



Fiscal Incentives for Greening

A policy paper by the British Property Federation

WHO WE ARE

BRITISH PROPERTY FEDERATION

The British Property Federation (BPF) represents companies and other organisations owning, managing and investing in property. This includes a broad range of businesses comprising commercial property owners, the financial institutions and pension funds, corporate landlords, residential landlords, as well as all those professions that support the industry.

Buildings alone generate almost half of all CO₂ emissions in the UK - 27% from the 26 million residential dwellings and 17% from the 2 million non-domestic buildings¹. The BPF has a dedicated team for sustainability issues, reflecting the priority which its leading members place upon issues of climate change and resource efficiency. We also provide Secretariat support to the Green Property Alliance, a group of the leading organisations representing both landlord and tenant interests (BPF, Investment Property Forum, UK Green Building Council, BCSC (the British Council for Shopping Centres), British Council for Offices, British Retail Consortium and the Royal Institution of Chartered Surveyors).

FOR FURTHER INFORMATION AND FOLLOW-UP

We would be delighted to expand upon any aspect of this paper and to provide further supporting information. Please contact Peter Cosmetatos (020 7802 0115; pcosmetatos@bpf.org.uk) in the first instance.

¹ All Party Urban Development Group, Greening UK Cities' Buildings, 2008

INTRODUCTION

1. There are real opportunities for reducing the significant contribution currently made by commercial property to the UK's carbon emissions. However, there are two reasons why achieving that is quite challenging.
 - a. The first is that buildings have long lifecycles, so emissions from **existing buildings** need to be reduced: concentrating on **new buildings**, while much easier in terms of generating emissions reductions, will not be enough on its own if Government targets are to be met.
 - b. The second reason is that the majority of commercial property (whether in terms of value, number, space or emissions) is separately owned and occupied. While that should have a relatively modest impact on how one might reduce emissions resulting solely from **the way buildings are used**, it has a huge impact on how one might reduce emissions by **changing buildings themselves**. That impact is greatest in the context of multi-tenant buildings such as shopping centres or office blocks, but in general it flows from the fact that the cost of changes to a building can be very high. The challenges that need to be addressed include:
 - i. operational issues (the disruption caused to occupiers while buildings are changed);
 - ii. information related issues (unavailability, or poor transfer between landlord and tenant, of information relating to energy use);
 - iii. commercial issues (varied and uneven distribution as between landlord and tenant of the costs and benefits of, and control over, energy use and changes in buildings or behaviours designed to reduce it); and
 - iv. legal issues (constraints within leases on how costs and benefits associated with emissions and related expenditure or behaviour can be allocated as between landlords and tenants).
2. Emissions reductions that can be achieved through changes in the way people use buildings are easy wins, largely because such changes generally involve no cost or low cost behavioural changes. It is vital for Government to help establish a consensus about the most valuable use-focused changes and to raise awareness of what they are, encouraging users of buildings to implement them without delay.
3. As regards changes to buildings, it is again important to achieve consensus and to raise awareness about the most valuable changes. However, it is also vital to understand how business approaches the question of cost effectiveness, having regard in particular to lease lengths and the way costs and savings can be passed from one party to another. No clear standard for assessing cost effectiveness in the tenanted commercial property context has emerged so far, but it is likely that some of the measures Government will want to encourage businesses to take will not be commercially cost effective.² It is therefore important to explore how Government can help make such behaviours and investments more cost effective – for example, through the tax system. That is the subject of this paper.

² This is discussed in the BPF response to the Heat and Energy Saving Strategy consultation, available here: <http://www.bpf.org.uk/topics/document/23657/bpf-response-to-heat-and-energy-saving-strategy-consultation>.

