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WHITE PAPER

February 2024

2023 U.S. Real Estate Round-Up: Effects of State ESG Laws on Commercial and Residential Building Owners

This 2023 U.S. Real Estate Round-Up provides key insights to commercial and residential building owners facing a flock of new state environmental, social, and governance ("ESG") laws proposed or taken effect in 2023, including how to prepare for upcoming compliance periods. In particular, this *White Paper* highlights the increasingly stringent sustainability mandates in Maryland, California, and New York City, outlining the scope, requirements, and potential impact on building owners in these jurisdictions. First, we detail Maryland's proposed Building Energy Performance Standards ("BEPS") and its implications for emissions benchmarking and reporting requirements. Next, we tackle California's Senate Bills 253 and 261 and Assembly Bill 1305, which demand comprehensive greenhouse gas ("GHG") reporting and climate disclosures from businesses and signal a substantial compliance shift for building owners. Lastly, we address New York City's updates to Local Law 97 and the evolving regulations on GHG emissions for covered buildings, underscoring the necessity for adaptability and compliance to avoid stringent penalties.

INTRODUCTION

ESG considerations were at the forefront of regulatory developments in 2023, and regions such as California, New York City and, most recently, Maryland, are leading the way in implementing sustainability-focused standards applicable to commercial and residential buildings. These changes encompass energy performance, carbon emissions reduction, and comprehensive climate reporting requirements. These laws will affect significant business aspects of owning and developing real property, including construction and leasing practices. Proactive adaptation to these regulatory shifts will be key to thriving in this dynamic industry in 2024 and beyond.

MARYLAND

The Maryland Department of the Environment ("MDE") published proposed Building Energy Performance Standards ("BEPS") on December 15, 2023. Maryland's Climate Solutions Now Act of 2022 requires the MDE to develop BEPS for buildings that, among other things:

- Reduce by 20% net direct greenhouse gas ("GHG") emissions by January 1, 2030, as compared with 2025 levels for average buildings of similar construction;
- Reduce by 40% net GHG emissions by January 1, 2035; and
- Achieve net-zero direct GHG emissions by January 1, 2040.

Scope and Requirements

Covered building owners must submit a benchmarking report reflecting all required emissions data to MDE by June 1 of each year, beginning in 2025. This means that covered building owners must begin collecting emissions data beginning January 1, 2024 (covering emissions data from January 1, 2024, to December 31, 2024) in order to submit the first report by June 1, 2025.

Covered buildings in Maryland are 35,000 square feet or larger, excluding the parking garage area ("Covered Buildings"). In addition to stand-alone buildings, Covered Buildings include condominiums governed by a single board of managers and groups of two of more buildings that are served by the same electric or gas meter, or are served by the same heating or cooling system. Historic buildings, public and nonpublic elementary and secondary schools, manufacturing buildings, agricultural buildings, and federally owned buildings are exempt.

Benchmarking information includes descriptions of a building's size and operating characteristics, and information generated by the ENERGY STAR Portfolio Manager regarding the building's energy consumption, efficiency, and performance including energy consumption totals for each fuel type used. **Note:** Electric and gas companies and, in limited cases, tenants in covered buildings, are required to maintain and provide energy consumption data for Covered Buildings to Covered Building owners.

The benchmarking reports are subject to third-party verification beginning in 2025 (benchmarking report due 2026) and as follows:

- 2030 (benchmarking report due in 2031);
- 2035 (benchmarking report due in 2036);
- 2040 (benchmarking report due in 2041); and
- Every five years thereafter.

The building owner of a newly constructed covered building must have a third party verify the first required benchmarking report and then comply with the above schedule for verification of subsequent reports.

Reporting obligations exclude sub-metered and separately metered energy consumption data for:

- Food service facilities that engage in commercial cooking and water heating;
- Electric vehicle charging;
- Electricity uses excluded from site energy by the benchmarking tool; and
- Certain emissions from required combustion equipment.

