Building resilience—California real estate opportunities and challenges during the drought

By Ian T. O'Banion and Alison B. Torbitt

California is in the midst of historic drought conditions and for those of us working on California real estate deals, it is time we start thinking about what this means and how these two relate. Hopefully, as sellers, buyers, developers, construction companies and lenders, you are already thinking about conservation, green building, sustainability, water risk and the other “buzz” words, but in case you are not, or, in case you want to think about it even more, here’s what our multi-disciplinary Drought Task Force is thinking about when it comes to what this means for the real estate industry and how businesses can position themselves to be more profitable as the dry spell continues. To set the scene, California’s governor has mandated a 25% reduction in urban water usage, the Sustainable Groundwater Management Act is being implemented, and water suppliers and users alike are in the process of developing strategies for compliance in midst of dwindling supplies.

As every developer, investor, buyer and seller knows, every real estate transaction involves performing due diligence. As the drought conditions continue, traditional due diligence should expand to focus on water supply, water costs, development costs and other water related issues during the due diligence phase of a project, as water, more and more so, will have a profound effect on property valuation here in California. By leveraging our knowledge of sustainable development and green building standards, including Leadership in Energy and Environmental Design (LEED®), we are helping our clients to evaluate real estate transactions in the context of the drought, and to build smarter, more resilient communities.

The drought may be part of a much longer cycle or simply a temporary condition, but in either case, the built environment will be impacted. Whether or not the drought is short-lived, it will certainly create challenges for the real estate industry in California. The good news is there are plenty of opportunities for those who plan ahead. For example, owners, managers and developers of real estate in California can and should lead the way in implementing water reduction and conservation strategies for their buildings and operations, as this will lower current operational costs and protect against the impact of future drought conditions, as well as potential fines or upcharges from water suppliers. Further, any creative solutions developed for dealing with the current drought in California could be marketed to others, or could serve as a model for responding to severe droughts in other parts of the world.
The well-being of the built environment is heavily dependent on water from the natural environment. As the built environment in California continues to grow along with the state’s population, the real estate industry must adapt to the changing (and reduced) supply of water in order to continue to thrive. The effect of the drought conditions in California will ripple through the real estate industry impacting it in a number of ways, including water rationing, cost of living, development costs, urban migration, increased utility costs, property values and lending restrictions. With each of these challenges there are also opportunities for creative solutions.

**Efficiency standards**

As we discussed in a prior alert ([California’s mandatory water restrictions—just in time for summer, but too little, too late?](#)) the governor’s mandate created a state-wide urban water usage reduction target of 25% in comparison to 2013 water usage. The State Water Resources Control Board translated this into a number of water targets for individual water suppliers ranging from an 8% conservation standard to a 36% conservation standard. The individual water suppliers have the discretion to determine how to best meet these conservation standards. It is important that building owners and operators proactively help policy makers to develop conservation and efficiency measures that are feasible, and potentially even beneficial to their businesses, in order to work with the water suppliers to achieve their mandatory reductions and escape the very real potential of quickly escalating water costs and penalties.

**Dense transit oriented development**

There are opportunities for developers to build dense transit oriented projects as the demand for these types of developments will increase. The drought will continue to impact agriculture production in the state, and lower production yields will likely mean higher food prices. As the cost of living increases due to the drought, Californians will look to offset these increases elsewhere, such as by cutting back on commuting expenses by living near work or near transit that connects to work. Thus, as the cost of living increases, there will likely be an increased demand for transit oriented developments near jobs and amenities, creating an opportunity for residential developers who are at the forefront of this trend.

**Water recapture and reuse systems**

There are enormous opportunities for implementing water efficiency measures in both new developments and building retrofits. Owners can design into their buildings creative ways to capture and reuse water such as green roofs and onsite water retention systems. There are also opportunities for building owners to collaborate and utilize shared infrastructure for water reuse and storm water capture and treatment. Working out solutions on a neighborhood-wide or district-wide scale could lower the cost of water reuse systems for individual building owners by utilizing shared infrastructure. Careful planning, negotiation and drafting of multi-party agreements will be essential to implementing shared water reuse infrastructure.

**Urban development**

There are opportunities for developers in urban areas to proactively work with municipalities to plan for and develop sustainable water and wastewater infrastructure in order to support California’s growing urban population. As the drought puts pressure on the agricultural industry, there may be a further migration westward toward California’s coastal urban centers. The trend toward urbanization is already happening in part due to the job growth in the tech industry and the desire of many to live near work and transit. One challenge for these urban areas will be upgrading and maintaining their water and wastewater infrastructure in order to accommodate the population
growth. Cities should start by setting citywide water capture and reuse goals and start planning now for future sustainable infrastructure projects. There is an opportunity for urban building owners to proactively engage in a dialog about sustainable water infrastructure and to help shape city policies.

**Utilities**

Those that proactively implement conservation measures, while being mindful of the ripple effect potentially caused in the wastewater stream, will be rewarded with lower ongoing expenses while maintaining stability as the cost of water continues to rise. With less water to go around, the rates for water and treating wastewater will increase. Further, with increased water conservation, the concentration of toxins in wastewater may increase, creating a greater toll on wastewater districts. Additional taxes and fees associated with water use and wastewater treatment will increase utility expenses. Thus, utilizing smarter, more efficient systems will allow businesses to stay competitive and thrive as the drought continues.

**Property values**

Water is critical to the agriculture industry. Depending on the severity and length of the drought conditions, certain agricultural land may lose value due to the lack of reliable water. On the other hand, land such as urban infill sites near transit could greatly benefit from an increased demand for urban property as office and residential uses move into urban areas where there is an economy of scale for water infrastructure.

**Financing strategies**

Borrowers should take the opportunity now to plan ahead and develop water reduction and conservation strategies and create plans for implementing them in order to best situate themselves to get financing for future projects. As the drought continues, banks may start looking more closely at a property’s access to water when making lending decisions. This would likely have the biggest impact on agricultural land, but could also impact lending for property containing water-intensive industries as well as property for residential development. Developing ways of using water more efficiently in your building will not only help lower current operational costs, it could also help when seeking financing.

The drought will certainly impact the real estate industry in California as the built environment is inextricably linked to the natural environment. The extent of the impact may depend on how quickly real estate owners, operators and developers react. The good news is implementing water reduction and water efficiency strategies can be done; it is within the control of property owners and operators to implement these plans, and we are here to help. The current drought conditions are an opportunity for real estate owners, operators and developers and their legal counsel, to think strategically about water usage and develop creative cross-disciplinary conservation and efficiency measures to stay ahead of the challenges that the real estate industry will face in the future.

For more information on the content of this alert, please contact your regular Nixon Peabody attorney or:

- Ian T. O’Banion at iobanion@nixonpeabody.com or (415) 984-8313
- Alison B. Torbitt at atorbitt@nixonpeabody.com or (415) 984-5008
- Paul E. Schrier at pschrier@nixonpeabody.com or (415) 984-8280
- Richard M. Jones at rjones@nixonpeabody.com or (213) 629-6070