Coming (Soon) to a Building Near You:
Mandatory Energy Disclosure for Commercial Real Estate

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In the near future, the owner of a commercial building in Minnesota may be required to provide a purchaser, lender or prospective tenant a detailed disclosure of the building's energy performance. Such disclosure might even include a ranking or scoring of its performance in relation to other buildings in its peer group.

What is evolving today through voluntary due diligence practice may, very likely, soon be mandated by law. How soon this happens depends on energy politics. Now in effect in other parts of the country, compulsory energy performance disclosure is headed for Minnesota, either as a consequence of federal energy or climate legislation or through state or local regulation. Meanwhile, with escalating energy costs, the marketplace already demands sophisticated energy performance disclosure.

This process, often referred to as Green Building Due Diligence, differs significantly from traditional environmental due diligence as the focus is on opportunity identification vs. risk avoidance. Given the highly energy *inefficient* status of the nation's commercial building stock, most reviews of this nature will identify low cost or no cost building modifications which can drive cash flow and thus asset value. Buyers and tenants are increasingly recognizing this as a tool in the negotiation process. Lenders are beginning to realize that educating borrowers about the Green Building Due Diligence process provides them with a competitive advantage vs. less proactive lenders as well as a new source of loan demand tied to energy efficiency retrofit projects which can be bundled with the core underlying transaction.

Environmental Site Assessment as a Model

The evolution of building energy due diligence may parallel that of "all appropriate inquiry" under "Superfund" law. Although the 1986 amendments to the federal superfund law provided a safe harbor for an "innocent landowner," the law provided no guide to the level of inquiry needed to establish such "innocence." Due diligence practices varied widely until, in 1993, the American Society of Testing and Materials (ASTM), a professional standard-setting organization, brought clarity to the process through its promulgation of ASTM E 1527, the standard for the conduct of the Phase I Environmental Site Assessment. This standard, in turn, was incorporated, in 2002, into the U.S. Environmental Protection Agency's own regulations.

Evolution of Building Energy Measurement Practices

The first widely-accepted energy assessment tool was the U.S. Environmental Protection Agency's ENERGY STAR "Portfolio Manager" software program, released in 1999, for use by building owners or managers on a voluntary basis, before energy conservation and green building codes or standards had assumed prominence. Portfolio Manager is

straightforward and mechanical. A user completes a series of online data entry screens, including physical description of the building (which must be one of fourteen prescribed building types), its location, energy cost as billed by utilities, and certain occupancy or use information. The program then generates, free of charge, a building energy "score" or ranking against its peers in its category, on 1 to 100 scale, with 50 at the median.

While useful, Portfolio Manager is being supplemented by other tools as transactional stakeholder needs require more in-depth and facility-specific analysis. There is growing recognition that dependable energy performance due diligence requires on site review and evaluation of the facility and facility records by an engineering professional – in essence, a level of expertise comparable to that required for the performance of the Phase I Environmental Site Assessment.

The New Draft ASTM Standard

A comprehensive, in-depth assessment protocol is under development by ASTM. Its new draft standard for a "building energy performance assessment" (BEPA), currently designated as WK24707, "Guide for Building Energy Performance Disclosure," represents a "second generation" energy due diligence tool. WK24707 defines a practice for the conduct by a qualified consultant of a BEPA and a detailed format for the reporting of the information so compiled and analyzed.

Under the draft standard, a BEPA report will address or include the following:

- A description of the property and building characteristics, including property type, building age, last major renovation, number of floors, square footage, occupancy, HVAC systems
- A synopsis of user-provided data on past or historic energy use and cost information. This will include water, electricity, oil, natural gas, steam consumption and cost.
- If included in the scope of work, local, state and federal renewable energy or energy efficiency grant or incentive programs
- Historical weather data
- Findings and analysis of current building energy cost and use, including ranges of building energy use and energy use "intensity" (cost per square foot), over multiple scenarios, together with a "pro forma" for current and prospective building energy use and energy cost.

In addition, and as with the E 1527 Environmental Site Assessment, provision is made for additional or "non-scope" services, depending on need. These may include benchmarking or ranking the building's energy use or energy costs against similar buildings in the area; identification of selected green building attributes that can impact energy use or cost; recommendations for specific no cost or low cost energy saving measures, along with an investment analysis of their return on investment (ROI) or payback time; or assessment, auditing or benchmarking under other existing standards or

protocols, e.g. those of American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE).

Mandatory Disclosure

While neither Portfolio Manager nor ASTM draft WK24707 by their terms mandate disclosure of their results to third parties, both are designed for use in disclosure, either voluntarily, e.g., by contract, or, in jurisdictions which require it, by law. The trend toward mandatory energy performance disclosure is clear. As energy conservation and greenhouse gas (GHG) reduction goals become more of a local concern, policy-makers are realizing that meeting these goals, over time, will require that green construction initiatives include not only new construction but retrofit of existing buildings, most of which will be around for decades. Energy performance disclosure is seen as a means of harnessing market forces to induce such retrofit.

