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Technical Brief for Commercial Real Estate Lenders & Environmental Professionals

Changing Landscape of Phase I ESAs - What It Means for You

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With permission by the publisher, RMA Journal, and the author, Kathryn Peacock, EDR Insight is sharing one environmental professional's reaction to the ASTM E 1527-13 revisions. Peacock's detailed analysis of the changes in the areas of REC-CREC-HREC determinations, vapor migration and agency file reviews also includes the first concise breakdown on the expected impacts of the ASTM changes on pricing for Phase I ESAs. With thanks to Peacock, EDR Insight shares her article titled "Changing Landscape of Phase I ESAs."

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Within the last decade, many banks have adopted environmental risk management policies and programs in order to minimize their exposure to environmental risks.

Indeed, potential environmental liability has become increasingly relevant to the banking industry. Environmental risks can have far-reaching consequences if not addressed during the due diligence process. Potential risks that may be encountered during the transaction process include 1) a reduction in the value of a collateralized property if contamination is identified, 2) disruption of property transactions due to environmental cleanup requirements, and 3) possible cash flow problems due to cleanup costs, particularly in default situations.

Identifying Environmental Risk

Financial institutions have several tools available for identifying environment risk, but the one most banks rely on is the Phase I Environmental Site Assessment (Phase I ESA). Risk management professionals often use Phase I ESAs as a tool for identifying the environmental risk associated with real estate transactions.

The current standard used by environmental professionals conducting Phase I ESAs is the American Society for Testing Materials (ASTM) E1527-05 Standard Practice for Environmental Site Assessments. ASTM E1527-05 was designed to meet the U.S. Environmental Protection Agency's requirements for All Appropriate Inquiry (AAI) for environmental due diligence. AAI is the process for evaluating a property's environmental condition and meeting the requirements of the Innocent Landowner Defense under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA).

ASTM requires that the E1527 standard be revisited at least every eight years, so ASTM E1527, last revised in 2005, is currently under review. A revised standard—ASTM E1527-13—is due to be released in 2013. The ASTM committee and task groups that oversee the revision process have been meeting over the past year to reach a consensus on the proposed changes. If no action is taken to reapprove or revise the standard, the standard expires or "sunsets," becoming invalid.

While the new standard and scope of work will remain largely the same, some important new changes are proposed. Industry professionals have followed the revision process closely because of the possible impact the proposed changes could have on the way Phase I ESAs are conducted and written. There is also a concern that the proposed changes might increase costs and lengthen report delivery times.

New Terms Essential to Understanding Environmental Due Diligence

The proposed revisions to ASTM E1527-05 include new procedures and new terminology. Knowing the definitions of the existing and proposed terms is essential for those reading and interpreting Phase I ESAs and for understanding the concepts proposed in ASTM 1527-13.

Recognized Environmental Condition (REC)

Current definition:

"The presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products into structures on the property or into the ground, groundwater, or surface water of the property. The term includes hazardous substance or petroleum products even under conditions in compliance with laws."

Many consultants and attorneys have found the wording of this definition confusing and ambiguous. The proposed revision to the REC definition appears below. This change is unlikely to have any significant impact on which conditions would be considered a REC; the change is simply to make the definition easier to understand.

Revised definition:

"The presence or likely presence of any hazardous substances or petroleum products in, on, or at a property 1) due to any release to the environment; 2) under conditions indicative of a release to the environment; or 3) under conditions that pose a material threat of a future release to the environment."

Historical Recognized Environmental Condition (HREC)

Current definition:

"An environmental condition which in the past would have been considered a REC, but which may or may not be considered a REC currently."

The HREC is intended to apply to releases that have been remediated in the past and have received closure from a regulatory agency. The HREC term has caused a fair amount of confusion in the industry, especially in regard to whether some HRECs can also be considered a current REC (if the site is closed but residual contamination remains) and what this all means to the owner or user of the report. Therefore, to clarify the purpose of the HREC classification, a revised definition has been proposed, as well as a completely new term that will better describe the risk level of certain past releases.