Covered Building owners may be exempt from benchmarking and performance standards if they are in financial distress or if the Covered Building was not occupied or was demolished in a reporting year. Additionally, Covered Building owners may be exempt from establishing the 2025 baseline performance if less than 50% of the floor area of the Covered Building was occupied during that year. The BEPS also provide relaxed requirements for affordable housing providers.

Beginning annually in 2030, the rules provide an alternative compliance pathway allowing a Covered Building Owner to pay a fee for emissions attributable to the building's failure to meet direct GHG emissions reduction targets, starting at $230 (adjusted for inflation) per metric ton of excess emissions.

Impact on Maryland Building Owners

Covered Building owners should ensure that internal data collection processes are in place to measure and collect all required carbon emissions data to be reported to MDE and promptly inform tenants that they will be required to provide certain benchmarking information. Covered Building owners should also familiarize themselves with the proposed BEPS once adopted, the ENERGY STAR benchmarking tools, and the Technical Guidance and Calculation Methodologies to Comply with Building Energy Performance Standards published by the state.

CALIFORNIA

The recent passage of California's Senate Bill 253 (the Climate Corporate Data Accountability Act, October 2023) and Senate Bill 261 (the Climate-Related Financial Risk Act, October 2023) requires extensive GHG reporting and climate disclosures, going beyond the scope of climate regulation proposed by the Securities and Exchange Commission and applying to both public and private U.S. companies.

Also passed in October 2023 was California's Assembly Bill 1305, otherwise known as the Voluntary Carbon Market Disclosure Act ("VCMDA"), which applies to entities operating in California that make claims regarding the achievement of net-zero emissions, carbon neutral status of the entity or its products, or significant carbon emissions reductions. For example, building owners operating in California that claim their buildings have achieved net-zero emissions would be covered under AB 1305.

Senate Bill 253 – Scope and Requirements

SB 253 mandates that U.S.-based organizations with annual revenues over $1 billion "doing business" in California ("Reporting Entities") must annually report Scope 1, 2, and 3 emissions, covering approximately 5,000 entities directly and many more indirectly. Reporting Entities must commence reporting their 2025 Scope 1 and Scope 2 GHG emissions by 2026, followed by their 2026 Scope 3 emissions from the entire supply chain in 2027.[1]

The reporting obligations in SB 253 are generally consistent with the GHG Protocol. Importantly, there is no materiality threshold that would excuse reporting of minor Scope 3 emissions, which are famously difficult to measure. As such, reporting entities would need to report Scope 3 emissions from e.g., purchased goods, business travel, employee commutes, processing and use of sold products, and all other supply chain emissions.

Reporting Entities must submit emissions calculations to a digital reporting platform overseen by California's Air Resources Board ("CARB"), and disclosures are required to be easily comprehensible to residents, investors, and other stakeholders. Reporting Entities will also be required to hire independent auditors with expertise in carbon accounting to verify their reported emissions—a process also overseen by CARB.

Senate Bill 261 – Scope and Requirements

SB 261 applies to U.S.-based organizations doing business in California with annual revenues exceeding $500 million ("Covered Entities"), covering approximately 10,000 companies. The bill requires Covered Entities to publish a biennial report beginning January 1, 2026, disclosing the entity's climate-related financial risks and measures adopted to reduce and adapt to climate-related financial risks. The report's risk assessment must be conducted in accordance with the guidance and recommendations of the Task Force on Climate Related Financial Disclosures ("TCFD").

Assembly Bill 1305 – Scope and Requirements

AB 1305 generally requires covered businesses (including certain building owners), to post detailed disclosures on their internet websites including: (i) verification and calculation methodologies supporting carbon emissions claims; (ii) descriptions of carbon offset projects and accountability measures; and (iii) disclosures detailing any carbon offset project that fails to be completed or does not meet projected emissions reductions or removal benefits.

AB 1305 requires disclosures to be updated on an annual basis. Note that there is no threshold for the size of the company to which AB 1305 applies.

Impact on California Building Owners

Failure to adhere to SB 253 and SB 261 could subject non-compliant Reporting and Covered Entities to civil penalties from the state's Attorney General, which may be up to $500,000 for violations of SB 253 and $50,000 for violations of SB 261 in a reporting year. Both bills also impose annual administrative fees on subject companies to be paid to the state.

