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Sustainable Real Estate and the Green Agenda: A Conversation

Steven Cox, Bonny Hedderly and Jonathan Lawrence interviewed by Colin Maguire of the SERF Foundation

On 2 July 2012, Colin Maguire of the [SERF Foundation](#), interviewed Steven Cox, Bonny Hedderly and Jonathan Lawrence of K&L Gates, London in connection with sustainable real estate and the green real estate agenda. The SERF Foundation is the Society of Environmentally Responsible Facilities Foundation based in Michigan, US and promotes practical environmental stewardship through written and online publication of green building design, materials and techniques.

Colin kindly provided us with this edited transcript.

The United States commercial real estate industry faces a number of challenges and opportunities, both legal and practical, when it comes to green building practices and the implementation of sustainability principles. Yet, are those challenges and opportunities unique to the US? I flew to London and interviewed some of the United Kingdom's top minds on the commercial real estate industry's struggles and goals in achieving sustainability.

The three individuals I interviewed were lawyers working in the K&L Gates London office. Mr. Steven D. Cox is Of Counsel at the firm, a member of their real estate practice group, a LEED® Accredited Professional, and works on many finance and development issues.¹ Ms. Bonny Hedderly is a Senior Associate and Professional Support Lawyer in the firm's real estate group and works with property development, finance, and investing.² Mr. Jonathan Lawrence is a Partner in the firm's finance group, but also practices in a variety of fields including real estate development, investment & finance, distressed real estate, and energy & infrastructure projects.³ All three collaborated to write "The Real Estate Green Agenda: What Banks Should Know," which was originally published in *Butterworths Journal of International Banking and Financial Law*, February 2012.⁴

The article, though short, proposed and explored numerous fascinating topics. For instance, do green buildings possess more value than other buildings, and from whose perspective?⁵ Also, the article looked at UK policy concerns for commercial real estate interests and extrapolated benchmarks for building energy-efficiency.⁶ Mr. Cox and Ms. Hedderly are no strangers to pioneering green concepts in the commercial real estate field, having written a comprehensive guide to Green Leasing.⁷ The group was also presenting a talk entitled "The Real Estate Green Agenda" later in the day. Therefore, it was a great privilege to sit down with them, and a tremendously kind act on

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⁴ Bonny Hedderly, et al., *The Real Estate Green Agenda: What Banks Should Know*, 2 BUTTERWORTHS J. INT'L BANK. & FIN. L. 99, 99-100 (2012). available at http://www.klgates.com/files/Publication/aa74c3da-22e5-4b87-b78f-1c3e7c0a4978/Presentation/PublicationAttachment/b806579a-7df6-40f5-aae9-28803fd69f06/JIBFL_27_02_10_Hedderly.pdf

⁵ *Id.*

⁶ *Id.*

⁷ Steven Cox, Green Leasing Guide. Available upon request, please email Steven Cox at <mailto:steven.cox@klgates.com>

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their part. The following is an edited transcription of our conversation. Again, I cannot thank enough all three of these knowledgeable counselors for their time.

2 July 2012, Offices of K&L Gates, One New Change, London, UK:

Maguire: *You wrote this great article about whether a building designated as a green building actually adds value to the building in a very tangible way – when the building needs financing to start construction, or even a remodel. Does a relationship exist between a building owner and their financing bank such that whatever sustainable developments are good for the building owner are also good for the financier?*

Lawrence: I'll answer that question in two parts: (1) the development side and (2) the investment side. The financier looks at the development side first and sees the cost of green building. To the financier, this is an additional cost. In the UK, if you get development financing for a project you get about 50% of the cost from the financing bank. You have to come up with another 50%. So right at the start, you have raised the overall cost of the project for both you and the financier. On the investment side, there is more interest in adding value to a building. Therefore, you see green building as more of a positive on the investment side. People are starting to collect data on whether buildings certified as green actually have more value than non-certified buildings. The Investment Property Databank (IPD)⁸ and their IPD Sustainable Property Indicator (ISPI)⁹ system collect this data. Actually demonstrating added building value or lowered operating costs are critical to promoting green buildings for investors. Banks will also look at the sustainability of the building when they ask a third party to value the building. Mr. Cox can address whether green building attributes factor into an assessment by the Royal Institute of Chartered Surveyors (RICS).¹⁰

