

Paul Sheridan explains why strategists within the hotel sector cannot afford to ignore the move towards a more environmentally friendly world – and points out the opportunities

Taking on green values

Mainstream item

While this was always going to happen, environmental concerns (and sustainability generally) have broken through to become a main business and political agenda item. Environment is no longer an issue simply of aspiration and conscience. It attracts powerful political and financial backing in most of the world's major economies. Indeed, globally the environment sector (now more often called the 'clean technology' sector) is financially as large as the aerospace or pharmaceutical sectors. Importantly this sector commands the close attention of governments for many reasons. One important issue is that it is creating more high value jobs than any other area. It is a so-called win-win sector. It is no coincidence that in the recent bailouts of the auto sector, governments have stressed that auto manufacturers must invest in greener vehicles.

Why so important?

Environment has not become so important simply in its own right. It is important because it has combined with many issues which, together, have convinced most governments of the leading econo-

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mies of the need to reshape those economies in order to survive. These include: damage to the planet, including climate change; energy security; security of commodities and resources, including water, food and oil; advancements in cleantech; and massive population growth (estimated at approximately 50% by 2050).

Hotels – direct and indirect impacts

As a response to climate change and energy security issues many governments (including the EU and

US) are bringing in significant law and policies relating to energy efficiency. This has a direct impact on hotels because buildings have been singled out for particular attention. Buildings in the EU are said to account for 40% of final energy consumption and 40% of CO₂ emissions. Hence also buildings could be 40% of the solution. The EU is currently recasting its Energy Performance of Buildings Directive to make buildings much more efficient and to promote greater onsite energy generation. This Directive will undoubtedly be made even more stringent in the not too distant future as cleantech develops in relation to buildings.

Transport is another area singled out by the legislators for particular attention. With emissions from transport increasing and security of oil supply being questionable, there are many transport-related schemes and proposals under consideration by governments of major economies. These include laws and policies relating to fuel types, vehicle efficiency and road congestion, emissions and pricing. These could impact on mode, availability and cost of transport, all of which could have significant impact on the hotel sector.

The shape of things to come–

Now	2050
High carbon, water, waste and resources	Low carbon, water, waste and resources
Low building operational efficiency and cost control	High building operational efficiency and cost control
Few smart metering and intelligent building management systems	Commonplace.
Questionable regard for value (of eg on-site microgeneration) (cf. cost and incidental benefits)	High regard for value
Little lifecycle costing	Substantial lifecycle costing
Disparate, inconsistent, ineffective certifications, labels, symbols, codes of practice, benchmarks etc	Comprehensive, effective and commonplace
Poor quality information	High volume, high quality and easily researchable information
Impact of green on investment decisions, asset values, income, saleability, and letability – largely anecdotal and questionable robustness	Robust and sophisticated Evidence-based investment analysis
Green influence on procurement decisions largely aspirational, with little commonly respected guidance	Mandatory or commonplace with sophisticated guidance
Low visibility and lobbying of policy makers, especially on indirect issues	High visibility and contact
Low engagement with the cleantech sector	High engagement

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A great many other laws, policies and sector-specific voluntary initiatives are being implemented or are under development which also need to be considered. These will relate to water demand, use and charging, lifecycle costing, resource consumption, waste management, operational building costs control and efficiency, benchmarking, certifications, labelling and professional advice.

Transformational change has begun

Virtually all governments of major economies are imposing an array of direct and indirect legal and policy measures which impose or incentivise energy, water and waste efficiency and/or are setting targets for carbon, waste and water reduction, with end dates, such as 2012, 2015, 2020, 2030, 2050 etc.

Some businesses may believe there is no immediate need to assess how the trend towards a low-carbon, waste, water and resources economy will impact them.

However, this approach is dangerously short-sighted. So, for instance, buyers or investors who intend to resell or realise an investment within a few years, should be making an assessment on acquisition or investment of how the next buyer, on divestiture, is likely to value the low-carbon, water and waste risks and opportunities of the business.

