

# **Green Landlord Scheme – informal discussions, summer 2005**

## **Introduction**

1. The Government has set challenging targets to reduce the UK's emissions levels, to ensure that economic growth is built on sustainable development. Improving energy efficiency is a key part of achieving this aim, and all sectors – including the private rented sector – can make a valuable contribution to this effort. Following the announcement made in Budget 2005 on the Green Landlord Scheme, the Government is now seeking the views of stakeholders on the best ways to encourage energy efficiency in the Private Rented Sector.

## **Background**

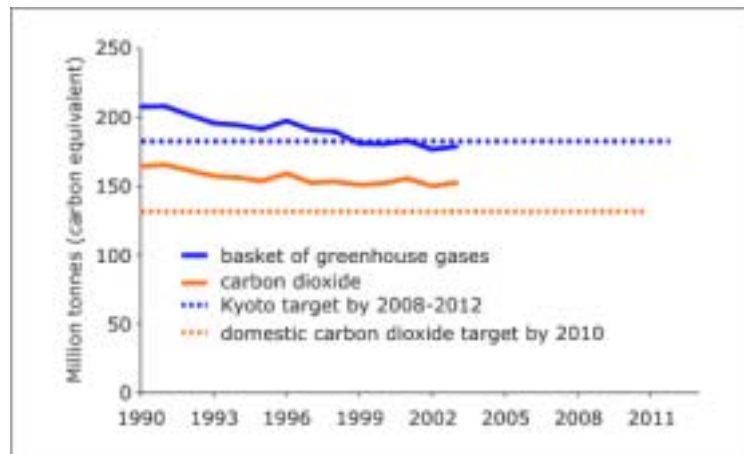
### The importance of energy efficiency

2. Climate change is one of the greatest risks facing the world and a major challenge for all countries. Global atmospheric temperatures have risen by about 0.6°C over the last 100 years, with about 0.4°C of this warming occurring since the 1970s. Depending on the amount of greenhouse gases emitted and the sensitivity of the climate system, it is predicted that global average temperatures could rise by between 1.4 and 5.8°C over the next 100 years and that annual average temperatures in the UK may rise by between 2 and 3.5°C by the 2080s.

3. Climate change has serious implications not just for the environment – changes are likely to have far-reaching effects on the environment, economy and society. Indeed, climate change is already placing an increasing burden on economies and those who operate within it. Economic prosperity must be built on a platform not only of high and stable levels of growth and employment but also high levels of environmental care. Economic, social and environmental objectives must be met together. Without effective action, climate-related risks and damages will increase.

4. Green house gases are the major cause of climate change. The principal greenhouse gas is carbon dioxide, with emissions arising predominantly from the combustion of fossil fuels. As such, the Government has committed to reducing these emissions. Under the Kyoto Protocol, the UK has a legal obligation to reduce emissions of greenhouse gases by 12.5 per cent below 1990 levels by 2012. The Government has also set its own, more demanding, goal of cutting UK carbon dioxide emissions by 20 per cent below 1990 levels by 2010. Figure 1 shows progress towards achieving these objectives.

Figure 1: emissions of greenhouse gases



5. The Government's Climate Change Programme sets out the actions being taken in each sector of the economy to reduce emissions of greenhouse gases. The 2003 Energy White Paper reconfirmed the importance of energy efficiency if these targets are to be achieved and that all sectors – including the domestic sector – need to contribute to these efforts. As such, the domestic sector has been set the target of making carbon savings in households of 4.2MtC per year by 2010, and a further 4 to 6 MtC by 2020. This is equivalent to reducing household emissions by about 20% by 2010.

6. The UK has made progress against these targets. Carbon dioxide emissions reduced by about 7% between 1990 and 2003, and the domestic sector has been part of this drive to reduce emissions. But the UK will not meet its targets if we continue along the path currently being followed. A step change in energy usage is needed so that economic prosperity can be based on sustainable development.

7. The Climate Change Programme Review is now looking for the most effective ways to continue to address environmental issues so that the targets can be met. Within this context, the Government is looking to find further ways to encourage investment in energy efficiency in the private rented sector (PRS). The input of those involved in the PRS will help to inform the Government's consideration of using economic instruments – alongside other measures – to improve energy efficiency levels in the PRS.

#### The domestic sector

8. Domestic energy consumption currently represents around 28% of UK final energy demand, and about a quarter of all UK carbon dioxide emissions. While insulation and the introduction of central heating have contributed to improved energy efficiency over time, this has been more than offset by increased demand for warmth, hot water, lighting and appliances, and consumption is continuing to rise.

