

PRELIMINARY RESPONSES TO THE DECRET TERTIAIRE IN FRENCH COMMERCIAL  
REAL ESTATE INVESTMENT

by

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# Abstract

The French government established the *Décret Tertiaire* (tertiary decree) in 2019, which will require steep energy reductions in commercial properties by 2050 with interim targets in 2030 and 2040. For many buildings, the later targets will require expensive, deep retrofits, in many cases more costly than the non-compliance penalty of €7500 per year. This research provides a glimpse into the early responses of real estate asset managers operating in France via interviews with representatives from four firms. Although there is clear evidence that the industry is preparing to meet the requirements, questions remain about how it will practically be achieved, at what cost, and what portion of buildings may slip through the cracks and become stranded assets.

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# Chapter 1

## Introduction

The real estate sector accounts for around 39% of global greenhouse gas emissions, meaning the built environment will play a major role in achieving global climate goals. It also means buildings are an important target for decarbonization policies, and that developers, owners and tenants will have to make changes to the way they do business to remain in compliance with emerging regulations. Because of the transition-related policy and market pressures accumulating for the sector, there is a growing awareness that the real estate industry faces climate transition risks, including the risk of stranded assets (UNEP FI, 2022). Institutions that own or manage real estate assets will need to assess and manage those transition risks in order to protect asset value, rental income, and returns on investment, as well as to help facilitate a more orderly transition to a low-carbon economy.

Policies aimed at decarbonizing the built environment will need to focus on new construction as well as existing buildings. Since real estate space is projected to double by 2060 (UNEP, 2021), addressing embodied and operational carbon in the development process now is crucial for achieving future Net Zero Carbon goals. However, in heavily developed regions such as Europe, new construction represents a small portion of the overall building stock. Much of the commercial real estate that will be operating in 2050 already exists and needs to be refurbished in order to achieve energy and carbon reduction targets (O’Roarty, 2022).

Recognizing the importance of addressing energy consumption and carbon emissions in commercial buildings, France has established policies for both new and existing properties in the tertiary, or commercial, sector. The *Décret Tertiaire*, announced in 2019, is a decree requiring

steep reductions in energy consumption by existing commercial buildings in France over the coming decades, in line with energy reduction targets established by the European Commission.

The energy reduction intentions of the decree are very clear. However, success in achieving the decree's intended outcomes, and avoidance of unintended negative outcomes, may depend on the responses of the real estate owners and managers, the strength (or lack thereof) of the decree's noncompliance penalty, access to the necessary data, skills and financing, and the effects of other market and regulatory pressures driving the sector to decarbonize. Potential impacts to property values and transaction prices may serve as a marker of how seriously the reduction targets are being taken and how costly they might be for underperforming assets.

This research aims to investigate whether and how commercial real estate owners and managers in France are adjusting their investment processes and decision-making to reflect the recently implemented *Décret Tertiaire*. Since there is understandably limited to no scholarly research or datasets available on this policy's impacts yet, the primary methods of research include reviewing industry publications and consulting with key industry experts and practitioners, namely investment professionals working for large asset management firms that invest in French commercial real estate.

A series of interviews with representatives of real estate asset management and consulting firms were conducted to explore how the *Décret Tertiaire* is impacting their firms' investment processes, in transactions as well as the management of their standing portfolio of assets. Interview questions explored how the acquisition due diligence process has been altered to take into consideration the preparedness of properties to comply with the decree, whether the costs and risks associated with the decree are being integrated into prices in transactions, and how these firms are preparing to address compliance within their existing portfolios.

Understanding how these firms are changing their policies and practices to comply with the regulation may provide a useful example for the global commercial real estate industry. Although transition policies in other geographies will differ in nature and timing, the real estate sector may benefit from seeing the strategic, operational, and financial impacts (intended or otherwise) of such a policy going into effect in France.

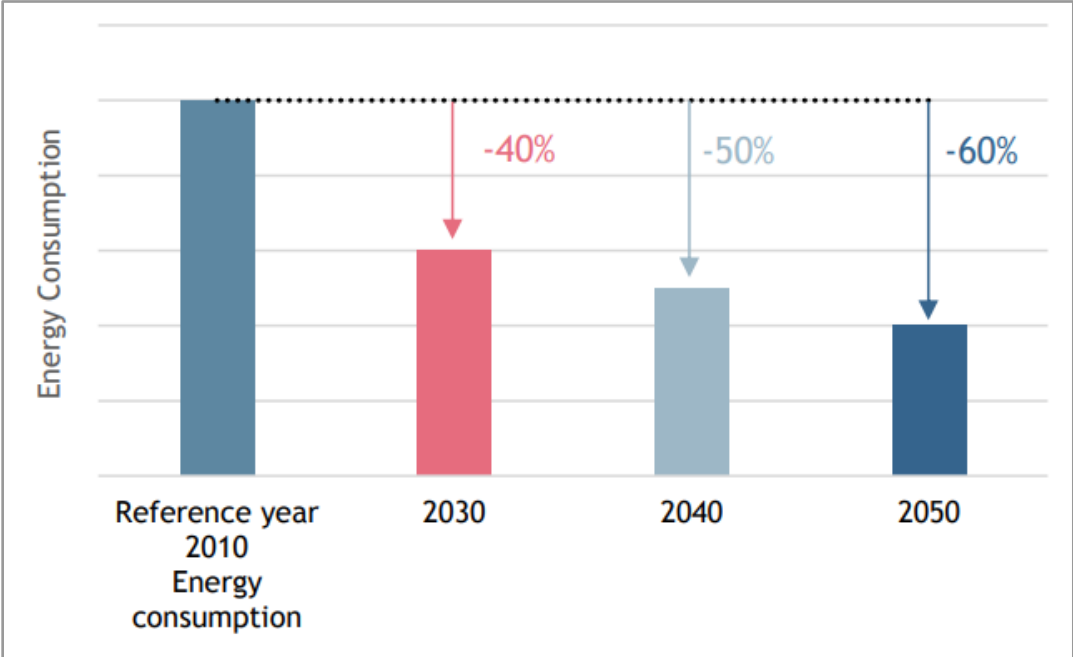
## **Background**

The *Décret Tertiaire* (or tertiary decree) was implemented in October 2019 and describes the terms of application of Article 175 of France's Energy Transition Law to enable the country to mitigate climate change. The *Décret Tertiaire* is an important part of France's ELAN Law (*la loi ÉLAN - Évolution du Logement, de l'Aménagement et du Numérique*), adopted in 2018. Article 175 of this law relates to energy renovations within housing, development and digital technology (Loi ELAN, 2018). This law plays an important role in helping France achieve its national decarbonization targets and manage total energy usage. As the transportation and building sectors shift toward electrification over time, reducing buildings' total energy consumption will help alleviate the growing strain on the electric grid.

The decree requires a decrease in energy consumption for all existing commercial buildings greater than 1,000 m<sup>2</sup>, which includes offices, retail shopping centers, and industrial properties and excludes all residential properties. From a baseline year between 2010 and 2019, the energy consumption reduction targets are as follows:

- 40% energy consumption reduction by 2030
- 50% energy consumption reduction by 2040
- 60% energy consumption reduction by 2050

Alternatively, an absolute value threshold for each decade can be targeted, depending on the nature of the building and its usage. Buildings constructed after 2020 should automatically fulfill these requirements for exemption due to recently implemented building standards. This approach is modeled after the guidance in the European Commission Energy Performance of Buildings Directive (EPBD) (Directive 2010/31/EU, 2010), which aims to achieve highly energy efficient and decarbonized building stock by 2050, with interim targets in 2030 and 2040.



