



**CONCERTED ACTION
ENERGY EFFICIENCY
DIRECTIVE**

Split incentives

Executive Summary WG 5.4

Energy services and ESCOs, energy auditing, solving administrative barriers

**Daniele Forni, ENEA/FIRE, Italy
Anett Zajáros, ÉMI, Hungary**

Date: 26 November 2014

1 Summary

Article 19 of the Energy Efficiency Directive (EED) requires Member States (MS) to evaluate and if necessary introduce measures to remove regulatory and non-regulatory barriers to energy efficiency. In particular point a) refers to the issue of “split incentives” in the building sector between the different parties bound by the terms of a contract i.e. the split of the motivations that prompt the parties engaged in a contract to pursue different objectives.

It is possible to refer to this issue in different ways: split incentives, the agency dilemma, principal-agent, landlord-tenant, misaligned financial incentives, etc. and it is a market failure that usually arises when one party is responsible for the investment costs while the other party takes advantage of the cost savings. In the building sector, the issue is present between owner and tenant when the tenant pays the rent and the energy bill so the owner has no interest in investing in efficiency measures. It is also present among owners or tenants – typically when it is not possible to measure the usage of energy or services – or within the same organisation when the owner and tenant are different offices or departments with different goals. There is also the case, sometimes called the “reverse split incentive”, when the owner pays for the energy/services and thus the tenant has little/no motivation to limit their use (e.g. hotels, but also schools).

Some of the solutions applied to tackle this issue in one sector can also fit for other sectors. For instance, Life Cycle Costing - utilised to optimise the planning, design and construction of state buildings in the US since the seventies - is among the minimum requirements for the evaluation of energy audit opportunities in annex VI of the EED.

To investigate the issue, a questionnaire was circulated among the participants of the Concerted Action for the EED: 24 of the 29 MS responded. In around 60% of the cases, MS gave some information regarding split incentives in the 2014 National Energy Efficiency Action Plan (NEEAP), underlining the fact that it is considered and perceived as a barrier in at least some circumstances. In around half of the cases NEEAPs contain a more or less detailed analysis of the issue and the on-going measures to address it, while in the rest of the cases NEEAPs had mainly or only proposals to modify or introduce new legal provisions.

Figure 1 shows how split incentives were reported to be a barrier to energy efficiency improvements. This was often the case between owners and tenants in residential and private buildings, and among owners in residential buildings. It was reported to be less of a barrier for owners of non-residential buildings, and between real estate developers and coming owners in residential and non-residential buildings. Each MS reported a different situation, with different predominant sectors. In only 2 of the 24 answers were split incentives not an issue, due to the particular conditions (building property, building typology, weather, etc.).

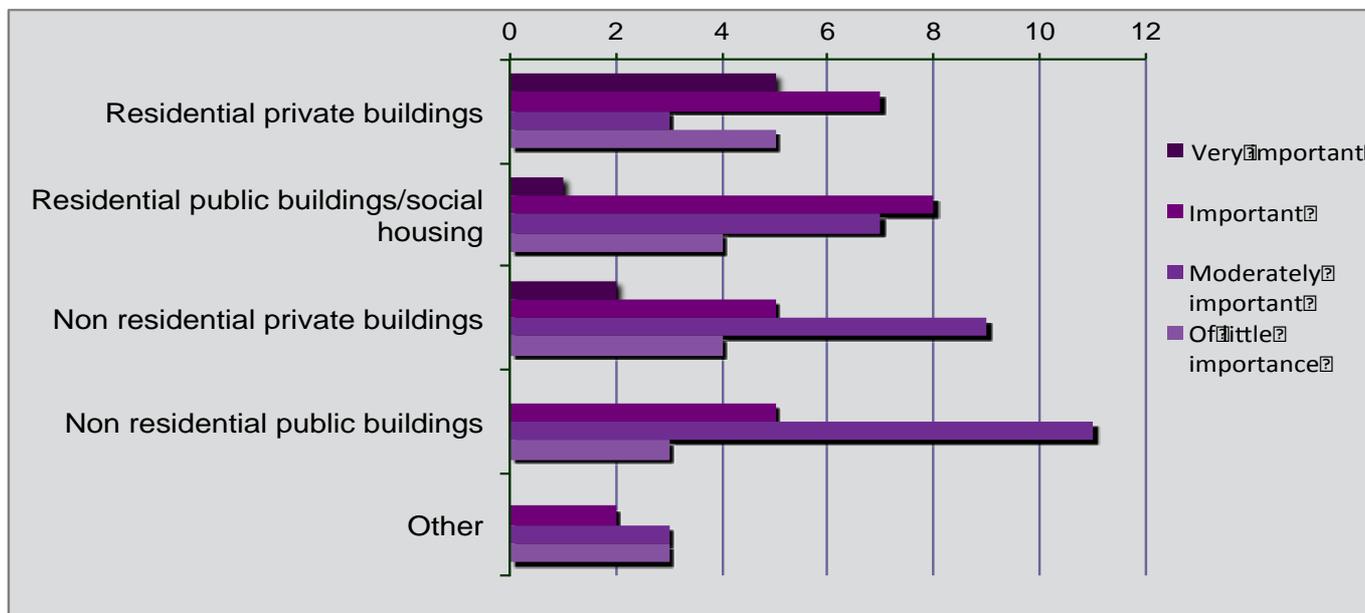
The category “other” refers to owner-owner or tenant-tenant in multi-family buildings with central heating systems, public and government buildings and split incentives inside (public and private) organisations.

