

The Financial Case for Commissioning

Understanding the Value of
Commissioning in Income Properties

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Office property context

- Owner has more control over building systems in office than in retail, industrial, etc.
- Leasing dynamics often stall energy-efficiency advances
- HOWEVER, if properly positioned, appraisal effects can help make a compelling case for commissioning

Compelling case for income property

- “The building IS the business”
- Energy is a very large portion of operating expenses
- Need to know how costs/benefits would be shared, AND...
- Need to know how *Owner's share* would affect value

Income property context

- Is commissioning “Cap Ex” or “Op Ex”?
- How would Owner/Tenant(s) pay/benefit?
- Tenant retention/attraction benefits?
- Property appraisal impact of *Owner's share* of savings (and/or rental revenue gains)?
- Could rebates/incentives improve “risk/reward ratio”?
- Other resources (e.g., article reprints)

“Cap Ex” or “Op Ex”?

- **Is the commissioning part of an expense-reducing capital project?**
 - If so, is Cap Ex project being “passed through” to Tenant(s)?
 - BOMA standard lease clause
 - “Side agreements”
 - Limitations to recoveries
 - “Capitalize” commissioning expenses along with other A&E costs?
 - Verify savings first, then calculate savings allocation to justify recoveries
 - Owner “double-dipping”...who pays/benefits?

“Cap Ex” or “Op Ex”? (cont'd)

- **Is commissioning being performed on existing building systems?**
 - Addressing tenant comfort issues
 - Dealing with complaints about high operating costs
 - Owner recognizes that he/she would get most/all savings
 - Owner might want to lower “base years” before new tenants sign “fixed-base” leases
 - Could commissioning expense be “passed-through” as an operating expense?
 - Owner may stage commissioning across multiple years to minimize impact on the “base year” for new leases
- **What if “Op-Ex-style” commissioning uncovers potential for an EE-related capital project?**

Leasing basics

- Gross lease
 - *Owner pays everything*
- Net lease
 - *Tenants pay everything*
- Fixed-base lease
 - *Owner pays up to a certain point, after which Tenant pays*
- Regional variations
 - *“Fixed-base” or “Modified Gross”?*
- “The devil is in the details”
 - *Is “energy” part of “Operating Expenses” or “operating expenses”?*

Electricity billing varies widely

- **Direct Meter**

Tenant pays what is on the meter directly to the utility company.

(Essentially a “Net” lease...After lease signing, savings mainly benefit Tenant)*

- **Submeter**

Applicable where permitted by law. Tenant pays the landlord what is on the meter plus a percentage "handling" fee (typically 10%). This is not always more expensive than a Direct Meter, as the landlord of a large building may be able to negotiate better rates than you can on your own.

(Essentially a “Net” lease...After lease signing, savings mainly benefit Tenant)*

- **Rent Inclusion** (“Electric Rent Inclusion Factor” or “ERIF”)

Tenant pays a fixed annual charge per rentable square foot.

(Essentially a “Gross” lease...After lease signing, savings mainly benefit Owner^{1,2})