EXECUTIVE SUMMARY

4. The BPF has consulted member organisations about, and formed working groups to consider, the ways in which the UK tax system might be used to incentivise reduced emissions from existing commercial buildings.
5. We are not convinced that there is a strong case for using tax incentives to encourage better energy performance in the **use of buildings**, for two principal reasons. First, we would not generally expect the behavioural changes that Government should encourage to involve substantial costs, and we would expect them to give rise to savings (as well as, potentially, to more engaged and empowered users of buildings). In other words, those changes should largely make financial sense as it is.
6. Secondly, better use should be incentivised based on a measure reflecting (presumably) actual energy performance: and the effectiveness of tax incentives sensitive to that would be heavily dependent on the robustness of the measurement systems available to assess it. The most obvious measurement system to use for that purpose would probably be the Display Energy Certificate (DEC).³ However, the DEC (like the Energy Performance Certificate (EPC)) is not felt to be sufficiently reliable, transparent and robust at this stage for tax consequences to flow from it; and the prospect that the use of DEC's might be extended to commercial buildings appears to be receding.
7. As regards the **physical building**, however, we consider that there is a very good case for making better use of the tax system to encourage investment that can improve the energy performance of the existing stock. The principal reason for that view is the fact that such investment can often involve very significant upfront expenditure and disruption, with payback through reduced energy bills often requiring a number of years. Without some Government support, it is not always possible to make the commercial case for such investment stack up.
8. With some 60% of the UK's non-domestic buildings being tenanted, the economic viability of such investment decisions will in practice turn not on whether payback can be achieved during the lifetime of the relevant measures or equipment, but rather on whether it can be achieved within a small number of service charge cycles, so that the landlord can pass the cost on to the tenants who will benefit from the investment (and similar considerations will apply if the expenditure is incurred by the tenant).
9. We urge the Government to consult on specific proposals for using the tax system to encourage 'green' investment in existing commercial buildings, as discussed in more detail below.

³ Using something as simple as energy bills would be a rather blunt instrument, as explained at paragraph 55 below, conflating the influence of industry sector, nature of premises and actual behaviour in terms of energy efficiency in a way that could be unhelpful and distortive.

EXPLORATION OF THE USE OF EXISTING FISCAL INSTRUMENTS

STAMP DUTY LAND TAX (SDLT)

10. This section highlights the particular benefits that use of an SDLT relief to promote sustainability could deliver, and discusses the key issues that will need to be resolved before such a relief can be put in place.

Summary Conclusions

11. A relief from SDLT linked to an appropriate sustainability measure would have the advantage of giving value to (and therefore motivating) those qualifying for it above and beyond its actual cost to the Exchequer, making this a highly efficient option in terms of bang for the Exchequer's buck. That result follows from the fact that the relief would have a revenue cost only when a relieved transaction occurred; whereas property owners would see a benefit on their balance sheets simply by qualifying for the relief, because doing so would increase the value of the property by reducing the disposal costs normally knocked off the value of a property at a valuation date. While identifying an appropriate sustainability measure poses challenges (the EPC, which might be the obvious choice, is not felt to be sufficiently robust at this stage), **we would urge the Government to consult on how such a relief might be implemented.**
12. We recognise that Government will wish to have a reasonable degree of control over, and to be able to assess the likely costs and consequences of, any incentive structure that is introduced. Ideally, administrative simplicity and transparency would also characterise any incentive. If the detail can be got right, we think an SDLT relief could help deliver significant 'green' investment at a limited Exchequer cost.

Benefits of SDLT relief

13. SDLT is a transactional tax payable by the purchaser of a property interest by reference to the value of the interest acquired (as well as by tenants, by reference to the rent payable, when a lease is granted). We focus on the main charge principally because the amount at stake – and thus the potential for influencing behaviours – is much greater than for SDLT on rent. It also follows that, since the main charge is a cost at the ownership (rather than occupier) level, any incentive should operate by reference to matters under the control of property owners rather than occupiers (in the many cases where the two are different).
14. The most obvious benefit of a relief from SDLT along these lines would arise at the time a property is sold, with the SDLT payable being reduced (potentially to zero). This would provide a clear benefit for the purchaser of a property, in which the vendor would expect to share through the pricing of the sale. The cost to the Exchequer would take the form of reduced receipts rather than any positive outlay.
15. Crucially, however, an SDLT relief of this type would deliver a further benefit. Property valuations typically apply a discount of 5¼% in respect of sale costs, which assumes that the full 4% SDLT cost is effectively passed back to the vendor. A relief from SDLT should allow that discount to be reduced (potentially to 1¼%), with a corresponding boost to the balance sheet value of a property investor's assets (with a helpful effect on loan to value covenant compliance, for example). This benefit would carry no cost at all for the Exchequer, with revenue implications arising only when sales actually occur. We would expect asset managers (who have operational control over procurement decisions) to be responsive to

such a relief, because their fees are typically structured by reference to the internal rate of return (IRR) delivered by the properties they manage, and that would be boosted by the valuation impact of an SDLT relief resulting from 'green' investment decisions.

