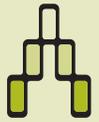


THE HIGH PERFORMANCE PORTFOLIO: LEASING & ENERGY: ALLOCATIONS



BETTERBRICKS
Bottom line thinking on energy.

SUMMARY:

While leases vary widely in their treatment of energy costs, most are a variation on one of the following themes: gross, net, or fixed-base. Each takes a different approach in allocating utility costs – and potential savings – among owners and tenants. With a thorough understanding of these allocations and a concerted effort to align lease terms with high performance objectives, you can pursue energy targets profitably in virtually any leasing environment.

IN DEPTH:

Office leases generally allocate utility expenses between a building owner and its tenants using formulas, as opposed to the metering approach that is more popular in retail and industrial settings. The formulas can vary widely, even among different tenants in the same building. As properties change hands, each new owner brings its preferred approach for allocating expenses. During lease negotiations, a broker's willingness to deviate from that approach depends on market conditions and the relative importance of retaining or attracting a particular tenant.

When it comes to allocating expenses between building owners and tenants in the U.S. office sector, three major types of leases prevail:

- Net leases, where the tenant pays for all expenses
- Gross leases, where the building owner pays for all expenses
- Fixed-base leases, where the building owner pays a certain amount of expenses (as defined by a "base year" or an "expense stop") and the tenant pays the rest

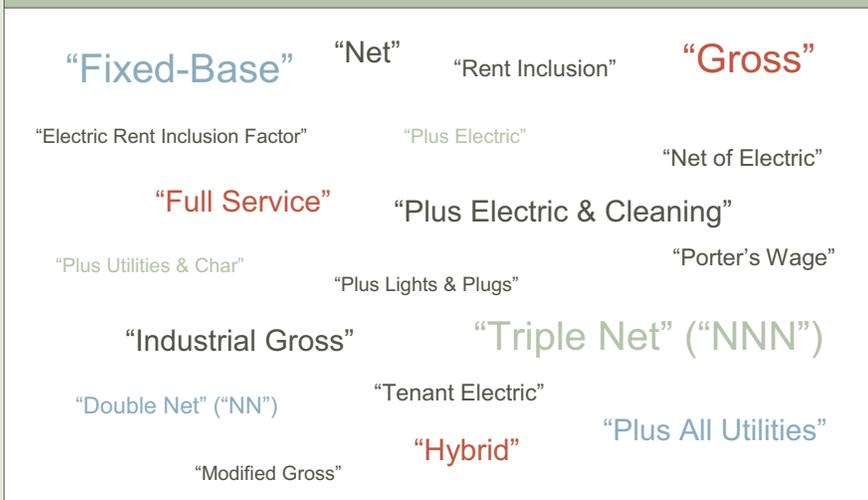
This nomenclature is by no means universal. A wide variety of expense-sharing structures are found in the real world, some with obscure names or market-specific subtleties. For example, some leasing markets use the term "modified gross" to describe a lease where the building owner pays the full amount of some expense categories and either a portion of or nothing toward others.

If the expense-sharing dynamics of a lease are not well understood, the financial implications of improved energy performance may be overstated or understated – clouding decision-making.



“What kind of lease did you say it was?”

The wide variety of lease structures



Another case is the term “Electric Rent Inclusion Factor” (ERIF), an agreed-upon utility cost per square foot added to the base rent.

The terminology and allocations can get even more complicated when the building owner negotiates unique, tenant specific “deals” covering non-standard uses such as data centers or 24-hour customer service centers. These situations often require additional effort to compute a tenant’s monthly bill, such as sub-meter readings, equipment surveys, and engineering calculations.

Given this complexity, opportunities to boost building value are easily overlooked. If the expense-sharing dynamics of a lease are not well understood, the financial implications of improved energy performance may be overstated or understated – clouding decision-making. For example, if a property manager perceives that a tenant is responsible for utility “escalations” he might erroneously label that lease “net” instead of “fixed-base.” Doing so would imply that improvements in energy-efficiency would benefit only the tenant, when in fact the building owner might capture a significant portion of the cost savings.

The good news is that energy efficiency can be pursued profitably in almost any scenario, provided that the building owner takes a strategic view of leasing practices. Too often, negotiations between tenants, brokers, and property managers simply adopt a lease structure from a standard template or update a copy from the last lease signing. In fact, everything is negotiable, and the utility allocation structure of a lease can be a powerful bargaining lever, just like rents, tenant improvement budgets, and operating hours.

Create a clear strategy for how you wish leases to serve your needs prior to entering negotiations. Regardless of lease type, define your best case scenario, and develop policies and practices that will reinforce your energy management goals while still maintaining your competitive edge.

Then, model the financial implications of energy performance, before and during negotiations.