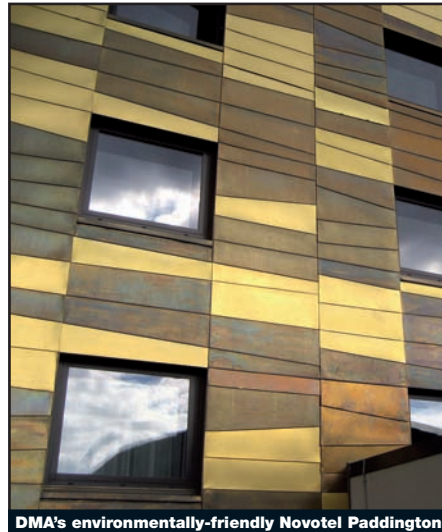
The ability to demonstrate vision and adaptation to the new economy could become a feature of the transactional due diligence process. At first it may be a fairly irregular feature, but over quite a short period of time it is not difficult to see it becoming a standard feature.

Long term assets – important new principles

From a legal and procedural point of view, some of the new legislation contains important principles which are generally not well understood by business. For those involved in investment in assets of longevity, such as hotels, these may prove to be pivotal. So, for instance, in the EU's Energy Performance of Buildings Directive and Water Framework Directive and in the UK's Climate Change Act, the EU Commission and UK government are legislatively obliged to carry out periodic reviews (eg every five years) of the workings of the legislation. Similar legislation is to be found in other countries.

Governments and the EU Commission must actively review whether the legislation is performing against targets or prescribed objectives. Unlike with traditional legislation, the governments cannot merely sit back and see whether interested parties become concerned enough to lobby for change.

The second aspect is that in carrying out such periodic reviews, governments and the EU Commission must have regard to developments in



relevant cleantech. The simple principle is that as cleantech develops (and, in some instances, it is developing at a fairly rapid pace), and particularly as new cleantech becomes commercialised, the law is intended to likewise develop, ie legal standards are to keep abreast of developing cleantech.

Investment – complicated by a period of uncertainty

The move to a low-carbon, water, waste and resource economy is so daunting that it is understandable many will choose to believe it won't happen or shouldn't happen, or choose to address it when it happens, or throw up their hands saying it's too large or uncertain to do anything meaningful.

They may tend to leave it to others to sort out – especially governments and regulators. But governments and regulators are already putting instruments in place, and there are hundreds of them – a myriad direct and indirect policies, laws and economic and fiscal instruments which, looked at on a one-by-one basis do not look too daunting but looked at as a whole are an entirely different picture.

The tasks ahead for directors and senior managers are not easy and the current economic crisis pro-

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vides little time for many to think of the bigger picture. However, many opportunities will also arise from the economic transformational changes.

Indeed, the cleantech sector itself is likely to go from strength to strength. There are also likely to be many inter-sector ventures which hitherto were barely considered.

There is already a strong and growing nexus between the waste and energy sectors in relation to various forms of energy that can be derived from waste materials.

The real estate sector and the cleantech sector will surely begin to understand the benefits of collaboration in relation to many aspects of, for example, energy, waste and water management.

In the near future, strategists within real estate will begin to understand, for instance, that the financial modelling of on-site microgeneration and technology for energy management and efficiency is not simply a question of capital costs and payback periods, and how this fits into the developer/landlord/tenant relationships.

These might also be considered, for instance, as a form of hedging and independence from volatile energy markets.

There are many other considerations to take into account. Indeed, there are likely to be many mutual interests between the real estate/hotels/leisure and cleantech sectors.

These sectors are huge employers. Governments may not be able to achieve their aims and targets without the support of these sectors. Conceivably it might be in the interests of these sectors to combine some of their lobbying power.

Knowing the end game

Valuation of assets of longevity, such as hotels, in a period of such transformational change will be difficult. However, ignoring the issues and sticking with traditional models of valuation carries risk.

The hotels sector would be sensible to at least examine whether current valuation models are fit for purpose (certainly the successful players will do this).

Perhaps a starting point in addressing the uncertainties which arise from the transformational change – and hence to inform an enquiry into future forms of valuation – is to ask: where are we now and where will we be in, say, 2050 (but keep in mind the many legal and policy milestones on the way to 2050)?

Summary

At the dawn of such transformational change, traditional valuation models (ie based upon following the market) arguably look a little shaky. At least conceivably a question arises as to whether the traditional models will continue to be fit for purpose.

This is perhaps something the hotels sector (and other sectors which invest in long-term assets) should consider carefully.

