

AFTER-HOURS HVAC

Understanding And Limiting The Tenant's Exposure: How To Save Real Money

It seems not long ago the work day began at 9:00 AM and ended at 5:00 PM. Gradually this shifted to 8:00 AM to 6:00 PM. For better or for worse, today's workplace often requires dramatically different and greatly extended working hours. Some of this has been caused by a company's need to be more productive or efficient; to do more with less people. Some of it is a result of the increasingly "flat" or "global" economy, requiring people "here" to be in the office when people "over there" are in their office. Whatever the cause, it is ever more common to drive past an office building at 7:00 PM or 11:00 PM or 5:00 AM and see the lights on and the employees at their desks. When you then add to this phenomenon the combination of deregulated utility markets and higher core energy costs, the result, for many tenants, is an increasingly unpleasant surprise in the form of a big bill from their landlord for after-hours HVAC service.

Since tenants cannot readily effect market-based utility or energy rates and cannot realistically reverse this new, longer work cycle, the only lever a tenant retains some control of is the manner in which – if at all – it is required to pay its landlord for after-hours HVAC usage. In most multi-tenant buildings, it is reasonable for the landlord to require the tenant to pay for after-hours HVAC usage for the following reasons:

- Charging tenants for after-hours HVAC usage discourages waste and/or encourages conservation.
- By charging a tenant for the service and applying the corresponding revenues against the expenses incurred by the landlord in providing that service (i.e., utilities, repairs, labor, etc.), it prevents the scenario where the tenants of a building who do not utilize after-hours HVAC end up, via the annual operating expense charges, subsidizing the usage of those tenants who do consume after-hours HVAC service.

However, the practice and details of how tenants are charged for after-hours HVAC service varies considerably from market to market and even from building to building or landlord to landlord within a market. For example, an hourly charge for after-hours HVAC service at a 100,000 square foot building in suburban Dallas might be \$25.00 per floor while the same service at a comparable building in suburban Boston or Chicago might be billed at \$50.00 per hour per floor. Similarly, it is not uncommon to find a landlord in New York City charging its tenants \$350 per hour per floor (often with a two floor minimum even though the tenant might only lease one floor in the building), while a comparable building in downtown Los Angeles may charge \$100 per hour per floor.

To put this in better perspective, consider the case of three (3) separate tenants, each of whom lease 20,000 square feet of office space on one floor of a multi-tenant office building. The first tenant operates its business 12 hours per day, 6 days per week. The second operates 18 hours per day, 6 days per week, and the third operates 22 hours per day, seven days per week. Assuming each tenant's

lease defined "standard" hours to be equivalent to 55 hours per week (i.e., 8:00 AM – 6:00 PM Monday – Friday and 8:00 AM – 1:00 PM on Saturdays), these three hypothetical tenants would, depending upon where they were located and how their lease allowed their respective landlords to charge them for after-hours HVAC service, be faced with the following bills each year for their after-hours HVAC usage:

	Excess Hours/Week	Suburban Dallas - \$25/Hour		Downtown L.A. - \$100/Hour		New York City - \$350/Hour	
		Annual Cost	Annual \$/RSF	Annual Cost	Annual \$/RSF	Annual Cost	Annual \$/RSF
Tenant #1	17	\$22,100	\$1.11	\$88,400	\$4.42	\$309,400	\$15.47
Tenant #2	53	\$68,900	\$3.45	\$275,600	\$13.78	\$964,600	\$48.23
Tenant #3	99	\$128,700	\$6.44	\$514,800	\$25.74	\$1,801,800	\$90.09

Considering the economic impact of even the lowest cost scenario above (i.e., Tenant #1 in suburban Dallas), tenants and their brokers, attorneys and lease administrators / auditors are well advised to pay extremely close attention to the negotiation of a lease's after-hours HVAC provisions as well as to each landlord's implementation of these provisions after the lease is executed. The following are some of the key considerations tenants and their advisors must proactively address in order to reduce their future after-hours HVAC-related obligations and to recoup past overcharges.

