# GREEN LEASE

CREATING AN INCENTIVE TO EFFECTIVELY DESIGN, BUILD AND MANAGE HIGH-PERFORMANCE AND SUSTAINABLE BUILDINGS THROUGH A GREEN LEASE.

BY B. ALAN WHITSON, RPA

The term green lease is often bandied about in conversations regarding office buildings, yet it's a term without a real definition. This might be because so few of the people have ever negotiated a green lease. Some believe you can "green" a lease by adding language to stipulate product requirements and construction practices. While that may give a lease a green tint, it's not enough to make a green lease. To create a truly green lease, we must rethink the basic tenets of today's office lease.

Start by examining how the office building lease has evolved into what it is today, and from there pinpoint which current practices should be changed, and what new practices are needed to create a green lease.

### INCREASING A BUILDING'S VALUE

An office building is a business, and the value of that business is based upon its ability to produce a desired return on investment. Valuation is an arcane subject with many ways to approach this important number, but at the most basic level, an office building's value is determined by capitalizing its net operating income (NOI).

Since capitalization rates are a function of the financial market, there is only one way for a landlord to directly increase a building's value – increase NOI. This can be done two ways: The first way is to increase income. This isn't as easy to accomplish as it seems. Office rents rose just 0.5 percent in 2005, and conditions in many markets will prevent landlords from getting large increases in 2006, according to Property & Portfolio Research. The second way is to decrease the operating costs for which the landlord is obligated – which is easier than raising rents.

During the last 30-plus years, there has been a steady shift in the marketplace from the all-inclusive "Gross" lease to the "Net" lease. The hyperinflation of the early 1970s and the First Oil Embargo started this move as landlords and their lawyers sought ways to protect investments from inflation, and avoid risks the landlord could not control – like rising energy costs. This trend accelerated in the 1980s, when personal computers began to appear on every desktop in corporate America.

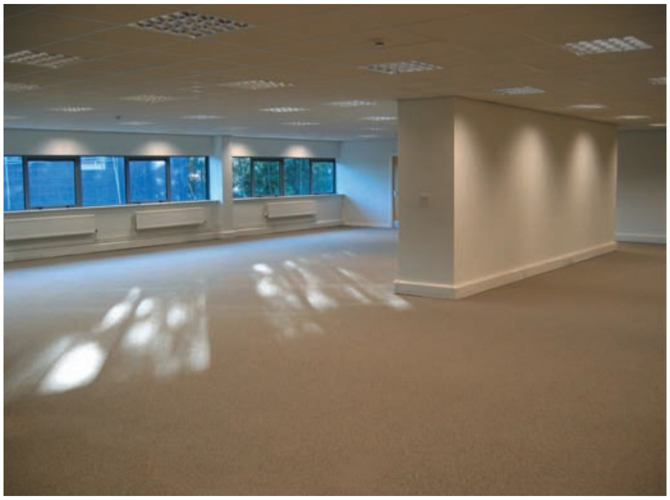
To insulate themselves from inflation, landlords started incorporating rent escalation clauses into their gross lease documents; e.g. annual consumer price index (CPI) adjustment, or scheduled rent increases. In theory, this protects the landlord from inflation and should be sufficient to cover increases in operating costs. However, energy costs, property taxes and the costs of complying with government mandates, such as ADA, began to rise faster than the CPI. Landlords responded by adding clauses to leases to pass through any increase in operating costs to tenants using the base year or expense stop method.

### EXAMINING THE NET LEASE

Other landlords simply chose to adopt the net lease – tenant pays a base rent plus a separate charge for all operating costs, i.e. utilities, maintenance, insurance and taxes. The net lease is similar to the gross lease in that it typically includes some form of rent escalation. The main benefit to a landlord is that a net lease effectively transfers all risks for building operating costs to the tenants. The downside side is that the landlord gets none of the benefits from reducing operating costs, since this has no impact on the building's NOI.

Real estate is a local business with local customs and practices. In some cities the gross lease is the norm, in others it's the net lease. Some cities, such as Seattle, have transitioned over the years from the gross lease to the net lease. Regardless of lease format, tenants in 58 percent of the nation's office buildings do not have energy costs included in their base rent according to CoStar, a national real estate information company.

Proponents of the net lease say this creates a more transparent lease arrangement, and creates an incentive for tenants to use less energy. While good in theory, it doesn't always work in practice. In the average office building, energy costs approximately $1.59 per square foot a year, which is 16 percent of the total operating costs, according to the *Building Owners and Managers Association's 2005 Experience Exchange Report* (BOMA EER). However, energy only represents 0.6 percent of an office tenant's cost of doing business.



