

## **Sustainability: Energy-Aligned Lease Structures Can Alleviate Split-Incentive Issues—Eventually**

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**By Brad Berton**



As commercial property executives know all too well, the old-school commercial real estate industry is not exactly progressive when it comes to adopting ground-breaking innovations. Even with critical 21st century energy-efficiency matters, progress tends to come in negligible nibbles rather than gargantuan gulps.

A pertinent case in point: Notwithstanding wide-ranging efforts to cut energy consumption in (and carbon emissions from) commercial buildings, a frustrating financial dilemma dubbed the “split incentive” remains an economic impediment to substantial energy retrofits in markets where the modified-gross lease structure is prominent. But that may be changing.

Under traditional modified gross leases, owners do not feel much compulsion to invest in retrofits—primarily because most capital-improvement pass-through provisions have tenants paying their pro-rata shares of common-area upgrades over the useful lives of the modernized

equipment. In other words, while tenants enjoy the lion's share of the energy savings resulting from these upgrades, landlords do not recover their upfront upgrade investments for two or three decades (or more)—not much of a meaningful financial motivation.

In fact, the office of New York Mayor Michael Bloomberg has cited landlord surveys in which 60 percent of building owners indicated long cost-recovery periods are significant impediments to retrofit activities.

But a structural innovation just trickling into the nation's biggest and most influential office market is aimed at helping resolve the split-incentive issue—and hence encourage retrofits—by dramatically shortening the cost-recovery period. The New York City marketplace's new-wave "energy aligned" structure repays landlords' retrofit costs over the much shorter timeframes during which lowered common-area operating costs cover the investments—and with tenants that benefit from those efficiencies ultimately flipping much of the bill.

A high-powered task force of tenant and landlord representatives, attorneys, engineers and other stakeholders collaborated in devising the structure, which was recently incorporated into two large transactions at one of Manhattan's newest high-rises: Silverstein Properties' 7 World Trade Center.

"We all agreed it makes a lot of sense to better align the amortization of capital-improvement costs with the actual energy savings that the improvements generate," noted task force member Greg Hale, senior financial policy specialist with the Natural Resources Defense Council's Center for Market Innovation.

Of course, the arguably complex structural solution had to address needs of both landlord and tenant. In this case, not only is the landlord able to pass through much of the retrofit costs by recovering expenditures in a far shorter period than has traditionally been the case but henceforth they also get the benefit of a more efficiently operating building that can remain profitable even while luring additional tenants at more attractive rental rates.

Tenants willing to adopt the innovative lease language gain more energy-efficient (and perhaps healthier) offices, and after the retrofit payment period expires, they continue benefiting from the lower pro-rata common-area operating costs without further financial obligation. Granted, the complex energy-aligned structure introduced in New York is unlikely to take the industry by storm over the coming couple of years. Ditto for any versions subsequently developed in other office markets around the country. Instead, the structure appears headed for adoption on quite a protracted basis: lease by lease by lease, as existing terms roll and new space needs arise. "It's hard to transform the marketplace quickly when office leases often run 10 or 15 years," observed Roy Torbert, an analyst specializing in retrofit investment issues at the Rocky Mountain Institute.

Indeed, the longer-term energy-aligned strategy for enlightened landlords is to sign all or at least a high proportion of a property's (or portfolio's) tenants to capital-improvement accounting language that shortens cost-recovery periods sufficiently to encourage substantial retrofits, added Brian Pearce, general manager overseeing Unico Properties' Portland portfolio.

For instance, Pearce's team since last year has been signing tenants at Portland's Commonwealth Building to an energy-aligned lease, allowing the landlord to recover energy-efficiency capital-improvement costs over a far shorter period than the traditional 39-year depreciation schedule associated with standard GAAP accounting. Thus, if an investment pays for itself through energy cost savings in just three years, the property owner can amortize the pro-rata cost to the tenant's capital improvement pass-through over that dramatically briefer period.

Ultimately, as more and more tenants sign on as leases roll, owners of efficiency-challenged properties in particular will see retrofits pencil out more and more economically, Pearce continued. And while Hale noted that nothing prevents landlords and tenants from modifying existing leases through energy-aligned "side agreements" mid-term, Pearce's experience indicates this is not likely to happen frequently.

Ultimately, though, both see the industry moving in that direction, despite considerable remaining challenges. Meanwhile, technologies and techniques will presumably continue advancing, making even more retrofit options financially viable.

"It's a natural progression of where the industry is headed," Pearce said, adding that a few other Unico properties outside Portland have inked leases with energy-aligned provisions. While Torbert would love to see such structures adopted in more fast-tracked fashion, he sees great promise in the Big Apple's broad-based approach. "Developers in New York are convinced the future is going in this direction, and they're preparing accordingly."

In announcing the first such transaction, Silverstein suggested the energy-aligned language "will become part of every lease" for Gotham high-rises. He has kept to his word, signing financial analyst MSCI to the property's last 125,000 square feet in a similar arrangement a few months after the inaugural 210,000-foot energy-aligned lease with law firm WilmerHale.

It also helps that the city government is "leading by example," as Hale put it. The Department of Citywide Administrative Services has agreed to push for energy-aligned language through its lease negotiations. In addition to the city and NRDC, the language has been endorsed by the influential Real Estate Board of New York, as well as the U.S. Green Building Council and Environmental Defense Fund.

The language is necessarily somewhat complicated. For instance, to buffer against efficiency-improvement miscalculations, the New York structure actually has tenants paying the additional pass-through dollars for a period that runs 25 percent longer than the best estimate engineers come up with for the payback period. Accordingly, the annual payments equate to 80 percent of what they would be if costs were amortized over just the projected payback period.

Despite the built-in buffer, however, some tenants still seem likely to resist energy-aligned leases, cautioned sustainability investment specialist Scott Muldavin, executive director of the Green Building Finance Consortium. Perhaps most fundamentally, some tenants are just not thrilled that the structure inherently requires accelerated pass-throughs for capital improvements compared to conventional leases.

And while engineers are getting increasingly accurate with estimates of retrofit-generated efficiencies, some tenants remain concerned about overpaying. Another concern is that tenants won't benefit much from helping fund certain retrofit investments if they are only interested in a short, five-year lease period.

Furthermore, large companies that are party to dozens if not hundreds of leases might simply see a switch to a new model as entailing too much effort. And there will always be tenants for whom energy efficiency is just not a priority.

"There are lots of barriers," RMI's Torbert acknowledged. "I don't think anyone's satisfied with how quickly this is being picked up."

Nevertheless, he perceives heightened interest among multi-property landlords to develop standard language they can use throughout portfolios— or at least sub-portfolios. And quite a few multi-market users are striving to incorporate energy-aligned language as part of culture-wide sustainability strategies.

Hale noted that city officials in Chicago and Philadelphia have contacted the NRDC to help determine whether energy-aligned language emulating the new New York model might spawn energy-efficiency investments in their respective commercial office markets. "It doesn't require any taxpayer funds," Hale stressed, "but we know it can help facilitate retrofits."

Looking forward to when the new structures do in fact spawn upgrades, Muldavin hopes energy-aligned lease language does not end up limiting investments to improvements motivated purely by financial considerations. He would prefer that lease structures also envision "separately negotiated" retrofit activities aimed at achieving less-documentable benefits, such as healthier work environments.

Muldavin likewise stressed that with or without energy-aligned language, landlords should not hesitate to invest in retrofits that will boost efficiency and help retain tenants—even if the payback period is fairly long. "If you're able to deliver space that helps tenants operate at lower costs, that's going to make them happy."