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Lease Structure Hinders Energy Efficiency

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Recently, CalPERS, the nation's largest public pension fund, made big news when it set a goal to cut energy use in its $7.9 billion, 144 million square-foot real estate portfolio by 20 percent within five years. The pension fund estimates it will take an investment of roughly $142 million to retrofit their real estate holdings. The payoff for CalPERS? $29 million a year in reduced energy costs!

Will other pension funds, REITs, and big real estate owners follow suit? Don't bet on it in the short term. Why? There has been a steady shift in the marketplace from the "gross" lease to the "net" lease. The hyperinflation of the early 1970s and the first oil embargo started this trend as landlords sought ways to protect their investment and avoid risk they could not control, like as tenant's energy usage.

Workplace & People – Ten Year Cost		
	Present Value @5.75%	
Office Rent 347 SF @ $24.03 – w/2.5% CPI	$68,973	8.0%
Tenant Improvements 347 SF @ $25.00	$8,683	1.0%
Office Furniture $6,000 + $300 Yr. – w/2.5% CPI	$8,014	0.9%
Technology & Support $10,000 + $10,000 Yr. – w/2.5% CPI	$87,471	10.1%
Salary & Benefits $83,678.40 – w/2.5% CPI	$690,356	79.9%
Total 10-Year Costs Present Value	$863,497	100.0%

Source: BOMA, BLS

During the last 30-plus years, landlords have been including various forms of rent escalation into their standard gross lease document; e.g. annual CPI adjustment, scheduled rent increase, pass through of any increase in operating expenses (base year or expense stop).

Concurrently, other landlords adopted the net lease. Tenant pays base rent plus a separate charge for all operating costs, including utilities, maintenance, insurance, and taxes. Proponents, like the U.S. Green Building Council (USGBC), say this creates a more transparent lease arrangement and creates an incentive for tenants to use less energy. According to CoStar, a national real estate information company, tenants in 58 percent of the nation's office buildings do not have energy costs included in their base rent.

This is good in theory, but it doesn't work on the street. An analysis by the Corporate Realty, Design, and Management Institute found that energy costs currently account for 29 percent of a building's operating costs. Energy costs only represent 0.6 percent of the office tenant's cost of doing business, while people and technology account for 90 percent. (See chart)

If the average tenant could reduce their energy usage by 40 percent, the average for EPA Energy Star buildings, the savings would only be $1.00 a day per employee. Sadly, this is an insufficient reward for a tenant to justify the time, effort, and cost needed to seriously reduce their energy usage.

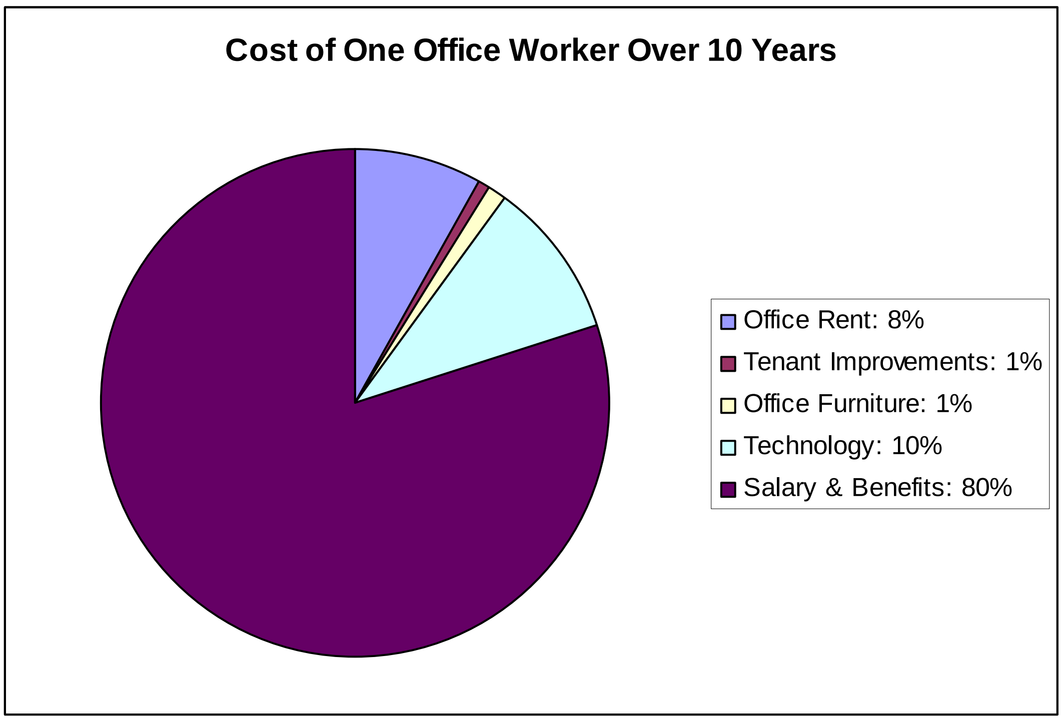
From a building owners perspective it's a totally different situation. Reducing energy costs in the average office building in BOMA International's 2003 Experience Exchange Report (EER) by 40 percent would save $0.76 per square foot. At a 7.75 percent capitalization rate, this would increase the building's value by $9.81 per square foot or $1,888,224.

