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# Consultation Paper

## "Financial Support for Energy Efficiency in Buildings"

(Directorate General for Energy, Unit C3, Energy Efficiency)

*Comments submitted by email to: ener-financing-energy-efficiency@ec.europa.eu.*

**Introduction**

The European Public Real Estate Association (EPRA) is the voice of the European publicly traded property sector. EPRA represents publicly listed property companies who are in the business of owning, managing, acquiring, selling, developing, refurbishing, and operating commercial property.

EPRA's membership also includes the investment institutions who have an interest in investing into the listed property sector and the firms and individuals who advise and service those businesses. Between them our 200 members represent over €250bn of commercial property.

The fact that we represent the interests of the property companies themselves and the investors in those companies puts EPRA in a unique position to engage with EU regulators on two factors that are critical to the energy efficiency debate - the needs of investors who provide the capital to finance green buildings projects and the response of the property sector to those needs.

EPRA's view is that it is crucial to deal appropriately with the barriers identified in the consultation paper that are responsible for the "energy efficiency gap" found in buildings. EPRA therefore welcomes this current initiative and recognises the role that property companies will play in achieving the objective of saving 20% of the EU's energy consumption compared to projections for 2020.

**Executive Summary**

- Stock Exchange Listed Property Companies are responsible for the delivery, operation and long term management of the built environment. They combine two aspects that are critical in the delivery/retrofitting of energy efficient buildings; 1) attracting finance (equity and debt capital) from the broadest range of sources (small/large investors, institutions, corporate bonds etc.) and 2) actually delivering and managing those buildings within a publicly owned, transparent, highly scrutinised, responsive and professional corporate environment.

- In this respect, we have a general comment which is that the Consultation Paper appears to consider the various key stakeholders in individual silos (e.g. para. 5.1 identifies separately providers of finance, construction companies and building "owners"). In our view, this could overcomplicate matters and runs the risk of overlooking an obvious but important point: successful, modern day, listed property companies are active, operational businesses that effectively combine the services of financing, developing and managing buildings for the long term, into one easily understandable corporate form. Although we recognise the need to devise possibly more innovative mechanisms for financing energy efficient developments, the importance of property companies as "one-stop" shop solution, which provide the key elements underlined as critical to the EU 2020 energy targets in a simple and long-established form, should not be overlooked.
- The Consultation Paper identifies a number of barriers which contribute towards the untapped potential in the property sector to reduce energy consumption. We broadly agree with the identified barriers, but believe that there is one major barrier/market failure that is not mentioned in the paper: ***Europe's listed property sector is fragmented and evidently small and underdeveloped relative to other global regions***. For the reasons described below and in more detail in our response, this puts the EU at an immediate and significant disadvantage in its aspirations to meet its 2020 energy savings targets.
- There is compelling evidence to support the intrinsically logical point that publicly quoted property companies are at the forefront in addressing both the risk management and opportunistic aspects related to energy efficiency in buildings. The listed sector, due to its very nature, is inherently more responsive to the evolving needs of investors, who increasingly perceive energy efficiency and sustainability as a risk/opportunity in their decision making.
- If a larger proportion of the European built environment were held within the listed property sector (in line with, or above global averages) Europe would undoubtedly be much better placed to meet its 2020 objectives. There are clearly identifiable reasons for its current underdeveloped nature and we strongly believe that the European Commission should, across a range of DG's, prioritise the development of the European listed property sector. In this respect, the pathway to achieving this has been already set in those other global regions which currently benefit from a larger, more vibrant listed property sector. Our recommendations are discussed further in this consultation response, but perhaps the key point is that EU regulators should develop a roadmap to reduce the fragmented nature of the EU property market and encourage national governments to introduce "Best in Class" REIT legislation across the EU (the most efficient form of listed property company).
- It is EPRA's strong view that EU-wide initiatives should include increased communications at an early stage between concerned DGs, e.g. DG TREN, DG MARKT, DG REGIO and DG TAXUD. The above recommendations and the issue of energy efficiency in the building sector cannot advantageously be dealt with through independent "silos" but rather as a co-operative effort between stakeholders within the Commission.
- By way of illustrating the above point, this Consultation Paper identifies an investment need of around €60bn per year in the building sector to realise the required energy savings potential. This figure is significantly less than the estimated capital that could be withdrawn from the real estate sector (taken out of productive use and held with a central counterparty) as a result of property businesses being incorrectly treated as "financial" businesses under recently introduced EU OTC Derivatives regulation[1], that imposes these

[1] 2010/0250(COD) - 29/03/2012 - Text adopted by Parliament, 1st reading/single reading.