16. The form of SDLT relief discussed above reduces the amount of SDLT payable on a sale after the relief has been 'earned'. An alternative approach might be for relief to be retrospective, as a refund of SDLT already paid on the acquisition of a property by reference to sustainability enhancing behaviours following acquisition. However, that approach may be complicated to administer in a fair and consistent way – for example, because of the stamp duty legacy and the extent to which property is held and transferred in corporate, unit trust or partnership 'wrappers'. Furthermore, the benefit of this approach would be limited to actual cash – it would not deliver the additional valuation-related benefit outlined above. Finally, it would of course require Government to pay back tax revenues already collected. For all those reasons, we prefer the sort of relief discussed above.

Key Issues

17. We have identified four key issues for consideration in deciding how the SDLT system might be used to encourage improved building sustainability.
- a. **Scope** - as mentioned above, SDLT relief may be of relatively limited interest to tenants/occupiers, because in the context of a leasing transaction the SDLT charge on rents may be too marginal for reductions to operate as an effective incentive. It may also be of relatively limited interest to long-term owner occupiers as opposed to investors. Given the complexity of the calculation of SDLT on leases and the lower rate of SDLT which applies to rents, it seems more appropriate for the relief to focus on the principal charge and the influence that may have on the behaviour of property investors.
 - b. **Measurement** - two alternative approaches – both with the aim of motivating taxpayers to make 'green' improvements to their buildings – would be to focus (i) on the installation of energy efficient/emissions reducing equipment, or (ii) on the actual energy performance of a building. The former would seem very close to the approach adopted in the enhanced capital allowances (ECA) regime, and that duplication may make it unattractive. The latter might be sensible in theory but it would risk duplicating the intended effect of the Carbon Reduction Commitment (and actual energy performance, which depends on **use**, is probably not the best measure for an SDLT relief which would seem more naturally suited to incentivising particular **investment** decisions).

Another approach might be to use the evolving certification technology, specifically, Energy Performance Certificates.⁴ In other contexts, EPCs are sometimes viewed as problematic because they look at a building in theory rather than in practice – but that would be quite appropriate for an incentive which is aimed at stimulating positive landlord investment decisions, and also fits with the idea of relief from the main charge to SDLT, which is charged on a property sale. A real problem is that EPCs are not generally felt to be a consistently reliable and accurate mechanism for assessing buildings, because of the scope for different assessors to take different views of the same building. Equally, the measures that an EPC may recommend as being 'cost effective' often fail to reflect what would be viewed as cost effective in a commercial context. However,

⁴ Display Energy Certificates are not relevant in this context because they focus on the use of a building rather than its potential (and SDLT is an incentive relevant only to investment decisions). We believe that DEC's could be a very important tool in stimulating engagement between owners and occupiers to ensure that the energy efficiency potential of buildings made available by the former is fully exploited in their use by the latter.

that problem should be addressed over time (EPCs are still quite new). There may also be scope for seeking to tackle it in the context of the recast of the Energy Performance of Buildings Directive.

- c. **Flexibility** - SDLT is charged at rates varying between 1% and 4%, so there is limited scope in percentage terms for giving significant benefits, or for gradations in the benefits given. However, as mentioned above, the benefits of a relief from SDLT could still be substantial. If the relief were less than 100%, the Exchequer would continue to benefit directly (albeit at a reduced rate) from transaction activity involving buildings benefiting from the relief.
- d. **Timing** - it may be desirable to impose a limit on the availability of an SDLT relief associated with sustainability improvements, because improvements made today are likely to lose value over time, and because new technologies and methods will continue to develop. The limit might operate by reference to a period of time or a number of relieved transactions. Alternatively, some sort of 'refreshing' of relief could be available where further qualifying improvements are made following the initial grant of relief. The right approach is likely to depend on the preferred approach on measurement.

