Europe: Net Zero Buildings in the EU

Greenwash At Your Peril

In brief

We know that the construction and operation of buildings has an enormous impact on energy-related carbon emissions, contributing around 40% globally. To deal with this, many real estate investors are committing to transition their real estate portfolios to achieve net zero greenhouse gas emissions by 2050 or earlier.

Owners, occupiers, investors and funders of the built environment will come under increased pressure to reduce emissions and substantiate their sustainability credentials. Investor groups and other stakeholders now expect greater disclosure and action on addressing climate risks. It is becoming increasingly clear that greenwashing will no longer be tolerated.

To support and underline this need for evolving business models to commit to achieving the agreed climate goals, political and regulatory policies are now fast evolving. For an international investor with properties in the UK, EU (and potentially Switzerland), it can be difficult to keep track of the changing EU regulatory landscape, especially now as outsiders looking in.

Those who develop, invest in, or occupy, real estate in the EU should be aware of the current topics on the legislative agenda and, just as importantly, be aware that some EU sustainability regulation will apply even to real estate activities undertaken outside of the EU.

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The "Fit for 55" package

The EU is working on the revision of its climate, energy and transport-related legislation under the "Fit for 55" package in order to align current laws with the target of at least a 55% reduction in emissions, which the EU has set for 2030.

This includes a proposed recast of the EU's 2018 Energy Efficiency Directive (which set energy efficiency targets for 2020 and 2030). However, we do not expect this to directly entail significant changes for real estate companies. Nonetheless, the commission's proposal contains some important reforms, including increasing the EU's overall energy efficiency target, increasing national energy savings obligations, reinforcing energy efficiency-related obligations and introducing a compulsory renovation rate for public sector buildings. This will undoubtedly influence national policies for buildings over the coming years.

The EU Renovation Wave

The "Renovation Wave" is an EU Action Plan proposed in 2020 to boost building renovation in the EU. It proposes a (minimum) doubling of the annual energy renovation rate of buildings in the EU by 2030. An "energy renovation rate" is the percentage of total floor area that is renovated each year to meet at least the minimum energy performance requirements.

The Renovation Wave strategy highlights the imperative for ancillary regulatory, financial and enabling measures to achieve this position. Three identified priorities for renovation are: buildings with very poor energy performance; public buildings; and de-carbonisation of heating and air-conditioning systems.

A small part of the Renovation Wave was already implemented by the Fit for 55 package, notably via the higher compulsory renovation rate of public sector buildings.

However, the key regulatory proposal of the Renovation Wave is the revision of the EU's Energy Performance of Buildings Directive, the main EU Directive setting buildings energy standard. The proposal for reform was published on 15 December 2021, and will likely be adopted by the end of 2023, much earlier than the originally planned review by 1 January 2026.

Although the proposal focuses on the reduction of operational greenhouse gas emissions, it does also take the first steps towards addressing emissions over the whole building life cycle. It notably introduces a new definition of a zero-emission building: "a building with a very high energy performance in line with the energy efficiency first principle, and where the very low amount of energy still required is fully covered by energy from renewable sources at the building or district or community level where technically feasible (notably those generated on-site, from a renewable energy community or from renewable energy or waste heat from a district heating and cooling system)." It also updates the definition of a "nearly zero-energy building", which is "a building with a very high energy performance … which cannot be lower than the 2023 cost-optimal level reported by Member States … and where the nearly zero or very low amount of energy required is covered to a very significant extent by energy from renewable sources, including energy from renewable sources produced on-site or nearby."

The key proposals include:

- A requirement that, from January 2030, all new buildings will have to be zero-emission buildings, as defined above. Those *occupied or* owned by public authorities will need to be zero-emission from January 2027.
- The Introduction of minimum energy performance standards, which will also apply to existing buildings and existing building units, with the standards designated by each Member State from 2027 at the latest, with a view to transforming the national building stock to zero-emission buildings by 2050.
- The phased introduction of enhanced mandatory minimum energy performance standards.
- Ensuring better quality, accessibility and adoption of energy performance certificates, through greater harmonisation.
- The introduction of Building Renovation Passports (containing a roadmap to renovation to net-zero by 2050) and of a deep renovation standard for sustainable finance.
- National building renovation action plans, to be established and submitted by each Member State by 1 January 2025 and every 5 years thereafter, to promote renovation to net-zero by 2050. These require a relatively granular level of detail, such as an overview of the national building stock, the annual energy renovation rate and the energy consumption and greenhouse gas emissions of buildings as well as identification of the worst-performing buildings and barriers to renovation.
- A requirement for Member States to provide appropriate financing and support to enable net-zero building stock by 2050, and reference to the funding instruments that will be used at EU level.

The Buildings Performance Institute Europe noted in September 2021 that this is "a make-or-break opportunity to make the EPBD 'fit for 2030', and crucially, fit to respond to the climate emergency."

The EU Taxonomy

The EU Taxonomy is a classification system. It stipulates the conditions that an economic activity has to meet in order to qualify as environmentally sustainable and sets out a list of potentially environmentally sustainable economic activities.

The Taxonomy Regulation, which provides the framework for the EU Taxonomy, sets out the six fundamental environmental objectives of the EU. The first two are broadly parallel to those of COP26:

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control; and
6. protection and restoration of biodiversity and ecosystems.

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The EU Taxonomy is intended to:

- create greater certainty for investors;
- protect private investors from greenwashing;
- help companies to plan the transition to net zero;
- mitigate market fragmentation; and
- eventually help shift investments to where they are most needed.

Under the EU Taxonomy, organisations covered by the Non-Financial Reporting Directive – that is, essentially large listed companies, banks and insurers and, later on, the more numerous organisations covered in the [proposed] Directive on corporate sustainability reporting – need to include information in their non-financial statements on how their business activities are aligned with the EU Taxonomy. For non-financial companies, this includes, in particular, the proportion of their turnover derived from "sustainable activities", and the proportion of their capital and operational expenditure linked to such activities.