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obligations on normal commercial interest rate hedges used on property loans[2] for the acquisition, development and refurbishment of property.

- Finally, EPRA shares the view that dealing appropriately with the well-known principal-agent problem could be very useful. This is not an easy task, but following examples such as in Germany (where the country allowed property owners, who upgraded an apartment, to increase the annual rent by a fixed percentage of the investment made) could represent an important incentive towards encouraging behavioural change.

Below, EPRA have responded to a selection of the questions asked in the Consultation Paper:

| 1. Addressing market failures |
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| <u>**Questions 1a, 1b and 1c**</u><br><br>**(a) Are the barriers identified in this document the most important ones? If not, which barriers are missing and why are they important?**<br><br>**(b) Which market failures would be most urgent to address? At what level (i.e. EU, national/regional/local) would these failures be best addressed?**<br><br>**(c) How could these failures be best addressed? For example; how could behavioural change needed for quicker uptake of energy efficiency measures by society be triggered at the national level? How could the development of an energy services market for households be further stimulated? What could be done to increase awareness raising and promotion of energy efficiency in buildings? How could the business community (e.g. Building sector, ESCOs, local banks, etc.) be better supported in delivering energy efficiency in buildings? How could the split incentive problem be best tackled?** |
| <u>*Listed property companies at the forefront of addressing energy efficiency*</u><br><br>Evidence supports the intrinsically logical point that publicly quoted property companies are at the forefront in addressing both the risk management issues and opportunities related to energy efficiency in buildings.[3] There is clearly still much do be done, but the listed sector, due to its very nature, is inherently more responsive to the evolving needs of investors, who increasingly perceive energy efficiency and sustainability as an important risk/opportunity in their decision making. This investor-driven behaviour goes hand in hand with the relatively high levels of transparency and disclosure of financial, operational and environmental performance reporting that is a feature of the public sector.<br><br><u>*Investors driven behavioural change*</u><br><br>We strongly believe that the greatest impetus for behavioural change in the built environment will come from the needs of investors. Investors will, overtime, become more sensitive to the risks and opportunities presented by the environmental performance of the buildings in which they invest. |

[2] "Evaluating EMIR's Impact on the Property Sector: Credit Exposure Model", October 2011, Chatham Financial. – Report estimates that €69bn-€101bn of capital would be diverted into margin accounts for the EU property market: 1) €22,5bn of cash collateral relates to initial margin, 2) €46-€79bn of cash collateral relates to variation margin.

[3] "Global Real Estate Sustainability Benchmark (GRESB)", Research Report 2011 - 26% of the listed companies surveyed were "green stars" compared to only 17% for private companies.



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There is evidence to show that this is already happening. For example, new empirical research conducted in the Netherlands on some 1'100 commercial rental transactions concluded that properties designated as less efficient (with energy labels D or lower) yield significantly lower rents. The research also shows that the rental growth of energy-efficient offices deviates strongly from rental growth of less efficient offices - a development that started in 2009.[4] The analysis provides evidence that, on average, a less efficient office building achieves a 6,5% lower rent as compared to similar buildings with a "green" energy label. In short, the research provides credible evidence that sustainability matters for corporate tenants in the European real estate markets.

Moreover, the impact of energy costs directly affects property investors and users: energy represents about 30% of operating expenses in the typical office building and is the single largest and most manageable item in the provision of office space.[5] Rising energy costs can only increase the importance of energy efficiency.

*Measurement and disclosure key to investor driven energy performance improvements*

Having said that, the speed at which the investor community can drive the right behavioural change in the developers, owners and managers of the built environment will be heavily influenced by the quality of the information they have on which to base their decisions to reward good or bad practices by management. This is why the listed property sector will be absolutely key to driving a pathway for the rest of the commercial property sector in behavioural change – as generally the levels of disclosure in the listed sector are evidently better than those of other less regulated and privately owned businesses. By way of example, over 95% of publicly quoted property companies in the European index (FTSE/EPRA NAREIT) present their properties on the balance sheet at fair value, assessed by independent valuer's (a disclosure directly impacted by the asset and operational environmental specifications of the building). This compares very favourably with the situation outside the listed sector and is a direct consequence of both financial reporting standards (IFRS) requirements applicable to listed companies and investors demands for high transparency in this sector.

*Underdeveloped European listed property sector – key barrier to EU 2020 targets*

In this respect, the Consultation Paper identifies a number of market failures which result in an untapped potential for the property sector to reduce energy consumption. We broadly agree with the identified barriers, but believe that there is one major barrier/market failure that is not mentioned in the paper; ***Europe's listed property sector is evidently small and underdeveloped relative to other global regions*** – and, for the reasons described below, this puts the EU at an immediate and significant disadvantage in its aspirations to meet the its 2020 energy savings targets.