ENHANCED CAPITAL ALLOWANCES (ECAS)

18. This part of this paper considers:

- a. the general perception of the ECA regime and whether or not it is effective at influencing business to make 'green' investment and procurement choices;
- b. whether changes to the operation of the regime could significantly improve its effectiveness in influencing business investment and procurement decisions, in particular by addressing:
 - i. its administrative complexity (including its poor compatibility with the way the procurement process works in practice and the extent to which smaller businesses can access the regime in an affordable way); and
 - ii. its limited scope (with investments that are extremely important from the sustainability perspective, such as certain types of expenditure on the fabric of a building, currently falling outside the regime).

19. We would like to explore with Government how the ECA regime could be improved, and have made certain proposals for improvement.

Summary Conclusions

20. We believe that the ECA regime has the potential to influence business, although it is important to recognise its structural limitations: more than a third of UK real estate assets are owned by non-taxpaying entities such as REITs and pension funds. There is evidence that some businesses have been using ECA qualifying expenditure as a metric, demonstrating a perception in the market that such expenditure is 'good' and delivers benefits which make it worth measuring and encouraging.

21. However, the ECA regime is far less effective at influencing decisions than it might be. Changes to its operation could greatly improve its effectiveness in delivering the investment decisions that are needed if the commercial property stock is to make a full contribution to meeting Government targets for reducing emissions. Widening its scope would broaden the range of positive behaviours the regime encourages, and reducing its administrative complexity would make it cheaper and easier for businesses – particularly smaller businesses – to take advantage of it.

22. Our proposals to improve the effectiveness of the regime are as follows:

- a. **As a matter of priority, Government should hold a full consultation on how the ECA regime might be simplified and extended.** Stakeholders besides property owners and occupiers – such as engineers, contractors and subcontractors and the manufacturers of relevant equipment – all need to be involved to ensure that the regime properly recognises how procurement actually works, so that ‘ECA compliant’ decisions can be made naturally in the specification-setting and procurement process without capital allowances specialists needing to be involved.
- b. **The administration of the regime needs to be simplified to make it more accessible to businesses (particularly smaller businesses without the resources to obtain specialist capital allowances input at an early stage when making investment decisions),** for example:
 - i. by linking ECA eligibility to industry standards for energy efficiency, so that businesses can claim ECAs based on kite marks or similar identifiers. This would make it easier for businesses to recognise ECA-advantaged opportunities in cases where tax specialists who can interpret a complex, self-standing regime are not involved;
 - ii. by improving the search tool on the ECA website that is used to identify ECA qualifying products;
 - iii. by simplifying or widening the criteria for ECA qualification;
 - iv. by accelerating the process that leads to new items being eligible for ECAs;
 - v. by making announcements of the intention to remove items from the qualifying lists and having a clear timeframe from announcement to actual removal from the list;
 - vi. by ensuring that HMRC guidance on the correct use of ‘claim values’ is clear and accords with the explanation on the website; and
 - vii. by extending the use of ‘claim values’ so that they are used in ECA compliant equipment as well as components, because the qualifying expenditure on equipment is not always easy to determine under the normal rules in the context of a substantial project. Allowing claims to be based on a manufacturer’s recommended price, for example, would be a valuable simplification in such cases. The values could be contained on the Energy Technology Product List (ETPL) where claimants would check to see if a product is included.
- c. **The regime should be extended so that the allowances are available for certain types of expenditure that do not currently qualify** – for example:
 - i. expenditure on the fabric of buildings, for example on lime hemp walls or sedum roofs, and
 - ii. energy generating equipment such as solar thermal systems.

Continuing to exclude such investments from the scope of the ECA regime risks distorting procurement decisions, working against innovation in building design by benefiting only plant and machinery

even where changes to building design may be more effective and efficient from a sustainability perspective.

