ESG UPDATE

APRIL 2023

European Green Directives

Seeking Clarity for the Real Estate Market

Green directives on the energy performance of buildings, including energy performance certificate (EPC) ratings in the European Union and United Kingdom, are urging the European real estate industry to assess non-compliance risks and the costs of compliance. This comes at a challenging time in the market cycle, when increased compliance costs have the potential to push projects into the red.

The practicality of compliance is another matter. Energy efficiency measures already need to be implemented with speed, which owners may find burdensome. Due to tightened EPC rating requirements in the UK and the looming reform of the EU's Energy Performance of Buildings Directive (EPBD), the compliance clock will now start ticking even faster. As a result, owners may face an increased risk of enforcement and potential negative impact on property value, rental value, and property marketability. Investors and lenders are becoming more focused on compliance requirements related to energy performance and carbon emissions to identify potentially "stranded assets" during their due diligence.

This Alert outlines the increasingly complex regulatory landscape regarding the energy performance of buildings and provides a roadmap to owners, investors, lenders, and occupiers navigating green directives.

HIGHLY DYNAMIC REGULATORY LANDSCAPE

The real estate sector is already subject to a variety of asset-related climate protection compliance obligations. These obligations mainly concern the energy performance of buildings. Depending on the relevant national jurisdiction, they may also include:

- carbon pricing;
- smart metering;
- rooftop solar obligations;
- the metering and billing of heating costs;
- and obligations to install charging infrastructure for electric vehicles.

The push for carbon neutrality stems primarily from the Paris Agreement on Climate Protection and the EU's commitment to reaching net zero emissions by 2050. Additional driving factors include national climate goals and landmark court decisions requiring efficient climate protection measures. To meet these ambitious climate goals, compliance obligations are expected to significantly tighten in the future.

On the EU level, reforms of various green directives relevant to the real estate sector are already ongoing – importantly in relation to the EPBD:

- A key element of the EPBD reform is the introduction of minimum energy performance standards. This will not only affect new construction, but also existing buildings.
- The goal of the EPBD reform is to impose a "renovation wave" of the worst performing buildings across the EU, which will be identified by more harmonised EPCs. These changes will apply to commercial and residential buildings alike.
- Even though the final wording of the EPBD must still be negotiated by the European Parliament, European Commission, and the EU Member states, it can be expected that the reform will be a game changer for the European real estate industry.

The goal of the EPBD reform is to impose a "renovation wave" of the worst performing buildings across the EU, which will be identified by more harmonised EPCs. These changes will apply to commercial and residential buildings alike.

The UK has already introduced stricter EPC rating requirements affecting existing and new buildings as of 1 April 2023 (pursuant to its Minimum Energy Efficiency Standard (MEES) Regulations).

EU VS. NATIONAL REGULATORY REGIMES

EU Member states are required to implement the EU's green directives in their jurisdictions. So far, ambition levels in imposing compliance obligations have varied between the Member States. The specifics of the UK regime must also be considered.

Owners, investors, and lenders therefore need to closely monitor the developments in their relevant markets. For real estate companies operating in different markets, making strategic comparisons of relevant regulatory standards may enable better investment and capital expenditure decisions.

GT GreenbergTraurig

For real estate companies operating in different markets, making strategic comparisons of relevant regulatory standards may enable better investment and capital expenditure decisions.

TIGHTENED RACE AGAINST THE COMPLIANCE CLOCK

The stricter EPC rating requirements in the UK and the proposed reform of the EPBD will lead to a shorter time frame for implementing existing and new compliance obligations.

In March 2023, the European Parliament voted to require all new buildings in the EU to meet a zero emissions standard by 2028. The reformed EPC ratings will be used to determine compliance. In November 2022, the ministers of the EU Member states suggested 2030 as the target year to reach the zero emissions standard for newly constructed buildings—the European Parliament's proposal shortens this timeframe. For existing buildings, the European Parliament's proposed timeline is also ambitious:

- Residential buildings must be upgraded to at least efficiency class E by 2030 and to efficiency class D by 2033.
- Commercial buildings must achieve at least efficiency class E by 2027 and efficiency class D by 2030.

In Germany alone, this "renovation wave" would require retrofits of approximately 45% of the total building stock by 2033 at expected costs of up to EUR 182 billion per year.

In the UK, as of 1 April 2023, it is unlawful to let commercial space with an EPC rating worse than E, even in the middle of a lease term (subject to certain exemptions). Further measures have been proposed by the UK government that would raise the minimum EPC ratings to C by 2027 and to B by 2030.

