Climate Change: Issues, Recent Developments, and Implications for Commercial Real Estate

Brian C. Rider, University of Texas, Austin, TX

It is unlikely that any of us are unaware of the issue of climate change. Climate change has been declared by our political and business leaders to be an existential matter for the United States and the world. Some of the enhanced interest has been generated by the recently concluded “COP26” (26th United Nations Climate Change Conference of the Parties) convention in Glasgow in November, by actions and pronouncements from Washington, and by press coverage of both enacted and proposed legislation at the federal level.

For real estate lawyers, our concern with climate change includes how responses to the issue might impact our practices and the businesses of our clients. Both public and private policy makers are considering and acting on the issue. This short article will be a quick review of recent developments and then some musings about the possible impact on real estate practice of policy responses to climate change.

A basic goal of the policymakers in Washington is to decarbonize the electricity generation industry. That is, the operation of that sector of the economy must stop emitting the carbon dioxide which is produced by power generation using coal, oil, natural gas and other carbon-based fuels. The announced methods to produce such decarbonization include closing carbon-based fuel generators and the installation of 500 million solar panels and 60,000 new wind generators of electricity with an enhanced electric transmission infrastructure to carry the newly generated sustainable electricity.

We in the real estate sector of the economy are brought into this mostly as users of electricity generated by use of carbon-based fuels. The policies related to the real estate sector would require staged reductions in carbon dioxide emissions attributed to buildings along with required measurement and reporting of progress toward those goals. A great deal of responsibility for emission of carbon dioxide to the atmosphere by buildings is by attribution, not direct emission of carbon dioxide. Carbon dioxide in the atmosphere, it is said, is a major contributor to climate change. It is said by the policy makers that 30% to 70% of all carbon dioxide emissions are the responsibility of buildings. How can this be? The answer is that emissions from several sources are attributed to buildings. Some emissions arise from direct burning of fossil fuels on site -- heating buildings, operation of restaurant stoves, operation of hot water heaters for restrooms, and other burning of fossil fuels. But such direct burning of fuels creates only a small part of the carbon dioxide attributed to buildings. The majority of emissions attributed to buildings is from the consumption of electrical power used in heating, cooling and other building operations (e.g. elevators, lighting, computers, printers, etc.). This attribution is a reflection of the sources of energy used to generate the electrical power used in the buildings – either fossil-fueled or sustainably sourced like wind or solar (something over which the building owners may or may not have any control). Finally, there is attributed to buildings the carbon dioxide produced in the
creation of the cement, glass, steel and other building materials used in the construction of the buildings (and by some commentators, the anticipated emissions from demolition and destruction of the buildings at the end of their useful lives). Fair or not, this is the background rationale by which public policy and private activities aimed at reduction of climate change have focused on buildings and real estate properties.

To provide some view of the impact of the climate change issue on our practices and our clients’ businesses we will first review recent legal developments, then review activities and pronouncements of private parties, and finally give some thoughts about the possible impacts of these developments on real estate law practices.

With respect to enforceable changes in law or regulation, there is not a lot to report. Neither COP26 nor the earlier meeting in Paris resulted in treaties ratified by the U.S. The current administration in Washington has submitted an earlier treaty proposal, commonly called the “Kigali Agreement” to the Senate, but it has not been ratified. That agreement deals with removing certain air conditioning and refrigerant products from use worldwide to protect the atmosphere in a campaign similar to the campaign for removal of ozone depleting chemicals in the past. The Biden administration has issued a number of Executive Orders of note concerning climate change, but those have mostly been instructions to various agencies and do not purport to be creation of laws or regulations.

The Infrastructure Bill (Pub. Law. 117-58) passed in late 2021, has some provisions concerning climate change which provide for funding for installations of electric charging stations for plug-in electric vehicles (with a target of 500,000 new stations) and for improvement of major power transmission lines for carrying wind- and solar-generated power from points of origination to population centers. The appropriations for charging stations total $7.5 billion. Federal agencies are to designate certain travel routes for installation of these stations and are then to delegate to the states and cities the actual awarding of contracts for the installation work. The legislatively permitted time for accomplishing these actions indicates little work will occur on the ground for at least a year, and possibly two years. That bill also contains an appropriation for removal and replacement of domestic water supply lines where lead contamination is a problem, but that might not be considered a matter of climate change policy. It appropriated money for improvement of major power lines to carry the sustainable energy which is to be developed.

A few cities (mostly in California but including Boston) have by ordinance restricted or prohibited the future installation of natural gas-burning appliances in residential and commercial buildings as their contribution to reducing carbon dioxide emissions.

But most of the changes in law which are intended to deal in major ways with climate change and the funding for those changes are contained in the “Build Back Better” proposed legislation which is under consideration in the Senate, as this is written in early January, and has not become law. That bill would deal with matters such as requiring wind- or solar-power generation, use of fossil-free fuels such as hydrogen for industrial production, direct removal of carbon dioxide from the atmosphere, use of nuclear generation as a carbon-free source of power generation, development of sustainable fuel source alternatives (“e-fuels”) for heavy machinery
like trucks and ships, together with appropriations of more than $500 billion in subsidies and tax credits and many other programs. These programs are contained in the House version of the bill and are not yet law.