Cox: The guidance for RICS valuation in the UK does say that they must have regard to sustainability. What is not clear, in the absence of data, is how building values should relate to green building practices. This is the crux of the problem. In the US, various studies have shown a relationship between green buildings and value. Therefore, commercial building owners in particular can demand a premium on rents. In the UK, nobody has demonstrated such a link between green buildings and added value. Therefore, it is difficult to demand some sort of premium in rent; even if such a premium should, instinctively, exist. This leads to investors looking at whether a green building is more leasable, will you retain your tenants, or if it will sell quickly, using factors aside from the sustainability aspects of the building. Though there is a string of thought that non-energy-efficient buildings could become obsolete, it is difficult to link that thought with hard data.

Hedderly: It is worth pointing out that the UK has vastly different real estate markets. The London market, for instance, operates with its own set of principles. For instance, a less sustainable building in London may prove very attractive to lease or buy because it sits in a prime location.

Lawrence: I agree. Location is very important in London because land is at a premium – the city cannot really expand out. Even within Central London, there are pockets of buildings that are more attractive than others purely for reasons of location. Therefore, somebody may choose to buy an inefficient 1960s building, tear it down, and put up a new structure. However, that initial transaction would not, standing alone, lend itself to the idea that green buildings have more value or are more desirable for financing. The UK also has a tremendous issue with secondary or tertiary buildings. These buildings often are not in good structural shape, but may prove a good investment and, eventually, could become a green building. However, often times in the green building field we get caught up in a vision of a gleaming, new building. The building we are

⁸ <http://www1.ipd.com/Pages/default.aspx>

⁹ <http://www1.ipd.com/Pages/DNNPage.aspx?DestUrl=http%3A//www.ipd.com/sharepoint.aspx%3Ftabid%3D2215>

¹⁰ <http://www.rics.org/>

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sitting in right now, One New Change,¹¹ is an example of a very attractive green building. It is a small section of the building market in London, gaining lessons from buildings like it can be difficult.

Maguire: *I have a follow-up question for Mr. Cox. The UK may not have hard data or studies on whether green buildings are more valuable. Still, are there any studies which suggest green buildings are more energy-efficient than other buildings?*

Cox: I'm not aware of any studies. I think you're right that energy-efficiency has been the focus of green building, even though other strands exist in the concept of green building, from both the investors' side and the direction of government policy. The government has pushed the Display Energy Certificate (DEC)¹² for many buildings. This certificate is placed on a building and grades a building's energy efficiency based upon hard data. Building grades range from 'A' as the most efficient, to 'G' as the least efficient. There is another government certificate called the Energy Performance Certificate (EPC).¹³ This certificate is more theoretical in terms of measuring energy use. There is a feeling among investors that the DEC is preferable because it actually measures hard data and gives the investors a partial measure of a building's operating costs. Recently, Parliament passed the Energy Act. The Act states that, by 2018, commercial buildings with a EPC grade of 'G' or 'F' will not be leasable or sellable. Obviously, this is a huge issue for building investors to consider. That is the government's stick approach. The government's carrot approach is the so-called "Green Deal."¹⁴ The idea with the Green Deal is to give incentives and assistance to building owners who must perform a great deal of retrofitting so that their buildings will rise out of the 'G' or 'F' classification. Again, the focus of the green building push is on energy efficiency. Still, I do not know of particular studies which look at the relationship between green buildings and energy efficiency...I also think it is fair to say that this government initiative is a direct response to European Union regulations to cut carbon emissions through reducing energy use. Also, this policy may change in response to business interest concerns and what may emerge is some sort of direct tax on high-energy consuming businesses.

Hedderly: It is also worth pointing out that companies have to self-report information which is used to calculate the EPC and DEC. Therefore, many companies have already incurred a huge amount of cost in assessing building energy use and providing information to back up the assessment. Generally speaking, the commercial real estate industry is unhappy with the process. Mr. Cox is quite right that business interests may well succeed and the government will scrap the current EPC plan for 2018 and maybe replace it with a direct tax. Still, that issue is undecided and we are only projecting future policy shifts.

