

PERSON OF THE WEEK: Joe Derhake On Environmental Due Diligence

Jessica Lillian, Monday 22 December 2008 - 22:00:00

What does the combination of a lending slowdown and an increased focus on environmental issues mean for due diligence on commercial properties? MortgageOrb spoke with Joe Derhake, principal at Partner Engineering and Science, about the essential trends that commercial real estate finance professionals should keep in mind for 2009.

Q: Have the more stringent lending and underwriting standards these days translated into more attention paid to the environmental component of the due diligence process?

Joe Derhake: The short answer is yes, we are definitely seeing a trend in that direction. Lending decisions are influenced by deal people and credit people, and as of late, the credit side is the more powerful group. For the environmental consultant, that means more thorough due diligence. Lenders are now more likely to order Phase I Environmental Site Assessments instead of limited products.

When contamination is found, however, the enthusiasm among lenders for quantifying the environmental problem and trying to underwrite around the problem is low. Lenders would prefer to pass on the deal.

Q: Vapor intrusion has received a lot of attention lately - though many in the lending community seemed somewhat unaware of it until recently. What emerging environmental issues are you seeing now?

Derhake: While the ASTM 2008 vapor intrusion standard created a lot of discussion in the environmental professional community, clients have been hesitant to use the new standard, instead relying heavily on the Phase I Environmental Site Assessment to address these environmental concerns.

An up-and-coming environmental issue is energy consumption, and California is leading the charge with Assembly Bill 1103, which mandates that all California nonresidential buildings participate in the Federal Energy Star program beginning in January 2009.

Benchmark data showing the building's relative energy consumption performance will be collected throughout 2009. After Jan. 1, 2010, building owners will be required to disclose these data to buyers, lessees and lenders. Energy Star will rate buildings against other buildings within the same class - adjusted for climate, but not age. Buildings within the top quartile are eligible to be recognized as an EPA Energy Star Building and can use the Energy Star label to communicate their energy efficiency to tenants, lenders and other stakeholders.

Not only will highly ranked buildings be more likely to capture a green premium when the property sells or rents, but analysis of these data will yield opportunities of energy savings and, ultimately, improvement of net operating income.

Will green buildings ever receive any sort of preferential treatment from lenders? Bank of America, Wells Fargo Bank and Citibank are among the national lenders that have committed themselves to billions of dollars of green lending.

To date, much of the green lending has focused on building green and LEED construction. However, Energy Star-rated buildings are gaining more and more attention, and with the data required by AB 1103 becoming available in the next year, lenders will have more objective standards to judge their collateral.

Lenders could easily aggregate their portfolio's Energy Star Rating and set goals to improve their portfolio over time. It is possible that other states will follow suit and implement similar building energy disclosure requirements in the future.

Q: What steps can cash-strapped financial institutions take to manage the costs involved with environmental assessments?

Derhake: Environmental policy can be thrifty and smart. To be thrifty, lenders should consider limited environmental products, such as environmental transaction screens and historical environmental reports. Historical environmental reports are inexpensive (typically under \$500) and focus solely on the history of the property.

This is a perfect product for an asset that clearly has no issues, due to a benign use such as residential or office, and most reasonable concern is centered on what was there before the current development. If environmental concern is identified during the historic research, further due diligence can be conducted.

Q: What are the most common forms of contamination you are finding these days? Are there any recent technological advancements in remediation strategies?

Derhake: The types of contamination that we find are across the board. However, the type of contamination that is receiving greater scrutiny by regulators is volatile organic compounds, which include chemicals such as benzene (an additive in gasoline and an industrial solvent) and tetrachloroethylene (PCE, a drycleaning solvent). These volatile chemicals are toxic and represent a vapor intrusion risk.

The concern that these chemicals will migrate up into buildings and create a cancer risk for occupants is driving cleanups. Many state regulators require soil vapor testing for all sites. To achieve closure, a property owner has to show that the levels of soil vapor are below action levels. Generally speaking, soil vapor-based action levels are more stringent than soil matrix-based action levels.

Volatile organic compounds have historically been remediated via soil vapor extraction and dual phase extraction. Each of these technologies involves more or less sucking the contamination out of the ground. We install vapor extraction wells, connect the wells to large blowers and pull. The toxic vapor stream extracted must then be treated.

In-Situ Chemical Oxidation (ISCO) is proving to be a significant alternative technology. ISCO involves injecting a reactive chemical into the ground, and the reactive chemical oxidizes the contaminant upon contact. This technology works very quickly, and for some contamination plumes, it is very cost-effective.

Q: What is the latest on the regulatory front for environmental compliance/liability issues? What might be on the horizon for 2009?

Derhake: California, Oregon and other states have published soil vapor action levels. When professionals are cleaning a site, the question becomes, "How clean is clean?" Environmental professionals compare our testing data to the action levels.

Historically, we collected soil samples and compared these data to soil matrix action levels. Lately, closure sampling must also consider soil vapor analysis, and we must compare these to far more stringent soil vapor action levels.

This shift is profound, as sometimes it means that the remedial system must run another year or more.

The Federal EPA has not yet pushed for any such soil vapor standards. With a new administration coming in 2009, we may see the Federal EPA addressing this issue. Commercial real estate owners do not benefit from stricter standards, as it likely will increase cleanup costs. However, greater uniformity from state to state makes environmental risk management easier.