With respect to Executive Orders, the first Executive Order (No. 14008) issued on January 27, 2021, promised an “all of government” response to the matter of climate change, but mostly ordered various studies by agencies to plan for future actions. That Executive Order contained only two direct commands: one to cease oil and gas leasing of some federal lands and one to submit the “Kigali Agreement” to the Senate for ratification. The order to cease leasing was enjoined by a federal district court, Louisiana v. Biden, 2021 WL 2446010 (W. D. La., June 15, 2021) and bidding occurred, only to have the underlying findings under NEPA which are required for lease execution remanded and vacated by a different federal district court in Friends of the Earth v. Haaland, 2022 WL 254526 (D.D.C., Jan. 27, 2022), which means that the leases will not be executed in the near future. An Executive Order in October, 2021 (No. 14030) ordered federal agencies to consider in their regulations and in their responses to regulated activities of private parties the financial “risks” of climate change. The most recent Executive Order concerning climate change was issued December 8, 2021 (No. 14057) and ordered the various federal agencies to use the inducement of their acquisition budgets to support the fight against climate change, including a goal to have agencies acquire only electric-powered light vehicles so that the federal fleet would be substantially electric by 2032 and all electric by 2045, seek carbon-free electricity, promote purchase of construction materials with lower embodied emissions, and achieve a net-zero emissions buildings portfolio by 2045. Amendments to regulations to allow sustainability considerations in procurement decisions will be forthcoming.

As a practical matter, regulations by federal agencies may become a factor in climate change law prior to legislative changes. The Securities Exchange Commission has announced plans to promulgate new regulations concerning how risks of climate change are analyzed and described in corporate reporting. The Treasury Department has announced plans to consider in bank regulation those risks in bank lending activity arising from climate change. Such risks have been said to include review of how climate change (including rising sea levels) might impact collateral value of real estate loans and risks to value of real estate collateral becoming obsolete from failure to invest in such things as on-site power generation from renewable sources, failure to install energy efficient equipment and other improvements, failure to acquire electrical power from carbon-free producers, and failure to acquire carbon credits.

The growing interest of actors in the private economy in matters of climate change promises to have more immediate impact on real estate business and our real estate practices than pending legislation. Wall Street and corporate leaders have announced that consideration of and action on climate change will be major goals for the near future in their financing operations. As to corporate leaders, the Net Zero Asset Managers initiative is an international group of money managers controlling, they assert, $57 trillion in assets, which has announced its backing for net zero emissions by 2050 or sooner. Other corporate groups have announced similar commitments in their operations and in their investments in finance. Forgive the possibly cynical observation that Wall Street organizations may have discovered that they can make money from issuance of
“green bonds” and promotion of other green projects or enterprises, and that profitable operations in those financial areas might be a motivation for their interest in the subject.

Whatever the source of the concern, it is becoming clear that the financing of real estate projects and not legislation will probably be the path by which the matter of climate change will first have significant impact on our practices and our clients’ businesses. The impact will be due to changes in underwriting standards. For example, underwriting of a loan or equity investment will involve the degree to which a project has been renovated to add on-site electrical generation from sustainable sources (meaning wind and solar power), whether the owner has contracted for renewable source electrical power from off-site providers, whether efficiency improvements much like LEED standards have been made, and whether carbon offsets have been acquired to offset remaining emission attributions. These underwriting standards will apply in project acquisition financing and project refinancing. Similarly, energy efficiency, carbon-free power sources both on- and off-site, compliance with building equipment standards such as use of heat pump HVAC systems, and acquisition of carbon credits will be required for construction loan finance.

Tenant demands for climate sensitive facilities will be another source of impact. Building occupants report that their workforces are increasingly concerned with occupying more energy efficient and climate-friendly spaces. Tenants may well choose those buildings which can demonstrate that the landlord has taken actions to make the property more energy efficient and has complied with regulations or recommendations leading to reduced impact on climate change from the operation of the building. Lease issues will be involved. For example, the majority of electricity used in a building may well be used within tenant spaces, and so it may be beneficial to have a lease provision requiring the tenant to acquire its power from carbon-free generation sources if the landlord must demonstrate that the building is operated on that kind of electricity. Or, perhaps the tenant may be put on an electrical budget for its energy use which could require reduced energy loads or restricted after-hours operations. Additionally, it may be that energy costs are part of the “pass-through” cost of building operation, but historically those “pass-through” clauses have required the landlord to acquire energy from the cheapest source, not the most environmentally sensitive source. If the landlord must acquire power from carbon-free generation sources which cost more than the standard generators, can the landlord pass through those higher costs? By sharing the additional cost, does it help both the landlord and the tenant to show publicly and to employees how environmentally sensitive they are in their respective operations?

We began with a statement that the issue of climate change is something we all know exists. What will develop in response to the issue is uncertain, but it is certain that there will be developments in law and practice which will impact our Fellows. Hopefully, some of this information will be helpful to you in keeping up with and coping with those developments.