9. The energy efficiency rating of properties is measured by Standard Assessment Procedure (SAP), with SAP ratings going from 1 (least energy efficient) to 120 (most energy efficient). The average energy efficiency rating in the domestic sector was 50.6 in 2003. To put this into context, the mean SAP rating of new dwellings is about 90 but the average level of properties is pulled down by the lower energy efficiency levels of existing stock.

10. The energy efficiency rating of properties in the private rented sector is typically lower than average levels for the whole sector – being around 45.3 in 2003. This means that a typical PRS property produces up to an additional 500kg of carbon compared to a property with an average sector-wide energy efficiency level.

11. Evidence suggests that levels of household investment in energy efficiency are lower than would be expected, given the potential financial benefits (eg lower energy bills) that could accrue to the household. This implies that there are barriers preventing householders making the most efficient decisions on these investments. This was borne out by responses to the 2003 consultation on Household Energy Efficiency which confirmed that there is currently a lack of incentive for PRS landlords to invest in the energy efficiency of their property. The main reason for this is that the benefit of that investment currently flows to the tenant (in the form of lower energy bills) rather than to the landlord. Government intervention might be needed to address the market failures that create these barriers.

#### Measures to encourage energy efficiency in the domestic sector

12. The Government has introduced a number of measures to promote energy efficiency in the domestic sector. Economic instruments are part of this range of measures as they can be an effective way to correct market failures. Specifically, they can provide incentives that encourage behaviour that protects or improves the environment, and can enable environmental goals to be achieved at the lowest cost and in the most efficient way. The main measures currently in place are set out in box 1.

#### **Box 1: existing measures aimed at the domestic sector**

<b>Energy Efficiency Commitment (EEC)</b> – Through the EEC, gas and electricity suppliers encourage and assist domestic consumers to take up energy efficiency measures.
<b>Affordable Warmth</b> – This tackles the incidence of fuel poverty.
<b>Warm Front</b> – This offers grant-funded support for low-income groups. Warm Front delivers mainly energy efficiency improvements through better-insulated and heated homes.
<b>Building Regulations</b> - These are revised on a regular basis, so that any work required on new buildings or existing stock should have higher efficiency standards.
<b>Energy Saving Trust (EST)</b> – The EST works through partnership to encourage and promote the sustainable and efficient use of energy by households. The EST promotes energy efficiency through advertising programmes, advice centres and endorsement of energy efficient products.
<b>EU Appliance Standards and labelling</b> – These help to improve the

domestic energy efficiency of domestic appliances.

**VAT reductions** – These are offered on certain energy-saving materials installed by contractors. This covers the installation of insulation materials, draught stripping, hot water and central heating system controls, and some micro-renewable sources of energy.

13. The Government has also announced measures aimed specifically at the private rented sector. In 2004, the Government introduced the Landlords Energy Saving Allowance (LESA). The scheme has been in place since 6 April 2004 and provides private landlords who pay income tax with upfront relief of up to £1,500 on capital expenditure for installations of loft insulation, cavity wall insulation and now solid wall insulation in residential property which they let (including first-time installations). The LESA scheme is due to expire in 2009.

#### Green Landlord Scheme

14. The Government also announced its intention to consider the scope for encouraging further investment in energy efficiency through a Green Landlord Scheme. Specifically, Budget 2005 stated that “as part of its consideration of a Green Landlord Scheme, the Government will explore how other tax deductions and reliefs, such as the existing Wear and Tear Allowance, might be developed to encourage and reward landlords who improve the energy efficiency and quality of their properties. Discussions with stakeholders will take place over the summer”.

15. As part of this work, the Government is interested in the views of stakeholders on a number of related issues and plans to hold informal discussions over the summer. This will help the Government to identify the most effective ways to encourage energy efficiency in the PRS. This document provides a framework for these discussions. Comments on any relevant considerations not covered by issues highlighted below are also welcome.

#### **Areas of interest to be covered by the informal discussions**

##### Awareness of energy efficiency

16. Energy efficiency is one factor that determines the quality of a property. The value and importance attributed to energy efficiency varies from person to person. This can influence the decision of whether to invest in energy efficiency. The Government would be interested to know how energy efficiency is perceived by stakeholders, and also their knowledge of the energy efficiency of their property. Specifically:

- Are landlords aware of the energy efficiency level of their property?
- Are landlords sufficiently informed about the technical possibilities that exist to improve energy efficiency in their property, and the possible cost savings that might accrue?