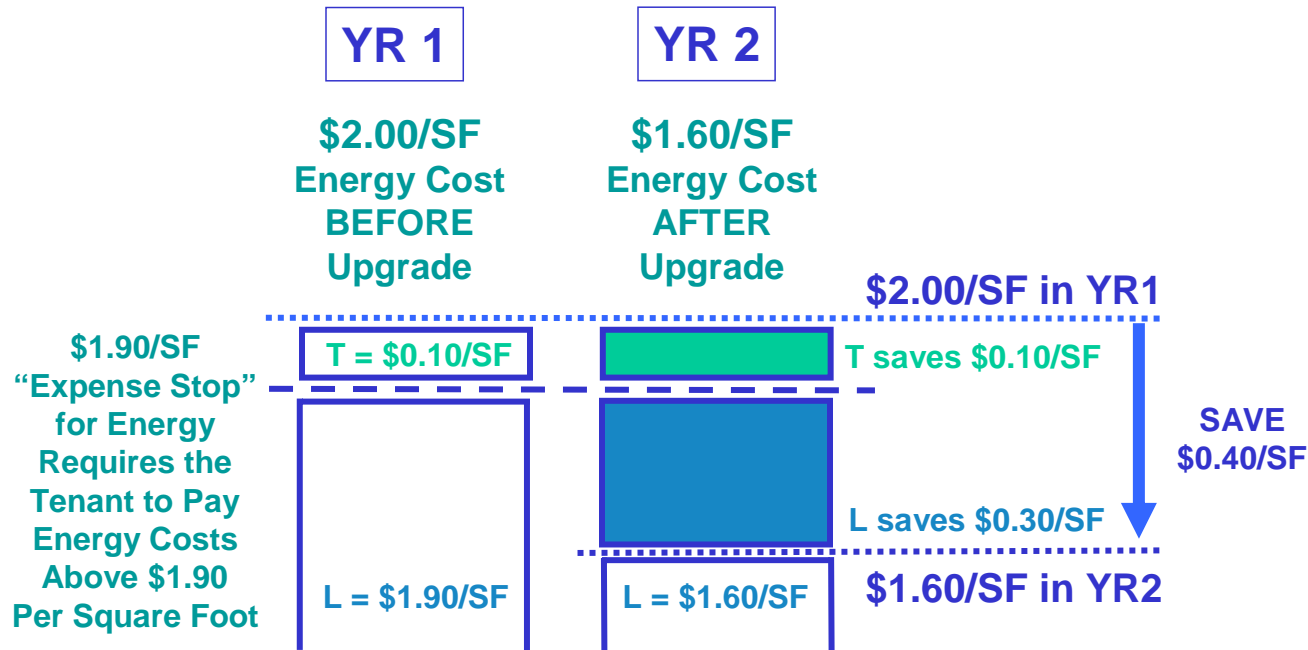
¹ Also need to consider who pays for commissioning & “persistence” of any benefits.

² Does Tenant have right to adjust energy \$ based on changes to equip./use/other?

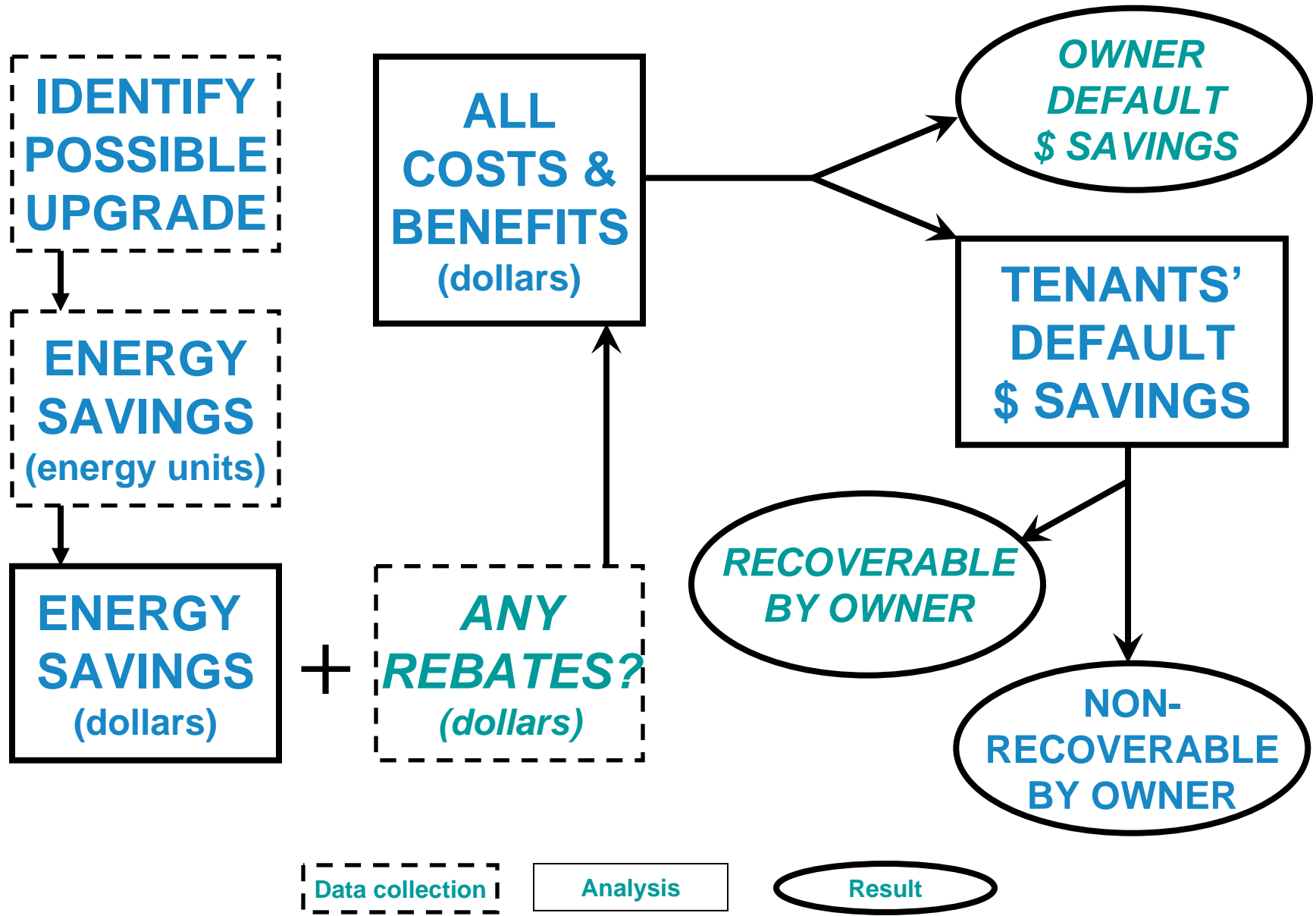
- **Other arrangements...Be sure you understand who pays/benefits!**

