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Lease Structure

Much of the discussion regarding the operating expense provisions of a green lease centers around the concept of so-called "split incentives" and how to structure the lease itself to address the question of how the parties to the lease share – or if they share – in the costs and benefits associated with a green building. Many have opined a green lease needs to be structured as a modified gross lease (i.e., base year, expense stop or stipulated base), as a triple net lease structure purportedly does not provide a landlord with economic incentives to undertake green initiatives. While this may be true in the case of a single tenant building with a long term lease, most buildings that are not owner-occupied have multiple tenants and the majority of those leases are for terms less than seven years. Moreover, the theory triple net leases should not be green leases overlooks many practical realities including (1) landlords will be faced with vacancy at some point, (2) when vacancies do occur even the grossing up of utility and cleaning expenses will not fully insulate a landlord from having to absorb some of the building's utility and cleaning expenses, and (3) the increased building value resulting from green initiatives inures to the landlord's benefit irrespective of lease structure. Beyond these considerations, the pending decision by FASB as to whether it will replace FASB Statement No. 13 Accounting for Leases, could have the effect of driving tenants away from using modified gross leases.

First, with respect to triple net leases and vacancy, nearly all buildings – green or not – will face at least some vacancy over the long term. By implementing green building systems and procedures the landlord can reduce those operating expenses it would otherwise incur with vacancy in the building. A building will still incur some amount of base-building electric, HVAC and common area cleaning costs even if it is entirely vacant. For example, lighting common areas, running HVAC systems to maintain air quality (and the HVAC systems themselves), and cleaning of common areas of the building will all require the landlord to incur costs despite the fact its building is totally vacant. Consequently, a building that has been designed or retrofitted to a green standard should cost the landlord less to maintain when vacant. Therefore, given the landlord's risks associated with building vacancy, landlords have an economic incentive to enter into a green lease even if that lease is structured as a triple net deal since doing so will mitigate the landlord's losses when its building is partially or wholly vacant.

Interestingly, some of the debate that favors modified gross lease structures over triple net lease structures has presumed gross-up provisions in commercial leases serve to eliminate the operating expense related portion of a landlord's economic risks which result from vacancy. This presumption, however, seems to rely on an overly simplified understanding of how gross-up provisions are implemented and is incorrect. In short, gross-up provisions require a landlord to extrapolate what the variable operating expenses of a building would have been had the building been fully occupied (i.e., either 95% or 100% depending upon the provision). However, in order to conclude landlords have no operating expense related risk or economic incentive with a triple net lease structure, one has to conclude all utility and/or cleaning expenses are purely variable in nature such that they are correlated on a one-to-one ratio with a building's occupancy rate. This, however, is not the case.

Operating expenses for commercial buildings fall into one of three categories: fixed, variable and semi-variable. Fixed expenses are, as the term implies, static and unaffected by a building's occupancy. Variable expenses are directly and proportionately affected by a building's occupancy. Semi-variable expenses are a hybrid of the first two categories – they have components which are fixed and components which are variable. Examples of semi-variable operating expenses include utility expenses and, depending upon the terms of the underlying vendor contract, cleaning expenses.

For example, some portion of a building's total electricity expenses can be identified as a fixed cost (i.e., exterior lighting, base building HVAC operation, elevators and escalators, lobby lighting, etc.), while the other portion of the building's electricity expenses will be variable in nature (i.e., tenant electricity, increased HVAC demand from tenants, etc.). Establishing or estimating those proportions requires a landlord's and/or its property manager's best, informed judgment. In making such a determination / estimation, a landlord or property manager should be saying "regardless of the building's occupancy, we believe this portion of the annual electricity bill would be incurred whether the building were fully occupied or if it were vacant."

Put another way, "fixed is fixed"; if the landlord of a fully occupied building believes 30% of its electricity expense is the "fixed" component, and if that 30% represents $150,000 of the $500,000 total paid for electricity, then the same $150,000 would be the fixed component even if the building's occupancy were to drop to ten percent. Consequently, the $150,000 in this example would not be subject to a gross up adjustment and therefore represents the landlord's risk exposure. In this example the landlord would only recover 10% of the $150,000 of fixed electricity expense from its in-place tenant(s), leaving the landlord to absorb the balance. As such, landlords have a clear incentive to implement green initiatives that will reduce energy and cleaning costs associated with base building and common area systems and services – even when utilizing a triple net lease structure with their tenant base. Though some might characterize these vacancy-related incentives as risk management tools, in today's commercial real estate markets there is great incentive for landlords to mitigate risk.