Clarifying the energy issues of a lease – questions to ask:

- What services are delivered to the common area and tenant spaces (lighting, HVAC, etc.)?
- Who delivers each service to the space (owner, utility, other)?
- How is usage tracked, estimated, adjusted?
- Which party actually pays the service provider?
- Is any of that cost reallocated to another party?
- If so, to whom, and how do they know the allocation is correct?
- Do these terms ever change, and if so, how often?
- Are there limitations to the amount of change?
- Who benefits from increased efficiency now?
- Who benefits going forward?

No- and low-cost energy management techniques make sense for owners and tenants regardless of lease type.

Determine what expense-sharing arrangements best meet your needs and those of your tenants, and resist the temptation to sacrifice energy performance goals just to get the deal closed.

One last caution – when it comes to energy, leases deal primarily with who pays the utility bills, and how costs are allocated when major investments are made. However, many of the advantages of high performance buildings can be obtained without major capital investments. No- and low-cost energy management techniques and solutions make sense for owners and tenants regardless of lease type. These operational practices should be explored and implemented prior to any consideration of the need to trigger cost-recovery language.

GROSS LEASES

A true “gross lease” makes the building owner responsible for all operating expenses. With a gross lease, a building owner can invest in energy-efficiency improvements at any time and receive the full benefit of any savings that result. Because the owner is fully responsible for operating expenses, reductions in those expenses will not be diluted between owners and tenants. Any reduction in the owner’s share of operating expenses raises the property’s net operating income, improves the building’s profitability, and supports higher appraised value. However, the final realized rate of return on that investment will depend on many factors, such as the number of years remaining on existing leases and the likelihood that the capital improvement will continue to generate savings when each lease rolls over.

Gross Leases Aligning with energy management goals	
Advantages	<ul style="list-style-type: none"> • Building owner receives the financial savings resulting from reduced energy consumption
Cautions	<ul style="list-style-type: none"> • Tenants have no direct financial incentive to limit energy usage
Best Practices	<ul style="list-style-type: none"> • Conduct needs analysis with tenants to determine expected operating conditions and hours and to optimize choices of equipment • Define procedures for confirmation of expected tenant needs versus actual use, and adjustments • Set minimum standards for installed or other equipment: <ul style="list-style-type: none"> ◦ ENERGY STAR labeled office, kitchen, or other appliances ◦ Building template for lamp count and ballast types for lighting ◦ Occupancy sensors for private offices • Clearly define specifications for: <ul style="list-style-type: none"> ◦ Expected operating hours ◦ Fresh-air standards ◦ Space temperatures ◦ Alternate settings for off-peak hours (nights, weekends)

NET LEASES

A “net lease” assigns the full responsibility for operating expenses to the tenant. This means that all utility expenses – and any increases or decreases to those expenses – will be absorbed by the tenant. Utility usage can be determined through a number of ways, such as direct metering or expense allocation based on square footage. In all instances, however, the tenant pays for its actual or calculated share of utility costs in addition to its base rent.

This arrangement shifts a great portion of the incentive for efficiency from the owner to the tenant, effectively lowering the occupancy cost of the space. Yet there are a variety of reasons that tenants might not be interested in working to improve energy performance in their spaces:

- Lack of information about potential options and savings possibilities
- Inadequate length of the remaining term of the lease
- Reluctance to invest in a property that the tenant does not own

But what if the building owner were willing to fund an energy-saving capital project that would reduce the tenant’s utility expense in return for slightly higher base rent? The tenant should be willing to entertain such a maneuver provided that the tenant’s occupancy costs (i.e., base rent plus operating expenses) are no greater than they were before the upgrade. Dollars that the tenant would have otherwise spent on energy would be redirected to the landlord’s rent roll, supporting higher net operating income and, ultimately, higher property value.

There are additional scenarios where it makes sense for a building owner to move forward with capital improvements to a net-leased space even though the resulting energy savings would fall primarily to the tenant:

- The lease may contain language that allows the building owner to recover the cost of any capital improvement that reduces the tenant’s operating expenses
- The building owner may want to lower operating expenses in anticipation of re-leasing the space at a higher base rent
- The building owner may be planning to transition the building’s leases to either gross or fixed-base

From the building owner’s point of view, cost recovery clauses in the lease should be used only as a last resort, if at all.

Net leases shift a portion of the incentive for efficiency from the owner to the tenant, effectively lowering the occupancy cost of the space.



