many private rented sector (PRS) homes as possible. To do so, government is looking to amend the Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015. This means that the Energy Performance Certificate (EPC), as required whenever a building is constructed, sold or rented out, will be the tool of choice for implementing the change. The consultation on the matter, entitled "Improving the energy performance of privately rented homes", closed at the start of the year and feedback is currently being analysed. It would be fair to assume however that significant change is coming to the sector based on the contents of that consultation.

Policy makers have proposed the following changes:

- Raising the energy performance standard to EPC energy efficiency rating (EER) band C
- That improvements must be achieved for all new tenancies from 2025 and all tenancies from 2028
- Adopting a fabric first approach; maximising the performance of materials before considering energy generation
- Increasing the cost cap on total investment in improvements to £10,000.

In Scotland, there had been plans to bring the Energy Efficiency (Domestic Private Rented Property) (Scotland) Regulations

> **"Taking the view that greater efficiency is both needed and possible, policy will push landlords to upgrade as many private rented sector homes as possible"**

> “Housing stock in the UK is diverse, meaning landlords across the country face an equally diverse set of challenges”

2020 into force on 1 April 2020, but this was postponed due to the Covid-19 pandemic. These regulations would have required all properties in Scotland's private rented sector to have a minimum EPC rating of E at the start of a tenancy from 1 October 2020. In November 2020, the Scottish government announced the intention to have minimum EPC regulations re-laid before parliament and enter into force by April 2021. These would require all rental properties to have an EPC rating of D by 2025 and by 2022 for new tenancies. The introduction of these regulations was once again delayed due to Covid-19 impacting on work programmes and materials availability. Despite numerous delays however, the direction of travel for Scotland, and indeed the whole of the UK, is clear. Energy efficiency in our homes is to become a priority with an ever increasing baseline of enforcement.

Why is policy targeting PRS households? The sector has undergone significant growth to become the second largest housing sector, but that alone is not enough to justify the legislative changes. According to government analysis, “PRS properties are among the least energy efficient in the domestic housing stock” and also account for a disproportionate number of fuel poor households. The changes then are not solely about energy efficiency and the environment, but also wider health and social concerns.

THE RURAL CHALLENGE

At first glance, the impact of the legislation within England and Wales looks set to be significant, though not all encompassing. 69% of homes currently hold an EER below band C, meaning they will fall short of the new requirements and could not be rented out in their current condition. Almost two-thirds (63%) of those homes hold an EER band D rating, meaning they could likely be brought up to standard with relatively little investment. Indeed, according to those same EPCs, 89% of PRS homes could be brought up to an EER band C or above.

Housing stock in the UK is diverse, meaning landlords across the country face an equally diverse set of challenges. That difference is no more apparent than between rural and urban settlements. *Figure 1* shows how the EER band shifts to poorer ratings as we move from urban settlements, such as conurbations and cities, to rural settlements such as villages and hamlets. For cities and towns, D is the most common band (43% of ratings) followed by C (28% of ratings) and then E (21% of ratings). Compare this to hamlets, where E is the most common rating (38% of ratings), followed by F (23% of ratings) and then D (21% of ratings). The future energy efficiency challenge for rural homes is glaringly apparent and if appropriate action is not taken the consequences could prove detrimental for rural landlords.