Figure 1 Between which subjects are the split incentives a barrier to energy efficiency improvements in your Member State?



The split incentives issue is considered the most important barrier in the private residential sector, followed by (in decreasing importance) public building/social housing, non-residential private buildings and non-residential public buildings (see Figure 2). In non-residential buildings, split incentives are less important, probably due to the fact that there is a smaller information gap and that for the private sector (at least in some MS) the lease contract duration is shorter making it easier to renegotiate contract conditions or find another solution on the market. From an energy efficiency perspective, shorter contracts mean the owner has fewer stimuli to invest, especially in measures with longer payback times.

Figure 2 How important do you consider the split incentives as a barrier in your Member State compared to other existing barriers to the efficient energy use?



Measures to tackle split incentives are already in place in over 60% of the MS who responded to the questionnaire and there are plans to introduce measures in around half of the rest. Some of those measures are specific to split incentives, while others also addressed additional issues.

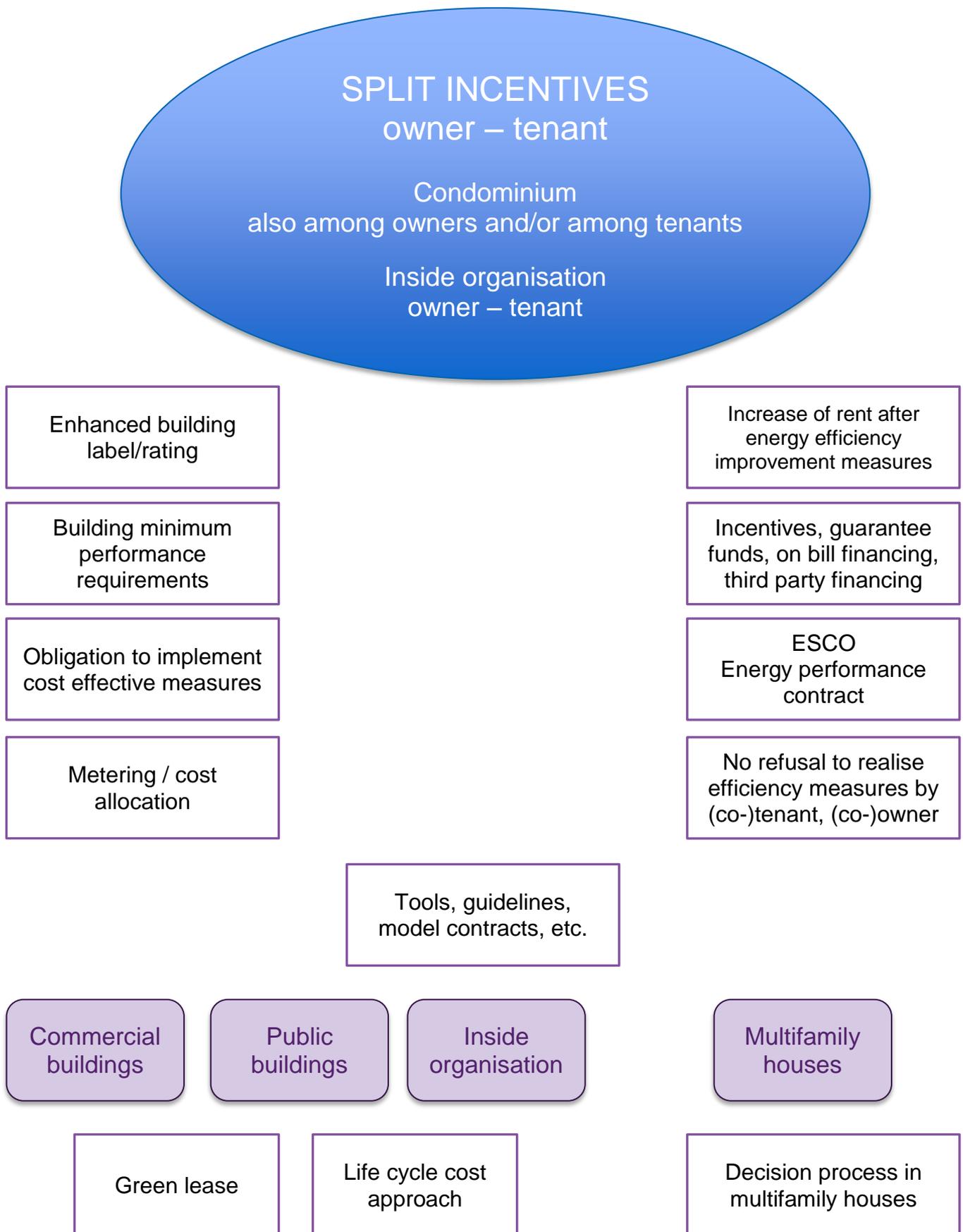
The measures described in the questionnaire responses and in the NEEAPs can be divided in regulatory/legislative (including economic and market-based policy instruments, e.g. guarantee funds, incentives, ESCOs and energy performance contracting) and other support measures such as tools, model contracts, etc.

Figure 3 shows an attempt to group the measures: on the left are those more related to buildings, on the right those more related to financing and at the bottom the tools, etc. divided by sectors.

Split incentives were also discussed in another session with the title **Core Theme 1: New or updated Energy Efficiency measures introduced in MS**