Net Leases

Aligning with energy management goals

Advantages	<ul style="list-style-type: none">• Building owner is insulated from utility cost increases• Tenants have a more direct incentive to support energy efficiency efforts
Cautions	<ul style="list-style-type: none">• Building owners have less direct financial incentive to limit energy usage• Tenant's "total occupancy cost" can be more volatile due to increased energy bills• Despite receiving significant financial savings, tenants may resist investments in energy efficiency when:<ul style="list-style-type: none">◦ Lease terms are shorter than the anticipated payback period◦ Insufficient knowledge exists on the benefits of energy performance◦ Investment is viewed as a solely benefiting building owners
Best Practices	<ul style="list-style-type: none">• See best practices in Gross Leases table• Coordinate decisions on energy efficiency projects with tenants• Establish measurement protocols to determine share of cost savings allocated to tenants:<ul style="list-style-type: none">◦ Engineering estimates◦ Sub metering• Offer to fund investments in capital upgrades completely, and split cost savings with tenants:<ul style="list-style-type: none">◦ Increase in capitalized value of incremental NOI may justify owner's investment◦ Position the resulting cost savings as an added "service" to tenants◦ Improved relations with tenants may aid future lease negotiations

EVALUATING THE CAPITAL COST RECOVERY OPTION

If your leases contain capital cost recovery language, consider the implications carefully. Some leases place limitations on these mechanisms such as:

- 1) Specifying a minimum number of years over which the cost can be recovered
- 2) Limiting annual assessments to the amount of savings realized by the tenant in that year

Keep in mind that many leases allow the building owner to add a cost of capital to the amortization schedule. In such a case, any dollars that the building owner invests in improving his building's energy-efficiency would be repaid – including interest – with dollars that his tenants would have otherwise wasted on excess utility expense.

Even if a tenant's lease permits capital cost recoveries, a building owner may want to evaluate other options before taking that approach. In fact, from the building owner's point of view, assessment clauses in the lease should be used only as a last resort, if at all. Assessing tenants to pay for energy-efficiency improvements eliminates most of the opportunity for the building owner to capitalize the energy savings and create property value. From a net operating income standpoint, raising the tenants' rent to offset the tenants' energy savings is a better option than having the tenants

reimburse the owner for the cost of equipment. This provides the owner with greater increased cash flow over time, and the best opportunity to increase the property's appraised value.

Finally, depending on the relationship with tenants and the timing of their lease renewals, it might make more sense to pay for the upgrade in its entirety as a "service" to the tenants. In addition to reaping some nominal financial benefits up front, the value of improved tenant relations and satisfaction may outweigh the capital costs incurred. The gains in building competitiveness and marketability will strengthen your negotiating position, and tenants who have benefited from energy management improvements might be more inclined to renew leases, potentially at higher rents.

FIXED-BASE LEASES

A true "fixed-base lease" is a gross lease with an upward limit on the owner's responsibility for defined operating expenses. This limit is generally expressed as either a "base year" or an "expense stop."

The term "base year" refers to the building's operating expenses in a given reference year. Some building owners use the previous year's operating expenses as the reference point for leases signed in the first half of the year, and the present year's operating expenses for leases signed in the latter half.

The term "expense stop" refers to the maximum level of operating expense per square foot that the building owner will absorb before the tenant starts sharing responsibility for that expense. Any amount the tenant pays above the base year or expense stop is called an "escalation."

A base year or expense stop can include all operating expenses or any subset of them, including but not limited to utilities, housekeeping, administrative, roads and grounds, repairs and maintenance, and security. If multiple expenses are grouped into a single base year or expense stop, a decrease in one expense could be offset by an increase in another. For example, assume that a particular lease assigns the building owner the responsibility to pay all operating expenses up to an expense stop of \$6 per square foot, and that when the lease was signed the energy portion of that expense stop was \$2 per square foot. Then in Year 2, energy costs rise to \$2.10 per square foot while all other building operating costs remain the same. Since total operating costs are now \$6.10 per square foot, the tenant would have to pay a \$0.10 per square foot escalation.

Now assume that in Year 2, energy costs rise to \$2.10 per square foot, but some other expense category decreases by at least the same amount. In this example, the tenant would owe no escalation, since total operating expenses did not exceed the agreed-upon expense stop of \$6 per square foot.

It is in the building owner's best interest to ensure that operating expense savings achieved in one category (like energy) are not overrun by increases in another (like janitorial).



To optimize decisions on these questions - and present the best proposals to tenants - calculate the cash flows of any potential project thoroughly.

It is in the building owner's best interest to ensure that operating expense savings achieved in one category (like energy) are not overrun by increases in another (like janitorial). Dividing operating expenses into several categories – each of which has its own base year or expense stop – is a common solution. In the example above, if the lease had specified a \$2.00 expense stop for energy, and a \$4 expense stop for all other operating expenses, the tenant would be

obligated to pay the \$0.10 escalation per square foot and the building owner would keep any savings realized in other operating expense categories.

