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The Commercial Classroom: Green leases, part two

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Do I make my building "green?" A real concern of developers/ landlords is economics. If I do improvements how or when do I get a "payback" of those expenses? In the long run reducing energy costs make sense but what about the initial outlay? Payback can be simply measured; cost divided by the annual savings equals the payback in years. If I put in high efficient lighting fixtures and bulbs in my building it will cost me $10,000, but I will save $3,000 in annual electric expenses. $10,000 divided by $3,000 is a payback time of 3.3 years.

New York City's first "Green Lease," developed by the NYC Mayor's Office of Long Term Planning and Sustainability, contained language to address this issue utilizing the "split incentive" scenario.

Basically this is a triple net lease: Landlord pays for capital improvements but does not benefit from any reductions in operating expenses because the tenant pays the operating expenses per the lease. But, in this lease form, the landlord will recover the costs of those improvements from the tenants based on "simple payback."

Here is how it works: Landlord may include in the operating expenses (to be paid by the tenant) the aggregate costs of such capital improvements not to exceed 80% of the projected annual savings. The aggregate costs of such capital improvements will be fully amortized over 125% of the simple payback period. For example, the capital improvement cost is $2 million, projected annual savings are $500,000, and the payback period is 48 months. The tenant pays additional rent of $400,000, (80% of savings) in operating expenses, for 60 months (125%) of payback period.

During the first five years of the lease: The tenant has their operating expenses reduced by $100,000 a year. The landlord is reimbursed by the tenant for the full cost of the capital improvement. In the following years of the lease the tenant has their operating expenses reduced by $500,000 a year.

Green leases are and will continue to be a hybrid. Just like there is no standard lease, there will be no standard green lease. There are now good models available, that attorneys will use to create new green leases. What is apparent is the new green leases will specifically address the issues and concerns of landlords and tenants and consequently be more transparent. We will see things in the lease like requirements for Annual Environmental Performance Reports, requirements for exchange of information about operating hours, energy usage, renewable energy, water usage and recycling efforts. A tenant may require the landlord to monitor indoor air quality (carbon dioxide and ventilation) on a regular basis.

We will see lease clauses creating tenants (environmental) rules like: Tenant shall turn off all interior lights and equipment when not in the premises; Tenant shall comply with Landlord's recycling program. This will require a section "violation of environmental rules." How to enforce the rules, fines? But when do repeated violations become a lease default? What if these occurrences become interference with third party certification of the building? This is an area that needs to be carefully worded by the attorneys drawing the lease.

As green buildings continue to increase in number, we will see more of these "green leases."

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