With new NEEAPs in place and national implementation plans well underway, this group asked MS to report on new or updated energy efficiency measures that fulfil EED requirements and were introduced after the NEEAP-2 in 2011. Among the measures discussed, those introduced to tackle split incentives were also collected. The Executive Summary from this topic is available on the CA EED website (www.ca-eed.eu).

Figure 3 Poster of Working Group 5.4: the split incentives issue and the possible measures to tackle it



2 Recommendations/Conclusions

The presence and the importance of the split incentive issue depends on many different factors such as climate (i.e. no heating needs), ownership, contract type (including energy/services or not), contract duration, presence of meters/cost allocators, energy prices, etc. and the measures in place to tackle the issue. Within any MS, the issue can be very important in one sector but almost non-existent in another.

The measures in place and those planned, in most cases, specifically address split incentives or particular aspects of split incentives. The issue is quite complex and involves a number of different subjects, thus it seems that there is no unique measures to address it but a combination of measures. Measures are in many cases linked or require others as prerequisite. For instance, there must be the possibility to increase rents, to take account of lower tenant energy/services bills, in order to use energy performance contracts in third party financing¹. An amendment to the regulatory framework could be required: a solution to smooth this process could be a voluntary agreement between associations of owners and tenants, with the guarantee that the total expenditure will not rise. A regulatory framework is also a prerequisite for energy services, third party financing, and no refusal of tenant (or landlord) to implement efficiency measures.

In multifamily houses, the decision process is critical and can preclude the implementation of measures even if incentives, funds and/or performance contracts are present. This issue requires an amendment to the rules between parties (e.g. a majority to take the decision) but this alone is not enough. It has to be addressed with communication and decision support tools, model conventions for common installation in private areas of the house, as well as tailored financing/revolving funds.

