IPE & REAL ASSETS

Opinion: EU climate law will transform real estate

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The climate action tipping point for real estate finally came on 14 July with the European Green Deal legislative package. It was more 'big bang' than incremental.

Twenty years of legislation have given the EU nothing more than:

- An obligation to include energy-efficiency improvements in renovation, but only for works of a certain scale and only when the owner freely decides to undertake them;
- An obligation to renovate 3% of the central-government building stock per annum or, if a government finds that too hard, some fuzzy alternative action;
- An energy performance certificate (EPC);
- Inspection obligations for heating and cooling systems.

Small wonder that renovation in Europe stays at 1% to 2% of the building stock per annum and that most of that is light renovation, locking in energy inefficiencies for decades. The European Commission calculates that this kind of progress gets us to climate neutrality in about 100 years.

It's true that during that time the EU also set greenhouse gas (GHG) reduction targets and that the target for 2020 was by and large met. But this and further targets set just three years ago didn't keep pace with climate warming.

That's why the EU just gave itself two new targets – climate neutrality by 2050 and a 55% GHG emission reduction by 2030 – that change everything. And the Commission is now combining them with proposals for binding legislation.

The coup for the Commission was to launch most of the 'Fit for 55' legislative package on a single day, so that the proposed laws can't be picked off one by one during the legislative process. For real estate, that gave:

- Extension of the Emission Trading Scheme (EU ETS) to buildings coupled with an EU social climate fund (€72.2bn) to help cushion the impact on the most vulnerable households;
- Reversal of the Energy Taxation Directive from favouring fossil-fuel heating to favouring the most carbon-free heating;
- An increase of the share of renewable energy in heating and cooling by 1.1% every year;
- Digital connection and smart recharging for publicly accessible parking areas, including those privately owned;
- Extension of the obligation to renovate every year 3% of the building stock owned and occupied by central government to those owned by "public bodies".

The latter means all public bodies' buildings at every level: central, regional and local, including social housing – and extended to rental housing. Buildings under public ownership have to become nearly-zero-energy buildings; buildings rented under a new contract have to be at EPC A or B levels. There are no more exemptions for heritage, military or ecclesiastical buildings, and no more "alternative approaches".

And on 14 December, another law will top it all off by creating unavoidable renovation obligations for the worst performing building stock, public and private.

All that together is political dynamite, a pincer movement with owners and occupiers doubly hit by renovation requirements and by higher bills for existing heating. You could expect the Council of Ministers to water these proposed laws down beyond recognition, as they have done so often in the past. But this time there's a difference: a scientific, political and 'street' consensus that decisive action must be taken now.

Combine that with the fact that there's no more wiggle room, especially for real estate. The European Green Deal/Fit-for-55 package is about much more than buildings – it severely regulates industry, transport and farming, and it zeroes in on new forms of high carbon emission like the digital economy and call centres, plus it has a mechanism to ensure that third countries wishing to go on exporting to the world's largest trading power won't be able to undercut with carbon-heavy processes.

The overarching 55% GHG reduction target makes it impossible to 'shift' the burden from buildings to the other sectors, first because of the share of buildings in the overall equation (36% of EU GHG emissions and 40% of energy consumption), and second because the other sectors are being hit just as hard, causing rapid and hyper-expensive reorganisation of whole industries as we see for cars. It won't be politically or practically possible to increase their burdens to alleviate buildings.

Inside the building equation, the same law of political physics applies: extending the ETS to buildings will hit millions of people hard, even with subsidies and staggered deadlines. No way will any politician make ETS even tougher in order to loosen the regulation on building renovation.

Finally, the 'hit' for real estate will be even bigger than the '55%' GHG emission figure suggests, because the Commission estimates that, to reach the overall 55% reduction that applies to all sectors included, buildings-sector emissions will need to fall by 60% by 2030 compared to 2015 levels, with emissions in the residential sector falling by 61%-65% and in the services sector by 54%-61%. Building emissions were reduced by 18% between 2005 and 2017. They now need to fall at nearly three times that rate*.

For property markets, it looks like the term 'stranded assets' is going to get new currency. For real estate professionals, it means there will be no time for a gentle shift via small market-value premiums for 'green assets' and small discounts for 'brown' ones. There'll need to be a rapid change of focus.

* European Commission findings quoted in Pricing is just the icing: The role of carbon pricing in a comprehensive policy framework to decarbonise the EU buildings sector – Regulatory Assistance Project, June 2021