**Figure 1:** Energy reduction targets laid out in EU EPBD (2010), the foundation for the Décret Tertiaire (AEW, 2020).

Annual energy consumption data for all eligible commercial properties must be reported to a platform called OPERAT every year as dictated by the decree. This requirement was set to begin September 2021 and has since been pushed back twice to December 2022 due to delays in preparedness. It should be noted that, due to COVID 19 impacts, energy consumption data from 2020 through 2021 may skew low and may not be representative of actual asset performance.



Publication of asset-specific action plans will be required from 2026 onwards. Publishing the steps required (and presumably the associated costs) to reach the 2030 target may serve as a market signal for an asset's energy performance and preparedness for the *Décret Tertiaire*, and potentially facilitate price adjustments in transactions.

The *Décret Tertiaire* reporting requirements and energy reduction targets apply to both landlords and tenants. This aspect of the decree may help overcome the split incentive, one of the perceived barriers to achieving energy and carbon reductions in the commercial real estate sector (White et al, 2020). The split incentive describes the disconnect between which party pays for and which party benefits from energy reduction measures in a building. There may also be challenges in accessing and upgrading space that is actively occupied by tenants, meaning landlords would have to wait until a break in the least to upgrade the space. By assigning responsibility to both parties to improve the energy performance of the space under their control, the *Décret Tertiaire* attempts to overcome these historical barriers.

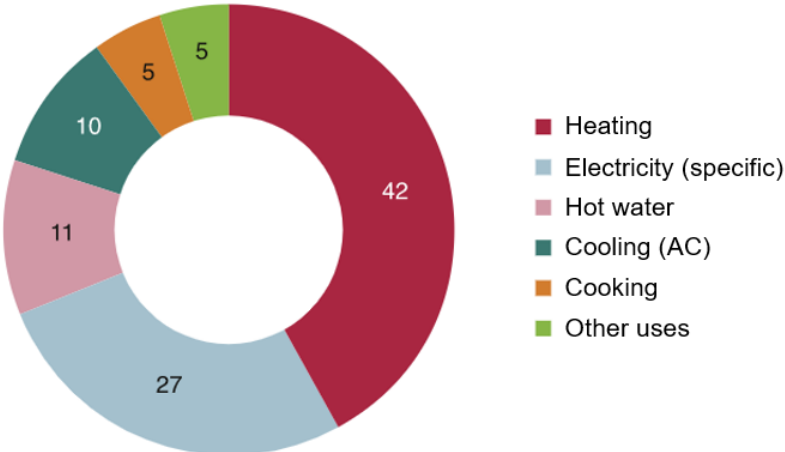
To achieve the *Décret Tertiaire* targets, owners and managers of buildings will first need to ensure comprehensive energy data coverage of the building. Accurate historical energy data will be crucial to selecting the appropriate baseline year for the assets. If there is anomalously high energy consumption in a particular year, for example due to an especially cold winter or technical problem in the building, it could present the opportunity to “game” the selection of the baseline year.

To develop an action plan, landlords will need to benchmark current energy performance and develop a set of retrofitting measures to achieve a total of 40% energy consumption reductions between the baseline year and 2030. This will likely require hiring specialists to

perform on-site energy audits to model the building’s energy performance and determine their options (and costs) to reduce energy consumption.

Building owners and managers have a range of options for retrofitting based on the building’s structure and materials, the age and efficiency of equipment, its end uses for energy, and how it is operated. Figure 2 shows a breakdown of final energy consumption in French commercial buildings in 2020, with 42% of energy being used for heating.

In % (data not normalized for weather variation)



**Figure 2:** Final energy consumption of the tertiary (commercial) sector in France according to end uses (*Ministère de la Transition Ecologique, 2022*).

Interventions could include energy demand control measures such as optimization software, replacing equipment with more energy efficient options like LED light bulbs, or minimizing waste by enhancing insulation. Measures may range from relatively low-cost and short-payback investments, such as upgrading to LED lighting, to more capital-intensive upgrades such as recladding the building to improve insulation. Properties that have already taken steps to improve energy efficiency, but haven’t yet achieved the absolute thresholds for exemption, may require more expensive structural improvements to achieve the deep energy reduction targets.

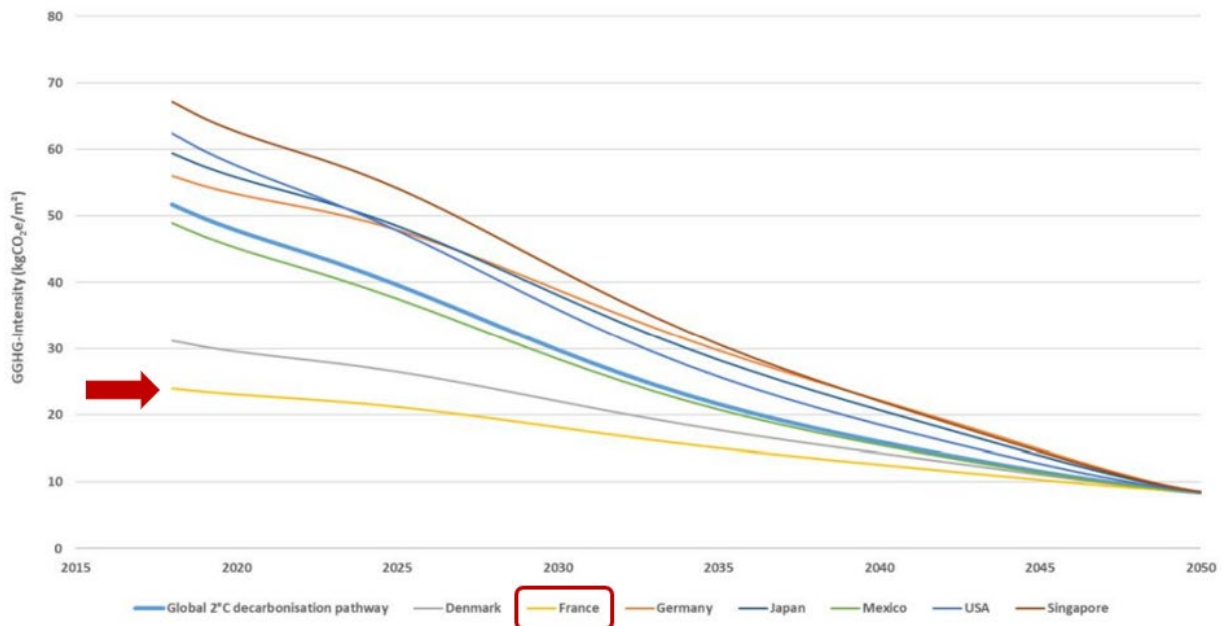
Failure to comply with the requirements of the *Décret Tertiaire* will be penalized with a fine of €7500 per year, which is a relatively small fee compared to the potential costs of efficiency measures and upgrades. Failure to achieve objectives by each target year will also be made public to “name and shame” noncompliant entities. The efficacy of such a meager penalty is one of the questions explored in this research: does the €7500 fine and public naming-and-shaming shift the cost-benefit analysis enough to ensure investment in energy reduction?