Revised definition:

"A past release of any hazardous substance or petroleum products that has occurred in connection with the property and has been addressed to the satisfaction of the applicable regulatory authority or meeting unrestricted residential use criteria established by a regulatory authority, without subjecting the property to any required controls (e.g., property use restrictions, AULS, institutional controls, or engineering controls), at the time the Phase I ESA is conducted (e.g., if there has been a change in the regulatory criteria). If the EP considers this past release to be a REC at the time the Phase I ESA is conducted, the condition shall be included in the conclusion section of the report as a REC."

New Term: Controlled Recognized Environmental Condition (CREC)

ASTM E1527-13 may include a new category of REC: the Controlled Recognized Environmental Condition (CREC). The CREC would apply to risk-based closures of contaminated sites where no further remediation is required, but where residual contamination still exists above residential levels and the property is subject to activity and use limitations. These sites, where contamination is controlled but could still pose ongoing or future obligations for the owner (such as special precautions during development activities), have been a source of some confusion to the environmental due diligence industry. Many have wondered, "Should this be an HREC or a current REC? It's not a huge red flag, but I don't want the client to think that there is no issue, either." The proposed changes make the classification much clearer.

If a polluted industrial property had been cleaned up to an acceptable extent (with some contamination remaining) and received closure by a regulatory agency, and the agency implemented a restriction limiting the use of the property to commercial and industrial uses, this would be a CREC.

If the industrial property had been cleaned up and closed, and there are no land-use restrictions (the property could be redeveloped into a residential complex), then this would be an HREC. In both the CREC and the HREC, the drivers are the presence of residual contamination.

Initially, there may be some confusion about what constitutes a CREC; however, once all parties get acclimated to the term, there is a strong potential that it will provide greater clarity in disclosing the degree of risk and the implications for the financial institution. For example, if a borrower is taking a loan out for redevelopment of a site with a CREC, the lender (and the owner) should be aware that there may be some additional costs and limitations associated with developing a site with known contamination. In other words, a closed site does not always mean that no further action is required. If identified in the Phase I ESA, CRECs should be a signal to the banking professional that contamination is still present and that there may be added costs to the bank (in foreclosure situations) or to the borrower.

If adopted, this new term will be included in the findings and conclusions section of the Phase I ESA.

New Emphasis on Assessing Vapor Migration

Vapor Encroachment Condition

Definition:

"The presence or likely presence of vapors in the sub-surface of the target property caused by the release of vapors from contaminated soil or groundwater either on or near the target property."

The potential liability and the impact on property value due to vapor migration and intrusion into a property's structures have been of increasing concern for lenders. This issue was most recently addressed in June 2010, when ASTM published E2600-10, Standard Guide for Vapor Encroachment Screening on Property Involved in Real Estate Transactions. The industry has been divided on whether an assessment of vapor migration risk is required as part of the Phase I ESA and, if so, whether this separate ASTM standard should be used in conjunction with all Phase I ESAs or if the Phase I ESA standard alone is sufficient.

Several proposed changes to ASTM 1527-05 will create a stronger emphasis on assessing vapor encroachment risk by 1) clarifying that the definition of a release does include contamination in the soil vapor phase, not just in soil or groundwater; 2) adding a definition of "migration" that includes vapor (as well as soil and groundwater); and 3) clarifying that vapor migration/intrusion does not fall under the category of an Indoor Air Quality concern (which is out of the ASTM 1527 scope of work).

If these changes are approved, some consultants may address vapor encroachment concerns more explicitly within the standard Phase I ESA scope of work. However, it's possible that consultants will add the E2600 screening at an approximate cost of $500 to $600. Currently, consultants commonly do one of the following:

- Conduct an additional ASTM E2600 screen to evaluate vapor risk.
- Evaluate vapor risk within the Phase I ESA.
- Ignore the issue and do not evaluate vapor at all within the Phase I ESA.

According to a recent survey conducted by Environmental Data Resources, the leading market monitor for the environmental due diligence industry, between 14% and 22% of the consultants surveyed are currently including vapor migration screens as part of their Phase I reports. Furthermore, only around 38% of these consultants are using a Tier 1 ASTM E2600-10 screen to do so. With such a small percentage of consultants addressing vapor at this time, a mandate to discuss vapor explicitly within the Phase I will likely result in a cost increase for the user.