The greater incentive for a landlord, however, is undoubtedly driven by the opportunity to charge higher rental rates and increase its net operating income through the implementation of green initiatives. A recent study showed compelling evidence that green buildings command higher rental rates and sales prices when compared against similarly situated non-green buildings.[1] Specifically, this study showed green certified buildings obtained rental rates three percent (3%) higher than their non-green peers and, importantly, their effective rents were more than six percent (6%) higher. Taken together these two data points mean landlords of green certified buildings are successful in increasing both their "top line" and

[1] *Eichholtz, Piet, Kok, Nils, Quigley, John M.: Doing Well by Doing Good? Green Office Buildings, 2009*

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"bottom line" revenues – and thus the value of their buildings – via green initiatives. This same study showed the selling prices of green buildings were sixteen percent (16%) higher than non-green equivalent buildings. Since the determination of a building's net operating income will be the same (all else being equal), with a triple net lease or a modified gross lease, these incentives for a landlord are not diminished by the structure of the lease itself, and they may very well outweigh the costs of implementing a green building initiative. With this data in hand it is reasonable to expect more tenants to negotiate for the landlord to absorb more of the capital or implementation-related costs while the tenant receives the cash flow / operating expense benefits of green initiatives since the landlord has an incentive to undertake these projects from a value creation standpoint. Further, since tenants usually do not receive a credit if the building's operating expenses fall below their base amount, tenants may realize more of the benefits with a triple net lease structure if capital amortization is diminished or removed.

Despite the conclusion across much of the green leasing front that triple net leases do not provide an incentive for landlords to undertake green initiatives, incentives and risk management benefits for landlords exist in a triple net lease structure. Fortunately this is the case, as landlords may soon find tenants having a greater interest in wanting to avoid modified gross lease structures. The Financial Accounting Standards Board, which is the organization in the United States that establishes financial accounting and reporting standards, is currently evaluating the replacement of the standard by which leases are to be accounted for (known as FAS 13). Under current standards (i.e., US GAAP as promulgated by FASB), leases are classified as either capital leases or operating leases. In a greatly simplified explanation, capital leases impact the balance sheet of an organization while operating leases do not, and historically most commercial tenants favor an operating lease treatment for purposes of their real estate commitments. However, the replacement of FAS 13 currently under consideration would eliminate the operating lease treatment and require all leases to be classified as capital leases, with the resulting impact on tenants' balance sheets, reporting ratios, financial metrics, etc.[2]

The importance of this issue in the discussion of modified gross versus triple net lease structures in the green leasing environment has to do with how operating expenses are treated under the structure of the lease. By way of example, assume a tenant was provided two options for its new, green lease: the first was a base year structured deal with base rent of $40 per square foot and the second option was a triple net lease carrying base rent of $25 per square foot and triple net charges of $15 per square foot, for a total of $40 per square foot. Though equal from a rent perspective, these two options would have very different accounting treatments under the capital lease accounting guidelines. If the tenant opted for the base year structured deal, effectively the entirety of the gross rental rate of $40 would be capitalized and hit the tenant's balance sheet. Under the triple net structured deal, only the $25 per square foot of base rent would be capitalized and hit the balance sheet, as the $15 of triple net / operating expense charges would be expensed as incurred. Consequently, if FASB replaces FAS 13 in the manner expected, tenants wishing to minimize impacts on their balance sheets or under particular pressures to maintain various financial metrics will want to avoid the modified gross lease structures currently favored as the best alternative for green leases. Consequently, the world of green leasing may find itself reconsidering how to best structure a green lease using a triple net model.

Green Leases – Tenants Get Charge Out of Electric Costs

One of the biggest opportunities for landlords to make strides toward LEED or other green certification is in the area of energy efficiency projects. A significant portion a building's overall operating expenses is in the form of electricity expenses, and often these costs are greater than any other category of expense, even including property taxes. Understandably this becomes a common target for landlords trying to obtain green certification on an existing building, and it often represents low hanging fruit in the greening process. Tenants, however, should be aware of how these projects might be affecting their operating expense and/or premises electricity charges. A few relevant examples illustrate the point.

1. Los Angeles – Co-generation

A landlord in Los Angeles installed a co-generation facility in its building's central plant, while, at the same time establishing the central plant as a stand-alone, affiliated limited liability company (the "CP-LLC"). The building then contracted with the CP-LLC to provide some of the building's electricity (the balance of the building's electricity was provided directly by the local utility company), and also to provide all of its chilled water and heat. The rates to be charged by the CP-LLC were, purportedly, to be market based rates, and the resulting charges were included in the Building's operating expenses.