France’s *Décret Tertiaire* differs from many other policies aimed at decarbonizing building stock in its focus on energy consumption rather than carbon emissions and its usage of a flat rather than progressive penalty. For comparison, New York Local Law 97 established a carbon intensity cap system that puts a price on the operational carbon emissions of buildings over a certain limit. Within such a system, building owners could theoretically avoid energy improvement expenditures by electrifying building systems and relying on the electric grid to decarbonize over time. Remaining carbon emissions could be addressed by the purchase of renewable energy credits or carbon offsets. Under the *Décret Tertiaire*, however, the only option for compliance, other than paying the annual fine, is to reduce the energy consumption of the building by investing in equipment upgrades or making operational changes.

The United Kingdom has decided to target energy performance as well, albeit using a different approach than France. The success of the programs may be interesting to compare over time. Under its current Minimum Energy Efficiency Standards (MEES) legislation, the UK requires assessment and publication of Energy Performance Certificates (EPCs) by landlords. If a building’s EPC rating is below a certain level, the owner legally cannot lease the space, which could be financially disastrous for investor owners. Currently, the EPC grade must be an E or higher to legally lease the space (on scale from A to G). In 2030, the UK government intends to

tighten the regulation to only allow letting of buildings with A or B ratings. This would mean that ~85% of current rented building stock will need to improve its energy performance to be rentable (UK Department for BEI, 2021).

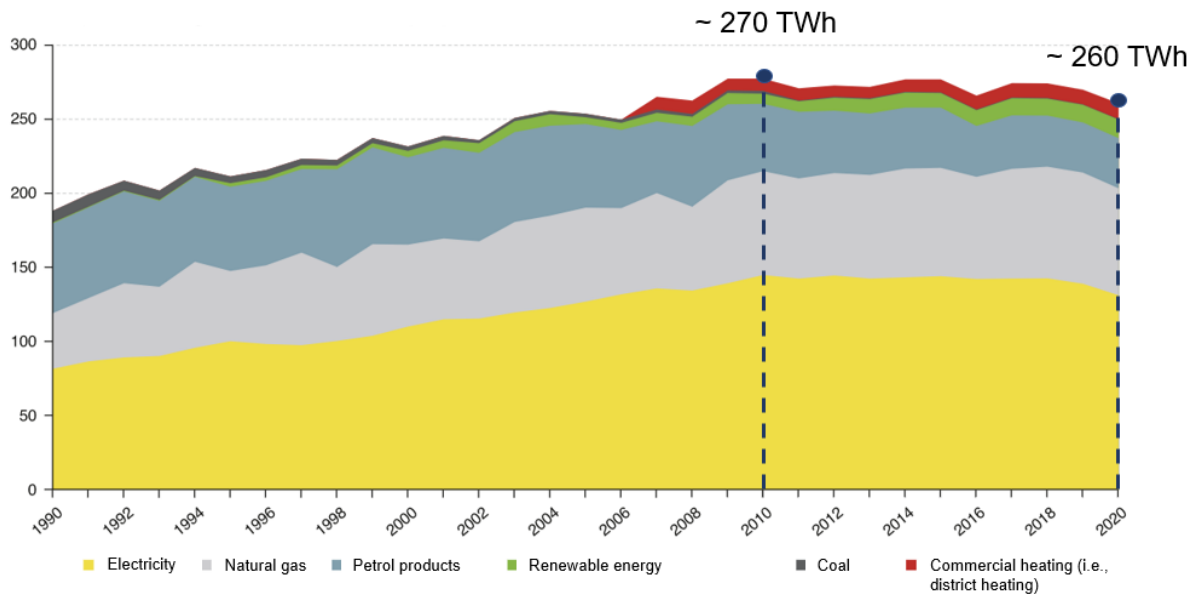
This focus on energy, derived from the European Commission’s EPBD (2010), is particularly interesting for France. The country has one of the shallowest decarbonization pathways in the world, thanks largely to its reliance on nuclear power and resulting low-carbon power sector. If the focus of the regulation were on GHG emissions rather than energy, French building owners could achieve most carbon reduction goals quickly by simply electrifying the building, for example by using electric heat pumps for heating rather than natural gas. By focusing efforts on energy consumption reductions, this policy will help reduce total energy demand and the eventual strain on the electric grid once these buildings (and a large portion of the transportation sector) electrify. Other drivers, including the anticipation of future policies, may still drive efforts to shift to lower-carbon energy sources such as on-site renewables in buildings.



**Figure 3:** CRREM 2°C GHG-Intensity pathways for selected countries (CRREM, 2020). Note that a 1.5°C pathway, which is used for many science-based targets, would require steeper reductions for all countries, though France’s would remain one of the shallowest.

From an overall baseline of 2010, the time allotment to achieve the first *Décret Tertiaire* target of 40% by 2030 is over halfway depleted. More information about progress to-date will be available in coming years with the data-sharing deadlines of the decree approaching, but the following chart (Figure 4) gives an indication of the relative steadiness of total energy consumption in France’s tertiary sector from 2010 to 2020. Current data tells us that a small decrease in energy consumption occurred in the tertiary sector between 2010 (approximately 270 TWh) and 2020 (approximately 260 TWh) (*Ministère de la Transition Ecologique, 2022*). It is unclear how much of this consumption is from existing buildings versus new tertiary properties that were developed and brought into operation in this period. But it is likely that a substantial portion of the 40% reduction target by 2030 is yet to be achieved.

In TWh (data normalized for weather variations)



**Figure 4:** Final energy consumption of the tertiary (commercial) sector in France (*Ministère de la Transition Ecologique, 2022*).