The "fixed-base" lease

Allocating savings in a fixed-base lease



Best practice for analyzing upgrades to income property



Remember the impact on building value!

- **Appraisal Methods**
 - Cost approach
 - Market comparison approach
 - Income approach
- **Efficiency can boost NOI and appraisal**

$$\frac{\text{net operating income}}{\text{capitalization rate}} = \text{asset value}$$

Knowing the Owner's share

The Owner's view of lower op ex

Before-Tax Cash Flow

- potential gross income
- vacancy and bad debt allowance
- + miscellaneous income
- = effective gross income
- operating expenses
- + operating expense reimbursements
- cap ex reserve for replacements
- = **net operating income**
- debt service (interest + princ. amort.)
- = before-tax cash flow from operations

In this example, a \$1.00/SF upgrade with ~2.5-year simple payback period or \$0.40/SF/year, 75% of which inures to the Owner, supports \$0.30/SF in higher NOI and \$3.00/SF in higher asset value.

Income Approach to Appraisal

$$\frac{\text{net operating income}}{\text{capitalization rate}} = \text{asset value}$$

$$\frac{\$0.30 \text{ SF/year}}{10\%} = \$3.00/\text{SF}$$

Taxable Income

- net operating income**
- interest portion of debt service
- depreciation allowance
- = taxable income

“At the end of the day...”

Owner's after-tax cash flow

	Before-Tax Cash Flow
	potential gross income
	- vacancy and bad debt allowance
	+ miscellaneous income
	= effective gross income
	- operating expenses
	+ operating expense reimbursements
	- cap ex reserve for replacements
	= net operating income
	- debt service (interest + princ. amort.)
	= before-tax cash flow from operations
	After-Tax Cash Flow
	before-tax cash flow from operations
	- taxes due
	= after-tax cash flow from operations
Taxable Income	
net operating income	
- interest portion of debt service	
- depreciation allowance	
= taxable income (loss)	
* tax rate	
= taxes due→

The importance of “persistence”

- **Owner’s share of savings affects NOI**
- **Increases in rental income affect NOI**
- **Increases in NOI affect appraisal**
 - Better valuations important both for sale and refinancing
- ***However*, how persistent are these upticks?**
 - Do benefits of commissioning last?
 - Will operating expenses remain lower?
 - Will Owner continue to enjoy his/her share of said savings?
 - Will rental rate increases last?
- **Increases in tenant retention/attraction due to improved comfort generally lead to “persistent” NOI benefits**

Using rebates/incentives

- **More than \$1.5 billion available annually**
- **Wide variety of sources**
 - Utilities
 - State and local energy/economic development offices
 - Auxiliary agencies
 - Non-profits
 - Other
- **Plenty of “technical assistance” money available**
- **Lots of “custom measures” programs out there**
- **Some specifically mention commissioning**

Conclusion

- Quantify the costs and benefits of commissioning
- Properly classify it as “Cap Ex” or “Op Ex”
- Understand the leases: allocate costs/benefits
- Calculate the Owner’s share of benefits
 - Owner’s share of immediate savings
 - Capital cost recovery, if any
 - Better tenant retention/attraction
 - Effect on appraised value
 - Remember rebates/incentives for studies *and* upgrades!
- ***Properly positioned, commissioning could be a very attractive value proposition to income properties***