Perceptions of the ECA regime in general

Understanding the procurement process and influencing investment decisions

23. In principle, the ECA regime is viewed as a good regime and very positive for taxpayers. There is growing evidence that ECA qualifying expenditure is being used as a metric for measuring green investment by some businesses. That demonstrates that the ECA regime has real potential to influence behaviour and encourages 'green' investment (assuming of course that the investments made are in fact environmentally beneficial, in the way they are used as well as in their intention).
24. We understand that certain major retailers with corporate responsibility policies that include specific objectives on energy saving and investment are beginning to use the level of ECA qualifying expenditure as a metric to determine spending on energy efficient products. This is done by considering the annual expenditure incurred on ECA qualifying equipment and benchmarking the level of expenditure on an annual basis to identify whether there is an increase in the level of expenditure. Certain businesses have a specific focus on ensuring that ECA eligible items are specified where possible and that processes are also improved to assist with the capture of qualifying expenditure.
25. However, the complexity of the regime and the relative lack of transparency and certainty around its operation have so far limited its actual impact, with smaller businesses in particular less likely to be using it effectively. Simplifying its operation so that making ECA eligible investment and procurement decisions is easier and can happen naturally without the need for input from capital allowances specialists would make the regime more widely accessible and thus both fairer and more effective.
26. It is worth looking a little more closely at how the ECA regime works in its commercial context, namely the procurement process for major refurbishment and construction projects. An ECA eligible item may be specified and incorporated into a building, but in order for the allowances to be claimed it is necessary to identify the qualifying expenditure incurred on the relevant item (product or component) by the claimant company. If the cost is not specifically identified in the contractor's tender or quotation for the project, it may be necessary to request the cost of the item through the contractor from the relevant sub-contractor/sub-sub contractor or supplier/sub-supplier, with whom the client may have no direct contractual relationship. In other cases, the client may not be aware that the ECA eligible item could be (or has been) incorporated into the building and may therefore fail to ask for it to be incorporated (or, if it has been, to claim the allowance). Also, component purchasing decisions, unlike system purchasing decisions, are generally unlikely to be considered from a tax perspective.
27. Engineers and suppliers are often not aware of the benefits of ECAs and therefore may not appreciate the after-tax saving they can deliver to the client. A full consultation on the effectiveness of the regime should also serve to increase awareness and lead to changes making it more workable in construction projects.

Administrative aspects of the ECA regime

28. It is widely felt that overly complex rules and an excessive administrative burden are barriers to the effective use of ECAs. We believe that addressing some of the concerns outlined below would improve the effectiveness of the regime by making it easier for end users to purchase items that attract ECAs. Where possible, we have suggested how these concerns might be tackled.

Understanding the rules

29. Many taxpayers have trouble understanding the ECA scheme. Items of energy-saving and/or environmentally efficient plant and machinery qualifying for ECAs are specified in Treasury Orders. Members have told us that many have trouble accessing or understanding the Orders.
30. Many report that the ECA website that is supposed to provide guidance is difficult to navigate and requires a detailed knowledge of the products. For example, there are two different categories of energy-saving technology qualifying for ECAs listed or detailed on the website, namely:
 - a. products listed on the ETPL; and
 - b. products that meet the requirements of the Energy Technology Criteria List but are not listed on the ETPL.
31. In order to determine whether products fall into the non-listed products category, a technical knowledge of the products involved is required, which the end user may not have.
32. It might be beneficial to converge the ECA eligibility criteria with industry standards for energy efficiency. Businesses could then claim ECAs on items bearing specified kite marks, for example. The Carbon Trust has created the energy technology list symbol to show that a product has been independently assessed and is listed on the ETPL, and therefore qualifies for ECAs, but the absence of that symbol does not mean that a given product is **not** energy efficient. Ensuring that ECAs are always available for all items that meet a specified industry standard and are never available for items that don't would be one way of simplifying and rationalising the regime.
33. Members also suggest that a more user friendly search tool would make the ECA website more useful.