NEGOTIATING THE LEASE TO LIMIT EXPOSURE:

Consideration #1: Focus on "actual, incremental, out-of-pocket costs"

All costs actually incurred by a landlord in providing after-hours HVAC service are already included in a building's operating costs. However, neither the hourly charge nor the operating expense escalations are intended to duplicate one another. Operating expense escalations are not intended to be profit generators to landlords. However, many landlords seek – if left unchecked or if their lease allows – to profit from providing after-hours HVAC service to their tenants. In order to eliminate this situation before it has a chance to begin, tenants must define the landlord's hourly rate as what the landlord represents to be its "actual, incremental, out-of-pocket cost incurred to provide one hour of after-hours HVAC service per floor [or zone, etc.], without mark-up or profit." In doing so, the tenant will have positioned itself to easily verify the aggregate sum of all after-hours HVAC revenues received by a landlord were applied against the building's operating expenses in order to eliminate the duplication of expense which would likely occur otherwise.

Understandably, some landlords react to language such as this by claiming to be unable or unwilling to calculate their "actual, incremental, out-of-pocket cost." Given the complexities of a building's HVAC and energy management systems, this is often a realistic response. However, the easy solution is for the landlord and tenant to agree upon a rate and stipulate that rate – whether it is \$10.00 or \$300

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per hour – represents the “actual, incremental, out-of-pocket” cost.¹ By virtue of establishing all of the revenues collected by the landlord reflect the costs it incurred in providing the service, not only does language such as the above achieve the widely understood basis for charging tenants directly for this service (i.e., to avoid the scenario where non-users subsidize the costs via operating expenses), it also eliminates future debate about what portion of the landlord's HVAC revenues need to be applied against operating expenses.

Consideration #2: Focus on prorating cost among simultaneous users

Most modern multi-tenant office buildings have sophisticated energy management / HVAC systems which allow them to deliver HVAC service to a relatively finite portion of a building upon request. As a result, it is common to find buildings with the ability to run particular components of their HVAC systems with minimal, if any, additional cost when a second (or fifth) tenant requests after-hours HVAC service at the same time it was requested by the first tenant. In other words, based upon a building's central plant / HVAC system design, once the chiller, cooling tower and associated pumps are running at a set capacity (i.e., 40% or 90%), there may very well be no incremental cost to provide after-hours HVAC service to an additional tenant aside from opening dampers or turning on air handlers or VAV boxes.

Consequently, tenants should negotiate their leases such that the hourly cost for after-hours HVAC will be apportioned among them and other simultaneous users. By way of example, the lease should stipulate the hourly rate for after-hours HVAC will be prorated among tenant and other simultaneous users to the extent the same HVAC equipment is running for both tenants, and that each tenant will pay for the cost of equipment operating only for that tenant's benefit (such as air handlers).

This issue should be addressed even in the case of a single tenant building (assuming there will even be after-hours HVAC charges billable to the tenant). Recently CyberLease performed an audit for a large insurance company which occupied 100% of a six story office building in Birmingham, AL. During the course of the audit we found the tenant was being charged \$25.00 per hour per floor for after-hours HVAC service. However, we also found the building's chiller and associated pumps were running at full capacity simply to provide one floor's worth of after-hours HVAC service. The tenant, however, had routinely been operating on an extended hours basis on every floor of the building and had been charged the same \$25 per hour for each floor. In reviewing the landlord's calculations it was clear that once the first \$25 per hour charge had been assessed for the first floor, the cost of providing after-hours HVAC service for the second through sixth floors was a mere fraction of the \$25 per hour per floor rate that had been charged to the tenant. Instead of paying \$25 per hour for each of those additional five floors, the tenant should have paid approximately \$3 per hour for each of those floors. The difference equated to nearly \$175,000 per year in savings for our client.