The monthly electricity invoices from the CP-LLC to the building listed the total kilowatt hours (kWh) of electricity the CP-LLC provided to the building during the prior thirty days, and charged a cost per kWh equal to the kWh rate that purportedly would have been charged by the local utility company if it had provided the same amount of kWh during that billing period. By way of example, if the co-generation facility provided 600,000 kWh of electricity to the building in a given month and if the local utility company would have charged $0.12 per kWh, then the building was billed $72,000 by the CP-LLC.

In reality though the cost of providing that 600,000 kWh of electricity was significantly less than $72,000. In order to produce 600,00 kWh of electricity, the CP-LLC purchased natural gas, water and a relatively small amount of electricity, and paid for various service, maintenance and engineering costs. In other words, the CP-LLC's cost to provide the 600,000 kWh of electricity was a fraction of the $72,000 paid by its affiliated building owner and included in the building's operating expenses.

[2] An informative summary of this issue entitled Operating Leases – "The Finale"? is available through Cushman & Wakefield's Knowledge Center.

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In this case, however, while the tenant's lease contemplated that the landlord would install a co-generation facility oddly it did not explicitly identify that project as being eligible for escalation to the tenant via the amortized capital / operating expense provisions of the Lease. Additionally, the operating expense provisions of the lease did not allow the landlord to pay an affiliate more than it would have paid in the absence of that relationship, and did not allow the landlord to include in operating expenses amounts other than those "paid or incurred" by the landlord. Needless to say, the audit of the landlord's financials revealed the amounts paid to CP-LLC exceeded the amounts that would have been paid (i.e., for the natural gas, water, etc. to produce the electricity), by the Landlord directly had it not established the separate entity. Similarly, whereas the landlord funded the operation of the CP-LLC the costs "paid or incurred" were only the supply costs, and not what they would have been if the local utility company had provided the electricity.

The capital language of the lease did generally allow for cost saving capital improvements to be amortized over their useful life, but stipulated the annual amortization could not exceed the actual annual savings. Consequently, a $1,000,000 project with a 20 year useful life would be amortized at a rate of $50,000 per year. So while the annual savings resulting from the landlord being able to produce electricity at a lower cost than it would have paid to the local utility company greatly exceeded $50,000 per year, the lease precluded the landlord from accelerating its amortization such that it equaled the annual savings. Despite the terms of the existing lease, the landlord billed the full "hypothetical cost" of what would have been paid to the utility company to the tenant via its operating expense escalations. In truth, the "hypothetical cost" was comprised of the actual cost paid or incurred by the landlord, the $50,000 of annual amortization and the balance was an improperly accelerated amortization charge.

In addition to the landlord's error in determining the annual operating expense charges, the installation of the co-generation facility also impacted, or more accurately, should have impacted, the cost the tenant was charged for its sub-metered electricity and chilled water charges. For example, the lease stipulated the tenant was to be charged for its sub-metered electricity usage based upon the landlord's average cost per kWh without mark-up or profit. In billing the tenant, however, the landlord took the average of its "hypothetical cost" per kWh from the co-generation facility and its direct kWh cost from the building electric meter, thereby overstating the true average cost per kWh that should have been billed to the tenant. Chilled water charges were similarly overstated. All of this shows even tenants signing leases that contemplate future green initiatives need to pay close attention to how the operating expenses are affected and calculated.

2. Southern California – Solar Power

If clean energy is a top tier objective for a green certified building, then affordable clean energy is the Holy Grail. Like the Holy Grail it is very elusive. The challenge for landlords in obtaining full adoption of a green lease form throughout a multi-tenant building is some tenants will agree to the concept of paying more for clean energy due to their own corporate initiatives, sustainability practices, etc., while others will only want, at most, to pay for cost-neutral projects. The pool of potential tenants who will conceptually agree to pay for clean energy despite its costs is arguably smaller than the pool of tenants willing to sign up for cost neutral projects. Consequently, a landlord intent on buying clean energy may find it has a longer lease up time or else needs to offer prospective tenants in the larger pool additional incentives in order to gain building-wide adoption of the desired clean energy plan.

