4. Overcoming Split Incentives for Owners and Tenants

Overview

Split incentives occur when the entity responsible for paying the energy bills (usually the tenant) is not the same as the person or entity responsible for investing in energy efficiency or renewable energy upgrades (the owner / housing association). In other words, split incentives stem from the misplacement of incentives between different actors (e.g. landlords and tenants), which discourages energy efficiency improvements from coming into effect. To help overcome this issue, the new Energy Efficiency Directive (Directive (EU) 2023/1791) includes a provision in Article 22, Paragraph 9, recognising the importance of addressing the barrier of split incentives in the building sector:

Without prejudice to the basic principles of their laws on property and tenancy, Member States shall take the necessary measures to remove regulatory and non-regulatory barriers to energy efficiency as regards split incentives between owners and tenants, or among owners of a building or building unit, with a view to ensuring that those parties are not deterred from making efficiency-improving investments that they would otherwise have made by the fact that they will not individually obtain the full benefits or by the absence of rules for dividing the costs and benefits between them.

Measures to remove such barriers may include providing incentives, repealing or amending legal or regulatory provisions, adopting guidelines and interpretative communications, simplifying administrative procedures, including national rules and measures regulating decision-making processes in multi-owner properties, and the possibility to turn to third-party financing solutions. The measures may be combined with the provision of education, training and specific information and technical assistance on energy efficiency to market actors (…).

There are different types of split incentives in the building sector depending on who is in charge of paying the energy bills, and the main issue it can lead to is inaction from the owner's side as non-resident owners do not have a direct interest in renovating. As they do not live in the district themselves, they do not necessarily participate in the community's life and can be hard to reach. Moreover, their quality of life will not improve after the renovation. Except in the countries (such as Sweden) where owners are the ones paying the energy bills, their reduction will not impact the owners. Unless the rent is increased there are then no incentives for the owners to renovate.

In this context, the European Commission's Joint Research Centre, on behalf of DG Energy, organised a workshop on unlocking the energy efficiency potential in the rental & multifamily sectors to exchange information about the extent to which split incentives act as a barrier to energy efficiency investments in the building sector as well as investigate current solutions, their effectiveness, and ways forward. This section is mainly based on the JRC report.

Types of split incentives:

i) Efficiency-related split incentives (ESI) refer to situations where the end user is in charge of the energy bills but cannot choose the technology needed to improve the energy efficiency of their property and thereby has limited power in reducing their energy bills or negotiating an energy efficiency upgrade. The landlord-tenant dilemma in rental housing is the most typical example. The landlords lack incentives for investing in energy efficiency upgrades as they do not directly reap the benefit.

ii) Usage-related split incentives (USI): These have also been referred to as the “reverse” split incentives. They occur when occupants are not responsible for paying their utility bills and have little or no interest in conserving energy. In other words, the occupants do not face the marginal cost of their energy use and are not given any incentives to use energy efficiently. They occur under “warm rent” and gross rent structures where the landlord bears utility costs for heating, other operating and capital expenses. Evidence exists that tenants under such rent structures tend to consume more energy, e.g. several studies have provided empirical evidence showing higher indoor temperatures during winter periods in the case of heat inclusion in the rent (e.g. Levinson & Niemann, 2004). The term “warm rent” is typically used in some Western or Northern European countries (e.g. Germany and Sweden) to refer to rent structures that include heating costs. Cold rent, on the contrary, refers to rent structures that do not include heating costs.

iii) Multi-tenant, multi-owner split incentives (MSI): Multi-tenant and multi-owner buildings face an additional challenge associated with collective decision-making between various actors. Energy efficiency projects in these buildings can only be realised if all decision-making parties reach a consensus. Unfortunately, current decision structures act as a barrier in collective agreements between owner-occupants of many existing buildings such as condominiums. In multi-tenant and multi-owner buildings, the benefits and costs of an energy efficiency upgrade may vary from apartment to apartment, further complicating the situation.

iv) Temporal split incentives (TSI) refer to situations where the energy efficiency investment does not pay off before the property gets transferred to its next occupant/owner. In this situation, the occupant (tenant or owner-occupier) does not know how long they will live in their property or plan to move relatively soon. An energy efficiency upgrade attached to a high upfront capital cost will not be appealing and may be perceived as risky.