Consideration #3: Focus on accelerated depreciation

When negotiating after-hours HVAC provisions, an increasing number of landlords are seeking to include in their hourly rate an allowance for “accelerated depreciation” of the HVAC equipment caused by the excess usage. The landlord's argument is, essentially, the tenant is causing the building's HVAC equipment to reach the end of its useful life prematurely. On its face, this may not be an entirely unreasonable request (though a tenant may arguably be concerned about the basis of the depreciation of an asset which may be bought and sold multiple times during a lease term), but great care must be paid to how the hourly accelerated depreciation charge is determined.

To properly negotiate an “accelerated depreciation” charge – assuming the tenant was not successful in defining the after-hours HVAC rate to be the Landlord's actual, incremental, out-of-pocket costs, as discussed above – a tenant needs three things: (1) an experienced broker to give them the negotiating leverage that comes from understanding which buildings do and do not seek to charge tenants for accelerated depreciation, (2) an auditor experienced in computing and negotiating accelerated depreciation charges for HVAC equipment, and (3) a landlord who views the issue reasonably and not as a vehicle by which it can shift the cost of replacing capital equipment to its tenant(s).

With these three things in place, the tenant first needs to determine what components of the building's equipment are impacted by the HVAC system running extended hours. They answer should look something like a list of the major components of the building's HVAC system, such as the chiller, a cooling tower and some associated, but relatively isolated, pumps or motors. This list should not include ducting, piping, VAV boxes or DDC controls, conduits, or other components which cannot logically be claimed to be directly affected or worn out by an extra hour of service or which are otherwise typically within the scope of a tenant's improvements to its premises.

Once the list is established, the real accelerated depreciation charge per hour can be computed based upon the original cost (not the anticipated future replacement cost), of those items when originally installed. Depending upon the age of the building and the number of times it has been sold, this may or may not be easily established. The cost, therefore, may need to be estimated, which is why the auditor must have extensive experience in dealing with this issue. Finally, with an understanding of the industry-standard useful life of each component (typically as reported by ASHRAE or other similar authoritative bodies), the hourly cost for accelerated depreciation can be established.

When this calculation is based upon correct data and performed correctly, both tenants and landlords (perhaps especially landlords) will be surprised at the nominal nature of an accelerated depreciation charge. By way of example, the hourly accelerated depreciation charge on a two story, 50,000 square foot office building

¹Additional caveats would be (a) the agreed upon / stipulated rate is standard for the building so the tenant in question is not paying more per hour than the other tenants, (b) the rate is not so high as to be expected to reduce a later year's operating expenses below the tenant's base operating expenses, and (c) the lease-defined “standard” hours are truly “standard” for all of the buildings tenants.

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with two (2) sixty-five ton cooling towers and one 110 ton chiller is less than \$0.85 per hour per floor – and that assumes both floors are not running at the same time, as otherwise the depreciation charge on the one chiller is duplicated.

Finally, because of the number of “what if” questions revolving around the concept of accelerated depreciation, (such as “if more than one tenant requests service at the same time utilizing the same equipment does the landlord prorate the charge?” or “what happens if the equipment reaches its full useful life, despite the extra usage?”), many landlords will find calculating and charging accelerated depreciation charges to not be worth the trouble.

Consideration #4: Focus on locating groups requiring after-hours service in the same HVAC “zone”.

It seems all too often multi-floor tenants have not asked themselves some basic questions before entering the space planning phase of a lease transaction. The questions that should have been asked in order to give them an opportunity to avoid unnecessary after-hours HVAC charges include the following:

- Which business units or departments are expected to be regular users of after-hours HVAC service?
- How many employees in those groups work the extra hours?
- Do the operating hours of the departments typically overlap?
- Can these groups be located next to one another, within the same HVAC “zone”?

To put these questions into perspective, consider the case of a tenant occupying 40,000 square feet on two floors of an office building with the following profile: (a) two departments are regular users of after-hours HVAC service, (b) each department includes 70 employees, only 35 of whom work extended hours, (c) the operating hours of the departments overlap, each typically working the same extra 50 hours per week, (d) the landlord's actual, incremental, out-of-pocket cost for after-hours HVAC service was established as \$75.00 per hour per floor, and (e) traditionally the tenant has kept these departments separate from one another in space planning.