California, as so often with environmental issues, was first off the mark on energy disclosure. AB 1103 (2007) requires building owners to provide pre-closing information on building energy consumption to buyers, tenants and lenders, using Portfolio Manager benchmarking data and ratings for the most recent 12-month period. Under draft regulations recently promulgated by California Energy Commission, effective in 2011, a building owner must, prior to a sale, lease or financing, open an account with the Portfolio Manager website; utilities serving the building must then upload the most recent energy use data into the account, whereupon the owner then generates the required disclosure for its buyer, lender or tenant.

An AB 1103 approach can – and may be – replicated elsewhere. Since 2007, several other jurisdictions, including New York City, the District of Columbia, Washington state, Seattle, Washington and Austin, Texas, have enacted energy disclosure and ranking regulations, Washington state's being expressly modeled on California's.

The Draft ASTM Standard in the Future

As noted, the draft ASTM standard reflects a shift of emphasis from a data-entry approach to an in-depth analytical review comparable to ASTM E 1527. Unlike Portfolio Manager, originally developed by EPA to support broad public policy and societal environmental goals, the draft WK24707 protocol has been crafted with an eye to the consistency, transparency and reliability demanded by the private sector. An owner of commercial property can, accordingly, soon expect to see a standard like WK24707 expressly incorporated by a transaction party into the due diligence clause of a real estate purchase agreement, loan commitment, or other deal document.

Also, and again unlike Portfolio Manager, the draft ASTM standard is designed to self-adapt to changing technology, practices and policies, through the breadth of its language, its cross reference to additional engineering protocols, such as those of ASHRAE, ENERGY STAR, LEED, CMP Green Value Score rating or Green Globes certification,

and its recognition that a BEPA conducted under it may include the non-scope items described above.

Forward thinking environmental consultants who provide traditional Environmental Site Assessments and Property Condition Assessments are now bundling a "BEPA-driven" scope of work into their underlying deliverable which leverages the professional skill set of the consultant as well as field visits and other resource review leading to a highly efficient means of delivering the BEPA into the transactional process. These consultants recognize that a BEPA is an effective impetus to ongoing post transaction retrofit projects which provides the client with a means of realizing the potential value creation identified in the BEPA.

Coming in the Near Future: "Carbon Footprint" and "Sustainability" Metrics

The ASTM draft standard expressly excludes evaluation of the building's greenhouse gas (GHG) emissions, an area as to which engineering metrics and standards are still evolving, and the measurement and reporting of which is – as to commercial real estate – not yet regulated outside of California (which requires reporting of certain industrial facility combustion).

Significantly, a requirement for carbon footprint analysis was eliminated from the body of the current working draft by the WK24707 drafting committee, as premature at this stage, and as of now (Summer, 2010) is included only as a "non scope" item, i.e., an additional service, in the draft. An appendix contains a methodology for calculating a building's carbon footprint, from both direct (on-site) and offsite (e.g., from purchase of fossil-fuel derived electricity).

It would not be surprising, however, to see this appendix, or something like it, added to a later edition of the standard itself, as the current movements toward both better energy performance and GHG reduction gather speed. In addition, as more jurisdictions adopt green building codes of varying types – and a representative list of such codes is found in an Appendix to draft standard WK24707 – building due diligence may extend beyond energy performance measurement itself using, e.g. a Portfolio Manager approach, to embrace such factors as building waste streams, and even the "sustainability" of building materials used in new construction.

Energy Performance Due Diligence in Minnesota

As of now, Minnesota has no mandatory energy performance disclosure requirements for commercial real estate, and its only statewide green building initiative, the "Minnesota Sustainable Building 2030" program (Minnesota Statutes, Section 216B.241, Subdivision 9), covers only state bond-financed projects.

But a forward-looking commercial building owner or manager should prepare. Starting points might include a targeted energy audit of the building, focused, for example, on HVAC systems or controls, and identification of existing state or utility company

incentives for energy efficiency improvements. As to the latter, a useful information source is the DSIRE database, an online updated listing of such programs, by state and locality, http://www.dsireusa.org/. And because long-term energy performance will likely be a future disclosure item, now would be a good time to institute detailed record-keeping of facility energy consumption and costs.

Energy performance due diligence is coming to commercial real estate, no matter what happens in Congress. As always in this industry, advance preparation is a sound way to preserve or enhance investment value.

Jonathan P. Scoll is a partner in the Environmental, Natural Resources and Climate Change Practice Group of Lindquist & Vennum, PLLP, in Minneapolis, MN. *This is the first of two articles on legal aspects of the energy performance of commercial real estate. A second article will deal with green property purchase, lease and finance issues.*

The author gratefully acknowledges the editorial assistance of Mark Bennett, Esq., the Chair of the Climate Change Practice Group of Miller Canfield, Detroit, MI; Mr. Bennett chairs the ASTM Committee E-50 WK24707 Guide for Building Energy Performance Disclosure Legal Subcommittee.