Changes to qualifying lists and requirements

34. There is little predictability or apparent rationale behind the way the qualifying lists and requirements change over time, and that gives rise to practical problems. Members feel that new products do not always get added to the list quickly, and that products can be removed from the list without appropriate advance warning. The problem is that construction projects are by their nature long drawn out and there are delays between the time when a particular item is specified, actual procurement, and expenditure being incurred. Sometimes, a newer, more energy efficient product will be used in substitution for a previously specified one which was on the ECA list, in the expectation that the list would be updated to include it, but that has not happened. On other occasions, items have fallen off the list between specification and the expenditure being incurred, meaning that ECAs that were anticipated are not in fact available. Speedy addition of items to the list and advance announcements about when it is intended that items will be removed from the list could address these problems.
35. In some cases, it has been suggested that the requirements for items to be included are too stringent. For example, we have been told that no products are listed under refrigeration (air cooled condensing units), and that manufacturers say it is impossible to produce a commercially viable product which meets the requirements. Since products in such categories will nevertheless need to be procured by end users, it may make sense to simplify or relax the criteria so that the best products available from time to time can attract ECAs.

Claim values

36. 'Claim values' are prescribed values which a company can claim where they incur expenditure on an ECA compliant component within a larger piece of equipment which does not attract ECAs (e.g. a compressor forming part of a refrigeration installation). These provisions are helpful, because it is not always easy to identify the expenditure which can qualify for ECAs.

37. Unfortunately, the guidance regarding the use of claim values for qualifying components within larger pieces is not consistent, resulting in uncertainty and a lack of clarity. The ECA website implies that claim values should be used where it is not possible to identify the cost of a component within a larger piece of equipment. HMRC's published internal guidance (the Capital Allowances Manual) advises that the claim value should be used for determining the value of components without having to obtain the actual cost of a component. The correct position should be made clear.
38. Subject to that concern, wider use of claim values could be made because it is not uncommon for the expenditure on ECA compliant equipment (not just components) to be difficult to identify within the cost of a wider project. The manufacturer's recommended price could be used in such cases as the claim value for ECA purposes. Claim values could even be contained within the ETPL so they can be obtained at the same time as checking that a particular product is included on the list.

Scope of the ECA regime

39. The effectiveness of the ECA regime in terms of encouraging investment which reduces emissions from buildings is limited by the fact that ECAs are available only for qualifying plant and machinery and not for expenditure – however valuable in terms of sustainability impact – on the fabric of a building.
40. In many cases, aspects of the fabric of a building can perform functions which might otherwise be performed by plant and machinery. For example, the current system in effect encourages the installation of an efficient (ECA listed) air cooling system, but not additional expenditure on a better designed building which might require no air cooling system at all. In this way, the ECA regime may actually work against certain forms of sustainability innovation. It would seem sensible to revisit the scope of the regime and consider extending it to appropriate expenditure on the fabric of a building.
41. Another possible extension of the regime would be to allow it to apply to energy generating equipment. With the exception of combined heat and power (CHP) and, to a certain extent, solar thermal systems, there is currently no tax incentive (although there may be some other grant mechanisms) for the provision of energy generation equipment such as wind turbines, photovoltaics etc. We would encourage Government to explore whether the ECA regime might offer a useful mechanism for encouraging investment in such equipment.

BUSINESS RATES

42. This part of this paper considers two options:

- a. A general 'greening' of the business rates system, such that the liability to business rates of a hereditament will to some extent depend on its 'green' credentials, and
- b. A more limited reform of the business rates system designed to remove disincentives and better align the system with the sustainability agenda.

Summary Conclusions

43. A general 'greening' of the business rates system is superficially attractive as a mechanism for rewarding – most naturally at the occupier/use level – better sustainability performance (potentially at the expense of worse performers). We would however strongly oppose such a move at present, because it would entail significant additional complexity and disruption to an already complex regime; and because the effectiveness of such a move would be far too uncertain to justify that complexity and disruption, owing to the lack of a sufficiently robust measurement system for assessing performance. That is not to say that a wholesale greening of business rates might not make sense at some point in the future.
44. We do however believe that there is scope for a thorough, sustainability focused review of the plant and machinery which falls to be ignored in valuation for rating purposes, building on the recent exclusion of microgeneration equipment. It is unhelpful, in policy terms, that a landlord who invests in energy saving equipment may end up causing his tenant's rates bill to increase as a result of the value added to the property by the investment. Excluding more forms of energy efficiency enhancing plant and machinery from the rating valuation would reduce that disincentive.

