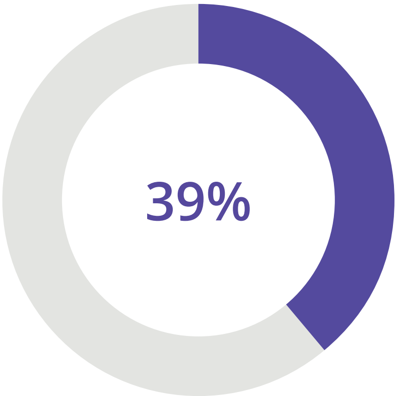
06

New lease of life

10 TRENDS FOR 2023

Despite the challenges of decarbonising real estate, commitment to do so is growing. Developers, investors, occupiers and governments are all making the right noises, but progress remains painfully slow. Whilst a lot of attention is focussed on making new buildings as green as possible, the crucial issues of retrofitting existing stock and then operating buildings efficiently to minimise energy use will require collaboration between owners and occupiers. Enshrining the respective responsibilities and obligations and balancing the incentives and share of benefits in “green leases” will be key.

Real estate represents one of the world’s major decarbonisation challenges given the sector is estimated to drive 39% of global carbon emissions.[1] Between material extraction, manufacturing, transportation, construction, maintenance, operation, and demolition, every aspect of the property lifecycle contributes to global energy use and carbon emissions. Urgency in decarbonizing the built environment is growing as countries around the world have committed to decreasing greenhouse gas emissions and meeting net zero targets. The Biden Administration announced a U.S. target of 50% emissions reduction by 2030[2]; the United Kingdom is committed to reducing emissions by 78% by 2035; and Canada will cut carbon emissions to 40% below 2005 levels by 2023.[3] To meet these targets, landlords and occupiers will need to collaborate to ‘green’ the built environment.



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The performance and efficiency of existing real estate assets are now clearly informing occupier and investor decisions on which assets they want to own or occupy – particularly at the "prime" end of the market.[4] As well as developing new net zero buildings, landlords are increasingly seeking to retrofit existing buildings to improve environmental performance and meet evolving occupier expectations. As financial institutions become ever more focused on managing and reporting on the sustainability of their portfolios and loan books, these considerations will rapidly proliferate through the rest of the market leading to measures such as performance-linked loan agreements. To improve the sustainability of loan books, financial institutions can tie loan interest rates and fees to predetermined indicators including greenhouse gas emissions and energy efficiency ratings.[5] This will be accelerated by the tightening of government regulations around construction and performance standards of buildings that is expected, or already underway, in most countries.

Landlords are increasingly seeking to retrofit existing buildings.

But two key issues are hanging over the sector that construction standards cannot address. First, how to manage and pay for the retrofitting of the existing stock that is needed to bring older buildings up to scratch – especially in cases where the building is already occupied. Second, how to ensure that a building is not just capable of being efficient but is actually operated efficiently when in use and that the resulting benefits shared equitably. The answer in both cases is greater collaboration between occupiers and owners.

Gathering momentum

The recent pandemic fostered an increased level of communication and cooperation between building owners and occupiers as they were forced to work together to deal with growing restrictions and enforced closures of facilities. A similar sense of communal effort is needed to tackle the climate crisis. A "community spirit" approach may help get through a short-term emergency, but it isn't a sufficient basis for structuring long term relationships involving allocation of costs, actions and incentives. The foundation for such a collaborative relationship needs to be incorporated into lease agreements.

"Green leases" or green lease clauses have been in use to some degree for almost 20 years in markets including Australia and the U.K. They have been relatively slow to be adopted more widely, largely reflecting the lack of impetus behind government action to enforce progress on retrofitting and reporting. However, we believe that is set to change in many cities, as a combination of market forces and government regulation stimulates change.

On the government side, tightening of building codes and Energy Performance Standards such as those being introduced in the E.U. and U.K. over the next 5-7 years will speed up the pace of retrofitting and the push for net-zero in new builds. In the U.K., owners of buildings with an Energy Performance Certificate (EPC) below Grade B will be unable to grant a new lease after 2030. Alongside the tightening of standards for existing buildings, the U.K. and Canada are imposing limits for carbon emissions in new constructions. The newest version of the National Energy Code of Canada for Buildings (NECB) introduced a baseline target for energy efficiency in new construction with four progressive tiers.[6] There is an urgent, and growing, need for owners to understand, plan and in many cases undertake the upgrade works that will be required on most existing buildings and to design new buildings for increasing efficiency standards.

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In some places, regulations will explicitly require collaboration to improve how buildings perform. New York's Local Law 97 – incorporated into the city's 2019 Climate mobilization Act – requires commercial building owners to report annually on building emissions and face tough fines if they exceed allowable limits.[7] As the whole building is captured in this report, this will include emissions from tenants, who could be expected to be made accountable for their portion – sometimes 90%[8] – of any emissions within their control exceeding the limit. The Big Apple is not alone: San Francisco introduced fines for buildings that exceed greenhouse gas (GHG) emissions standards at the end of 2022, Washington D.C is set to do so from 2026[9], and in total over 30 U.S. municipalities are in the process of introducing standards for commercial real estate emission reductions and energy consumption. These include major cities across the country including Atlanta, Denver, Chicago, Los Angeles, Miami and Houston.[10]

Market forces and government regulation are driving change.