Greater Imperative to Conduct Regulatory File Reviews

Another potential change to E1527-05 is the stronger recommendation for regulatory file reviews on adjacent properties. With this change, file reviews for adjacent sites listed in a regulatory database will be recommended unless the environmental professional is of the opinion that a review is not warranted. However, the environmental professional must explain in the Phase I ESA why the regulatory file review of adjacent properties was not conducted.

Another factor that may add to report-production time is the number of days it takes to complete a file review, which varies widely from state to state and from agency to agency. Some county and municipal agencies may be able to search records online and e-mail the results. But while one week may be sufficient for a file review in one state, a month may be the required time in another. Finally, some state agencies charge large fees to search for records and may take up to four weeks to notify the consultant if records are available.

Comparing a Phase I ESA Written in 2012 to One Written to the New Standard

A good way to see how the changes may impact costs and decision making is to consider a Phase I ESA written in accordance with ASTM E1527-05 and then determine which changes would make it compliant with the proposed ASTM E1527-13.

Consider a warehouse building located in a heavily industrialized area historically used for manufacturing purposes. Past operations resulted in an on-site release of solvents to soil and groundwater. Under the direction of a regulatory agency, remediation was conducted and the case was granted closure. Elevated levels of contaminants were allowed to be left in place with a land use restriction. Adjoining properties in each direction include industrial facilities with known releases.

HREC vs. CREC

Before:

Under ASTM E1527-05, most consultants would call the on-site release an HREC based on the fact that regulatory agencies had granted the property closure. However, many in the industry struggled with this term because it did not address either the contamination that was left in place or the land-use restriction and how they might impact the property owner's continuing obligations.

After:

Under the proposed ASTM 1527-13, this case would fall under the umbrella of the Controlled Recognized Environmental Condition, owing to the presence of residual contamination and an associated land-use restriction.

A Comparison of ASTM E1527-05 and ASTM E1527-13

	ASTM E1527-05	ASTM E1527-13	Cost Increase	Timing Delays
HREC	Contamination present with regulatory closure	Regulatory closure; contamination may still be present, but only if below residential cleanup standards	None	None
CREC	N/A	Regulatory closure; contamination present above residential levels with land-use restriction	None	None
File Review	Not explicitly addressed	Recommended for adjacent properties	From $50 to $500, depending on size and types of files	One to six weeks
Vapor Risk	Not explicitly addressed	A strong emphasis on assessing vapor migration/encroachment risk	Highly variable; prices could increase from $500 to $600 if a separate E2600 screen is performed	Minimal

Regulatory File Reviews for Adjacent Properties

Before:

The exact number of consultants who would have performed a file review for the adjacent properties is unknown. However, it's likely that approximately half of the consultants would have performed file reviews for these adjacent properties under E1527-05.

After:

Under ASTM E 1527-13, it's possible that more consultants will choose to perform file reviews for each adjacent property rather than explain why file reviews were not conducted. Reviewing files for these industrial properties would be important to understanding whether the releases are impacting the subject property, but could also result in a timing delay and a cost increase. Meanwhile, explaining why file reviews were not conducted is also time consuming and, in this case, would not be a prudent option given the presence of known contamination at these sites.

Vapor Encroachment

Before:

As mentioned, the results of industry surveys conducted by Environmental Data Resources in 2012 indicate that fewer than 25% of consultants are currently addressing vapor risk within the Phase I ESA. Therefore, it's highly likely that vapor encroachment risk would not have been addressed explicitly in this case.

After:

Consultants will be explicitly addressing vapor risk, and an extra effort to explain this risk will be required under the new ASTM 1527-13. This could also increase the imperative to review files for releases on adjacent properties to determine if they could pose a vapor encroachment or intrusion risk.

What Does This Mean for Risk Managers?

A decision on the proposed changes likely won't be final until late spring of 2013. Banking institutions should expect to see Phase I ESAs transforming into ASTM E1527-13-compliant reports within one year from the date the revised standard is approved. The proposed introduction of new terminology and procedures will likely have some impact on pricing and report timing; however, it is too early to determine just how much impact the proposed changes will have on the Phase I ESA. Still, the revised standard may provide risk managers with a more comprehensive risk screening tool and further assist banking professionals in understanding, interpreting, and minimizing exposure to environmental risks.

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Questions or comments?

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