Tom Page reports on the likely impact of green issues on commercial due diligence in future transactions, as the pace of legislative change is set to speed forwards rapidly in the sector

Protecting your greens

There has been much talk about “going green” and sustainability in the hotel sector, but as not as much real action. A few operational initiatives to turn off lights and recycle more waste are just skirting around the bigger issue. Real savings and reductions in carbon footprints and waste and water usage will only be achieved when buildings are designed to be green from the start.

IHG have their “Innovation Hotel” which won *Hotel Report’s* award for Innovation in CSR earlier this year, but this is still just a drawing board concept. And of those few developments that go well beyond current legal requirements that have got off the ground, some are just pilot developments to test the technology, such as Premier Inn’s recently opened green hotel at Tamworth.

What are so few hotel developments future-proof?

The reason why we have not yet seen more development of truly green hotels is the lack of incentives for developers to build them. At the moment, while clean technology is falling in price, it still seems to be more expensive to build a green hotel. Whitbread estimated that their Tamworth hotel, which utilised as many green building techniques as possible, cost around 20% to 25% more to build. But in doing so, it reduced energy usage by 80%, which should make the hotel more profitable to operate, but perhaps not enough to make up for a 25% increased up-front capital cost.

Developers who are selling a hotel soon after opening will be reluctant to make it super-compliant (i.e. going well beyond the minimum requirements of today’s environmental and planning laws) until valuations recognise a premium for green super-compliance. Also a super-compliant green hotel may not get financing for the increased build costs unless the bank can be convinced of the enhanced value of that super-compliance upon completion.

Modelling the value of super-compliance

But this is a shortsighted view. We already know that new laws and new carbon reduction and waste reduction targets for new buildings will be arriving in coming years with tough targets for 2012, 2020 and 2050. A hotel that is built to today’s minimum standards may find that it is obsolete in eight to 12 years’ time, not in 40 to 50 years’ time as previously assumed. Proper due diligence on a hotel acquisition or development financing can be undertaken to ensure that the value of that asset will not depreciate quickly due to obsolescence caused by non-compliance with forthcoming legislation and carbon reduction targets.

The value of super-compliance can be modelled financially, but may be technically more difficult than traditional valuation and investment return

With existing requirements demanding a proportion of on-site energy generation, future due diligence must consider whether generation from wind and solar power is adequate

methodologies. The difficulties arise because although we know roughly what legislation is approaching, we do not always know the exact form it will take, how it will be implemented and what the cost of the future technology will be, let alone exactly how much energy and cost will be saved. But as with any valuation of future cashflows, we can make sensible estimates and assumptions and model best and worst cases.

When modelling the future cashflows from a conventional hotel development or acquisition, it is important that the calculation of returns factor in the capital costs of adding clean technology at a later date. Adding features such as wind turbines and photo-voltaic cells, which can be easily added to an existing building, may actually be cheaper to do in the future than today, due to reducing prices from economies of scale. But adding in a grey-water recovery system, wastewater heat exchange systems, natural ventilation and cooling systems and sophisticated building management systems after initial completion of the building could be extremely expensive.

What legal due diligence can be done?

Legal due diligence on green issues will examine whether or not the building and hotel business is compliant with current legislative requirements and will ensure that the relevant documentation, such as energy performance certificates have been provided. In relation to proposed new development, legal due diligence can examine whether or not it has sufficient green features to qualify for planning permission.

But none of that is new. What is required going forward is that expert legal advisers will also be able to advise on the risks of future legislation requiring costly alterations to the building to maintain ongoing compliance. The identification of these risks will allow those undertaking the financial and commercial due diligence to factor them into their analysis.

Financial and commercial due diligence

Financial due diligence has always looked at the credibility of the hotel’s trading performance pro-

jections from an operational perspective and have taken into account expected capital costs, e.g. for refurbishment.

However, in our experience, financial due diligence in the past has paid very little attention to the risk of significant capital costs in future years required to ensure compliance with green legislation. In the past this has not been as issue as cash flow projections have looked perhaps only five years into the future and in the past, green legislation has not changed radically in such a short timeframe.

However, in the future, we believe that the pace of legislative change will increase rapidly and the recession is already forcing investors to consider a longer investment horizon of perhaps ten years rather than five. Together this means that the risk of non-compliance due to legislative change within that investment period becomes much greater and financial due diligence will need to take account of these risks.