Current EER by rural-urban classification

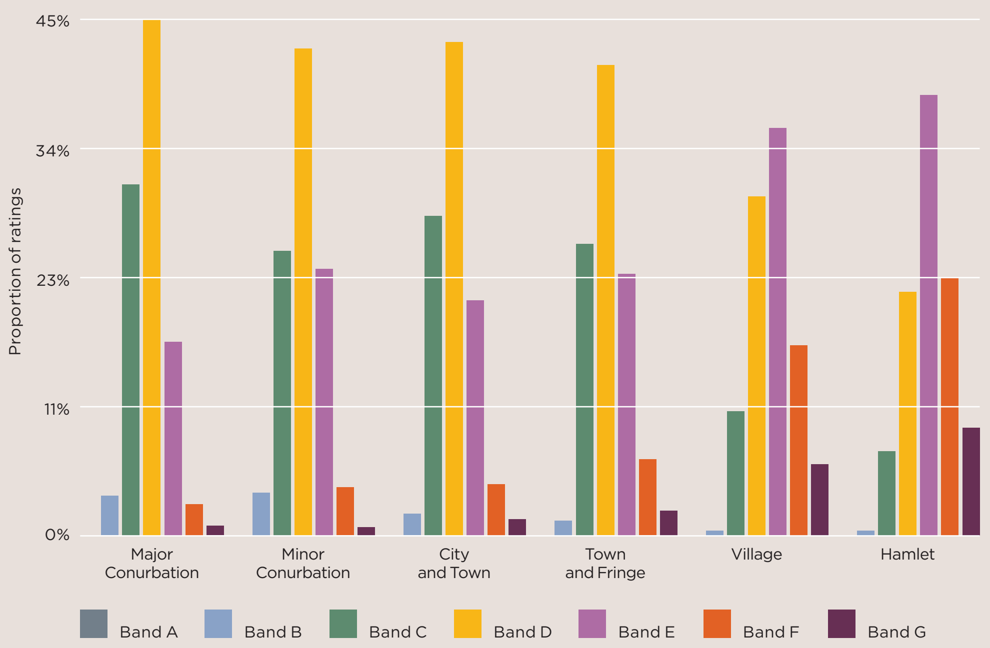


figure 1 **Source** Savills Research, MHCLG

IS THE RURAL PENALTY FAIR?

Reliance on the EPC process is biased against rural property for several reasons. For example, data suggests that age may be a contributing factor. Two-in-five PRS properties in villages date from before 1900. That figure rises to close to over half (52%) of PRS properties in hamlets. Compare that to major conurbations such as London and Manchester, where the figure falls to only 14% of properties. Across all EPC data from houses constructed before 1900, we find that close to a third (31%) are EER band E and 10% EER band F. Less than 1% of houses constructed from 2003 onwards were deemed to be EER band F, while 70% are EER band C.

Traditional features, such as solid walls, solid floors or thatched roofs are simultaneously less efficient and harder to rectify. There is also evidence to suggest that the thermal performance of traditional materials is underestimated, leading to older properties being penalised by the EPC process. A far larger proportion of rural homes are also reliant upon alternative fuels, particularly oil, as installing a connection to the gas grid is either impractical or entirely impossible. This sees rural properties further penalised by the EPC process.

Such challenges are felt by landlord and tenant alike. For rural tenants, income may well be lower than their urban counterparts and expenditure on fuel higher. It is unsurprising then that instances of fuel poverty are far more prevalent among the rural population. For rural landlords, each piece of legislation will require significant funds to be invested in hard-to-treat areas across multiple properties. With the failure of the Green Homes Grant, the stick now lacks any form of carrot to assist the rural community in addressing the issue.

> "Landlords who spend £3,500 up to 2023 to comply with the current regulations may well be faced with another £10,000 bill in 2025 if the original expenditure didn't achieve band C"

Demand for higher energy performance

What do the new rules mean for rural landlords?

For rural landlords the thought of achieving higher energy performance in their let portfolio having only just crossed the last cut off point will seem daunting and, perhaps, frustrating. How will rural landlords respond to a new, higher bar set by the government?

ARE UPGRADES REQUIRED?

The current English regulations allow six exemptions and it is anticipated that these will remain under the proposed changes. However, the definitions used in the regulations mean that a number of properties in the PRS have still not been impacted by Minimum Energy Efficiency Standards (MEES). The premise of these rules only apply where there is a valid EPC. Some tenancies such as tenancies under the Housing Act 1988 where the rent exceeds £100,000 per year fall outside the scope of the regulations.

For landlords who might look back at recent improvement work, or have an upcoming void that could be an opportunity to complete works in preparation for the proposed changes, caution is advised. The "no cost to the landlord" exemption was scrapped in favour of the £3,500 cost cap in April 2019. This meant landlords would have to demonstrate that the costs required to bring the property up to an E rating would be greater than £3,500 (including VAT) to be considered exempt. Only investment made after 1 October 2017 was permitted to contribute to the cost cap.