ALLOCATIONS IN FIXED-BASE LEASES

In a fixed-base lease that sets a separate base year or expense stop for utility costs, the tenant is only responsible for utility costs above a certain level. A rise in utility costs during the lease term could be the result of a rate increase, an increase in the tenant's utility use, or a lease formula that changes the allocation between the building owner and the tenant under certain conditions.

Incentives for building owners and tenants to improve energy efficiency will depend upon where the tenant's utility usage is in relation to the fixed-base limit placed on utility expenses. Moreover, the incentive for either party to invest in new equipment may change as a tenant's utility usage approaches, and then crosses, the fixed-base limit defined by the lease.

When does it make sense for owners to pursue energy savings in fixed-based leases? That depends. If the operating expenses were presently higher than the current expense stop, the tenant would already be paying for a portion of the energy cost. Reductions in energy usage would first financially benefit the tenant. If the savings were sufficiently large to reduce the operating expenses to a point below the expense stop, the owner would benefit as well. The age of the expense stop, the volatility of energy prices since the lease was negotiated, and other factors determine how much of the operating expenses the tenant has begun to pay and how large the savings figure would have to be before the owner begins to benefit.

To optimize decisions on these questions - and present the best proposals to tenants - model cash flows to all parties to explore impacts before and after a given capital upgrade. This can be accomplished using your mechanisms for tracking leases or cash-flow – a spreadsheet or an Argus run, for example. Different scenarios will impact the parties in multiple ways, but by exploring different iterations and approaches, a solution that builds value for both owners and tenants should emerge.



One last consideration of fixed-base leases is their potential to affect long-term revenues. As referenced above, new leases often use the current year’s operating expense level to define their “base year,” which is effectively the owner’s maximum liability for operating expenses for each year of the new lease. The higher the base year, the higher the owner must set the base rent in order to reach the owner’s targeted net rent per square foot. Conversely, the lower the base year, the more competitively priced the base rent can be.

Looked at another way, if operating expenses are at or above the expense stops on existing leases, you’ll likely have to set higher expense stops for future leases. Unless you can increase base rents on all new leases to compensate for this increased stop, net operating income will fall as tenants roll over, which may depress the appraised value of the property. By reducing energy costs now, you’ll have more flexibility in setting base rents, and will compete more effectively for price-conscious tenants.

Fixed-base Leases Aligning with energy management goals	
Advantages	<ul style="list-style-type: none"> • Building owner is insulated from utility cost increases above a certain negotiated point
Cautions	<ul style="list-style-type: none"> • Utility cost increases can overwhelm caps on tenant escalations • Expense stop levels should be monitored and adjusted to mitigate any financial liabilities due to sudden energy price or usage changes • Combining utility costs with other operational expenses in one expense stop pool term can mask shifts in individual expenses • Interactions between multiple tenant’s energy use can distort savings • Despite the prospect of significant financial savings from improving energy performance, tenants may resist investments when: <ul style="list-style-type: none"> ◦ Lease terms are shorter than the anticipated payback period ◦ Insufficient knowledge exists on the benefits of energy performance
Best Practices	<ul style="list-style-type: none"> • See best practices in Gross Leases and Net Leases tables • Examine removing energy use of tenants who pursue energy efficiency upgrades from the base year/expense stop calculation pool: <ul style="list-style-type: none"> ◦ Isolates the financial benefits of reduced energy costs to their space ◦ Limits “free rider” effect of other tenants benefitting from adjustments to base years, expense stops and/or escalations without sharing in the cost of implementing the improvements • Renegotiate expense stop or base year levels reflecting new operating expenses due to lower utility costs • Establish separate base years or expense stops for utility expenses and other operational costs

THE BOTTOM LINE:

- Lease structures, and their definitions, vary widely.
- While lease language can have an important impact on efficiency-related capital budgeting, no- and low-cost approaches to improving energy performance make financial sense regardless of lease type.
- All three major forms of leases – gross, net, and fixed-base – can be profitably exploited to improve building performance.
- Thoroughly understanding the allocations of costs and savings defined in your leases is critical to making sound management decisions.
- Most leases permit the owner to recover the cost of capital improvements that reduce operating expenses. However, in some cases it makes more sense for the owner to waive the right to such recoveries in the interest of improved tenant retention/attraction or other issues.

USEFUL LINKS:

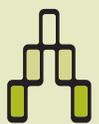
The High Performance Portfolio Framework
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Leases & Energy: Administration
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Leases & Energy: Modeling
www.betterbricks.com/office/briefs

Upgrading Tenant Spaces
www.realwinwin.com/White_Papers/06.12.15_Upgrade_Tenant_Spaces.pdf

Energy Efficiency Economics: What You Need to Know
www.realwinwin.com/Articles/2003_What_You_Need_To_Know.pdf



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