If the average tenant with a net lease could reduce their energy usage by 40 percent – the average for U.S. Environmental Protection Agency (EPA) ENERGY STAR buildings – the savings would be $1.00 a day per employee. Clearly, this is a minuscule reward for the cost and effort needed to reduce energy usage. When tenants seek to cut costs, the usual response is not a lighting upgrade. Tenants opt for a hiring freeze or a layoff, as workers are 80 percent of the cost of doing business. Even if the tenant did a lighting upgrade, the savings would be diluted beyond anything meaningful without the sub-metering of each tenant's electrical usage, which is prohibited in many states.

For the owner of an office building with gross leases, it's a different situation. Reducing energy costs in the average office building by 40 percent would save $0.64 per square foot. If these savings were capitalized at 7.75 percent this would increase the building's value by $8.26 per square foot.

Net leases create an unnecessary hurdle for green buildings. Landlords that have embraced green buildings often find they are paying a premium of one to five dollars per square foot to build a superior building. To compensate for the added investment, they have boosted their asking base rent. On the surface this seems logical. Yet, this logic breaks down because tenants and their real estate brokers know that under a net lease the landlord has little incentive to aggressively control a building's operating costs. Therefore, when a landlord tells prospective tenants, "My building's operating costs will be lower than other buildings in the market," tenants aren't buying it.

When tenants and their real estate brokers look at

## GLOSSARY

**BASE YEAR:** ACTUAL OPERATING EXPENSES FOR A SPECIFIED BASE YEAR, MOST OFTEN THE YEAR IN WHICH THE LEASE COMMENCES. ONCE THE BASE YEAR EXPENSES ARE KNOWN, THE LEASE ESSENTIALLY BECOMES AN EXPENSE STOP LEASE.

**CAPITALIZATION:** A METHOD OF DETERMINING THE VALUE OF REAL PROPERTY BY DIVIDING THE NET OPERATING INCOME BY A PREDETERMINED ANNUAL RATE OF RETURN. ALSO CALLED "INCOME CAPITALIZATION METHOD." SEE "CAPITALIZATION RATE."

**CAPITALIZATION RATE:** THE RATE THAT IS CONSIDERED A REASONABLE RETURN ON INVESTMENT (ON THE BASIS OF BOTH THE INVESTOR'S ALTERNATIVE INVESTMENT POSSIBILITIES AND THE RISK OF THE INVESTMENT.) USED TO DETERMINE THE VALUE OF REAL ESTATE THROUGH THE CAPITALIZATION PROCESS. ALSO CALLED "CAP RATE" OR "FREE AND CLEAR RETURN." SEE "CAPITALIZATION."

**ESCALATION CLAUSE:** A LEASE CLAUSE THAT PROVIDES FOR THE RENT TO BE INCREASED. THIS MAY BE ACCOMPLISHED BY SEVERAL MEANS SUCH AS FIXED PERIODIC INCREASES, INCREASES TIED TO THE CONSUMER PRICE INDEX OR ADJUSTMENTS BASED ON CHANGES IN EXPENSES PAID BY THE LANDLORD IN RELATION TO AN EXPENSE STOP OR BASE YEAR REFERENCE.

**EXPENSE STOP:** AN AGREED DOLLAR AMOUNT FOR OPERATING EXPENSES (EXPRESSED FOR THE BUILDING AS A WHOLE OR ON A SQUARE FOOT BASIS) OVER WHICH THE TENANT WILL PAY ITS PRO-RATED SHARE OF INCREASES. MAY BE APPLIED TO SPECIFIC EXPENSES (E.G., PROPERTY TAXES OR INSURANCE). ALSO CALLED "DOLLAR STOP."

**NET OPERATING INCOME:** THE CASH AVAILABLE FROM COLLECTED RENTAL INCOME AFTER DEDUCTING ALL OPERATING EXPENSES FOR WHICH THE LANDLORD IS OBLIGATED FOR UNDER THE LEASE. ALSO CALLED "NOI."

**OPERATING EXPENSES:** THE COST OF OPERATING AN OFFICE BUILDING, SUCH AS UTILITIES, JANITORIAL, MANAGEMENT FEES, TAXES, INSURANCE AND SIMILAR DAY-TO-DAY EXPENSES. OPERATING EXPENSES SHOULD NOT INCLUDE FINANCIAL EXPENSES LIKE DEBT SERVICE, GROUND LEASES, DEPRECIATION AND INCOME TAXES; CAPITAL EXPENSES SUCH AS ROOF REPLACEMENT; ANY EXPENSE ASSOCIATED WITH THE PRODUCTION OF INCOME SUCH AS LEASING COMMISSIONS AND LEGAL FEES. A WELL-CRAFTED LEASE WILL CONTAIN A SECTION THAT CLEARLY STATES WHAT IS INCLUDED AND EXCLUDED FROM THE OPERATING EXPENSES FOR THE BUILDING.