This consultation suggests a similar approach, with investments made before 2023 not counting towards the £10,000 cap. Landlords who spend £3,500 up to 2023 to comply with the current regulations may well be faced with another £10,000 bill in 2025 if the original expenditure didn't achieve band C. If landlords do not act decisively, additional costs could be incurred beyond the £10,000 with the consultation questioning whether the cap should be adjusted for inflation.

Currently, MEES is enforced by local authorities meaning the approach varies from area to area as the bodies are forced to prioritise resources in light of increasing economic challenges. The government is attempting to address some of the issues surrounding resource by resolving some of the administrative hurdles the current system creates.

With an estimated 10% of PRS eligible for an exemption, resourcing will have to improve significantly to police breaches quickly and efficiently. However, since the regulations were introduced in 2015 there has been an improvement in rural housing stock, with the percentage of rural PRS properties in band F dropping from 28% of EPC lodgements in 2015 to 8% in 2020.

Similarly the percentage of rural PRS properties in band G dropped from 13% of lodgements to 3% in the same timeframe. This may, however, be as a result of the restrictions on serving a valid Section 21 notice, rather than as a result of landlords' fears of enforcement action.

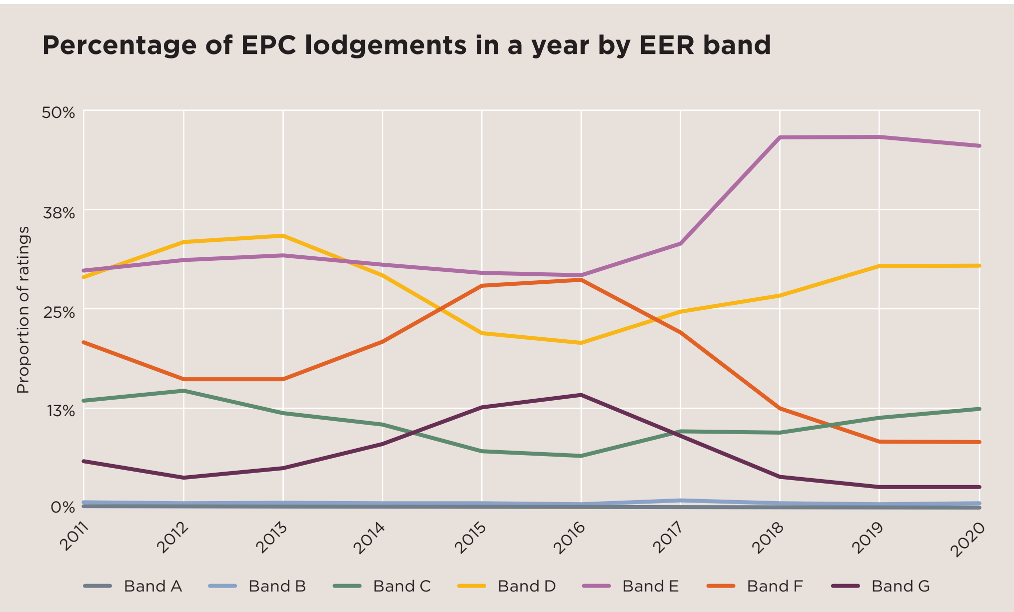
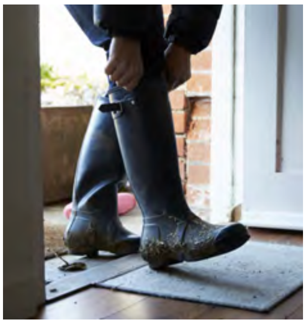


figure 2 **Source** Savills Research, MHCLG



PROVIDING STAFF ACCOMMODATION

For landlords who have a significant number of properties requiring upgrades, it might be possible to change their use. One solution for properties that are the most difficult, or expensive, to upgrade could be staff accommodation if practical. Dwellings offered under service occupancy arrangements (excluding agricultural workers) are not required to have an EPC, nor do they need to comply with MEES if a valid EPC exists.

While this might seem like one answer to a difficult problem, it is worth bearing in mind the impact this might have on the recruitment of estate staff. The most recent Savills estate and farm staff salary survey shows that over two-thirds of full-time staff have accommodation provided and 73% of those staff receive rent-free accommodation for the duration of their employment. Accommodation provision is therefore common and it may be wrong to assume that staff will tolerate whatever is offered.