# Chapter 2

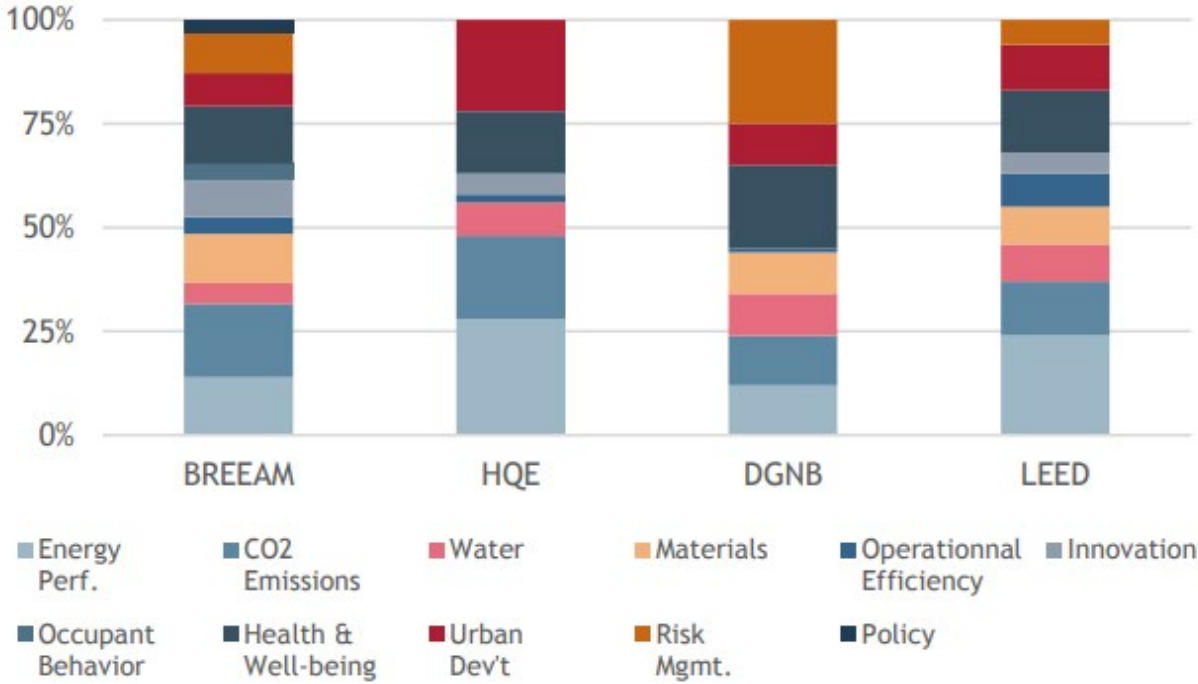
## Literature Review

At the time of this writing, there does not appear to be any scholarly literature or datasets examining the impacts of the *Décret Tertiaire* on French property valuation or management, likely because the decree is so recent. With the first round of mandatory energy data submission due in late 2022, further analysis will be possible once this information is published. Ideas for future research can be found in the Discussion section of this paper.

Beyond this decree, a significant amount of literature exists on the correlation between sustainability and asset value or rent rate of commercial buildings. These studies typically investigate a “green premium” or “brown discount” associated with voluntary green certifications like LEED or BREEAM (Miller et al, 2008; Kok et al, 2008; Warren-Myers, 2012; Chegut et al, 2014; Dermisi, 2020). A benefit of using a green certification as a proxy for greenness or sustainability is that the label is clearly displayed for tenants and buyers to see, therefore providing a signal to the market, whereas energy or carbon data may not be published or easily understood. New research shows that Paris is an especially sensitive market for green certifications, with an observed 35% premium for certified assets (MSCI, 2022).

However, there are acknowledged limitations to using certifications as a proxy for measuring the green premium or estimating regulatory risk. Firstly, it’s difficult to distinguish whether the positive impacts to value and rental income are caused by the green attributes of the building or by it being “best in class”, as many LEED or BREEAM certified buildings are. Secondly, the mainstream green certifications include a range of different sustainability attributes including health and well-being and may lack the precise focus investors need to measure against specific energy or carbon targets (AEW, 2020). In a 2021 study, Clay et al found no effect of

LEED certification on energy consumption, stating, “If energy efficiency is the primary policy goal, LEED certification may not be the most effective means to reach that goal” (Clay et al, 2021). In other words, a green certified building could theoretically still have a long way to go to achieve the *Décret Tertiaire* targets. To isolate the effect of energy or carbon performance on rental income or value, energy and carbon consumption data would need to be tracked over a significant time horizon, and other influences on price and value would need to be accounted for.



**Figure 5:** Composition of factors contributing to European green building certifications (AEW, 2020).

There is limited scholarly evidence on how climate risks or opportunities, either physical or transition, may be impacting values in commercial real estate markets. Physical climate risk tends to be studied in terms of negative impact on pricing, typically using data from residential housing markets rather than commercial (Clayton et al, 2021). Transition risk costs or “value at risk” are sometimes modeled by applying a carbon price to an asset or portfolio’s GHG emissions, or to projected excess emissions compared to a decarbonization pathway (Black et al,

2019). This approach may be suitable as a risk proxy for a global portfolio of assets, but would not capture “real world” policy considerations like carbon intensity caps (i.e. NY Local Law 97), energy efficiency ratings (i.e. European Energy Performance Certificate (EPC) legislation), and the cost of retrofitting to decarbonize.

In recent years, industry bodies have published guides for the real estate industry on managing transition risks (UNEP FI, 2021) and achieving decarbonization targets (BBP, 2022). The UK Green Building Council has published a guide on net zero carbon for real estate (UKGBC, 2019), and the ULI C Change initiative was launched to better understand and overcome the barriers to successfully decarbonizing the commercial real estate sector, targeting the investor perspective (ULI, 2022). Most of these frameworks and guidelines are aimed at pan-European or global asset managers (often originating from UK-based organizations), and therefore address transition risk and mitigation at a broad level rather than focusing on a single policy like the *Décret Tertiaire*.

While many real estate investors claim to integrate climate risk and sustainability into their investment process (EVORA Global, 2022), the details of that integration, and whether it materially impacts their investment decision making or pricing, can be unclear or inconsistent among firms and the markets in which they operate (O’Roarty, 2022). Some firms have begun describing their portfolio transition plans in their annual reports, driven particularly by the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), though most of the reporting thus far remains high-level and focuses on portfolio-level Net Zero Carbon strategies. European asset managers have broadly adopted the CRREM tool to determine asset- and portfolio-level decarbonization trajectories and to estimate dates of stranding.



The definition of asset stranding in the commercial real estate sector differs slightly from the standard definition of stranding originating from carbon-intensive sectors such as oil and gas. Lloyd's defines stranded assets as those "that have suffered from unanticipated or premature write-downs, devaluation or conversion to liabilities" (Lloyd's, 2017). In the real estate sector, the Carbon Risk Real Estate Monitor (CRREM) has set the standard for stranding, defining stranded assets as "properties that will not meet future energy efficiency standards and market expectations and might be increasingly exposed to the risk of early economic obsolescence" (CRREM, n.d.). Real estate asset managers in Europe have begun assessing assets' timelines for stranding by projecting when a property's GHG intensity will exceed its country- and sector-specific carbon reduction trajectory in the CRREM tool. In more practical terms, energy performance mandates such as MEES in the UK could cause stranding by prohibiting a property from being leased or sold.

Understanding the details of how energy and carbon emission reduction strategies will be implemented, particularly for compliance with a specific regional policy such as the *Décret Tertiaire*, still requires discussion with a practitioner. Further research will be needed to understand the impacts of transition risk and specific regulations such as the *Décret Tertiaire* on pricing and valuation.

## Chapter 3

### Methods

The French commercial real estate market provides a case study for observing the impacts of a discrete transition policy in the form of the *Décret Tertiaire*, albeit one that is focused on reductions in energy consumption rather than carbon emissions. This paper

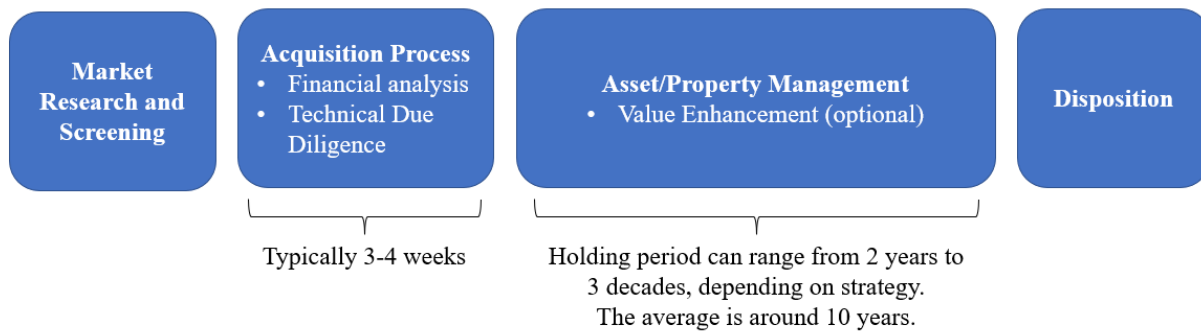
investigates whether the decree impacts how real estate assets managers transact and manage their standing assets. It also discusses apparent limitations, barriers, best practices, and suggested next steps for the industry as it grapples with achieving the impending energy reduction targets.