By way of example, consider a building in Southern California that installed a sizeable solar array to provide clean energy. The amortized cost of the project, including a reasonable rate of interest, along with the annual maintenance and repair costs served to make the cost per kWh of the solar produced electricity greater than what the landlord was paying for the balance of its electricity service. In negotiating a lease with a large, cost conscious tenant (aren't they all today?), who was not fully subscribed to the theory that it would or should pay more for clean energy, a unique compromise was reached.

The lease carried a base year for purposes of taxes and operating expenses and provided for the tenant to pay for its premises electricity usage on a sub-metered basis. While the tenant was more comfortable with the clean energy costs affecting operating expenses (provided those costs were similarly included in its base year), it was decidedly uncomfortable with the impact on its premises electric charges. Ultimately the compromise consisted of two components. First, the parties agreed to put a cap and a floor on the cost per kWh for premises electric. Second, to the extent the premises electric costs exceeded the cap, the amount above the cap would be paid by the tenant if the operating expenses had decreased, but only to the point where the decrease in operating expenses and the amount above the cap netted to zero. Conversely, if the premises electric costs dropped below the floor, the tenant would be able to apply the amount below the floor against its operating expense obligations if expenses had increased above the base year's costs.

Though admittedly a bit complicated from a lease administration and property management perspective, this compromise allowed both parties to achieve their respective objectives. The landlord received a key agreement from a major tenant that it would pay for clean energy, and did so without having to offer base rent or

economic concessions that would directly hit the building's value. The tenant, on the other hand, was able to boast of its tenancy in a LEED certified, clean energy building and was comfortable that the attendant costs would be within a range of manageable expectations.

3. Dallas, TX – "Plus E" Considerations

The Dallas office market utilizes a rather unique lease structure referred to locally as the "Plus E" deal. In short, it is a base year for operating expenses and taxes, but a net lease for electricity (the "E" in Plus E), where the tenant pays its prorata share of the costs. Two common variations of the electric part of the Plus E deal persist; all electric expenses are billed to the tenants on a net basis or common area electric is included in operating expense billings.

With this as background, consider the case of a green certified building that has undergone major upgrades to its HVAC and lighting systems. The capital costs of these projects have been amortized and included in operating expenses. The existing tenants are paying their respective prorata share of these costs (to the extent their base years pre-date the greening projects). However, the tenants are also receiving the benefit of these projects via reduced "Plus E" charges.

From the tenants perspective this may all be well and good, but what consideration has been given to what would happen if the tenant vacated its premises during the lease term? In today's economy, where many tenants have undergone significant restructurings and downsizings, leased but vacant space is increasingly common. When drafting green leases with a Plus E or other similar structure, landlords and tenants will want to consider the following:

- Should the tenant continue to pay for its share of the cost of installing green building systems and/or upgrades if the tenant continues to lease but not occupy the space? In other words, in the example above, since the tenant is arguably not benefiting from the project due to the fact it has vacated its premises, should it continue to pay for the cost of the project? Understandably, landlords will certainly argue they should, as the decision to vacate was the tenant's alone. However, if the lease allows capital costs to be escalated only to the extent of actual savings, the eligible capital amortization would arguably decrease since fewer kilowatt hours of electricity were consumed, thereby reducing the savings.

- Should the cost of "going green" be tied to a tenant's physical occupancy of its premises or otherwise tied to consumption instead of based on amortization? Most landlords implement savings calculation and thus the amortization assuming the building is entirely occupied, thereby maximizing "savings", and do not revisit the calculation after its been set the first time. Consequently, if a tenant of any significant size vacates its premises, the savings and hence the amortization charges would arguably need to be recalculated.

- Does the typical operating expense exclusion of "costs incurred in providing services to other tenants which are not provided to Tenant or not provided to Tenant in consistent proportion to other tenants," serve to exclude the cost of green initiatives if the tenant is not in occupancy to benefit from them. For example, if as part of its green certification process the landlord implemented a daylighting program or installed a photovoltaic solar system, is the tenant exempted from having to pay the associated costs if it does not receive the service, or is it a question of whether the landlord makes the service available?

Though it is easy to scrutinize lease forms after they have been signed and the parties have begun to learn the real world issues that arise from the unexpected, landlords and tenants are well advised to consider more "what if" scenarios, particularly when dealing with a lease or issue that is rapidly evolving. The scenarios above illustrate how the initial cost versus benefit analysis can end up being significantly different than one or both parties expected. If the party on the unfavorable side of that revised equation finds their expected costs are materially greater or benefits are materially less, it could very well diminish their interest in future green leasing which would be the ultimate of unintended consequences.

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