69% of estate and farm staff have accommodation provided

10%
of PRS properties are eligible for an exemption, according to estimates

£10k
Value of proposed cost cap on total investment in improvements

Heritage properties

With an increase to the cost cap even heritage properties will fall within the scope of the EPC

There is a commonly held belief that heritage properties are exempt from MEES. While often the case, it is something of a grey area within The Energy Performance of Buildings (England and Wales) Regulations 2012, which set out the basis of MEES. It was originally stated that the regulations do not apply to "buildings officially protected as part of a designated environment or because of their special architectural or historical merit, in so far as compliance with certain minimum energy performance requirements would unacceptably alter their character or appearance." This understandably left owners of heritage properties uncertain of their position.

Later MEES guidance clarified this, firstly accepting that "to comply with minimum energy performance requirements, many of the recommendations in an EPC report… would likely result in unacceptable alterations in the majority of historic buildings." It goes on to say that "in these cases an EPC would not be required". However, there are upgrades that would not unacceptably alter the character or appearance that could be recommended within an EPC, meaning an EPC is required and MEES would apply. The consultation itself also contemplates the issue, questioning whether "listed buildings and those in a conservation area which are to be rented out" should be explicitly required to have an EPC, believing that this would "create clarity on the position".

It is therefore recommended that owners of heritage property look to undertake works that do not cause unacceptable alterations to the property. Previously, this would have seen relatively minor works undertaken before the works surpassed the £3,500 cost cap, however we will soon see the cost cap increased to £10,000. With this, more major works will fall within the scope of the EPC, even in heritage buildings.

Heritage property owners should therefore look to reconsider the energy efficiency of their property on the assumption that upgrades may be required. It would be preferable to formulate a contingency plan in the event that an EPC and, therefore, compliance with MEES becomes necessary, whether that involves applying for alternative exemptions or implementing well-considered upgrades. In this plan, consider again that investment made before 2023 will not count towards the £10,000 cap and landlords may well be faced with another £10,000 bill in 2025 if the previous upgrades did not achieve band C.

ARE UPGRADES FEASIBLE?

An option considered by some rural landlords is to sell underperforming property whose relative performance will only be worsened by the imposition of the £10,000 cap. However, the ambitious targets the government has set for reducing emissions across all housing stock suggests that privately owned homes might soon be in the crosshairs. Currently, it is only a requirement to obtain an EPC when marketing a property for sale, but "green mortgages" with the best interest rates are already targeting properties with better energy performance.

The risk, therefore, is that poorly performing rural properties will become stranded assets, with owners struggling to sell due to poor energy efficiency, but also unable to be let without significant financial investment. Furthermore, whether selling or letting, there is increased demand from buyers and tenants for health and wellbeing to be considered by owners of property as well as the environmental and energy efficiency. Evidence of a so-called "green premium", an additional value conferred by positive credentials, is still emerging. In contrast, a "brown discount", a loss in value inflicted by obsolescence, poor maintenance and an outright deficiency in such positive credentials, is far more apparent.

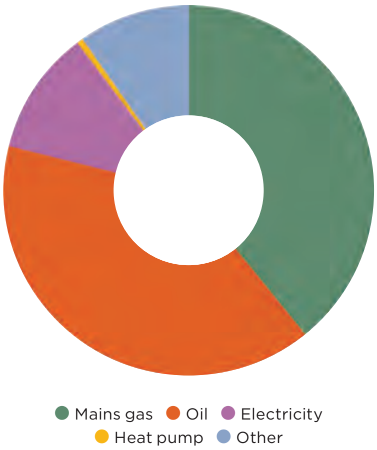
There have been calls for the government to create permitted development rights for property owners to be able to knock down poorly performing dwellings and rebuild them on the same footprint. While the cost of this clearly exceeds the proposed £10,000 cap, the argument remains that being allowed to create high quality, highly efficient rural property may result in a better return on investment, and will be more beneficial to rural communities and will lead to future proofing against further changes. For the worst performing buildings, the potential energy savings over the lifetime of the building may well justify the environmental impact of its demolition, the replacement materials and construction.