- What extra return (in terms of rent or the market gain of the property) do improvements in energy efficiency give landlords?

#### Reasons why landlords invest to improve their property

17. Landlords will normally look to make the best possible return on the investment they make – whether it is in improvements to their properties, buying new properties or investing their funds in financial products such as unit trusts or bank or building society accounts. The decision as to whether to invest in energy efficiency or to make other types of improvement to existing property will be part of these deliberations. The Government would therefore be interested to hear what the key factors underpinning investment decisions are and, in particular, what factors shape attitudes towards investing in energy efficiency. Specifically:

- What are the considerations that drive the investment decisions of landlords?
- To what extent are landlords driven by short-term return and/or by long-term return on their property?
- To what extent is the decision not to invest in energy efficiency a consequence of perceived cost or non-price costs (eg time; nuisance)?
- Do landlords take tax into account when deciding what to spend (and when), or is it only factored in after the event?
- Would a fiscal incentive for energy efficiency changes landlords' attitudes towards investing in energy efficiency?

#### Whole house or targeted measures

18. Incentives could be offered that are targeted at specific areas of improvement in energy efficiency (eg LESA). Alternatively, a more 'whole house' approach could be taken whereby an annual tax relief allowance would reward landlords of properties that meet a certain level of energy efficiency.

19. Both approaches have their relative merits – a more prescriptive approach might help to make landlords aware of specific energy-savings measures, whilst a more general approach could allow the landlord to decide which particular improvements should be made in order to achieve the required overall level of energy efficiency. The Government would be interested to hear stakeholders' views on how they perceive the two different possible routes. Specifically:

- Should incentives be targeted at specific investment or should any incentive relate to the general level of energy efficiency of a property?
- If you believe that incentives should be a focused measure, what areas should be targeted?
- Where is there more scope to increase the energy efficiency of a property – by using more energy efficient products within the property or improving the fabric of the property?

#### Incentive mechanism

20. For a 'whole house' measure, a way to create an incentive for landlords would be to adapt an existing mechanism which is already in place and used by a large number of landlords. The Wear and Tear Allowance (W&TA) currently provides landlords of furnished properties with an allowance of 10% of net rent received<sup>1</sup>. So the amount of the W&TA which may be deducted on a tax return is not dependent on the amount of expenditure actually incurred on renewing or replacing these items. The original purpose of this allowance was to cover the cost for landlords of renewing or replacing the furniture, furnishings and equipment included in a furnished property when it is let.

21. A possible way to incentivise landlords would be to adjust the W&TA so that landlords would be eligible for a greater level of additional allowance if their property met a certain level of energy efficiency. The Government would be interested to hear stakeholders' views on the use of the W&TA as a vehicle for incentives. Specifically:

- Would adjusting the current W&TA to include an incentive encourage landlords to invest in energy efficiency?
- If so, what level of incentive would need to be offered to make a landlord act upon this thought?
- Would it be appropriate to extend the scope of an allowance based on energy saving to cover unfurnished as well as furnished properties?
- What other routes – be it existing or new measures – do landlords feel the Government should consider as a vehicle for incentivising landlords to invest in energy efficiency of their property? How do landlords envisage this working in practice?

#### W&TA or Renewals Allowance

22. The W&TA is one of two possible ways that landlords can make a deduction for expenditure on furniture, furnishings and household equipment. The other way is to deduct the actual cost of renewing or replacing such items. The approach (often called "Renewals") allows landlords to claim for the exact level of expenditure they incur. Landlords have to choose whether to use the W&TA or Renewals when they start letting a property – they cannot use both methods and they cannot switch from one method to the other. (Landlords may also deduct separately the cost of repairs and maintenance of the fabric of the property and of any fixtures, and for repairs and maintenance of furniture, furnishings and household equipment.) The Government would be interested to hear stakeholders' views on both of these methods, and the factors that cause landlords to use the method they do. Specifically:

- What are the reasons that determine whether landlords claim the W&TA or use the Renewals methods?
- Do landlords know if they lose out or benefit financially on the exact cost of replacement furniture and fittings because they claim the 10% W&TA, and to what extent?

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<sup>1</sup> To find the 'net rent', deduct any charges or services (eg Council Tax) that a tenant would normally bear but which are borne by the landlord.