Maguire: *You advocate that all newly constructed buildings should be Net-Zero by 2020 and that all buildings achieve near net-zero status by 2050. It seems like an ambitious plan. Are you, or your clients, optimistic that this achievement is possible...at least by 2050?*

Hedderly: It is very ambitious, but we remain optimistic. A lot of the sustainability push, as we have discussed, is driven through government regulation. As we mentioned earlier, we expect the government to modify things like the EPC/DEC plan and the Green Deal. We expect this, in part, because attitudes towards this policy have shifted with the transition from the former Labour Party government to a new coalition government. Yet, many of our property development clients undertake outstanding sustainability initiatives on their own. The extent of these sustainability initiatives suggests market-based reasons for green building practices, not just a response to government regulation. Still, we made our year-specific projection in the article based upon

¹¹ <http://www.onenewchange.com/eco.aspx>

¹² <http://www.display-energycertificate.com/>

¹³ <http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/Energyperformancecertificates/index.htm>

¹⁴ http://www.decc.gov.uk/en/content/cms/tackling/green_deal/green_deal.aspx

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existing legislation. Again, we expect Parliament to revise this legislation. Also, location plays a key role in projecting the prevalence of sustainability in development. Green building practices are popular in London, but the same practices often lack support in Northern England's industrial towns. Other concerns like employment and any type of property development may predominate, there.

Lawrence: In the US, there is a movement against red-tape and regulation in various industries. A version of that sentiment is at play here in the UK. This is especially true in property development where many people believe a green building is something like a luxury item. Therefore, green building often gets associated with premium investors and developers.

Cox: I agree that there is a form of disconnect between green building and the masses. The British Property Federation (BPF)¹⁵ is the main property investor/developer lobby here in the UK. The BPF believe the Green Deal falls short in assisting property developers and owners to reach those EPC/DEC benchmarking goals. Therefore, they are lobbying for more tax incentives to assist developers and owners.

Lawrence: I think this is a good example of where the Parliament could connect two issues. First, the country has lower employment than usual. Second, the government has mandated lots of building retrofitting. It makes sense for them to combine those two issues into a comprehensive program which could lead to a mutually beneficial solution. At the moment, the thinking on these two issues has not joined together.

Maguire: *If every building is a net-zero building, then is every building a green building?*

If so, would that lower the value of a green building designation, especially vis-a-vis building value?

Lawrence: If not having an energy-efficient building, including a net-zero building, inhibits the ability to market property, as is the case under the current Energy Act, then that does affect a building's value. Looking to the future, we could see a market for how 'green' your green building really is. Perhaps it comes down to a comparison between private certifications like LEED®¹⁶, BREEAM®,¹⁷ or SERF®.¹⁸

Hedderly: I think every jurisdiction is distinct in how they measure and value a green building. Every country does have its distinct rating system, so it is relative. As a global law firm, K&L Gates may like to see one or two globally-recognized designations so that all of our property development Attorneys can easily relate to one another. At the moment, LEED® is probably the most recognizable designation across the globe.

Cox: I agree. Across the UK and Europe specifically, BREEAM® is more prevalent. However, the further you go into the Middle East, China, and certainly the US, LEED® buildings are very common. Also, I understand that BREEAM® and LEED® may want to converge in certain markets and within their criteria. As a LEED® AP, I have heard the most recent version of LEED® was held back one year. Perhaps one reason is that the authors wanted it to relate to BREEAM® better. In terms of green buildings and value, there is a lease structure issue in the UK. Here, the tenant pays all of the utility costs in a commercial lease. Therefore, if the owner makes energy-efficiency improvements to a building, then only the tenant will see a direct financial benefit. Conversely, leases in the US allow for the opposite situation. So in the UK an energy-efficient building is a very attractive proposition for a tenant, but not necessarily the landlord. If the landlord wants to see a return on investment from energy-efficiency improvements, the landlord could try to raise the rent. However, this rent raise might not

¹⁵ <http://www.bpf.org.uk/>

¹⁶ <http://www.usgbc.org/>

¹⁷ <http://www.breeam.org/>

¹⁸ <http://www.serfgreen.org/>

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correspond to the actual added value to the building and might scare away potential tenants... One possible solution is for landlords to write in lease clauses which require the tenant to share energy consumption data. Over time, the landlord could then understand the benefit of energy-efficient improvements and adjust the rent accordingly. Ideally, the landlord and client work together to set energy-efficiency targets. For many, collaborations like this fly in the face of the adversarial nature of the landlord-tenant relationship, but attitudes are changing. In fact, some of our clients do use this method.

