WATSON FARLEY & WILLIAMS

THE UK'S CROSS CUTTING NET ZERO STRATEGY – REAL ESTATE

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In this sector article of our Net Zero series, our team looks at what the UK's Net Zero Strategy ("the Strategy") means for industry stakeholders in the real estate sector and any updates since the Strategy's initial release. In particular it is important to consider the Strategy's impact on funds and private family offices, who are looking to invest in BTR and PRS and whether BTR and PRS will remain an attractive asset class in the future as a proven income stream.

WHAT DOES THE STRATEGY MEAN FOR YOUR SECTOR?

> "The Strategy is not ambitious enough and without clear cut-off dates and better targeted financial assistance, change will be too slow."

In the real estate sector, there are ambitious commitments from the government to wean off the UK's reliance on gas, though it is clear government investment will need to be substantially increased in order to drive down the cost of transitioning to low carbon buildings.

Key commitment: *levelling up the regions of the UK through supporting 175,000 green skilled jobs by 2030 and 240,000 by 2035.*

Key commitment: *helping homeowners and businesses transition to low-carbon buildings by phasing out the installation and replacement of natural gas boilers by 2035 and by reducing the cost of heat pumps by at least 25-50% by 2025, with the aim of making heat pumps as cheap to buy and run as gas boilers by 2030.*

The government aims to grow the heat pump market to support 600,000 installations per year in residential homes by 2028. Unlike other key areas such as heavy industry or the power sector this target relies on individual homeowners taking their own initiative in making substantial changes to their properties. This seems overly ambitious in 2022, as the average cost for a typical heat pump can vary from £6,000 – £18,000[1] depending on the amount of heat required. The government is providing capital grants of £5,000 towards the cost of installing air source heat pumps and £6,000 towards the cost of installing ground source heat pumps through the Boiler Upgrade Scheme. However, incentivising the average consumer to pay the difference between the installation cost of a heat pump and a boiler is unlikely considering the current price of a replacement boiler is significantly cheaper.

Key commitment: *improving energy efficiency in homes so that as many homes as possible achieve EPC band C by 2030.*

Although the government announcement on 21 February to provide £67 million in initial funding under the Home Upgrade Grant to improve the energy efficiency of up to 4,300 residential homes[2] is welcome news, this is inadequate to achieve the Strategy's target "to ensure all homes meet EPC band C by 2035". Around 15 million UK properties need energy efficiency upgrades to meet EPC band C with an average cost of £8,579 for owner occupier homes[3]. The aim of this initial funding is to save low-income households up to £200 a year, however, due to recent political events any savings are likely to be offset by a spike in fuel prices.

The government is however trying to lead the industry by example in the public sector with the latest release of £179 million of funding to be distributed via local authorities under the Social Housing Decarbonisation Scheme to improve 20,000 social housing stock with rating D or lower.

Key commitment: *developing 5GW of low carbon hydrogen production capacity by 2030, enough to power 1.5 million homes.*

There have been no substantial updates, announcements or decisions regarding the use and role of hydrogen since the Strategy was released and there are ongoing consultations, looking at the cost effectiveness of hydrogen as an alternative power source. Key decisions are due to be taken by government in 2026.

Key commitment: *funding of £338 million to scale up low-carbon heat network deployment and delivering new heat networks zones by 2025.*

Key commitment: *launching a new policy framework for energy related products to ensure products use less energy.*

WHAT ARE THE RISKS AND OPPORTUNITIES?

The opportunities in relation to the decarbonisation in the property sector could have significant benefits for the UK economy. The Strategy confirms the government intends to rely on a mix of state intervention through policy and regulation, investment in the public sector and of market growth in the private sector:

Government support will stimulate this investment and will need to be focussed on growing key markets for low carbon heat and supporting vulnerable and low-income housing, the social housing sector and the public sector (paragraph 7).

> "Risk the government may not implement their policies correctly as shown by the scrapped green homes voucher policy."

Industries ranging from manufacturing to services could benefit from substantial growth in this market for low carbon housing and technology if the government continues and increases their investment in this sector through assisting innovation and giving grants.

However, the risk is the Strategy is not ambitious enough and without clear cut-off dates and better targeted financial assistance, change will be too slow.

There is also a risk the government may not implement their policies correctly as shown by the scrapped green homes voucher policy (released by the Department for Business, Energy and Industrial Strategy in July 2020 as part of the governments 'green recovery' from the pandemic[4]) of giving grants to homeowners to improve the insulation in their homes. The grants were "*plagued by incompetent administration*" (Ed Matthew, campaign director at EG3, a climate change think-tank), serving as a reminder that funding and implementation are at very different stages of development in the net-zero scheme.

Without more detail from government, it is hard to say what further risks and opportunities there might be and we will have to see if the initial grants kick-start growth in this sector over the next 12 months.

WHAT DOES THIS MEAN FOR:

- **Landlords?**

In the residential property sector, with gas boilers due to be banned in new builds by 2025 and new gas boilers or replacements phased out by 2035 in all households where possible, gas could become more expensive whilst the cost of electricity might become cheaper. This will affect landlords who pay utility bills in their properties such as in an HMO or serviced accommodation. It will also have an impact on encouraging prospective tenants and maintaining decent rental yields for properties where the cost of energy in the property is high.

Landlords will need to invest more in their properties to keep them attractive to tenants, and compliant with government regulations.[5]

Good news for landlords is they can benefit from government schemes such as the Boiler Upgrade Scheme. However, it is unclear as to what new policies might emerge from government in the future which, due to the lack of housing in the UK for first time buyers, are unlikely to be advantageous to buy-to-let landlords.