> **"There is increased demand from buyers and tenants for health and wellbeing to be considered by owners of property as well as the environmental and energy efficiency"**

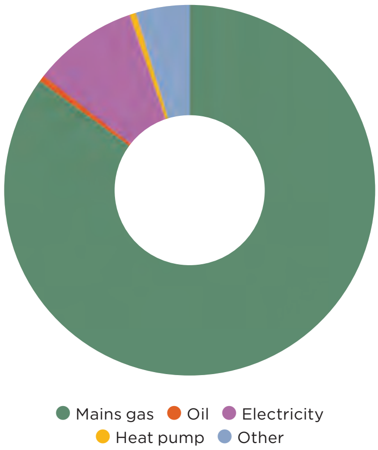
43%
of rural properties are dependent on oil for heating

£400m
The expected budget for a new Clean Heat Grant scheme, due to launch in April 2022

Heating type: rural homes



Heating type: urban homes



Source Savills Research, ONS

Beyond the EPC

There are many co-benefits that can accompany calculated and conscious upgrades

We have so far assumed that the source of our data and the subject of regulation, the EPC, is infallible. Of course, this is not necessarily true. After all, the EPC is vulnerable to human error and the insensitivities of equations and calculations. Compromises within the methodology itself can amount to a noticeable impact across a property portfolio. Those same compromises also neglect myriad co-benefits that can accompany calculated and conscious upgrades.

HEATING: A CASE STUDY OF THE PROBLEM

Data from the Savills property management database suggests that a significant number of rural properties (43%) are dependent on oil and that another third rely on gas. Compare this to urban: oil fades into near insignificance, whereas gas becomes responsible for heating 17 of every 20 homes.

This is a major concern for the energy transition needed to reach net zero. Aside from electricity and some minor commitments to heat pumps and other technologies, a significant majority of the UK's heating fuel is entirely non-renewable. EPC assessments propagate this by recommending technology upgrades without altering the fuel source, i.e swapping an old oil boiler for a new oil boiler.

THE SOLUTION

Such like-for-like upgrades will probably have relatively minor impact on an individual property. However, across a rural residential portfolio, piecemeal upgrades could amount to a significant expense with little overall gain in costs, emissions or efficiency. A whole-portfolio evaluation of energy would be far more worthwhile, for example in being able to consider the feasibility of an off-grid heat network that may be able to make use of pre-existing assets.

The government's focus on "fabric first" should be carefully considered as it means that previous estate-wide solutions, such as installing a wind turbine or solar PV panels, are less favourable than investing in improving energy efficiency in each property first. However, the latest government proposals on revisions to the Standard Assessment Protocol centre around recognising and encouraging the opportunities of heat networks and "recovered heat". Such proposals would see certain heat networks assessed far more favourably in EPC assessments.

In Scotland, heat networks have been supported by the Heat Networks (Scotland) Act, which was passed unanimously by the Scottish Parliament in February. The act creates a new licensing system that aims to drive up standards across the sector and inspire consumer confidence. A new consent system will also be introduced to make sure that new networks are developed in areas where they will have most benefit. The guidance and regulations required to implement the act will be forthcoming over the next two years.

Of course, not all estates will lend themselves to heat networks, such as those with a dispersed portfolio. That is not to say that an estate-wide overview would be any less effective. Efficiencies may be gained by considering opportunities such as ground source heat pumps on a district heating network, or water source heat pumps if a suitable body of water is present for example. A switch to a modern electrical heating system in each home may be the most cost-effective decision if offset by renewable energy generated on site. Similarly, a biomass-based system would integrate well into an estate already invested in growing or sourcing biomass. As UK estates are defined by their individuality, it is arguable that their energy strategy can be too.

ECONOMIC BENEFITS

Properties promising lower energy bills will undoubtedly appeal to many, something that the EPC has focused on since its inception. However, rural energy generation may prove an attractive income source too. By metering energy use within the properties, there is the opportunity to monetise what would otherwise be wasted, while meeting tenants' enhanced expectations of energy efficiency, sustainability performance and quality of life.