**RIGHT TO AUDIT:** A LEASE CLAUSE THAT GIVES THE TENANT THE RIGHT TO AUDIT THE LEASE AND DEFINES THE PROCESS FOR DOING SO. THE GOAL OF A LEASE AUDIT IS TO DETERMINE WHETHER CHARGES ASSESSED BY THE LANDLORD UNDER A TENANT'S LEASE ARE CORRECT AND PROPER, AND REFUND ANY OVERCHARGES BY THE LANDLORD TO THE TENANT. A LEASE AUDIT IS ALSO CALLED A RENT AUDIT, CAM AUDIT, LEASE REVIEW OR ESCALATION EXPENSE AUDIT.

space in a new building, some analysis is needed. Typically, the tenant's real estate broker will take the prospective landlord's estimate for operating costs and compare it to other buildings in the market – then to be prudent, assume it to be at the high end of the range.

How big is the range? Much bigger than many people think. With data from the 2005 BOMA EER for 48 office buildings over 600,000 square feet in downtown Chicago, operating costs range from $12.18 to $15.43 per square foot for the middle 50 percent of the sample (24 buildings). That's a spread of $3.25 – a whopping 26.7 percent! The top 25 percent of the sample (12 buildings) have operating costs above $15.43.

An office lease is often a tenant's largest single contractual obligation. A tenant's No. 1 objective is getting the best possible space at lowest total occupancy costs. However, a net lease removes the dollars representing the operating costs from the table. This shifts the tenant's negotiating efforts solely to the asking base rent. The tenant is now in a situation of seeking the lowest total occupancy costs, but is limited to bargaining on 45 to 60 percent of that cost. To aggravate matters, the tenant must prudently

## TEN ESSENTIAL ELEMENTS FOR A GREEN LEASE

A green lease encourages landlords to compete for tenants by designing, building and managing sustainable buildings without sacrificing comfort or service while maximizing the landlord's return on investment. It ensures that tenants receive the full use of space in a high-performance building over the lease term at a competitive price. To meet this dual objective, a green lease must have these 10 essential elements:

1. Gross lease format with appropriate escalation clause and expense stop clause to reward landlord for operating a high-performance building.
2. Appropriate operational procedures and building control/management systems for charging tenants for after hours/excess energy usage, supported by appropriate lease language.
3. A comprehensive and equitable definition of building operating costs in the lease to protect the interest of both the landlord and tenant.
4. As part of the definition of building operating costs, the lease should contain language that allows the landlord to amortize the cost of projects that will reduce operating costs and treat those amortization costs as operating costs, as long as they do not exceed savings.
5. Right to Audit – This lease clause protects the tenant from overcharges and defines the audit process to protect the landlord from frivolous audits.
6. Hazardous Materials – A clause that defines what it is and that neither the landlord or any tenant violates laws or regulations regarding the hazardous materials.
7. Green Cleaning Specifications – This lease exhibit should define the materials, procedures and protocols for cleaning the building in a sustainable manner.
8. Building Rules and Regulations – This lease exhibit stipulates a building-wide recycling program.
9. Tenant Construction Agreement – This lease exhibit defines sustainable product requirements and construction practices.
10. Tenant Manual & Development Guidelines – A guide to explain the building's sustainable features and benefits, procedures and operating parameters, that should provide insights into how to maximize the building's features to create a sustainable workplace.

assume the operating costs will be at the high end of the range.

The landlord enters the negotiations knowing that a prospective tenant with a savvy real estate broker will have other buildings on their short list. At this point, it's all about the dollars and making the deal. Experience has taught landlords that 80 percent of something is better than 100 percent of nothing. The result is that the base rental rate gets disproportionately reduced to make the deal, thus lowering the landlord's return on investment. Oops, it's not a good case for investing in green buildings.

### TIME FOR A CHANGE: GROSS LEASE FORMAT

Clearly, it's time to change. Advances in technology and improved O&M practices make it easier than ever before for landlords to manage operating costs and reduce energy use. Simultaneously, operating costs such as energy have become a smaller percentage of an office tenant's cost of doing business. The net lease fails to take these facts into account, and punishes operational excellence, environmental performance and energy efficiency.

To create the green lease we must return to the gross lease format. The gross lease, with the appropriate language, transfers the fiscal responsibility for controlling operating costs back to landlords, who are far more qualified to do so than the tenants. It creates a financial incentive for landlords to effectively design, build and manage high-performance and sustainable buildings without sacrificing comfort or service while maximizing the landlord's return on investment.

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