As there is limited published literature describing how firms are responding to the *Décret Tertiaire*, the primary research methodology was conducting interviews of subject matter experts. I contacted several asset management firms operating in France requesting to speak with investment professionals about whether and how their firms are preparing to comply with the new policy. The discussions focused on the series of questions below, with opportunities for the experts to then expand on their own experience and insights.

Experts from three asset management firms and an ESG consultancy firm agreed to share their insights for this research. Participating firms represented a range of investment strategies, from Core to Value-Add, asset holding periods of various lengths, and a range of commercial property types. Collectively, their total commercial real estate assets under management (AUM) in France represent approximately €30 billion.

- Primonial REIM, a European real asset management company based in France
- BlackRock Real Estate, the real estate private equity arm of the world's largest asset management firm
- PATRIZIA SE, a European real assets investment manager based in Germany
- EVORA Global, an ESG consultancy for real estate investment managers in Europe

To provide context for the commercial real estate investment life cycle, a highly simplified diagram of the standard process is presented below.



**Figure 6:** Simplified representation of a typical investment life cycle for a commercial real estate investment.

Real estate asset management firms typically offer various funds with potentially different investment strategies, holding periods, geographic focus and degrees of commitment to sustainability or impact investing. They attract investment capital from institutional investors, which can include pensions, insurance companies, sovereign wealth funds, or high net worth individuals. They typically earn management fees on the assets they manage, and potentially performance fees for investment returns beyond a particular hurdle rate.

Interview questions can be found below. Discussions were not strictly limited to these questions, rather they formed a basis for discussion as the practitioners shared a range of insights from their firms' perspectives.

#### Transaction-focused questions

1. When considering potential acquisitions, is your firm/fund assessing an asset's readiness to meet *Décret Tertiaire* requirements?
2. What, if any, additional data is your firm/fund requesting in due diligence for acquisitions because of *Décret Tertiaire*?
3. For potential acquisitions, is your firm/fund estimating Capital Expenditures that would be needed to achieve the energy reductions required under *Décret Tertiaire*?

4. Has your firm/fund adjusted pricing for any assets based on costs/risks associated with achieving the *Décret Tertiaire* requirements?
  - a. If so, can you share an example of a transaction as a short case study (can be anonymized) where the *Décret Tertiaire* requirements impacted decision or pricing, and how?

#### Questions focused on management of standing portfolio

1. Is your firm/fund assessing the relevant assets in your standing portfolio for readiness to meet *Décret Tertiaire* requirements?
2. Is your firm/fund estimating Capital Expenditures needed to achieve the energy reductions required under *Décret Tertiaire* for your standing portfolio?
3. Has your firm/fund changed business plans for any standing assets or funds based on *Décret Tertiaire*, i.e. CapEx planning, acquisition/disposition strategy, lease agreements, etc.

Following the discussions, interview transcripts and notes were coded to identify key themes and findings. Insights have been summarized to identify initial findings such as best practices, challenges, benefits, and potential gaps or barriers to achieving compliance with the decree, from the perspective of the practitioners.

## **Chapter 4**

### **Analysis and Findings**

#### Overview

All of the participants stated that their firms are actively preparing to comply with the *Décret Tertiaire* and confirmed that this includes adjusting their acquisition process as well as establishing a plan to bring many standing assets into compliance before 2030. There was broad consensus that professionals across the industry are working to understand the decree and establish plans for compliance, and that compliance is essentially mandatory in order to continue doing business with institutional investor clients. They acknowledged that this decree, among a range of ESG initiatives and expectations, was increasing the cost and difficulty of doing business for real estate asset managers. They all spoke to gaps in information or tools, including challenges in data collection, technology solutions, availability of energy auditors, and the need for clarification of the regulation. In the context of price and value impacts, all participants cited that the potential pricing impacts of the *Décret Tertiaire* were currently being overshadowed by broader economic trends, notably rising interest rates and yield decompression.

### Drivers for Compliance

The participants agreed that market-based drivers, such as investor demand, anticipated impacts to building value and liquidity, and tenant expectations, are the driving forces behind the sector's compliance with the *Décret Tertiaire*, rather than the penalty of €7500. Two participants questioned whether the decree could even be considered a “hard regulation” with such a low penalty for noncompliance, as opposed to “soft” general transition policy risk. Several expressed concerns about diminishing asset value and liquidity for non-compliant assets, noting that no institutional buyers will buy a non-compliant asset without a discount in the future. From the rental market perspective, anecdotal evidence was provided of a prospective office tenant

screening exclusively for leased space that is already in compliance with the decree, in order to avoid having to make the capital expenditures themselves during their occupancy period.

Investor pressure for compliance may not solely focus on *Décret Tertiaire*, but on the industry-wide drive toward achieving Net Zero Carbon and minimizing transition risk. All asset management representatives interviewed discussed cross-benefits with other ESG initiatives, including firm-level Net Zero Carbon targets.

Although the financial penalty is viewed as negligible today, there was consistent concern among all experts that the penalty could increase over time or that the mandate could expand to legally prohibiting leasing of space that is not in compliance (like MEES legislation in the United Kingdom). They also expressed that institutional buyers would not be willing to buy non-compliant assets in the future, thereby making compliance with the *Decret Tertiaire* requirements necessary to minimize liquidity risk and protect asset value into the future.

### Transactions

All respondents confirmed that they are adjusting their acquisition process in some way to assess and account for *Décret Tertiaire* compliance requirements of the assets they intend to acquire. Although most of the discussions centered on the due diligence stage of the acquisition process, it was apparent that the decree is also beginning to influence their research and screening stages as well.

One participant (Primonial) detailed the changes their firm is making to their acquisition process and the associated challenges. Their acquisition process typically occurs over three to four weeks. Ideally, they would like to have a specialist consultant perform an on-site energy audit during this time to assess the intervention options and costs, which could then be factored

into underwriting and the asset business plan. However, this has proven to be too short a period to schedule, perform, and receive feedback on a specialized audit. They also noted a bottleneck in energy auditors due to increased demand. Instead, they request information that could be used to estimate the improvement opportunities and CapEx. This includes 1) historical energy consumption data and 2) incorporating questions about energy performance and equipment into the standard technical due diligence process, which is not as detailed as a proper energy audit but is easier to integrate into the process. If enough information is available, the asset's performance is compared to industry benchmarks such as the absolute thresholds for exemption from the *Décret Tertiaire* and rules of thumb for strong energy performance (below approximately 120 kWh/m<sup>2</sup>/year). From this information, they estimate a CapEx budget for reducing energy based on “rules of thumb” for standard measures.

When discussing whether they observed impacts to asset valuation or pricing due to the *Décret Tertiaire*, several professionals noted a difference in theory versus practice. Theoretically, it was agreed that the buyer should deduct the estimated CapEx required to achieve the *Décret Tertiaire* targets within their expected holding period (for all examples discussed, this included only the 2030 target of 40% reduction from baseline) from the offering price for an acquisition. One participant confirmed that they do this for most acquisitions as part of the negotiation process, though the reduced price might not be accepted by the seller. Other participants noted that, although theoretically logical, they did not consistently bake energy reduction-related CapEx into the price negotiations. A frequently cited reason for this was that broader economic concerns are currently overshadowing price impacts from the *Décret Tertiaire* or other ESG factors, particularly that rising interest rates have been putting downward pressure on asset

values. Other reasons included the uncertainty of the estimated CapEx values and concern that reduced prices would lead to uncompetitive bids.