Reporting and Covered Entities may face challenges preparing for the upcoming compliance periods due to the ambiguities baked into the bills—namely, whether or not they "do enough business" in California to become subject to the laws' requirements. The term "doing business in California" is not well defined, but is a legally significant aspect that CARB will define in implementing regulations. CARB may need to clarify whether the test for "doing business" is calculated on a gross rather than net basis, whether it covers income generated solely in California, domestically in the United States, or worldwide, and whether it applies to activity of affiliates (domestic or worldwide).

The "doing business" definition could extend to private companies owning buildings in California, landlords, and real estate investment firms. As a result, landlords may request more exacting reporting requirements from their tenants in lease agreements to ensure they, as building owners, can provide accurate information in their disclosures.

Additionally, to ensure compliance under AB 1305, companies that make any of above-described claims should ensure that processes are in place to collect and measure required carbon emissions data to support covered claims, as applicable. Companies should also be aware that while some VCMDA disclosures overlap with other voluntary carbon offset programs, no other registry currently requires companies to meet all VCMDA disclosure requirements.

NEW YORK CITY

Updates to Local Law 97

Introduced by the NYC Department of Buildings ("DOB") in 2022-2023, the rules prescribed under 1 RCNY §103-14 provide clarity to existing annual carbon intensity limits on GHG emissions from covered buildings in New York City under Local Law 97.

1 RCNY §103-14 adds to Local Law 97 by:

- Creating a credit for beneficial electrification for buildings that transition to electric heating or hot water systems before 2030;
- Lowering the electricity carbon coefficient to support electrification;
- Limiting renewable energy credits ("RECs") to offset emissions from electricity use;
- Aligning the law with New York State climate mandate;
- Expanding property types subject to emissions limits, which will help differentiate building types that use more energy (e.g., supermarkets or datacenters);
- Setting emissions limits through 2050; and
- Establishing criteria for granting "good faith" exemptions (mitigated penalties) to non-compliant buildings that are engaged in work but struggle to meet their annual carbon emissions limit.

Scope and Requirements

Covered building owners are required to bring buildings into compliance with emissions and energy efficiency limits by January 1, 2024, with penalties for noncompliance beginning in May 2025.

With certain exceptions, "covered buildings" are:

- Buildings that exceed 25,000 gross square feet;
- Two or more buildings on the same tax lot that together exceed 50,000 square feet; or
- Two or more buildings owned by a condo association that are governed by the same board of managers and that together exceed 50,000 square feet.

The annual emissions limit for a building is determined by calculating the emissions intensity factors for its various occupancy categories within the building code. Emissions limits ratchet down over five compliance periods (2024-29, 2030-34, 2035-39, 2040-49, and 2050), increasingly restricting the carbon each building will be allowed to emit over time.

Note that certain types of affordable and income-restricted housing have relaxed requirements. For example, buildings with more than 35% rent-regulated units fall under the law's definition for "Article 321 buildings," and must implement certain prescribed low-cost energy upgrades by 2024, rather than meeting the law's emissions limits.

Impact on New York Building Owners

While "sustainable" buildings may increase tenant attraction and retention, costly compliance measures can lead to substantial financial commitments for building owners.

Compliance may necessitate investments in retrofits, transitions to electric heating and cooling systems in the building, and operational efficiency improvements needed to meet emissions limits and support the city's decarbonization goals. Building owners may consider carbon control measures such as set temperatures for building heat and hot water systems, dwelling unit temperature controls, and insulation for piping and steam and hot water tanks. GHG emissions reductions may also be achieved through improvements and retrofits such as adding solar panels, retrofitting HVAC systems, electrifying building systems (e.g., the wholesale replacement of gas stoves with electric alternatives), utilizing LED lighting, and installing temperature-insulating windows.

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ENDNOTES

1 Scope 1 refers to directly controlled or owned GHG emissions and Scope 2 covers indirect emissions from purchased electricity, steam, heating, or cooling. Scope 3 covers indirect upstream and downstream GHG emissions originating from sources not directly controlled throughout the Reporting Entity's supply chain.