In a modern office's space plan, each department's 35 “extended hours” employees could be located comfortably on the same 20,000 square foot floor (285 square feet / person). Locating these employees on the same floor / in the same “zone” would result in the tenant paying \$195,000 per year (50 hours per week x 52 weeks x \$75.00 per hour x 1 floor). Over the course of a five year lease this amounts to \$975,000.

Doing the status quo, however, would see the tenant waste an additional \$975,000 over the five year lease term. In other words, by not asking the questions, or by ignoring the answers, the tenant forced itself into a space plan that caused it to pay for after-hours HVAC service on two floors when all of the “users” of after-hours

HVAC service could have been located on one floor. Though it may seem obvious here, the frequency with which this aspect of the after-hours HVAC issue is overlooked or discounted for “political” reasons is, in our experience, surprising.²

Consideration #5: Focus on alternatives to Landlord-provided HVAC Service

When landlords view after-hours HVAC service as a profit opportunity it is because of one basic thought: they believe they can. The tenant is viewed as a “captive” market who cannot – usually – go elsewhere to obtain the service. While this certainly underscores the importance of having an experienced broker on the tenant's team to make sure the buildings on the tenant's “short list” are competing on all economic issues and not just base rent and tenant improvement allowances, it also points out the need to consider all options available to the tenant at the building of choice.

Depending upon (a) the characteristics of the building in question, (b) the tenant's anticipated after-hours HVAC usage per year, (c) the square footage of the tenant's premises which would require extra HVAC service and (d) the length of the lease term, it is entirely plausible for a tenant to install supplemental, dedicated HVAC equipment as part of its tenant improvements in order to serve its extra HVAC needs. Best of all, when these conditions line up correctly, a tenant can save a considerable amount of money if its landlord otherwise insists on profiting from its after-hours HVAC rates or using unrealistic accelerated depreciation charges.

As with the consideration above regarding the co-location of those employees who utilize after-hours HVAC service on the same floor or in the same “zone”, if the area of a tenant's premises that will actually require after-hours HVAC service is less than 10,000 square feet, the tenant may be able to by-pass the landlord's HVAC system by installing supplemental or “package” HVAC units. If the tenant has a constant, predictable need for after-hours HVAC service, this can prove to be a viable way to save meaningful dollars. The downsides are (i) if the tenant's needs decrease later, its savings will diminish (since it could have simply stopped requesting service from the landlord), and (ii) upon lease expiration the tenant may be required to remove the supplemental equipment from the building, thereby exposing itself to added costs.

Needless to say when negotiating a new lease there is much more to think about when it comes to after-hours HVAC than simply the hours and the rate. Moreover, even tenants who may never utilize after-hours HVAC services need to pay close attention to how the operating expense, utilities and above-standard services provisions of their leases interrelate to one another. An unintended oversight can result in the non-user effectively subsidizing the after-hours HVAC costs incurred on behalf of another tenant.

²However, it is not uncommon to find regulatory issues hindering a tenant's desire to locate different business units or departments on the same floor of an office building.

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QUESTIONS TO ASK:

- Have you confirmed if your hourly rate charged by your landlord is in accordance with your lease?
- Many landlords use after-hours HVAC as a profit center. What does your current lease do to protect you from overpaying?
- Do you know if your landlord is offsetting its annual after-hours HVAC revenues against the operating expenses charged to you? Some landlords “double dip”, wherein the cost of the after-hours HVAC is already in operating expenses (of which you pay your pro rata share) and the landlord also charges you directly for the after-hours HVAC charge. The landlord should offset the income it receives against the associated expenses it incurred.
- Do other tenants in your building fit the profile of typically heavy users of after-hours HVAC (i.e., law firms, accounting firms, educational facilities, etc.)? Even if you do not use after-hours HVAC, you may be paying for other tenants' after-hours HVAC if the landlord is not offsetting the costs.

Additional Questions? Contact us.