Primonial also described their usage of scenario analysis to account for best-case, base-case, and worst-case CapEx scenarios in acquisition underwriting. This allows them to allow for uncertainty in the costs to comply with the decree, particularly when there is uncertainty as to whether the tenant or landlord will ultimately be responsible for the expenditures.

Several participants noted challenges with data gathering in the acquisition process but noted that this would be easier in a few years after the deadlines for publishing asset level data and energy action plans.

### Management of Standing Assets

All respondents confirmed that they are preparing or currently implementing a strategy to 1) assess their standing commercial real estate portfolio for *Décret Tertiaire* readiness and 2) establish and execute action plans to ensure compliance by the first target year of 2030.

Assessing a portfolio's readiness first requires a substantial energy data gathering effort, which participants acknowledged to be a time-consuming challenge, particularly when it involves obtaining tenant data. Deepki was noted as a popular energy and carbon data management tool in the French real estate market, which has a module specifically for *Décret Tertiaire* management.

Once eligible assets are identified, a baseline year between 2010 and 2019 must be selected for each asset. Ideally, the asset managers would select the year within that period with the highest energy consumption as the baseline for the reduction targets. In actuality, the existence and quality of historical data varies and may depend on how proactive the ownership



was during that period. One participant noted the need for more Prop Tech (property technology) to obtain real time energy consumption data.

The asset managers recognized the need to identify and estimate costs for interventions to reduce energy consumption across their standing portfolios, which would require having energy audits performed on each asset. For larger portfolios, given the bottleneck in energy auditing services in France, this process could take years and will need to be scheduled over time. One participant noted that their firm is in the process of determining how to prioritize which assets will receive audits first. Factors influencing prioritization could include age of the asset (or year of last major refurbishment), holding period and anticipated year of sale, and tenant-related issues such as anticipated vacancies. Even assets that will be sold before the first target year of 2030 need to be addressed, since underperformance could impact liquidity and sales price.

The findings and recommendations of the audits would be reviewed and converted into economically feasible action plans for the assets. Multiple participants noted that these action plans would need to align with broader ESG initiatives and Net Zero Carbon targets, which was largely viewed as beneficial. Types of common interventions mentioned included: LED lighting upgrades, installing motion sensors for lighting, improvements to HVAC equipment, and insulation. Interestingly, certain interventions were suggested that are associated with carbon reductions (such as shifting from natural gas to electric heat pumps or installing on-site renewables) rather than energy reduction.

Budgeting for the significant CapEx needed to transition standing assets was noted as an important part of the process, but details were not available at this time. Fund investment strategies are likely to play a role in ability and willingness to make capital investments in the assets. Value-Add strategies involve greater amounts of capital investments to enhance asset

value and are thus better positioned to execute the refurbishments. Core funds aim to earn income from high quality assets that don't require significant additional capital expenditure and could therefore be at a disadvantage as the necessary CapEx was not planned for those investments.

“Low hanging fruit” with short payback periods such as lighting upgrades may have already been captured for many assets in their portfolios. The remaining options could be more expensive. One participant expressed optimism that the 2030 target of 40% reduction in energy consumption was achievable for their portfolio, but that the 50% and 60% targets would be difficult and costly.

Tenant engagement was also mentioned as an important part of the strategy to achieve the *Décret Tertiaire* targets. One participant noted having to make over a dozen requests for data to a single tenant before receiving a response, indicating how time-intensive tenant engagement can be. This was also noted as one of the benefits of the decree, as it requires action and collaboration from both parties where there may have been deadlock in the past.

Several participants acknowledged the increase in the cost of doing business that the *Décret Tertiaire* is creating for asset managers. This includes expenses and time associated with data gathering and reporting efforts, third party assurance of data, energy audits, tenant engagement, and increased (and potentially unplanned) CapEx.

### Challenges

Participants noted the following challenges of complying with the *Décret Tertiaire*:

- Data collection, particularly of tenant data and for prospective acquisitions
- Determining tenant vs. landlord responsibility to achieve energy reductions

- Selecting the appropriate baseline year for an asset
- Access to energy audits in order to have an accurate view of the asset’s current performance and recommended intervention options
  - There is a bottleneck for energy audits in France caused by high demand, which means many asset managers must prioritize and schedule audits for their assets over several years
  - Rule-of-thumb CapEx estimates may be used in the meantime, but their accuracy is poor
- Significant unplanned CapEx for certain assets
- The policy is more difficult for some assets to achieve than others, based on several factors
  - Vintage or year of last major refurbishment
  - Property type and nature of usage
  - Tenant lease arrangements and number of tenants

### Benefits

Participants named the following as potential benefits of implementing the *Décret*

#### *Tertiaire:*

- The focus on energy reduction is beneficial for “properly” achieving Net Zero Carbon (versus electrifying and waiting for the grid to decarbonize, buying renewable energy credits and carbon offsets, etc.) based on the widely accepted Energy Hierarchy (see Appendix 2) and pathway to Net Zero Carbon laid out by organizations such as the UKGBC (see Appendix 2)

- Compared to other geographic markets in which the asset managers operate, having a “hard regulation” in France helps justify adjusting asset pricing and increasing investments in energy saving interventions
- Cross-benefits with other initiatives have been identified, namely achievement of Article 8 or 9 labels under the Sustainable Finance Disclosure Regulation (SFDR), and progression toward Net Zero Carbon targets

## Chapter 5

### Discussion

It’s clear that many large real estate asset managers operating in France are preparing to comply with the *Décret Tertiaire* and significantly reduce the energy consumption of the assets they manage. Questions remain as to how orderly the transition will be, how costly it will be, what portion of tertiary buildings will achieve compliance versus becoming stranded assets, and whether the penalty will become stricter over time.

A self-reinforcing “tapestry” of hard and soft policies and pressures may be the key to coordinating action to reduce carbon emissions. With such a low penalty (€7500), a cost-benefit analysis might show in many cases that paying the annual fee until disposition is more economical than performing a comprehensive retrofit, which could cost millions. In markets without hard regulation, it’s proven difficult to formally price in the costs of energy and carbon reduction measures based solely on the pressures of increasing voluntary Net Zero Carbon targets, resulting in a “carbon bubble.” But the combination of general transition risk, a distinct “hard” regulation like the *Décret Tertiaire*, “soft” policies such as SFDR creating demand for

sustainable funds, investor and peer pressure to achieve Net Zero Carbon by 2050, and increasing tenant demand seem to be hardening into a requirement to comply in order to business in French commercial real estate – at least for those asset managers aiming to attract institutional capital.

The challenge of pricing and valuation, and the persistence of a carbon bubble, is attracting more attention. Energy intensive assets requiring upgrades will need a discount to be attractive to investors to justify the capital investments to retrofit them. Globally, this has been reinforced by stagnation in the valuation and appraisal community (ULI C Change, 2022). In France, with a “hard policy”, will this turn the tide? Will appraisers default to pricing in the €7500 annual penalty into operating expenses for non-compliant assets, or will they consider the costs to reduce energy and threat to liquidity and future demand?