In our view, if a larger share of the European built environment were held within the listed property sector (in line with, or above global averages) Europe would be much better placed to meet its 2020 objectives. There are clearly identifiable reasons for its current underdeveloped nature and we therefore strongly believe that the European Commission should, across a range of DG's, prioritise the development of the European listed property sector, as outlined further in our response to

[4] "The impact of energy labels and accessibility on office rents", Kok, N., Jennen, M., Energy Policy (2012), http://dx.doi.org/10.1016/j.enpol.2012.04.015.

[5] The Economics of Green Building, Piet Eichholtz, Nils Kok and John M Quigley, Working Papers, Berkeley Program on Housing and Urban Policy, Institute of Business and Economic Research, UC Berkeley, September 2010. The provided figure was computed for the US. The number should be similar in Europe.



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Question 3.

*Additional barriers: Impact of other EU initiatives on financing Energy Efficiency in the building sector*

It is EPRA's strong view that EU-wide initiatives should include increased communications at an early stage between concerned Directorate-Generals, e.g. DG TREN, DG MARKT, DG REGIO and DG TAXUD. The issue of energy efficiency in the building sector cannot advantageously be dealt with through independent "silos" but rather as a co-operative effort between stakeholders within the Commission.

We are very concerned with the possibility that property operating businesses risk being incorrectly classified as "financial" businesses under the Alternative Investment Fund Managers Directive (AIFMD). If the European property sector is deemed to fall within the scope of the AIFMD, estimates show that this would result in significantly more than €60bn of capital being withdrawn from the commercial property sector (effectively taken out of productive use and held with a central counterparty) due to the resulting implications under the EMIR regulation that impose these obligations on normal commercial interest rate hedges used on property loans.[6] Getting the AIFMD scope wrong, would have severe consequences to property businesses in accessing much needed productive capital from the sector and in turn make even less available for investment in green buildings and energy efficiency improvements. This makes co-operation all the more important between relevant parts of the Commission in order to achieve the proposed goals with private investments.

EPRA strongly encourages the Commission to take a comprehensive view in the energy efficiency gap in buildings. The property sector, whilst being an important part of the productive "real economy" is also heavily interlinked with the financial sector. In fact, the two sides are very much inseparable as the building sector is very capital intensive.

As further illustration of the above-mentioned points, one could mention DG REGIO's "urban development platform", featuring priorities such as energy efficiency in buildings (located in European cities) and urban regeneration. This interesting project, together with regulatory developments in the financial side of the industry and the present initiative would greatly benefit from a further joined-up approach. This would allow EPRA members, and the broader property sector, to participate more effectively toward the 2020 Growth Strategy.

## 2. Improving access to financing

**Question 2b). How could more private financing (both from the institutional investors as well as building owners) for energy efficiency by mobilised?**

The European listed property sector, whilst being at the forefront of the commercial property sector's drive to respond to the environmental issues effecting the built environment, is underdeveloped compared to other global regions. This puts the EU at an immediate disadvantage in terms of addressing energy efficiency of the built environment. It is therefore EPRA's strong suggestion to encourage the Commission in designing initiatives geared toward growing the sector.

[6] "Evaluating EMIR's Impact on the Property Sector: Credit Exposure Model", October 2011, Chatham Financial. – Report estimates that €69bn-€101bn of capital would be diverted into margin accounts for the EU property market: 1) €22,5bn of cash collateral relates to initial margin, 2) €46-€79bn of cash collateral relates to variation margin.



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Our recommendations are outlined further in our response to Question 3.

*REITs – the most efficient form of financing the built environment*

We believe that one key objective for the EU should be to push for the creation of an attractive EU-wide regime for listed property companies. The model for the most efficient listed property company, as a form of attracting finance into the built environment, has been well established in a number of countries over a number of years (e.g. US, France, Australia and the UK) in the form of REIT legislation.

The fragmented nature of Europe's property market (only 12 out of 27 member states have REIT legislation in place, many of which are sub-optimal compared to globally recognised best in class models) acts as a considerable barrier to it delivering its full potential with respect to energy efficiency. The evidence clearly points to the fact that a larger, less fragmented European listed property sector, would improve access to finance and significantly increase the number of energy efficient projects in the building sector and build momentum in energy efficiency of buildings.