ENERGY EFFICIENCY AND ESG

Fuel poverty is repeatedly raised throughout the government consultation and is known to affect rural households to a greater degree than urban ones. In 2018, the average fuel poverty gap, the reduction in fuel bills needed to take a household out of fuel poverty, for fuel poor households in rural villages, hamlets and isolated dwellings was £690. That is more than double the national average of £334. Rural landlords must charge enough for any heat supplies to recoup their expenditure but not so much as to render tenants in a

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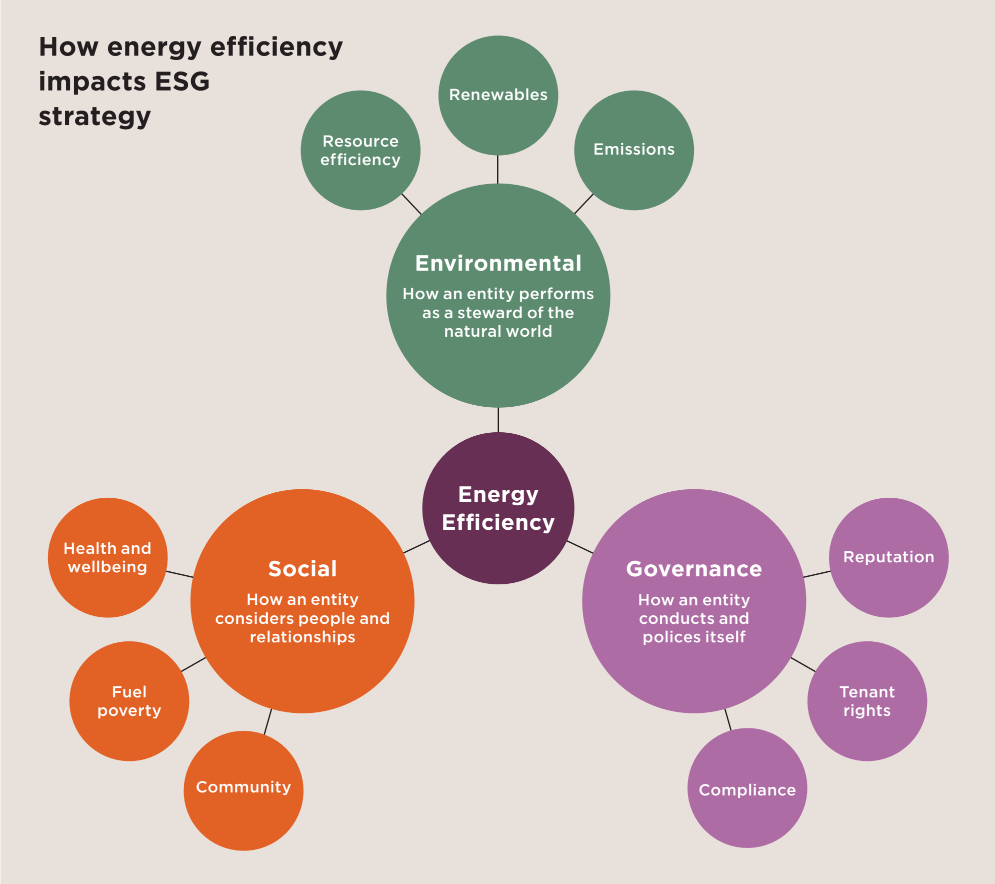
worse position. If pursuing this approach, then rural landlords would be wise to do so with the objective of improving the tenant's circumstances and not simply to make a profit.

The reputational risk of getting energy performance wrong is significant. New proposals would give tenants the power to request that non-compliant landlords carry out energy performance improvements, as well as request redress.

Therefore investing in improved energy efficiency should lead to significant social gains on an estate from maintaining a vibrant and engaged local community in rural places, and improved energy efficiency is a simple method of enhancing the social benefits to tenants to benefit the wider estate too. This should benefit the estate as it will be seen as taking an enhanced approach to the community, leading to an improved reputation and increased resilience, in addition to the inherent and obvious environmental benefits of investing in energy efficiency.

£690

The average fuel poverty gap in rural areas (2018) – more than double the national average of £344



FUNDING UPGRADES

For many rural landlords, the changing regulations will create a significant financial burden despite any benefits that may emerge from the investment. When MEES was first announced, it was partnered with a policy package known as the Green Deal, a scheme that attempted to help landlords who typically derived no return on their investment in energy efficiency improvements. However, due to low take-up the government stopped backing the scheme after two years and it now only exists privately. Last year, the government announced the launch of the Green Homes Grant, however, this scheme suffered the same fate and was closed after only six months.