One of the immediate challenges of an energy reduction requirement like the *Décret Tertiaire* is the difficulty in estimating the cost of compliance. Gauging the cost of energy reduction measures accurately requires an on-site energy audit or estimating through a desktop assessment or rule-of-thumb estimations. Costs to reduce energy consumption could span a wide range for affected properties in France, especially for the deeper reduction targets in 2050 and 2060. Failure to understand the costs early enough in the investment lifecycle could result in insufficient capital budgeting, the risk of improperly structured leases, failure to reach targets, and ultimately the risk of stranded assets.

Certain participants rightly expressed cautious optimism in the ability to achieve the 2030 target of 40%, depending on the building’s history. Energy consumption reductions of 20% to 40% are considered achievable and relatively affordable using comprehensive retrofit options for commercial buildings today (Roberts, 2017). Achieving more significant reductions of 50% and

beyond will likely require more state-of-the-art “deep” retrofits. This would involve more elaborate and costly changes such as replacing a building’s external facade, which brings into question the economic feasibility of achieving the deeper reduction targets of 2040 and 2050.

Given that the average hold period for commercial real estate investments hovers around 10 years, asset managers are logically focusing their planning on the 2030 target of 40%. What will happen in the following two decades, when basic retrofits have been completed and equipment has been installed with an average life of 20 to 30 years? Will building owners be willing to undergo “deep retrofits” on top of basic retrofits that were completed under previous ownership? Will new technology be available then to wring out the remaining 20% energy savings without replacing building fabric? How will the nature of commercial building usage, which has been evolving rapidly in recent years, and the associated energy demands differ in 2045 compared to today? Given that France has one of the world’s least carbon intensive electric grids, could it be more economical and less wasteful to shift the focus from energy to carbon and use available capital investments to fully electrify older assets once they have reached the limits of reasonably affordable retrofitting?

This also raises questions about the efficacy of focusing on energy consumption rather than GHG emissions. Considering France’s already low-carbon power sector, there may be more room for improvement in energy consumption savings. Beginning with a focus on energy demand and efficiency does follow the recommended pathway to Net Zero Carbon buildings from standard-setting organizations (UKGBC, 2019), and local authorities such as the City of Boston are increasingly embracing a dual-target approach for both energy consumption and GHG emissions reductions (Silverman, 2021). Will France’s focus on energy result in as much (or more) carbon emission mitigation when compared to regions that instead introduce a market-

based mechanism for pricing carbon emissions, such as New York? Granted, the focus on energy reductions comes from an EU directive and is not solely France's decision, and future French policies for existing commercial buildings may extend to requiring or incentivizing electrification and on-site renewables. But it may still serve as an opportune case study for comparing an energy reduction policy's total costs and effectiveness versus that of market-based carbon reduction policies.

Further research could explore how compliance costs affect asset valuation and market price, particularly how the appraisal community incorporates the policy into formal valuation methodologies. As more data is gathered and published over the coming years - specifically historical energy consumption data (2022), selected baseline years (2023), and action plans (2026) - trends and progress will become more visible. It may also be beneficial to research examples of noncompliance in the future to understand the barriers and consequences for potentially stranded assets. ULI's C Change project could be a useful forum for these discussions, as they are exploring ways to overcome the deadlock in pricing in carbon transition risk in the real estate sector. Their recent work discusses how the inconsistent (and sometimes absent) approaches to integrating transition risk into valuations could result in two-tier markets: large institutional owners will likely upgrade their high-value assets, but lower-value assets in secondary markets owned by smaller investors may fall behind and become stranded (O'Roarty, 2022).

## Conclusion

France's *Décret Tertiaire* is driving significant change in the country's real estate industry by requiring dramatic reductions in existing commercial properties in the coming decades. Despite the relatively small fixed annual penalty for noncompliance, the institutional investment management sector is broadly preparing to comply with the energy reduction requirements, sometimes at great expense. This is largely thanks to increasing systemic awareness and pressure to improve ESG reporting and achieve Net Zero Carbon before 2050, as institutional investors and a growing number of tenants are demanding. Leading asset management firms are adjusting their acquisition processes and business plans for assets in their portfolios to meet the *Décret Tertiaire* targets, initially focusing on 2030, often among an array of other ESG goals. However, it remains to be seen whether, and at what scale, certain actors will attempt to bypass compliance by paying the annual penalty, potentially resulting in a subset of assets that are devalued and ultimately stranded due to their excessive energy performance over time.



# Appendix 1

## Glossary of Terms

**Acquisition:** The process of gaining ownership (i.e. purchasing) or control of a real estate property.

**Asset Manager:** A financial firm that manages money, securities, and other forms of assets on behalf of an asset owner, with the goal of growing the value of the assets under their management.

**Asset Owner:** The institutions or people, such as pension funds, insurance companies, banks, foundations, sovereign wealth funds, family offices and individual investors, who ultimately own the assets; sometimes referred to as LP's (limited partners) in a private equity setting.

**BREEAM:** Building Research Establishment Environmental Assessment Method, a sustainability assessment method launched by the Building Research Establishment (BRE) that sets standards for the environmental performance of buildings through the design, specification, construction and operation phases.

**Capital Expenditures (CapEx):** Spendings used by real estate companies to invest, purchase, renovate, and maintain physical assets such as properties, technology, or equipment.

**Capitalization Rate:** A real estate value of measurement used to compare different real estate investments; generally calculated as the ratio between the annual net operating income produced by a real estate asset to its market value; often serves as a proxy for risk.

**Commercial Real Estate (CRE):** Property used for business purposes rather than as a living space (which would be referred to as the Residential sector); includes offices, industrial or logistics units, and retail properties.

**Core:** A real estate investment strategy that targets Class A real estate located in high-quality locations with high-quality tenants that is purchased with little to no debt, with a relatively low risk profile.

**Core +:** A real estate investment strategy similar to Core, but which targets assets or locations of slightly lower quality, and may purchase with more debt.

**CRREM:** Carbon Risk Real Estate Monitor, a tool for a global real estate investor to understand where the portfolio sits against the pathway that aligns with the Paris Agreement in a globally consistent manner.

**Disposition:** The process of selling a commercial real estate property.

**Due Diligence:** In the context of real estate investment, Due Diligence refers to a phase of the Acquisition process during which prospective buyers review documents, perform financial calculations and projections, and evaluate risks of a property and its surrounding area.

**ESG:** Environmental, Social, and Governance factors.

**EPC:** Energy Performance Certificates are a rating scheme to summarize the energy efficiency of buildings. In the European Union, EPCs are regulated by the European Directive on the energy performance of buildings.

**Green lease:** a standard lease that has “rehabilitated” certain clauses in order to better align financial incentives and sustainability goals between a landlord and a tenant.

**GRESB:** Formerly the Global Real Estate Sustainability Benchmark; an independent organization offering an assessment framework that rates and benchmarks real estate and infrastructure funds based on ESG factors.

**LEED:** Leadership in Energy and Environmental Design, a green building rating system used worldwide but most popular in the United States, developed by the U.S. Green Building Council (USGBC).

**MEES:** Minimum Energy Efficiency Standards in the UK that require a minimum energy efficiency standard, measured by EPC rating, to lawfully let property in certain circumstances.

**Opportunistic:** The riskiest category of real estate investment strategies, usually focused on ground-up developments.

**SFDR:** The Sustainable Finance Disclosure Regulation is a European regulation introduced to improve transparency in the market for sustainable investment products, prevent greenwashing, and increase transparency around sustainability claims made by financial market participants.

