Enhancing the real estate sustainability policy framework

IIGCC
Institutional Investors Group on Climate Change

Executive summary

The analysis presented in this paper is the result of the experience of investors in the real estate sector who participate in the IIGCC's Property Working Group. The IIGCC recognises that with a supportive and effective policy framework in place, the market will be able to deliver finance to energy efficiency programmes at the speed and scale required. We believe, however, that the current regulatory framework in the EU would benefit greatly from a critical reassessment in order to tackle a number of weaknesses and we propose the following policy recommendations to address them:

- Policies should focus on those who have control over sustainability and energy efficiency performance, those who pay for energy and utility costs, and those who have control over capital allocation at specific times in a building's lifecycle;
- Policies should exploit and explicitly target the most relevant opportunities for sustainability and carbon improvement during each stage of a building's life;
- The effectiveness of the existing regulatory framework could be seriously improved by properly and strongly enforcing it;
- Ultimately, to be effective and unlock substantial capital investment, the policy framework should support the integration of sustainability risks into the market fundamentals of real estate financial investment: rents, yields and values.

Introduction

The Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration between 79 investors holding some EUR 7.5 trillion in assets. We believe that clear, credible and long-term domestic and international policy frameworks are vital for shifting our sector's investment focus and balance towards low-carbon opportunities. This would help to catalyse private sector investment at the scale required to meet emission reductions targets and remain on a safe climate change pathway.

We recognise that climate change, directly through altering weather patterns and indirectly through legislative and regulatory responses, will impact the performance of property investments in the medium term. In response, the IIGCC Property Working Group engages with policy makers at national and international levels to ensure that appropriate policies are developed in order to maximise environmental benefits whilst maintaining and enhancing investment returns. Across Europe, institutional investors allocate an average of 5.5% of assets to property investments[1].

Taking into account their full life-cycle, buildings are responsible for 40% of final energy consumption and constitute 36% of CO_2 emissions in the EU[2]. It has been estimated that implementing existing technologies (such as better insulation, efficient lighting and heat recovery) can reduce the total energy consumption of buildings by about 30%, in turn reducing the EU's overall energy consumption by as much as 11% by 2020. Furthermore, energy efficiency can save money and generate jobs, thus fostering competitiveness, a consideration that is particularly important in times of economic crisis. The draft EU Directive on Energy Efficiency shows that achieving the European Union's 20% energy efficiency target by 2020 could create up to 2 million new jobs, with savings in the EU's annual energy bill reaching a potential EUR 200 billion[3].

[1] *Asset Allocation Survey European Institutional Marketplace Overview 2012*, Mercer, 2012.

[2] *Financial Support For Energy Efficiency In Buildings – consultation paper*, Directorate for Energy, European Commission, Brussels, February 2012.

[3] For analysis of the data put forth in the EU Directive on Energy Efficiency, see both the Ecofys report, Saving energy: bringing down Europe's energy prices, May 2012; as well as The Commission Staff Working Paper Impact Assessment accompanying the document on energy efficiency, Brussels, 22.6.2011.

Environmental issues are not yet critical factors in property investment and management decisions, particularly at a time when rents and yields are under intense pressure. This limits the allocation of capital investment to low carbon technologies. However, there is emerging empirical evidence in markets where sufficient data is available that regulatory pressures and market demand relating to environmental issues present significant long-term risks to property-investment performance. The day is fast approaching when sustainability will be incorporated into the assessment of real estate asset values and financial performance. Already, the industry has implemented a number of voluntary initiatives to foster the uptake of sustainability and energy efficiency practices in the sector in the last few years as outlined in the box below.

Voluntary sustainability initiatives led by the real estate sector[4]

Reporting: *GRI CRESS* real estate and construction sector sustainability reporting guidelines under the Global Reporting Initiative, launched in September 2010; *EPRA's Best Practices Recommendations on Sustainability Reporting*, launched in September 2011; and *INREV's Sustainability Reporting Recommendations*, launched in January 2012.

Benchmarks: *The Global Real Estate Sustainability Benchmark (GRESB)* provides rigorous benchmarking of the sustainability performance of global real estate portfolios, started in 2009, now covering some US$1.7 trillion of assets under management; *Jones Lang LaSalle operational sustainability benchmarking*, launched in 2008; *IPD IPF sustainability index*, which assesses the link between sustainability and financial performance, launched in 2009; *EcoPAS IPD sustainability index service*, launched in May 2012 with the unique advantage of engaging with valuers to collect the sustainability data used in the index.

Voluntary labelling: Across the EU there is a growing uptake of voluntary environmental and energy certificates such as: BRE Environmental Assessment Method (BREEAM), Leadership in Energy and Environmental Design (LEED), Haute Qualité Environnementale (HQE), Deutsche Gesellschaft für Nachhaltiges Bauen (DGNB) and Bewertungssystem Nachhaltiges Bauen (BNB).