Here's the rub. The growing popularity of having energy costs excluded from a tenant's base rent has reduced the operating expenses for which the landlord is responsible. Saving energy in those buildings will not increase the landlord's net operating income, nor will it increase the building's value.

The Hurdle for Green Buildings

Landlords who have embraced green buildings often find they are paying a premium of one to two dollars per square foot to build a superior building. Since many of them are using net leases they do not get the financial benefit of reduced operating costs. Landlords have boosted their asking base rent to compensate for the additional investment. It's a logical step since the tenants will benefit from the lower operating costs.

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. When a landlord tells prospective tenants, "this building's operating costs are lower than other buildings in that market," the tenants aren't buying it.



When tenants and their real estate brokers look for new space, some simple math and a few careful assumptions are needed to compare buildings. Since a gross lease includes operating costs, this becomes the baseline. For an existing building with a net lease, it's the asking base rent plus the current year's operating costs. For a new building with a net lease, it's the asking base rent plus some estimate for operating costs. Typically, a tenant and their real estate broker will take the landlords number and compare it to the operating costs of other buildings in the market area - then to be prudent assume it to be at the high end of the range.

How big is the range? Much larger than many people think. Using the 2003 BOMA EER as a source, operating costs range from $13.48 to $16.12 per square foot for 17 of 33 office buildings over 600,000 square feet in downtown Chicago. This $2.64 spread covers the middle 50 percent; eight buildings representing the top 25 percent have operating costs higher than $16.12. What dollar figure do you think a prudent tenant uses as a basis for negotiating a net lease?

Since landlords will not guarantee the operating costs for a building with a net lease and tenants want the lowest total cost of occupancy, this becomes a game of chicken. The prudent tenant is forced to grind on the landlord's asking base rent. Since this is the main focus for negotiation, the base rental rate gets reduced to make the deal, lowering the landlord's return on investment. Oops, not a good case for investing in green buildings.

Despite these economic obstacles, a handful of developers, i.e., Durst, Hines, and Liberty Property Trust, are forging ahead with green buildings. Hines, for one, believes there are a growing number of tenants that will appreciate the value of occupying a green building and market forces will swing in their favor over the long haul.

Ironically, advances in technology and O&M practices make it easier than ever before for landlords to manage energy costs. Simultaneously, energy costs have become a smaller percentage of an office tenant's cost of doing business. The lease structure most landlords use fails to take these facts into account.

It's time to change. A properly crafted gross lease with appropriate escalation clauses creates an incentive for landlords to manage their buildings well without sacrificing comfort or service. The ability of current technologies to control, monitor, and report energy costs can be used to protect the tenant's interest. To do so puts the financial incentive to save energy back in the right place, with those that own and manage the building.

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