**Stranded asset (real estate):** According to CRREM, stranded assets are properties that will not meet future energy efficiency standards and market expectations and might be increasingly exposed to the risk of early economic obsolescence.

**Tertiary sector in France:** Includes a wide range of sectors including social and administrative services, such as local government, health, and education; wholesaling, distribution, and transport and communication services; consumer services, such as retailing and the hotel and catering trades; and producer or business services, including banking, financial, legal, advertising, computing, and data-handling services.

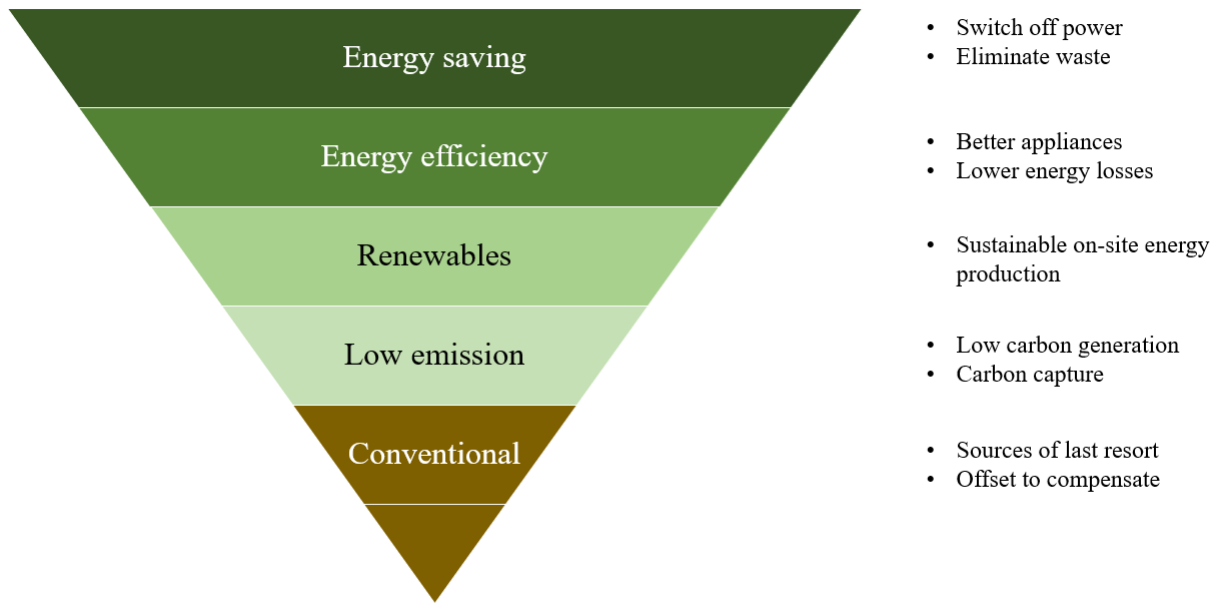
**TCFD:** Task Force on Climate-related Financial Disclosures.

**Value-Add:** A real estate investment strategy with high to moderate risk levels and considerable upside potential, often targeting properties with low occupancy or considerable capital expense needs for refurbishment or repositioning; uses high leverage or debt.

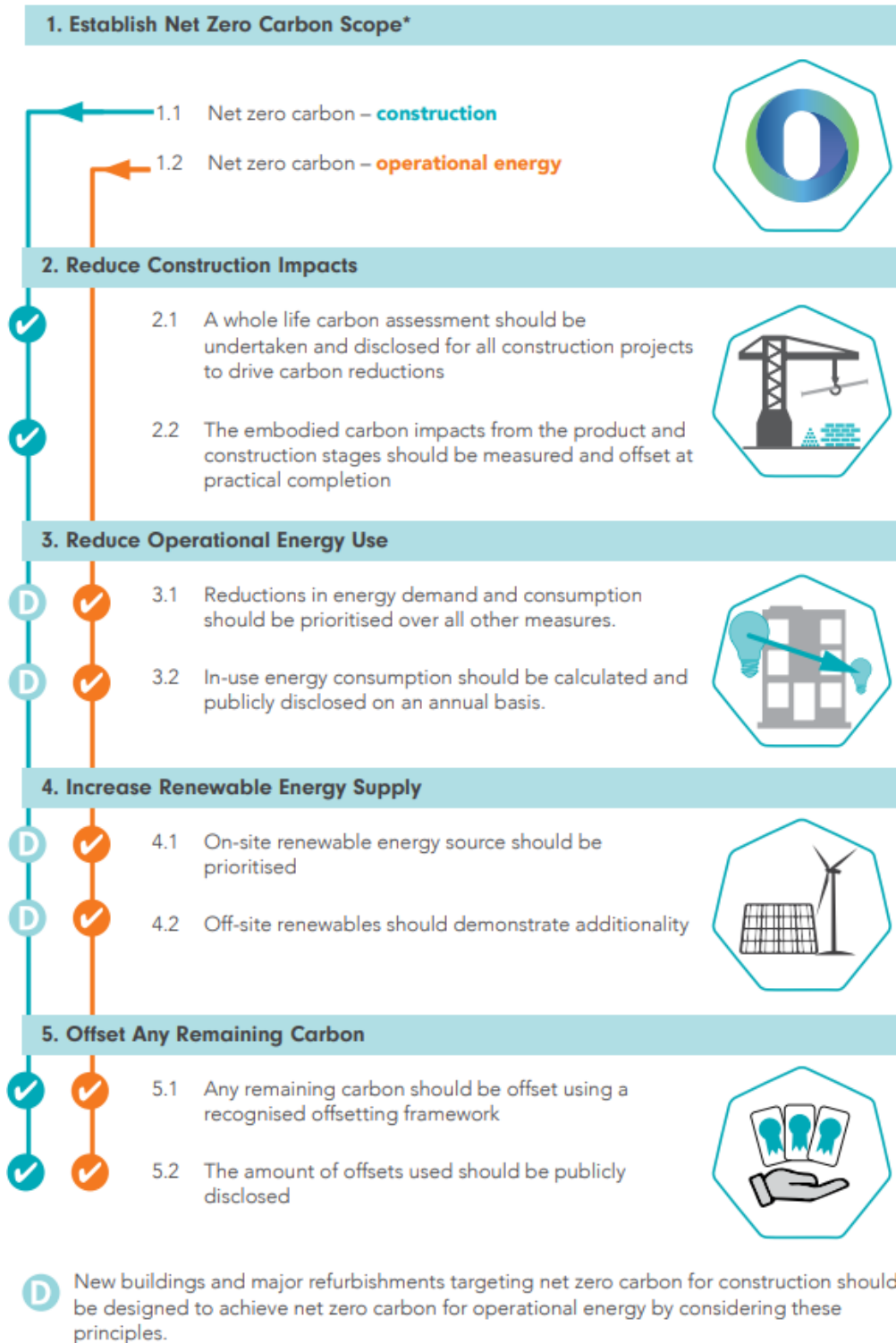
**Yield:** In the context of commercial real estate, yield refers to the annual income from the investment, expressed as a percentage of the investment's total cost (or in some cases its estimated current value); another term for the rate of return.

# Appendix 2

## Diagrams



**Figure 7:** The Energy Hierarchy, adapted from the Institute of Mechanical Engineers (2009).



**Figure 8:** Steps to Achieving a Net Zero Carbon Building (UKGBC, 2019).

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