*Property operating businesses – not "funds" or financial businesses*

The European listed property sector already invests heavily in sustainable buildings despite currently difficult business conditions. It is nevertheless important for regulators to realise that investments in buildings (new or retrofit) are very capital intensive and for private money to continue to flow in, financial conditions must be acceptable to the industry. As already mentioned in our comments to question 1b, getting the scope wrong in AIFMD, in a way that results in real, commercial operating businesses be classified as "financial" businesses, could extract much needed private capital from green projects in the European built environment.

## 3. Strengthening the regulatory framework

**Question 3b). What could be specific measures to be taken at national level to implement and complement most effectively the EU-level regulatory framework for energy efficiency?**

Listed sector fragmented and underdeveloped – barrier to achieving 2020 energy targets

Section 4.3 of the Consultation Paper states: "Another hindrance is the often decentralised nature of institutional competences in the building sector, with national, regional and local authorities playing different roles in enforcement, subsidy allocation, tax policy, etc. In the absence of proper coordination this can easily result in a sub-optimal support for energy efficiency in buildings". This is absolutely true for the European listed property sector, whose fragmented nature is in large part down to the uncoordinated national tax and other policy rules applicable to the property sector. The slow development of REIT legislation within Europe, despite clear evidence of the benefits of such a regime, is a case in point.[7]

In order to address the relative small size of the European listed sector compared to the situation in other global regions, which in turn directly imply suboptimal investments in energy efficiency of buildings, EPRA recommends the following courses of action:

- EU regulators to develop a roadmap for national governments to introduce "Best in Class"

[7] "REIT" status generally refers to a special tax status that is available in many jurisdictions and is applicable to property investment companies that develop, own and operate commercial property for the long term.



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REIT legislation across EU – the most efficient form of listed property company.

- EU regulators to develop a system of "Mutual Recognition" of REIT regimes for cross border REIT investments – so that listed property companies are not discouraged from cross border investment.
- EU to encourage and support the development of OECD treaty recommendations to reduce cross border tax inefficiencies and encourage adoption of existing OECD Model Treaty Recommendation for REITs.
- Establish an acceptance of property companies engaged in the long term development, ownership and management of property as real economy, operating businesses which are not the intended target of EU regulation intended for "funds" or "financial" businesses.
- Utilise REITs for addressing issues of investment in and supply of "affordable" housing – as alternative to owner occupation (social housing, subsidised and full market rental sector).
- Ensure that developing EU Pension and Insurance fund legislation facilitates, rather than hinders, the ability for smaller institutional investors to access the benefits of liquid real estate exposure.

Returns from energy efficiency improvements

The relatively slow acceptance by investors of the income return benefits arising from energy efficiency improvements continues to be one of the most important barriers to energy efficiency investments. Part of the return to energy efficiency improvements consists of relatively predictable energy savings, but under standard lease contracts and in multi-tenant buildings, these typically flow to the occupants. For the property companies themselves and their investors/capital providers, the return is thus uncertain, consisting of better marketability of properties (e.g., lower vacancy risks, higher rents while keeping total housing costs fixed, shorter rent-free periods) and higher valuations (following lower cap rates and reduced depreciation).[8] This is highlighted by Fig 1 below.

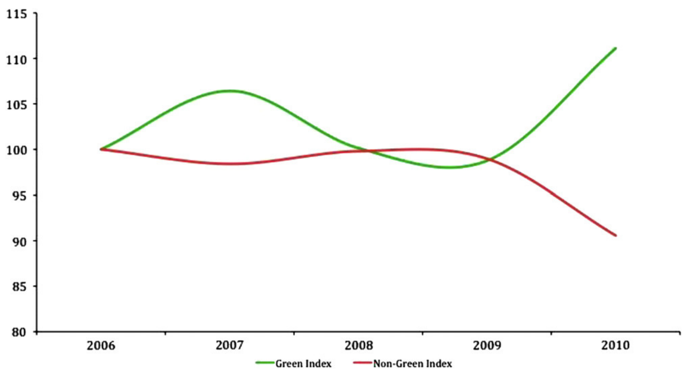


Fig 1: Rent index efficient office buildings (labels A, B and C) and non-efficient office buildings (labels D and lower).

In that respect, EPRA shares the view that dealing appropriately with the well-known principal-agent problem could be very useful. This is naturally not an easy task but following examples such as in Germany (where the country allowed landlord, who upgraded an apartment, to increase the annual rent by a fixed percentage of the investment made), this could represent an important incentive towards encouraging behavioural change.

[8] "The impact of energy labels and accessibility on office rents", Kok, N., Jennen, M., Energy Policy (2012), http://dx.doi.org/10.1016/j.enpol.2012.04.015.



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