General 'greening' of business rates

45. We do not think that it would be a good idea to change the business rates system so that the rates liability of each hereditament depends, to some extent, on its green credentials. There are a number of reasons for this view.

Mismatch between the fundamental principles underlying the rating system and promotion of the 'green' agenda

46. Rates are a tax on the use and occupation of property based upon its rental value, meaning that, very broadly, they go up when rental value goes up: one of the key components of the rates liability, the rateable value, is a reflection of rental value. One would expect investment that improves the capacity of a building to be used more energy efficiently, reducing emissions and bills, to increase its rental value, and thus (other things being equal) its liability to rates.
47. It follows that, by its very nature, the rating system operates as a **disincentive** for any 'green' investment likely to enhance the value of a property. That is clearly a problem in policy terms, and one which we think should be addressed through more modest changes to the rating system, designed to limit its disincentive effect (see further below).

Owners and occupiers

48. A further difficulty flows from the fact that most commercial property is tenanted, rather than owner-occupied. It is vital to remember that point in the sustainability context generally, because the split between owner and occupier means that there is no natural unity or alignment of incentives, costs and benefits in relation to the emissions produced by a property. A specific aspect of that point in the context of business rates is that there is a general perception that the market will normally sustain a certain level of aggregate cost of occupation (comprising rent, service charge and rates), such that a lower rates bill should feed through –over time and imperfectly – to a higher rent.
49. It follows that, while ‘green’ business rates might seem a natural way of influencing occupier behaviours (rates being an occupier tax), their impact would in fact be complex and uncertain, including on account of the relationship between rates and rent (and the friction and time lag involved in that relationship). Equally, the fact that business rates clearly do affect occupiers most directly makes them a poor influencer of owner behaviour. It is likely, therefore, that business rates would be an inefficient tool for influencing the behaviour of either owners or occupiers.

Defining ‘green’ objectives

50. The owner/occupier split also brings into focus the importance of determining precisely what kind of investment or behaviour a ‘green’ business rates system might be used to encourage.
51. Arguably, as a tax on occupation, rates should be used to encourage more efficient **use** of premises (as opposed to changes to the specification of those premises). But the fact that falling rates may lead to rising rents is problematic, because a significant part of the benefit of occupier behaviours may then ultimately accrue to the owner.
52. Using ‘green’ business rates to encourage investment in the fabric of a building or in the way it is equipped, on the other hand, would seem less intuitive and also risks significantly overlapping with the enhanced capital allowances regime (discussed above). Further, to the extent that such investment would be carried out by the owner, rather than the occupier, of a building, the fact that the impact on the rates bill primarily affects the occupier suggests this is unlikely to be an efficient incentive.

Measuring ‘green’ behaviours/investment

53. The question of whether ‘green’ rates target use or investment also impacts on measurement. On the face of it, it would be attractive to use existing measurement mechanisms rather than inventing new ones.
54. If one focuses on energy use (and changes in use), probably the most relevant existing measurement mechanism would be the Display Energy Certificate (DEC) – but we note (with some disappointment) that the Government is not contemplating a roll out of DEC to business premises at large. Other possible approaches might involve using emerging carbon reporting data, or even actual energy bills, but each gives rise to particular issues which would need to be thought through carefully.
55. Both DEC and carbon reporting are new or developing methodologies, created with a view to influencing behaviours directly and not through tax consequences. In the short to medium term, neither is sufficiently robust – in terms of reliability, consistency or accuracy – for tax consequences to flow from them.
56. In a sense, energy bills most directly reflect carbon emissions; but they are also a very blunt instrument, because they do not convey the efficiency with which property is being used, different kinds of buildings

and different kinds of business will have very different energy requirements, and the way energy is procured and paid for in tenanted buildings can complicate the picture of the emissions to which a particular occupation or use of property gives rise. Furthermore, a focus on energy bills would risk significant overlap with the Carbon Reduction Commitment (CRC), and might most simply lead to a direct carbon tax, rather than engaging the business rates system.