- Could adding a conditional element to the W&TA encourage landlords to change to the Renewals method of claiming for expenditure incurred? At what point would making the allowance dependent on energy efficiency cause landlords to switch to using Renewals?
- How do landlords rank the priorities of financial gain and administrative simplicity when choosing between using the W&TA and the Renewals method?

### Current use of W&TA

23. The W&TA relates to landlords' expenditure on maintaining the standard of furniture, furnishings and household equipment in a property. Understanding the decision-making underpinning existing expenditure may enable some assumptions about future/new spending to be made. Understanding stakeholders' approach to this expenditure may also help the Government to gauge the scope for using the W&TA as the vehicle for an incentive, and for getting a feel for whether the incentive might be effective. Specifically:

- How do landlords decide the focus, level and timing of their spending to maintain their property?
- Are properties not in the UK<sup>2</sup> dealt with in the same way as UK properties, or are there differences in (for example) the way landlords decide to spend and when?
- Do landlords keep detailed records of their income and also expenditure on repairs and replacement of fixtures, fittings and furniture for rented properties?
- If so, and on average, how much do landlords spend a year on replacing furniture and fittings (including items such as TVs and white goods) in rented properties, and how much time does this task take?
- What return do landlords look for before they will incur the expense?
- Do enhanced tax reliefs get factored into these decisions?
- Is W&TA/Renewals a major consideration for tax practitioners or letting agents in calculating clients' rental income? If so, why?
- Are decisions whether to let furnished or unfurnished properties influenced by the availability of the W&TA for furnished lettings?

### Scope for improving a property

24. If a scheme were to be put in place to encourage landlords to invest in the energy efficiency of their property, the ability of landlords to take advantage of the incentive would be a factor that determines the effect it would have. The Government would be interested to hear stakeholders' views on landlords' ability to take up an incentive, if it were introduced. Specifically:

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<sup>2</sup> UK resident landlords of overseas property are entitled to deduct the W&TA or use of renewals method in calculating the profits for UK tax purposes from an overseas letting in the same way as for a UK letting. In calculating the profits of an overseas letting for the purposes of tax in the country concerned, the country's tax rules on calculating property income would have to be followed.

- What are the main energy efficiency improvements that could be made to a landlord's property which have not already been made?
- Are there any physical restrictions, relating to the property, which would prevent the landlord carrying out improvements in energy efficiency?
- Is access to funds an obstacle to landlords making improvements to the energy efficiency of their property?
- Is a landlord's decision about making energy efficiency improvements to a property influenced by whether it is let furnished or unfurnished?
- Do landlords see energy efficiency improvements as an alternative to improving the standard of furniture, furnishings and equipment in let furnished property?

### Energy Performance Certificates

25. The introduction of Energy Performance Certificates (EPC) is planned. These certificates will be a requirement for all landlords entering into new leases of their property, and will need to be presented to potential tenants. Each certificate will set out the energy efficiency level of a property, and what this means for fuel bills. EPCs will provide more information to landlords and tenants on the issue of energy efficiency, and the Government is interested to hear how this might influence the behaviour of landlords. Specifically:

- Will EPCs increase the importance of energy efficiency in properties?
- Do you think that the introduction of EPCs will strengthen the link between energy efficiency and the return on a property (both short term and long term)?
- Will EPCs encourage greater investment in energy efficiency?
- Are landlords likely to act upon the recommended energy efficiency improvements set out in EPCs?
- Would a fiscal incentive be an effective complement to EPCs and encourage a positive reaction to the certificates?

### Operational issues

26. The ease of use of a measure can shape the level of incentive effect it would have. It is important to make sure that a measure is accessible, straightforward to use and easy to administer. The Government is interested in the views of landlords, agents and tax practitioners as to the key issues that would need to be covered to ensure that a new measure would be effective. Specifically:

- How long would be needed to ensure a smooth introduction of a scheme, in order to prepare landlords and to maximise its impact?
- How should a scheme be handled on the Self-Assessment form?
- What extra guidance would be needed for landlords on any additional allowance?
- What publicity would be appropriate to ensure maximum take up by landlords?

### Wider priorities

27. Efforts to improve energy efficiency need to be seen in the wider context. Environmental aims are not the only priorities for landlords and the Government. The Government is interested to hear of landlords' other considerations which might be touched upon by incentivising to improve the energy efficiency of their property. Specifically:

- Does incentivising investment in energy efficiency have any potential positive or negative impact on landlords' wider priorities?