What's included in the EU Taxonomy?

The following activities related to the real estate sector are included:

- Construction of new buildings
- Acquisition and ownership of buildings
- Renovation of existing buildings;
- Installation and maintenance of "energy-efficiency equipment"
- Installation and maintenance of "electric equipment"
- Professional services relating to energy efficiency
- District heating/cooling distribution.

"Buildings" means all residential and commercial buildings, but there are some criteria that only apply to one type. What "acquisition and ownership" covers is a complex question, but includes buying, selling and leasing real estate.

In addition, entities such as insurance undertakings, investment firms, pension providers and fund managers will have various disclosure obligations regarding the alignment of financial products in their portfolios claimed as sustainable, or those claimed to have ESG characteristics, with the EU Taxonomy.

Lastly, all EU member states are required to use the EU Taxonomy as the system underlying all requirements for financial firms in respect of financial products or corporate bonds that are marketed as environmentally sustainable.

The Taxonomy Regulation has been in force since 12 July 2020, but reporting is as yet only partially mandatory. The mandatory reporting scheme started in January 2022 and will be fully introduced by January 2023.

Activities are reviewed under specific technical screening criteria, which are used to assess whether the relevant activity contributes substantially to one or more of the environmental objectives of the Taxonomy. If it makes the requisite contribution, then it can be considered sustainable.

Most activities related to the real estate sector are included, such as the development, acquisition, sale and leasing of buildings. These must meet stringent criteria to qualify as environmentally sustainable (see below).

Real estate activities need not be carried out within the EU for the EU Taxonomy to apply, as it is not intended to be restricted to the EU continent. The question is where the relevant sustainability claim is being made, rather than where the asset or portfolio in relation to the claim is located. Therefore, if an organisation or entity is advertising an investment (for example a real estate-related financial product) as "green" to EEA investors in a way which is subject to EU sustainable finance-related disclosure rules, then this would have to be backed up with a Taxonomy analysis, regardless of the location of the building or portfolio itself.

There are reputational and financial risks to those who do not comply with the relevant reporting and disclosure requirements. The EU Taxonomy is complex, and many open questions remain. Very few official guidelines have been made available, and total clarity cannot be expected. It is new to regulators, auditors, markets and the public. However, risks of sanctions (by regulators or public stakeholders) are low if the following principles are followed:

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- Adopt a "no green washing" approach. Disclosure priorities should focus first on adopting the most reasonable approach, not necessarily the approach that is best for a given taxonomy score.
- Carefully and clearly justify any choice made in the interpretation of the criteria as part of the explanation of KPIs in the disclosure. Transparent justification is the main remedy against ambiguous or unclear criteria.
- Keep up to date with new guidelines issued by the Commission and pay attention to what becomes "market practice".

What is 'environmentally sustainable'?

For the following real estate activities to qualify as environmentally sustainable under the EU Taxonomy, these stringent criteria must be met:

Construction of new buildings

- The primary energy demand of the new building is 10% lower than for nearly zero-energy buildings (certified via EPC).
- For buildings larger than 5,000 sq m, there are transparency requirements:
  - Either (i) robust/traceable quality control processes are in place or (ii) the final building is tested for air-tightness and thermal integrity, and deviations compared to design are disclosed to investors/clients.
  - The lifecycle global warming potential of the building resulting from the construction has been calculated for each stage in the lifecycle and is disclosed to investors and clients on demand.

Acquisition and ownership of buildings

- Buildings built before 2021:
  - The building has an EPC of class A or above; or
  - The building is within the top 15% of the national or regional building stock in terms of operational primary energy demand.
- Buildings built from 2021 on: the building meets the criteria for the construction of new buildings applicable as at acquisition.
- For some large non-residential buildings: the building is efficiently operated.

Renovation of existing buildings

The building renovation either:

- complies with the applicable energy efficiency requirements for "major renovations"; or
- leads to a reduction of primary energy demand of at least 30% (which can be achieved through a succession of measures over a maximum of three years).

Primary energy demand means "the calculated amount of energy needed to meet the energy demand associated with the typical uses of a building expressed by a numeric indicator of total primary energy use in kWh/m2 per year and based on the relevant national calculation methodology and as displayed on the EPC".

Global warming potential is the numeric indicator for each lifecycle stage expressed as kgCO2e/m2 (of useful internal floor area) averaged for one year of a reference study period of 50 years.

Reform of 'unfair commercial practices'

In March 2022, the Commission tabled a specific reform which is intended to equip consumers for the green transition by the provision of better information, guarding against greenwashing.

Although this reform isn't specific to the real estate sector, it will impact the nature of the credentials and types of claims that real estate companies are allowed to make regarding their building stock. This reform is intended to address sustainability or environmental claims that are made by businesses to consumers and so, although it does not affect claims made between

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commercial real estate parties, it is relevant to claims made by developers to private residential tenants or purchasers, for example.

In particular, the Commission's proposal would designate the following as unfair commercial practices:

- displaying a sustainability label which is not based on a certification scheme or not established by public authorities;
- making an environmental claim related to future environmental performance without clear, objective and verifiable commitments and targets and without an independent monitoring system;
- making a generic environmental claim where recognized excellent environmental performance relevant to the claim cannot be demonstrated; and
- presenting requirements which are actually imposed by law on all products in the relevant product category on the Union market, as a distinctive feature of the offer made by that business.

This means that self-declarations of 'net zero' targets that are not certified under an independent certification scheme or unsubstantiated claims of providing 'sustainable' buildings will likely become prohibited, even in cases where the Taxonomy Regulation would not apply.

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