Partnerships: *Better Buildings Partnership*, a partnership of property owners which aims to develop solutions to improve the sustainability of the UK's existing commercial buildings; *Green Rating Alliance*, a not-for-profit association launched in 2009 and dedicated to improving and monitoring the environmental performance of existing buildings; *International Sustainability Alliance*, a global network of leading corporate occupiers, property investors, developers and owners dedicated to achieving higher sustainability in the built environment.

We recognise that the market will be able to deliver finance to energy efficiency programmes at the speed and scale required if a supportive and effective policy framework is in place. However, we believe that the current regulatory framework in the EU would benefit greatly from a critical reassessment to tackle a number of weaknesses. The analysis presented in this paper is the result of the experience of investors in the real estate sector who are members of the IIGCC's Property Working Group and provides the view of institutional investors with a majority of assets invested in commercial real estate. While the focus of our view is commercial real estate some consideration is given to residential properties where applicable.

[4] The list is non-exhaustive and aims to provide a brief overview of the large amount of sustainability initiatives in the real estate sector.

Critical analysis and recommendations for enhancing the real estate sustainability policy framework

A wide range of regulatory and legislative instruments targeting the sustainability and energy efficiency of buildings are already in place at European Union and member state levels. The approach is a mix of targeted policies designed to take account of local conditions, using instruments such as standards, building codes, voluntary labelling and tax exemptions. On the whole, this multi-faceted approach is considered to be among the most appropriate and cost-effective strategies, as shown in a number of studies[5].

Despite the ambitions of the regulatory framework and ample policy research indicating that economy-wide energy efficiencies are more cost-effectively achieved in the commercial and residential building sectors than in any other economic sector[6], uptake of this type of initiative has been very slow. We believe that this is partly due to the fact that the current policy framework is not sensitive enough to the heterogeneous nature of the building sector (including residential, commercial, public, private, owner/occupied, rented, multi-let buildings) nor the fragmented and shifting patterns of rights and responsibilities and of management arrangements involving numerous interests and practitioners during the long economic life-cycle of buildings.

Based on a critical analysis of national and local policies and practices, we outline below a number of weaknesses of the regulatory framework and make policy recommendations to improve its effectiveness:

Inadequate targeting of the relevant practitioner making key management and financial decisions

The complex management arrangements, fragmented responsibilities and conflicts of interest between the number of practitioners (owners, lenders, occupiers and service providers) with stakes in buildings throughout their full life-cycle prevent a clear identification of responsibilities and long term planning. This results in the key problem of 'split incentives' where the instigator of a measure or action is not necessarily its beneficiary.

Example: Carbon Reduction Commitment (UK)

Under the UK CRC scheme, the owner is legally liable to pay the carbon tax if they are the purchaser of energy for the building, even when it is the occupier who controls consumption. As there is no equivalent regulatory or voluntary measure that incentivises occupiers to change their patterns of energy consumption, this considerably limits the carbon effectiveness of the scheme in the real estate sector.

Overcoming these barriers requires policies to focus on those parties who have control over sustainability and energy efficiency performance, pay for energy and utility costs, or have control over capital allocation at specific times in a building's life-cycle.

[5] Including the seminal work by Urge-Vorsatz and her team, *Appraisal of policy instruments for reducing buildings' CO_2 emissions*, in Building Research & Information, 35:4, 458-477, 2007, and the report by the World Business Council for Sustainable Development, *Energy Efficiency in Buildings: Business realities and opportunities*, WBCSD, September 2008.

[6] The Intergovernmental Panel on Climate Change (IPCC, 2007) has identified buildings as having the greatest potential for carbon mitigation at lowest cost, at any given cost per ton of carbon dioxide and every level of economic and national development.

Failure to target opportune stages in a building's life-cycle

There are only a number of opportunities in the life of a building where sustainability improvements can technically and cost-effectively be implemented: maintenance, fitting, end of lease, refurbishment, and development. Moreover, the terms of occupier leases restrict the opportunities when owners are able to carry out extensive refurbishment of existing assets.

Example: Tenant control over fit-out of buildings (EU)

The fit-out of buildings, covering anything from flooring, carpeting and partitioning, to lighting, heating and cooling specifications, tend to determine how efficiently the building will be used. At present there are very few regulations beyond appliance standards and some voluntary labels (such as RICS SKA rating) that target this specific phase of the cycle.

Policies should exploit all of the most relevant opportunities for sustainability and carbon improvement during each stage of a building's life. While we support deep renovation of the overall building stock over time, at the building level, regulation should focus on a phased renovation approach exploiting the most relevant opportunities for sustainability and carbon improvement during each stage of a building's life. For example building codes and minimum standards could contain requirements for the fit-out or refurbishment stages of the cycle that would considerably impact the actual environmental efficiency of the building in use.

Focus is on design over operational performance

There is technical evidence of a big performance gap between the design intent and operational performance of buildings[7]. However, despite its fundamental link to sustainability impacts, there is limited measurement and regulation targeting the actual sustainability and energy performance of buildings.