COMPLIANCE ENFORCEMENT

Many buildings – and therefore many owners – may be unable to comply with the proposed stricter minimum energy performance requirements. This may lead to considerable enforcement and unfavourable public exposure risks.

In the EU, compliance enforcement for energy efficiency requirements is handled by the Member States. So far, enforcement mechanisms have varied significantly between the Member States. The main enforcement mechanisms include:

- penalty fines;
- administrative orders;
- and private enforcement through tenants' rights to lower the rent or claim damages.

It is not clear yet whether Member States would enforce the stricter minimum energy performance standards imposed by the EPBD reform through these same mechanisms or if they would introduce tougher or new sanctions such as letting prohibitions.

In the UK, compliance mechanisms include civil penalties and fines based on the rateable value of the property. Details of the breach may also be made publicly available, leading to reputational damage.

The UK is also an example of how rigid compliance enforcement mechanisms may disrupt the market. Tightened EPC rating requirements may make up to an estimated 8% of inner-London commercial stock unlettable as of 1 April 2023. If the UK government implements its plan to raise the minimum EPC rating standard to rating C by 2027, it is estimated that more than 50% of central office stock may become unlettable.

Assessing the risks of non-compliance will likely play a much bigger role in the strategic decision-making for real estate companies in the future.

Assessing the risks of non-compliance will likely play a much bigger role in the strategic decision-making for real estate companies in the future. In this context, it will be important to assess which exemptions and grace periods for compliance requirements may apply to the buildings in question.

OTHER COMPLIANCE INCENTIVES

The EU Sustainable Finance framework provides another incentive for energy efficiency compliance:

- Assets with insufficient energy performance do not meet the requirements of Art. 8 and Art. 9 funds under the EU Sustainable Finance Disclosure Regulation (SFDR).
- They may also not qualify for “green” financing schemes offered by banks and other financial institutions.

The EU Sustainable Finance framework seeks to increase information exchange and transparency to deliver high-quality financial instruments, products, and services, free from “greenwashing,” that legitimately meet investors’ ESG preferences. The UK has plans for its own economy-wide Sustainable Disclosure Regulations (SDR) and sustainable investment labelling regimesimilar to the EU framework. As a result, it can be expected that the market for non-green assets will shrink in the coming years.

It can be expected that the market for non-green assets will shrink in the coming years.

To facilitate compliance with the stricter energy performance requirements, the EU, its Member States, and the UK plan to set up various funding programs and tax incentives. In addition, rent price regulations may serve as another compliance incentive if owners are entitled to transfer certain modernisation costs to their tenants. As the unfolding discussions in various countries suggest, the cost-allocation of carbon neutrality in the real estate sector will likely be a sensitive political topic moving forward.

To prevent significant market disruption, it will be important to consider implementing modern, flexible, and more accessible financing tools (including direct grants, energy efficiency mortgages, and targeted financial support schemes). This offers financial institutions and financial market participants opportunities to invest while contributing to building renovations and the success of the transition.

CONCLUSION

To make effective and strategic decisions, real estate companies should compare the energy performance requirements in relevant European markets and analyse the landscape given the new European green directives. This new landscape may impact investments, disposals, capital expenditure planning, and fundraising (equity and debt). Given the dynamic regulatory landscape as well as growing enforcement and valuation risks, closely monitoring legal developments will be key for a successful path to carbon neutrality.

GT GreenbergTraurig

About GT’s ESG Practice

GT’s multidisciplinary, multi-industry, global team of lawyers routinely advise clients on Environmental, Social and Governance criteria, including working with companies to develop and implement systems to produce sustainable and credible ESG performance, advising on ESG reporting and communication, the application of ESG principles to investing and financing, and the development of international standards relevant to ESG. GT helps clients stack financial incentives, gain regulatory approvals, and utilize other tools to help businesses adopt environmentally and socially conscious practices.

Authors

Johann-Frederik Schuldt
+49 30 700 171 289
Johann.Schuldt@gtlaw.com

Natalie Kopplow
+49 30 700 171 279
Natalie.Kopplow@gtlaw.com

Local ESG Real Estate Contacts

Marijn Bodelier | AMSTERDAM | Marijn.Bodelier@gtlaw.com
Florian Rösch | BERLIN | Florian.Roesch@gtlaw.com
Dani Martin | LONDON | Dani.Martin@gtlaw.com
Marzio Longo | MILAN | Marzio.Longo@gtlaw.com
Agnieszka Stankiewicz | WARSAW | Agnieszka.Stankiewicz@gtlaw.com

Greenberg Traurig, LLP | www.gtlaw.com