57. As mentioned above, we think it would be particularly inappropriate for the business rates system to be 'greened' by reference to investment expenditure on buildings (a tax on occupation being more suited to influencing the use of buildings). However, if that approach were to be adopted, the most natural measurement system would be the Energy Performance Certificate (EPC). The problem is that, like the DEC, the EPC is a new tool created to influence behaviours directly and not through tax consequences, and it is widely felt not yet to be sufficiently reliable, consistent or accurate for tax consequences to flow from it.

Would 'green' rates drive better responses to climate change?

58. Regardless of how the points outlined above are dealt with, another major challenge is determining the level of 'greening' that would be required to influence the responses of businesses to climate change. As rates are generally seen as a cost of occupation which depends principally on the rental value of property – and would indeed continue to operate in that way – it is uncertain whether a liability adjustment of, say, 2% or 5% would be sufficient to drive changes in use (or investment) behaviours. It would be disastrous, particularly in difficult economic times, for a complex, costly and pervasive reform to fail to deliver its intended policy objective.
59. The incentive effect might be enhanced (and the Exchequer impact managed) by trying to make the reform broadly revenue neutral, i.e. by increasing liability for poor performers to pay for reductions in liability for good performers. However, that would also add to the complexity and significantly increase the need for accuracy, efficiency and robustness in the reformed regime and the mechanisms it relies on to identify and measure 'greenness'. Such an approach would also pose real communications challenges for Government, with many likely to perceive the change as a revenue raising measure rather than one driven by the climate change agenda.

Other technical challenges

60. The rating system is already very complex. A generalised 'greening' would affect a huge number of properties and businesses, further complicating and obscuring the basic liability formula of liability = rateable value x uniform business rate multiplier. Particular challenges would arise in the following areas:
- a. Rating applies to "hereditaments", and the definition of a hereditament is not aligned either with the concept of a building, or with that of a unit of occupation for commercial property. It would be inappropriate for any sustainability focused aspect of the rating regime to affect hereditaments like advertising hoardings, car parks, ports, or the UK's fixed line telephone network, for example. It might also be sensible to exclude some or all hereditaments with a rateable value below a specified threshold. Any generalised 'greening' of the rating system would give rise to potentially complex boundary issues.
 - b. The rating system is fully devolved, with different regimes applying in England, Wales, Scotland and Northern Ireland. It would be important to consider the implications of a generalised 'greening' that applied only in certain of the UK's constituent countries.

More limited reform of business rates

61. We have already noted the mismatch between the fundamental principles underlying the rating system and the promotion of the 'green' agenda and recommended that it be addressed through more modest reform designed to remove the disincentive effect.
62. In broad terms, that might be achieved by identifying 'green' enhancements to buildings which are desirable and requiring them to be disregarded in the rating valuation. The Valuation for Rating (Plant and Machinery)(England)(Amendment) Order 2008 sought to adopt that approach in relation to microgeneration equipment, but there is room for improvement.
63. At a technical level, the 2008 Order has important limitations. Its disregard applies only in England, only to plant with a generating capacity below certain relatively modest limits, and only until the next general rating revaluation comes into effect on 1 April 2010.
64. At a more practical level, disregarding particular plant is far from straightforward, because it requires a valuation officer to determine the extent to which the rental value of a hereditament is attributable to the excluded plant, so that the rateable value can be set at a level that disregards that element. That exercise is further complicated by the fact that green technology is constantly evolving, so there is little opportunity to establish normative approaches (this problem has also compromised the effectiveness of the enhanced capital allowances regime, discussed in greater detail below).
65. It is vital that we find pragmatic and creative solutions to the challenges faced by the 2008 Order and that those solutions be applied more broadly to mitigate the disincentive impact of the rating system on fighting climate change. We urge the Government to consult on this issue as a matter of urgency.