This section will address the following questions:

- How to overcome split incentives in building renovation?

Recommendations and Good Practices

I. How to overcome split incentives in building renovation?

Overcoming split incentives involves addressing the misalignment between the party responsible for making decisions about renovations and the party bearing the financial burden of the same renovations. A number of measures can help correct this misalignment. However, a comprehensive approach to removing the barrier should consider a mix of measures to be effective. Based on the findings of JRC, the following principles were drawn to determine a successful approach:

- Redistribution of costs and savings between involved parties should be considered, e.g. a landlord can be entitled to amortize the capital expenses of an energy efficiency investment by passing a share of the costs to the tenant;
- Agreements between involved parties should be structured so that the energy efficiency investment benefits all of them. Owners should also take into consideration the positive impact of an energy efficiency upgrade that will have on their rented property value, while tenants should consider the gains in increased comfort.
- A performance correction factor derived from empirical evidence, should be considered to overcome accuracy issues between actual and predicted energy savings in cost recovery models. This incorporates a buffer to protect tenants against underperforming energy efficiency measures. The correction factor should be based on robust evidence of the performance gap from real case studies.
- Energy use and costs need to be made more transparent. While energy performance certificates offer a valuable tool for understanding the energy performance of a building during sale and lease transactions, the information provided in the certificate does not directly

determine the energy-related operating expenses for the user. More transparent information can lead to more informed decisions.

- Owner-occupiers and tenants need to be more closely engaged in energy efficiency. This could be achieved through energy tenancy rating systems, which assess their impact on overall consumption and separate it from the building-related impact. Landlords should be in charge of the efficiency of the building, while tenants should be in charge of the efficiency of their own premises. The installation of smart meters and provision of direct feedback on consumption can help occupants identify wasteful habits, have better control of their own operating expenses, and appreciate the benefits of simple improvement measures.
- Attaching the energy efficiency upgrade to the property rather than the owner or tenant offers the flexibility of engaging in energy efficiency upgrades whose payback time is longer than the occupancy or ownership duration, effectively removing the barrier of temporal split incentives. This can be done by attaching the capital cost recovery to the utility bills (on-bill finance model) or property tax (PACE model).
- Owners and tenants are required to make expert decisions and engage in complex projects despite their lack of technical knowledge. Good planning and project execution are essential, especially in large and complex projects such as renovations of multi-apartment buildings. The involvement of an independent energy expert is necessary to facilitate and co-ordinate the process.

If the burden falls on the tenant alone, an agreement can be reached where a rent increase will be compensated by a similar reduction on the energy bill or other similar cost.

EXAMPLE

Western Europe

Amsterdam - Netherlands

De Flat Kleiburg

Kleiburg is the last original honeycomb style apartment block in Amsterdam. Given the high investment costs that a deep renovation would entail, the building owner at the time – the Rochdale social housing association – saw no alternative but demolition. In a last attempt to preserve the building, they launched a competition to receive ideas. The consortium DeFlat – a team of private developers – saw an opportunity to promote an alternative business model: the apartments were renovated and sold unfinished at an affordable price for residents to re-design themselves. Since then, the de Flat Kleiburg project has become a thriving neighbourhood and is widely recognised as the largest 'DIY home' project in the Netherlands.

Some programmes demonstrate that using a combination of funding sources, such as grants and low-interest loans, and performance-based financial models can make energy renovation of affordable housing financially viable for building owners while providing significant benefits for tenants, such as reduced energy consumption and costs and improved living conditions.

As a rule though, financing solutions are required to address energy and operating costs (low rate loans, grants, national or regional subsidies). Such solutions can be backed by banks and provide guarantees to facilitate equitable cost sharing between landlords and tenants.

Further Reading and Online Resources

- Joint Research Centre (2016). "Unlocking the energy efficiency potential in the rental & multifamily sectors". Event proceedings. Documentation available at: https://e3p.jrc.ec.europa.eu/events/unlocking-energy-efficiency-potential-rental-multifamily-sectors
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- Melvin, J. (2018). “The split incentives energy efficiency problem: Evidence of underinvestment by landlords.” Available at: https://www.sciencedirect.com/science/article/abs/pii/S0301421517308157
- De Flat Kleiburg project. https://kondorwessels.nl/en/portfolio/deflat-kleiburg/