Example: EU EPBD design vs. operational performance (EU)

In the majority of EU member states Energy Performance Certificates (EPC) are calculated on the design characteristics of a building and are the legal responsibility of the owner. However, the actual environmental performance of the property is known to vary greatly depending on how it is actually used and managed.

In order to be more effective, regulation should shift the focus to the operation and refurbishment of the existing built stock as much as it has historically focused on new construction. One way in which this can be done is through Display Energy Certificates (DECs) in order to target the actual energy consumption of a given building in operation. This should be the responsibility of whoever is in control of the actual energy consumption.

[7] See for example, *Europe's buildings under the microscope, a country-by-country review of the energy performance of buildings*, Buildings Performance Institute Europe (BPIE), 2011.

Current policy framework fails to link sustainability risks to market signals

The current limited links between sustainability indicators and real estate market financial performance presents further challenges to the wide adoption of sustainability improvements in the building sector. Policies to correct this are emerging but not yet fully realised in the EU.

So far, there has been limited market demand from occupiers and buyers for energy efficient buildings and sustainability performance is not yet included in valuation assessments or reflected in the financial performance of assets. This is compounded by the limited availability of data to market participants on energy use and carbon emissions. Furthermore, the low ratio of energy costs to total occupancy outlays in commercial real estate dampens the appetite for investment and the relative inelasticity of energy demand limits the effectiveness of energy price signals.

Example: Energy services obligations (Belgium, UK)

Schemes imposing energy efficiency requirements on utility suppliers, successfully implemented in the UK and the Flanders region in Belgium, have had no noticeable impact yet on the financial performance of buildings despite demonstrating significant negative net societal costs.

Providing stability, including the provision of clear targets and policy aspirations for environmental improvements is crucial to help investors plan and price opportunities. The introduction of market and fiscal instruments, for example a strong and sustained price signal on carbon, carbon taxes, tax breaks or capital allowances would foster the integration of sustainability risks into the market fundamentals of real estate financial investment, namely, rents, yields and values. Encouraging fund and asset level reporting of energy use would also support this integration.

Lack of strong compliance and enforcement regimes

Effectiveness is seriously hampered by the fact that sustainability regulations are less rigorously enforced than most building regulations, such as structural integrity or fire safety.

Example: Limited enforcement of building codes (EU)

Numerous studies have shown that implementing building codes can be patchy and difficult in terms of compliance, suggesting there is still much room to further upgrade these codes and their enforcement across the EU[5].

Existing building codes and sustainability regulation should be properly and strongly enforced, ensuring the effectiveness of the present regulatory framework.

[8] As shown in the recent study of the Building Performance Institute Europe, *European buildings under the microscope*, BPIE, 2011.

Failure to consider unintended consequences of policy

Of particular importance is the risk of certain types of property becoming prematurely obsolete, both functionally and physically, because of regulation which could potentially lead to the early demolition of buildings. Such outcomes would increase overall sustainability impacts and diminish the value of real estate assets and funds, ultimately resulting in losses to policy-holders, pension-plan members and shareholders.

Example: Minimum energy performance standard (UK)

The requirements included in the UK energy bill for buildings to comply with minimum energy performance standards from 2018 in order to be leased or let would have a large impact on the real estate sector. While this can transform the market and incentivise uptake of sustainability measures, there is a real risk that part of the building stock will be made obsolete. This could lead to the demolition of assets before the end of their functional life, thereby triggering greater carbon events.

Performance standards and regulations must be sensitive to and mitigate potential unintended consequences, in particular the risk of demolition and its compounded carbon emissions and financial impacts.

Lack of information and skills

Finally, public policy could help to address the human, contractual and procedural weaknesses of the sector. Limited awareness among the service providers involved, such as property managers, surveyors, leasing and letting agents, lawyers and valuers, hampers changes in behaviour. While the lack of a legal framework assigning responsibilities for sustainability impacts to various parties entrenches the status-quo and results in responsibility shifting between practitioners.

Policy makers should encourage the development of training to improve sustainability skills in the sector across the range of practitioners. The development of standardised contracts and agreed savings and return measurement methodologies would clarify legal responsibilities and support the development of bundling and securitisation of small scale energy efficiency measures.

We urge policy makers to consider the specific recommendations in response to the existing issues and regulations above. We believe that a better appreciation of, and a more nuanced response, to the complexities exhibited across the real estate market, especially when developing national and local regulations would support the delivery of finance to energy efficiency programmes in the real estate sector.

While this statement was prepared based on the expertise of the IIGCC property working group, the messages are consistent with the overall policy goals of the IIGCC to ensure that regulatory frameworks are relevant, well designed and ensure the effectiveness of the institutions charged with implementing them. This document will serve to inform on-going dialogue between investor members of the IIGCC and national and EU policy makers on issues relevant to real estate sustainability and investment.

IIGCC Membership June 2012

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AP1 (First Swedish National Pension Fund)
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BlackRock
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