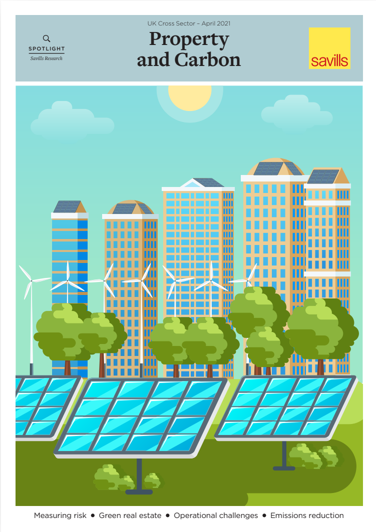
Despite the scrapping of the Green Homes Grant in March, there are some alternative funding schemes available that may help landlords fund upgrades:

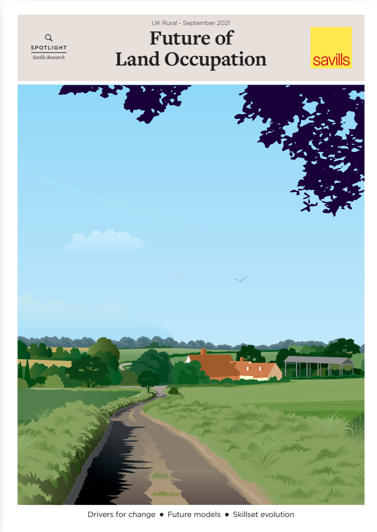
- Energy company obligation – the largest energy suppliers help to fund work to improve energy performance in homes, with a focus on supporting vulnerable, fuel poor or low income households with PRS households being only eligible for high cost measures such as first time central heating installation.
- Green deal finance – now in the hands of private companies, the scheme finances improvements through the savings made on energy bills. The “Golden Rules” mean repayments should not exceed the savings made, but it is not a guarantee and interest rates can be high.
- Other third party funding – such as support from local planning authorities. These tend to focus on low income or fuel poor households.

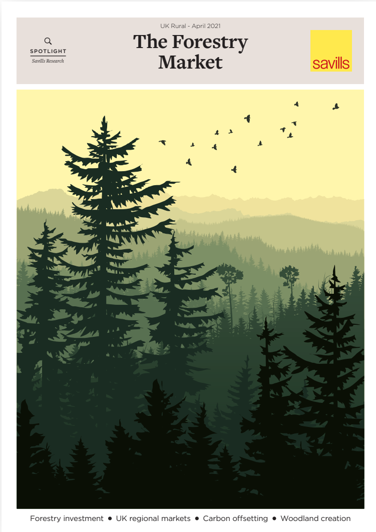
There are plans to unveil a new Clean Heat Grant scheme, in which homeowners could be offered up to £7,000 to replace gas boilers with low carbon alternatives, particularly heat pumps. The scheme will be launched in April 2022 with an expected budget of £400 million. While full details are not yet known, eligibility requirements are expected, such as “minimum insulation requirements”, in keeping with the fabric first approach, as well as an EPC issued within 10 years of the grant application. As the scheme is expected to be announced in advance of 2023 with a significant advertising campaign, rural landlords should assess whether investment with government support will bring their properties up to standard or if further expenditure is needed.

For landlords who are looking for a bank loan to fund improvements interest rates are, of course, at a record low level. However, given the possibility that money spent on a property before 2023 will not contribute towards the £10,000 cap, landlords may be better to wait. For properties that can achieve a band C without reaching the proposed cap, investing in those properties while finance is cheap remains a good option for rural landlords.

Green mortgage products are not solely reserved for the purchase of green properties. There is also an indication that they may be obtained for the upgrade of underperforming properties. Such products would offer more favourable rates to borrowers looking to invest in green credentials. The fundamental offering is not yet fully developed and only a limited range are available. However, this is likely to change in the future as positive Environmental, Social and Governance (ESG) credentials become associated with lower risk borrowing.







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