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Insights

MINIMUM ENERGY EFFICIENCY STANDARDS – HERE TO STAY OR AT RISK OF BECOMING REDUNDANT?

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SUMMARY

In September, ahead of the Conservative party conference, Rishi Sunak announced a step back from the Government's net zero policy and targets. This was followed up last week by the Government's formal response to the Climate Change Committee's 2023 Annual Progress Report to Parliament (October Response). Whilst we await detail on what might follow from a legislative perspective (several consultations are promised to land before the end of this year), the messaging suggests that the next steps in the domestic Minimum Energy Efficiency Standards (MEES) regime are now off the table, meaning domestic premises with an EPC of E or above may continue to be let on the open market, without any regulatory requirement for further investment from landlords (or resulting higher rents for tenants). If domestic MEES have been put on ice, where does that leave their sibling commercial (aka non-domestic) MEES?

With a backdrop of the cost of living crisis, the mood music from Westminster is not very MEES friendly (notwithstanding the table of achievements and progress included within the October Response) especially when you take into account the decision to scrap the Energy Efficiency Taskforce. The Taskforce was set up to help focus on the decarbonisation of buildings, working towards the target of a 15% reduction in energy demand across all buildings and industrial processes by 2030. Meanwhile at their party conferences the Labour and Liberal Democrat leaders promised cleaner, cheaper, home-grown, energy but didn't commit to the compulsory upgrading of properties to limit their energy consumption.

If domestic MEES have been put on ice, where does that leave their sibling commercial (aka non-domestic) MEES? It is telling that one often sees commentary in the property and wider press suggesting that the Government mooted EPC B by 2030 target is already enshrined in law. It seems remarkable that there has been nothing concrete from Government on this since the 2019 and 2021 consultations. In its October Response, the Government suggests that it is currently working on proposals and that it intends to issue its long awaited response to the 2021 consultation "in due course", but in the meantime has acknowledged that the proposed timelines within the original consultation (EPC C by 2027 and B by 2030) will require updating. In reality, this lack of certainty has meant that investors and developers have had to make their predictions as to the future trajectory of the legislation, but also decide the ESG principles that should be driving their own businesses. Arguably, it is now the market, not the Government that is driving change.

There is a lot of talk about the bifurcation of the office rental market (the largest sector of commercial real estate), driven partly by factors such as the new post COVID balance of office versus home working and perhaps increasingly by technological developments. All office space is not equal and BCLP's own research[1] shows that sustainability credentials are given considerable weighting when corporates are deciding on space (ranking only behind state of repair, the user experience and location) – partly as it goes to a corporate's own ESG strategy and partly because it helps with employee recruitment and retention. This is being termed the "green premium". 71% of those investors we surveyed expect a property with strong energy performance standards to have a higher resale value than an equivalent property with weak energy performance standards and they also expect that same property to benefit from greater occupier demand, reduced void periods and higher quality tenants. Three quarters of those same investors believe that the green premium applies mostly to buildings that meet official sustainability certifications such as LEED and BREEAM, but there is clear sentiment that a lack of global standardised regulation and policies is a significant barrier to investment.

Transformational change also requires a change in culture and a confidence in a robust stance against any perceived greenwashing. Asset managers must take into account, as applicable, the EU Sustainable Finance Disclosure Regulation (SFDR) (introduced in March 2021) and in due course the UK's Sustainability Disclosure Requirements (SDR) (the FCA's Policy Statement on this is expected imminently) and provide the appropriate detailed disclosures about the sustainability features of their products. Meanwhile, organisations such as GRESB (Global Real Estate Sustainability Benchmark), based in the Netherlands, are endeavouring to cut through this by offering assessments and benchmarks that can be used by businesses to track their performance against their peers and find actionable advice on upping their ESG credentials.

Meanwhile, what of the assets that are sub-standard now or predicted to be below the market bar come 2030? Our research shows that investors believe that on average, over half of their property portfolio (55%) will still be made up of real estate assets that have unknown, poor or average sustainability performance by the start of the next decade. Green lease provisions and initiatives, such as the Better Building Partnership's green lease toolkit, provide some light at the end of the tunnel for landlords who are keen to collaborate with their tenants on renewals or brand new leases but perhaps the biggest head scratcher is below par buildings multi-let on longer term leases where a mid-term re-gear might be the only practical (if expensive) solution to getting into the space to get the work done.

It is not just the investors, developers, occupiers and fund managers who drive the market – increasingly we're seeing pressure from lenders in both the domestic and commercial markets who ultimately want to protect their own investment from becoming at risk. It is in their interests to mitigate against a sliding EPC asset rating to avoid the value of an asset dropping, or worse becoming unlettable without costly upgrading works. There are two main types of green finance product in the real estate market: green loans and sustainability-linked loans, and the main difference between the two is how the proceeds of the loan are used. Generally, the proceeds of a sustainability-linked loan will seek to improve the borrower's overall sustainability profile by linking certain loan terms to the borrower's performance against a set of predetermined KPIs. An example of this would be margin ratchets aligned to the borrower's performance against particular sustainability targets, which could see the margin go up and down over the term of the loan. Proceeds of green loans are usually applied to a project or endeavour that is categorised as green or social, and, in some instances, a loan may be structured to allow for it to be both a green loan and a sustainability-linked loan. In the current climate where the cost of borrowing is a huge factor in the slowdown of the real estate market, could the green incentive prove impossible to resist?

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[1] The Sustainability Imperative: The Future of Real Estate Investment campaign is based on an independent, global opinion research study, and supplementary qualitative interviews with BCLP partners and industry thought leaders. The 700-strong opinion research sample consisted of 400 investors (200 private equity investors and 200 institutional investors) and 300 corporate occupiers (business leaders responsible for their organization's real estate decisions).

The interviews took place in 2023 and were conducted under the ethical research guidelines set by both the MRS (Market Research Society) and ESOMAR.

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MEET THE TEAM

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