



FAQs - PlaNYC Energy Aligned Clause (EAC)

Q: Who is using the EAC?

A: In April 2011, Silverstein Properties and law firm Wilmer Hale signed the first lease including the EAC for space at 7 World Trade Center. In September 2011, MSCI Inc. also signed with Silverstein Properties with the EAC. The City of New York, leasing about 8 million square feet with the split incentive problem, has also committed to using this language. Up to October 2012, 400,000 square feet of space leased by the City of New York included the EAC.

Then Real Estate Board of New York's (REBNY) President Steven Spinola has endorsed the Energy Aligned Clause, saying "REBNY... will be recommending this language to all of our members."

Feedback from key players in commercial real estate during the outreach effort suggests that there will be significant uptake in the use of the EAC in the next few years.

Q. Equipment can be depreciated in accordance with the federal tax code. Does the use of the EAC change how equipment is depreciated?

A. No.

Though there are logical arguments suggesting that the current tax code can mildly discourage investments in energy conservation measures (e.g. repairs on old, inefficient equipment can decrease the owner's tax liability in the short term more than replacing it with more efficient equipment), this is a separate issue. The use of the EAC does not affect how equipment is depreciated.

Q. Can the owner increase the scope of a capital project so that more work is done under the guise of an energy conservation measure, thus passing more capital expenditures along to the tenant?

A. No.

The model clause clearly states in paragraph (b)(i)A that it applies to "capital improvements intended to improve energy efficiency... that the independent engineer certifies in writing will... reduce the Building's consumption of electricity, oil, natural gas, steam, water or other utilities..."

Q. If the capital expense is not paid off before a tenant's lease expires, does the owner end up with a reduced profit margin?

A. No.

After the lease is up, the owner will fill the space with a new tenant paying market rate. The energy retrofit will have reduced the building's operating expenses, so the owner's net operating profit margin from the new tenant's market rent will be greater than it would have been if the owner had not undertaken the energy retrofit (by an amount equal to the total energy savings generated by the retrofit, multiplied by the "tenant's proportionate share" of the building). The new tenant's operating expense base year will be set to reflect the building's lower operating expenses, so the owner will lock in the higher net operating margin, and in effect will enjoy the energy savings for the duration of the lease. Owner will use these savings to recoup the remainder of the retrofit's upfront capital expense, with all subsequent energy savings flowing to the owner's bottom line – representing the return on the owner's capital investment in the retrofit.

Q. In a typical modified gross lease, the tenant agrees to a "base rent" for the first year that includes a base operating expenditure (OpEx). Payment for annual increases in OpEx in addition to the base OpEx is the responsibility of the tenant. If an energy conservation measure is completed at the end of year 1 of a lease, might the reduction in OpEx drop below the base rent, thus requiring the tenant to pay the base rent in addition to 80% of the predicted savings?

A. No.

In the vast majority of cases, escalations in non-energy OpEx are much larger than the savings from energy-related OpEx. Thus, even accounting for savings from energy-related OpEx, it is very unlikely that the overall OpEx would decrease.

Q. Sometimes retrofit or replacement projects have incidental energy savings. Under the EAC, does the tenant have to pay for those capital improvements?

A. No.

The EAC applies to "capital improvements intended to improve energy efficiency," as stated in paragraph (b)(i)A. Thus passing through costs to the tenant according to the EAC should only be done on projects that are executed primarily to save energy.

Q. Suppose the engineer's prediction overestimates cost savings by more than 20%. Does the tenant pay more under these circumstances?

A. In the short term, yes.

The EAC was designed to mitigate the risk to the tenant of paying more than if the energy conservation measure had not been done as long as the engineer does not overestimate energy cost savings by more than 20%. Industry experience shows that engineers are able to predict savings within +/- 20% in the great majority of cases.

In the unlikely event that actual savings underperform estimated savings by more than 20%, the tenant will pay slightly more year over year during the payback period. However if the tenant is still in the lease when his or her pro rata share of the capital expense is fully paid, the tenant then receives all the energy cost savings, which is very likely to result in a positive NPV overall.

Keep in mind, though, that if the engineer overestimates savings by more than 20%, other issues come into play, particularly contractual issues between the owner and the engineering firm.

Of course, if the engineer *under*-estimates the savings, the tenant's cash flow and overall NPV is affected in their favor.

Q. Besides the split-incentive problem, are there any other reasons the owner is not incentivized to do the work?

A. Yes.

In many relevant leases, the owner may pass along repair and maintenance costs to the tenant. So if an expensive, inefficient piece of equipment fails, the owner is motivated to simply repair the system and pass the repair costs along rather than replace it.

With the Energy Aligned Clause in effect, a full replacement has a much better payback scenario for the owner, so he or she is more likely to install more efficient equipment, thus reducing the tenant's energy cost.

For more information about the Energy Aligned Clause, visit www.nyc.gov/eac and <http://www.urbangreencouncil.org/EnergyAlignedClause>.