For the non-residential public sector and split incentives inside organisations, all inclusive rent and life cycle costing approaches should be considered². Also the creation of an internal revolving fund fed by savings from implementing energy efficiency improvements should be evaluated if compatible with legislation and accounting rules.

For the non-residential sector there is a lot of interest in green leases (a collaborative owner-tenant approach to save resources and money) although few have been implemented by MS. The main support for this practice is model contracts or an interactive web platform (see the Netherlands' presentation in section 3 below³).

Among the other measures, an enhanced building rating/certificate targeted at split incentives is probably the most replicable one, since the instrument is in place in all MS. It seems from the retail sector example in the Netherlands that with relatively limited additional effort it could be possible to achieve much higher results compared to the standard rating/certificate. This would also be an opportunity to enhance the effect of the rating/certificate on the market.

¹ See for example: Overcoming the split incentive barrier in the building sector, Marco Corradi, presentation at JRC workshop in Namur 19 March 2014 http://iet.jrc.ec.europa.eu/energyefficiency/sites/energyefficiency/files/files/documents/events/03_corradi_13.03.14.pdf

² When owner and tenant are different offices or departments with different goals

3 Practical Examples

The duration of a lease contract is one of the many parameters that vary widely from one MS to another, which also influences the way they approach the issue. For example, the “no refusal” obligation to implement energy efficiency measures is on the owner in UK, where the average contract duration for the private households is 18 months, whereas in other MS it is on the tenant and contract durations are longer. The UK approach is also linked to the presence of the Green Deal on bill financing, so energy efficiency measures can be implemented by tenants even with short contracts: this can also trigger the owner to implement measures in more convenient inter-tenancy periods.

Obligations to implement cost effective efficiency measures with payback times under certain thresholds and minimum efficiency requirements were discussed. Both require either a building rating or survey, but the obligation could increase the energy efficiency of buildings over the minimum level through a package of measures, while the minimum target risks delivering only shallow retrofits.

The green lease doesn't seem to be complex: the benefits are for both parties, not only in terms of energy and economic savings, but also of public image. To better manage and share benefits, there is a need to control energy use and behaviour (e.g. cost of meters, etc.). In some cases, regulatory changes may be required.

Presentations

The Netherlands' presentation³ summarised the main future and on-going measures to address the split incentives issue via:

- The Ministry of Internal Affairs action plan
- The 2013 National Energy Agreement for Sustainable Growth, requiring the implementation of energy efficiency measures with an average payback period of 5 years
- Green lease and supporting tools (Green Lease Menu & Dashboard)
- Enhanced energy performance of building certificates for retail sector (Duolabel and Energy Card Retail)
- Tool for energy performance contracting (EPC Menu & App)
- Public buildings' all inclusive rent by 2016

Green leases are voluntary between tenants and landlords to reduce the cost and enhance the benefits of the lease. They are a translation of the sustainability policy and social responsibility of the organisation. An on-line tool (also available in English) provides a personalised contract according to the options selected in the “green house menu”.

By 2016 the RVB (Central Government Real Estate Agency) will let over 1300 buildings to the public sector which will incorporate the energy bill. This is expected to deliver 2% savings per year (alternative approach art. 5.6)

³ <http://www.esd-ca.eu/good-practices/member-state-presentations/energy-services/split-incentives/energy-services-and-esco-s.-split-incentives-netherlands>

For more information please email
forni@fire-italia.org

Legal Disclaimer

The sole responsibility for the content of this report lies with the authors. It does not necessarily reflect the opinion of the European Union or the Member States. Neither EASME nor the European Commission are responsible for any use that may be made of the information contained therein.

The Concerted Action for the Energy Efficiency Directive (CA EED) was launched by Intelligent Energy Europe (IEE) in spring 2013 to provide a structured framework for the exchange of information between the 29 Member States during their implementation of the Energy Efficiency Directive (EED).

For further information please visit www.ca-eed.eu or contact the CA EED Coordinator Lucinda Maclagan at lucinda.maclagan@rvo.nl



Co-funded by
the Intelligent Energy Europe Programme
of the European Union