Hedderly: This collaboration is usually problematic when we are dealing with sophisticated landlords or tenants as clients. To the sophisticated client, every small detail of the deal requires a cost analysis and a push-back leading to added time, effort, or payments is only natural.

Maguire: *We can see from the ISPI reports that designations like Green Star outperform the average building, but does a green building designation need to be proactively marketed by the building owner to tenants and lenders? If so, would a market exist for such a marketing-based designation?*

Lawrence: To talk about K&L Gates, we do market our offices if they move into a LEED® building because we want to promote corporate responsibility. Also, we want to align our values with the values of the clients we serve. The K&L Gates Pittsburgh office is LEED® certified and the building we are in right now is BREEAM® certified.

Hedderly: I think the hard data is important. That is why we have worked with the IPD and their ISPI program. The sophisticated investor or bank does not want marketing in an aesthetic sense. Rather, they want marketing that shows cost savings or higher valuations. It is hard to prove the direct link between a building's sustainability and value; people have worked many years on this relationship. However, ISPI is beginning to give us value generalizations based upon the type of private green building certification attached to a building. We think tools like ISPI will actually change investment behavior.

Maguire: *Many points of your article focus on net-zero and renewable energy efforts in the UK, is the energy industry ready to transition from a utility model to a sales and maintenance model?*

Hedderly: Controversy already exists about where and to what extent people should install things like solar panels or wind turbines. Indeed, many UK electrical utilities are on the cutting-edge of these renewable energy systems. Still that industry is very much in its infancy. Also, government regulations in this field are developing and unsettled. It is certainly true that a company selling solar panels as their only business is not threatening energy utility companies.

Lawrence: The solar panel industry had a significant government subsidy. Recently, this subsidy was withdrawn. The effect on that industry has proven dramatic. Many companies have gone out of business. The solar power industry definitely owes its problems to recession related budget cuts. Wind-based power is running into difficulties on a zoning level.

Cox: As far as I can tell, the energy companies are trying to jump on the renewable energy band wagon. Still, they clearly see there is a lot of work needed to make broad-scale renewable energy possible. The energy companies also want consideration in the Green Deal, in its current form or as modified, because they would like government assistance to make renewable energy promotion economically attractive in the immediate to near future.

Maguire: *Finally, do you think green building issues in the US mirror those in the UK, or do major differences exist?*

Lawrence: Beyond the differences we already discussed, the biggest difference is in the way laws are generated. We have the European Union setting certain environmental targets. I also get the impression there is more direction from central government here in the UK, as opposed to the US. Anecdotally, we tend to think states like California offer more green building direction than some

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others. *Question to you, do you think this California example is more of a stereotype or is this true?*

Maguire: There is a lot of truth to that. California courts, for example, tend to permit more government involvement with environmental issues, even on private property. Also, the state legislature in California passes laws which state agencies, and the courts, can point to as justification for certain actions. In other states, the legislature simply lacks the same level of interest in environmental issues. This also plays itself out when states try to enact something like your Green Deal. Some states will, through the legislature, express interest in paying taxes to create sustainability subsidies. Other states are only interested in cutting budgets, right now. Though, a lot of “Rust Belt” states in the Midwest, so-called because the states feature lots of abandoned factories or housing, chose to embrace sustainability anyway as a means to attract more jobs and new industries.

Lawrence: *Is building retro-fitting popular in these areas? We have not spoken much about this issue of reusing buildings, but that seems like one area where the US and the UK could share interest.*

Maguire: Absolutely! Adaptive reuse of buildings is a major industry. At the very least, building materials often get reused. We do have a separate government regulation and subsidy issue with buildings or sites called Brownfield sites. These sites were once used for some purpose which led to contamination in the soil. Until recently, it was customary to secure government funding to remove this soil and, in some case, subsidize the project. Since 2008, this is less common.

In closing, thank you so much for your time and thoughts. I know your time is very valuable and you are too generous to share it. It was also a pleasure to see your absolutely stunning offices.

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