Commercial due diligence will need to cover an examination of the building or plans to identify the scope of existing compliance, the scope for additional reductions in energy, waste and water usage, the risks associated with transport of customers to and from the hotel and energy security. With existing planning requirements already demanding a proportion of on-site energy generation, future due diligence will need to consider whether generation from wind and solar power is adequate, whether or not these can be added to existing buildings and whether the hotel has access to other renewable energy sources.

Capital expenditure decisions will also have to start considering whole lifecycle costs for buildings and equipment, rather than the more simple ‘pay-back period’ models.

Tim Warham from Deloitte says: “The energy and infrastructure sectors have been used to modelling contingency and lifecycle costs for business-critical systems and back-up systems in the event of failure of primary systems. The hotel and real estate sectors can learn to adapt some of those methodologies to help with commercial decisions on clean technology capital expenditure on buildings and equipment.”

A change in mindset

In the past, due diligence has always focussed more on the past and present, in verifying the historic accuracy of information and in ensuring current compliance. In the future, due diligence should look more to the future, to anticipate change that we know or believe is coming and to ensure that our hotel assets will retain and increase their value over the long-term.

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One planet, one solution?

Much as one man's meat is another man's poison, one man's green is very much another man's fiddling while Rome burns.

What passes for a green solution in one country would not be seen as such elsewhere, if that other country had such a solution at all.

The global nature of the hotel sector means that

when buying, building or operating a hotel, those involved must be aware of, and compliant with, a range of different laws, which may be above, or below, their own existing green strategies.

The following guidance covers China and eastern Europe – two of the most popular regions for expansion in the sector at the present time.

As *Hotel Report* was going to press, China announced plans to have 20% of its energy produced from renewable sources, investing \$30bn (£18bn) in low-carbon projects, an example of the rapidly-shifting green environment. Now that China has joined the debate, the rest of the world has run out of excuses.

China

In China, green legislation can be found in national laws, State Council's regulations, ministerial rules, local laws, regulations, rules, as well as state, local, and industry standards.

Overview of the current green legislation

Green legislation in China has developed rapidly since 2006 and impacts the industry in areas such as environmental protection, energy conservation, recycling economy and renewable energy.

China has formulated a number of laws regarding environmental protection, energy conservation and development of recycling economy.

Environmental Protection Law

The Environmental Protection Law, which was first enacted in 1979 and revised in 1989 is the green constitution of China. However, this law lags far behind the country's rapid economic growth and revision has been urged.

Energy Conservation Law

China amended this law in 2007 and in doing so emphasised the policy of energy conservation as one of its fundamental national policies.

The new version provides, for the first time, that the plan, design and construction of construction projects should comply with relevant building energy conservation standards. It also sets up a responsibility and evaluation system to conserve energy as well as a scheme of offering incentives to support development and promotion of energy conservation technology and the implementation of certain key energy saving projects.

Recycling Economy Promotion Law

The Recycling Economy Promotion Law establishes a basic legal mechanism and policy framework for recycling economy development. This law particularly obliges enterprises in the catering, entertainment, hotel and other service industries to use energy-saving, water-saving, material-saving and environment-friendly products, to reduce energy waste and to stop using contaminating products.

Renewable Energy Law

This law came into effect on 1 January 2006 and imposes liabilities and obligations on the government and the public for renewable energy exploitation and usage and establishes a series of systems and measures in this regard, such as encouraging renewable energy industry development and technology development and allocation of special funds for renewable energy.

Regulations in Civil Buildings

The regulation covers three areas – energy conservation for new buildings, energy conservation for existing buildings and energy conservation in

building energy using system management and officially adopts an incentive policy for buildings employing energy efficiency, for the first time. For new buildings, this regulation sets out approval procedures regarding energy conservation requirements and relevant obligations for various parties, including the owner, the contractor, the design and supervision company.

Ministerial rules

The Ministry of Construction and National Tourism Administration of the PRC are the two major departments in the central government which are in charge of drafting more detailed and specific rules and policies in order to effectively implement and support the implementation of the basic laws and administrative regulations in the industry.

Legislation from the Ministry of Construction predominately focuses on building/construction environment efficiency and technical measures on energy conservation design in civil buildings, evaluation and certification of green buildings and of civil building environment efficiency.