"businesses are increasingly looking for more energy efficient premises as part of their drive to show their awareness of the 'climate emergency'."

In the commercial property sector, businesses are increasingly looking for more energy efficient premises as part of their drive to show their awareness of the "climate emergency" and how this connects with their values. Although there is little evidence at this moment that this is the top priority for prospective tenants.[6]

- **Lenders?**

The strategy has emphasized its drive to increase Green Finance and has suggested mortgage lenders may have to disclose the energy efficiency of residential homes they lend on and set themselves voluntary targets to improve the insulation of buildings in their portfolio by 2030.[7] The government hopes this will encourage lenders to fund homeowners to carry out green improvements when they move into a property, with the money spent added to the mortgage and repaid via cheaper bills in the future. However, lenders have raised concerns that first time buyers could find it difficult to get a mortgage unless they are committed to spending substantial sums on improvements. This could also have unintended consequences, by trapping some owners in negative equity, if a property cannot be cost-effectively improved.[8]

- **Investors?**

There is some reassurance for investors that energy efficient investments will enhance the value of a property. A study commissioned by BEIS indicates that properties with an EPC rating of C and above transact at a premium of up to 5% higher than comparable band D-rated properties. That same study showed those properties benefitted from a price appreciation of 5.6% per square metre relative to comparable D rated properties.

We believe that appreciation of real estate assets will be a tangible benefit of early investment in energy efficiency technology in buildings. As the requirements become stricter and more time-critical as we move towards the 2030 target, investors should seek to invest now for a healthy medium-term outlook.

Equity investors have favoured developers with ambitious net zero emission targets in place as they seek to solidify the green credentials of their real estate portfolios. Early signs of post-pandemic recovery suggest this is a shrewd decision. Vacancy rates in newer, higher spec buildings with lower impact carbon use have fallen at a faster rate, due to the appetite of commercial tenants to reduce their own carbon footprints. The rental growth in these buildings is a sign to investors of the short-term opportunities in the real estate market.

A further question investors should be asking themselves is how the value of more ‘environmentally friendly’ buildings may be gauged. A recent government consultation found room for a performance-based framework for the heat and energy efficiency of commercial buildings over 1,000m2. It is hoped that measuring the actual metered energy consumption of such buildings – and having to mandatorily disclose them – will develop an ‘investment grade’ ratings system which will be translate into tangible benefits such as lower energy bills, increased asset or rental value for high performing buildings, lower insurance premiums, or performance-driven financing packages. Though proffered as an advantage for investors, this should be doubted, since the scheme rewards behaviour, as opposed to investment or intent.

- **Developers?**

Under new building regulations due to come into effect in June 2022, new residential homes and buildings in England must be around 30% lower in emissions than current standards and emissions from other new buildings, including offices and shops, must be reduced by 27%. This announcement as part of the Future Homes Standard (2025) is no doubt part of the government’s strategy of banning gas boilers by 2025 in new homes. Developers usually adapt quickly to new regulations and will need to budget for modern heating systems, smart meters and energy storage for new schemes. Installing new heating systems into older buildings, however, is likely to involve highly skilled jobs and will be costly for redevelopments.

An often overlooked feature of the net-zero target is the role of insulation in new buildings, which will require a ‘fabric first’ approach in realising their low energy consumption targets.[9] This is equally relevant for those developers retrofitting green technology in buildings – the benefits of such technology would hardly be noticed if the heat they themselves generated were to immediately escape. Developers should be aware of the ‘Approved Document L’ (ADL)[10] which outlines a ‘fabric plus technology’ combined approach which should overcome that problem. The purpose of the document is to ensure new build homes are built to a higher standard of efficiency by broadening the scope of the Building Regulations to bring the net-zero ambitions within the remit of the purpose of buildings. Hopefully the task of fulfilling such a purpose will not impede on the structural and material quality of such buildings, as we know can happen with insulation with disastrous results.

HOW WILL PROGRESS BE MEASURED OR DEMONSTRATED?

As for the key commitments, the measure of success will be the number of heat pumps installed on an annual basis, the take up of the government incentives on offer and continued investment by funds and other investors in the BTR and PRS sectors. The number of green skilled jobs over the next few years will also be a measure of success, to show whether the market in this area in growing.

Associate Nicholas Davies and Trainee Toby Hunt contributed to this article.

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[1] https://www.evergreenenergy.co.uk/heat-pumps/much-heat-pump-cost/
[2] https://www.gov.uk/government/news/households-save-200-on-bills-with-energy-efficiency-investment
[3]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1000052/EHS_19-20_PRS_report.pdf
[4] https://committees.parliament.uk/publications/8007/documents/82623/default/
[5] https://www.propertyinvestmentsuk.co.uk/heat-and-buildings-strategy/
[6] https://www.ft.com/content/fd8b3d98-3c4e-49bc-b3ef-25a03d17dfa7
[7] https://www.insidehousing.co.uk/insight/insight/the-heat-and-buildings-strategy-explained-how-it-will-affect-the-housing-sector-72963
[8] https://news.sky.com/story/heat-and-building-strategy-homes-with-inefficient-energy-rating-may-struggle-to-get-mortgages-leaked-government-plans-12437804
[9] https://labmonline.co.uk/features/rockwool-the-role-of-insulation-in-achieving-net-zero/
[10] https://www.gov.uk/government/publications/conservation-of-fuel-and-power-approved-document-l

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