In 2008 the National Tourism Administration of the PRC requested tourism enterprises and hotels in China carry out various measures to save energy and improve service methods to reduce the consumption of energy. Those energy-saving measures include automobile gasoline-saving measures, boiler oil-saving measures, air-conditioner electricity-saving measures, lighting electricity-saving measures, water saving measures and building energy conserving measures.

Technical standards for evaluation and certification of green buildings

In addition to the methods and policies for green building evaluation and certification, the Ministry of Construction issued the first Green Buildings Evaluation Standards in 2006.

Green Hotel Standards

In December 2002, the National Economic and Trade Commission of the PRC promulgated the first commerce industry standards for green hotels, being the Green Hotel Rating Criteria. In March 2006, the National Tourism Administration of the PRC issued the first hospitality industry standards for green hotels.

In September 2007, PRC published the first state standards on green hotels.

These Green Hotel Standards incorporate a number of relevant standards, including, but not limited to, standards on drinking water, sewage drainage, indoor air quality, food safety and environment management.

Green hotels are divided into five grades. The green hotel certificate is valid for a four-year period and reviewed every two years.

Green Hotel Standards are not mandatory standards, however, most hotels are willing to make efforts to apply to be rated. The local government will usually provide quasi "symbolic" financial incentives to green hotels to do so. Up to the end of 2007, more than 200 hotels in China were awarded the green hotel rating and all of these were given four or five stars.

Forthcoming draft legislation

The Environmental Protection Law of the PRC will soon be amended. To the best of our knowledge, the revision of the law will focus on the following:

- adopt energy conservation, recycling economy and sustainable development as basic principles and guidelines of the law
- redefine the current principle in environmental legislation that economic growth and environmental protection shall take place in parallel, which actually weakens the enforcement power of the law and causes ambiguity when economic growth and environmental protection are in conflict;
- incorporate provisions on protection of natural resources as the current law is limited to pollution prevention;
- establish more environmental rights for individuals, in particular the right to report perceived breach of the law and present relevant public hearing procedures, in order to promote public awareness of environmental protection; and
- clarify the duties of local governments to protect environment holding them responsible for environmental protection and accountable for abusing their power to interfere with environmental law enforcement.

Impact on the sectors

The proposed amendment to the Environmental Protection Law of the PRC will not directly influence the hospitality industry and its investors. However, it can be foreseen that more detailed and stricter rules and regulations to effectively enforce the revised Environmental Protection Law of the PRC will affect it.

In addition, more and more voluntary standards and criterias may become mandatory or semi-mandatory in the near future due to the critical status of environment protection and energy saving in China. It is expected that the rating standards will foster in the Green Hotel Standards for four or five-star hotels in first tier cities.

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Eastern Europe

Hungary

As a member of the European Union, Hungary is complying with EU standards and adopting all EU legislation. In relation to environmental regulations affecting the developers or operators of hotels in Hungary, three recent developments need to be highlighted:

Energy Performance Certificates

As of 1 January 2009 any newly erected building, as well as any previously erected building to be sold or let, must obtain an energy performance certificate. The energy performance certificate of newly-erected buildings should be obtained by the developer before the granting of the occupancy permit, while the certificate for buildings to be let/sold should be presented to the tenant/buyer before the execution of the agreement.

Restrictions on smoking in public places

The Health commission unanimously passed a draft bill amending the current regulation on smoking in public areas. If the changes are passed, smoking will be banned from all workplaces and all indoor areas of restaurants operating a hot food kitchen from 1 July 2010.

Health Preservation Programme

The Hungarian Ministry of Health will create a trademark to be used by hospitality facilities contributing to the preservation of health. The main targets are restaurants which have to satisfy the following criteria in order to be able to use the trademark: (i) the facility should be wholly non-smoking; (ii) calories contained in each meal should be specified on the menu as well as how much exercise is necessary to burn the calories consumed with the meal; (iii) there should be no salt on the table, only on request; (iv) drinking water should be provided free.

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Czech Republic

In general, Czech environmental law is in harmony with EU legislation. Environmental laws are being amended to implement new European legislation or to increase the level of environmental protection in the Czech Republic.

Recent or proposed amendments to Czech legislation, which may be relevant to the hotel industry, include amendment to legislation concerning the energy performance of buildings, a draft of the new Waste Management Act and governmental promotions of eco-labelling.

Energy Performance of Buildings

In January 2009 one of the amendments to the Energy Management Act which is relevant for those who develop new hotels or plan to carry out reconstruction to hotels or other buildings with a floor area over 1,000 sqm, became effective. During the process of obtaining construction permission, the developer/hotel owner has to submit the so-called “energy performance certificate of a building” to the construction authority. An authorised person must have issued the certificate. The construction or reconstruction of the

building will be permitted if the “energy performance of a building” meets the criteria set out by law. It is necessary that the certificate is displayed in a publicly accessible area of the hotel. The law does permit some exemptions to the rules, which unfortunately are not clearly drafted and raise several interpretation issues.

Draft of the new Waste Management Act

The draft provides for the implementation of a fee scheme aimed at motivating waste producers, including hotels, to reduce the amount of waste they produce and to dispose of it in a more environmentally friendly way. The draft also extends the duty to businesses selling electronic, photographic or computer equipment or batteries. The law will require them to provide a free service for their customers to return any used batteries to the store. However, according to the draft law, hotels and restaurants, as well as some other operations, should be excluded from this obligation.

Eco-labelling

The eco-labelling of services has not been particularly widespread in the Czech Republic to date. The step towards the promotion and support of eco-labelling was made last year when the national logo “Environmentally friendly service” was added to the Czech Quality Programme, a national governmental programme supporting products and services of high quality. The right to use the environmental friendly service’s logo is a clear indication to customers and guests that the environmental standards of the offered service were subjected to evaluation by an independent third party and were found friendly to the environment. The guarantor of the programme is Ministry of Environment of the Czech Republic, which gives the labelling system and the label itself considerable weight.

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Bulgaria

As a growing economy, Bulgaria is facing a rapid increase in the development of tourism and tourist-related services. Many leisure and hotel projects are being planned or are in the process of development and there are several pieces of legislation that govern the environmental implications concerning these projects.

The Black Sea Coast Development Act provides for two zones, “A” and “B”, which place certain limitations on the construction parameters. Zone “A” stretches for 100m inland from the coastline, while Zone “B” covers the area 2km inland from where zone “A” ends. Neither construction, nor placement of movable assets can take place only after compliance with the construction limits imposed by the law.

The Biodiversity Act is another relevant act which provides for the establishment of a national bio network, “Natura 2000”.

The Environmental Protection Act specifies when environmental evaluation and an environmental impact assessment should be performed. The evaluation and assessment procedures aim to establish the risks for the surrounding environment

resulting from the development of the project within the relevant area. Examples of the cases where environmental evaluation and/or assessment are required are in the approval of investment construction designs and when there is a change in the zoning designation of agricultural lands occurs for construction purposes.

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Poland

Planned amendments to the building law

The law in Poland governing the process of obtaining building permits for various investments, including hotels, is currently being amended. The change means that notification of construction will replace the standard building permit, which means, in particular, that neighbours are unable to appeal against the permit. This is because any protest against a development will have to go through the civil court procedure, which is a lengthy administrative system. However, though the law has recently been passed through the Parliament, it is still being reviewed by the Constitutional Tribunal.

Special procedures for Euro 2012

On 21 May 2009, the amendments to the Euro 2012 special purpose Act came into force. Under these amendments non-public investment projects, such as the construction or modernisation of accommodation centres for national teams, hotels and sports and entertainment halls, may be considered as Euro 2012 investments. This means that private investors will have an opportunity to take advantage of the benefits of the fast-track administrative procedures under the Euro 2012 act.

Hotel developers may consider applying for the inclusion of their project on the list.

Energy performance certificate

From 1 January 2009 the Building Law introduced a requirement that applications for an occupancy permit will have to include an energy performance certificate as an attachment. The certificate may refer to the entire building or a separable part thereof. Moreover, on concluding a purchase or lease agreement of buildings, apartments and premises the seller or landlord is obliged to disclose an energy performance certificate to the buyer or the tenant.

The energy performance certificate specifies the type of the building, its relevant features and the energy consumption.

These certificates are issued by individuals holding certification authorisations issued by the Ministry of Infrastructure or persons authorised to prepare construction designs or graduates of dedicated postgraduate studies.

As a consequence, before the occupancy certificate is issued for the hotel an energy performance certificate must be obtained.

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