The Securities and Exchange Commission (SEC) is also about to amend the rules for public companies to require disclosure of climate risks and carbon emissions[11]. The proposed SEC rules would require companies to disclose Scope 1 and 2 emissions from direct operations and power usage.[12] This would place greater emphasis on building owners and occupiers to gather, and have verified, accurate data on what goes on inside their buildings. However, a gaping hole in the industry right now is access to quality data on which to rely. As technology and AI platforms make advances, the start of a radical transformation in transparency and data sharing of building performance is a likely outcome for companies needing to comply from the mid-part of this decade onwards. Equally, occupiers looking at both the reputational risk and operational cost of their emissions and energy usage will need to work with owners and managers: to collect data, ensure the building runs as efficiently as possible and, where appropriate, undertake work to the building to improve its performance.

Key to note is that these U.S. approaches focus on actual in-use emissions, which is a critical component of net zero and behind the rising demand for performance verification initiatives. The Australian-based NABERS[13] performance-based system is gaining market popularity in the U.K.[14] to help organisations monitor and set targets for the energy and water of buildings in use. As a result, the building owners which stand to gain the most are those that can work with occupiers to realise these targets, equitable sharing of the costs and any upside, demonstrated through reliable and verified data to reflect actual improvements in performance.

Occupiers will need to work with building owners and managers.

Green leases get serious

Owners and occupiers will increasingly look to have their respective rights and obligations incorporated into lease agreements, to clarify the division of benefits from capital improvements and to determine the party responsible for financing and meeting efficiency targets. The use of green lease clauses is already expanding significantly[15], but we believe it will accelerate dramatically. It's time for green lease clauses to step into the mainstream but what clauses are typically covered in a binding contract? It is now over ten years since the Better Buildings Partnership published their Green Lease Toolkit, however BBP is expected to update the Toolkit this spring – an indication of the guide's continued relevance for those looking at how best to incorporate key issues into commercial lease terms.[16] It sets out best practices and model form green lease clauses covering a variety of key issues including co-operation, energy, water, and waste management. Critically, the Green Lease Toolkit addresses agreement on principles for assessing environmental impact of any works and conditions of reinstatement where owners could choose to waive occupier reinstatement requirements at the end of the lease where occupier alterations improve the environmental performance of the building.

This latter point could become a hot topic in the U.S. where proposed government subsidies and tax credits for sustainability-related building improvements could be available to either the owner or the occupier, depending on who does the work. The Biden Administration's Inflation Reduction Act (IRA) introduced the 179D Commercial Buildings Energy-Efficiency Tax Deduction (CBEETD) – an incentive aimed at increasing the installation of energy efficient systems in commercial real estate. Owners and tenants of new or existing buildings can claim up to $1.88 USD per square foot of construction if they install systems that lower utility usage below a predetermined standard.[17] The possibility of joint beneficiaries from this deduction could accelerate the development of lease clauses surrounding the installation of energy efficient systems, given that the tax deduction is awarded to the "owner" of the energy-reduction system.[18]

We are already seeing leases include innovative clauses.

We are already seeing leases include innovative clauses such as limits on offsetting costs being passed through in service charges and could even see performance linked service level agreements seen in the likes of the data centre industry, particularly for those buildings selected by occupiers for their net zero claims. For existing buildings in transition, we might see occupier penalty break clauses introduced if landlords fail to meet a decarbonisation pathway by the date mutually agreed future date.

Encourage progress rather than prevent conflict

When it comes to green leases, innovation will drive success. The proliferation of green lease clauses could lead to the development of creative strategies such as penalties in leases for non-performance on net zero by target date or a service level agreement structure that mirrors those used in data centre leases. However, green leases won't prevent disagreement where differing views exist and in cases where interests aren't aligned. As the table below indicates, there are some areas where agreement between landlords and tenants should be able to reach agreement relatively easily – but others remain contentious.

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GREEN LEASE CLAUSES RANKED BY LEVEL OF CONTENTION

Contentious

- Tenant compliance with minimum energy performance criteria
- Responsibility as to who shall undertake improvement works
- Who will fund the liability works
- Access to undertake the improvement works and how to mitigate disruption
- Tenant use of sustainable sources and compliance with the landlord's policy

Possibly contentious

- Sharing performance data for the premises and the building
- Landlord right to enter the premises to install, maintain and repair metering equipment
- The landlord/tenant shall procure renewable energy

Non-contentious

- Carrying out periodic audits of the environmental performance of the building
- Who shall attend sustainability forums (to review environmental performance) with the landlord and other tenants

Upgrading buildings and running them efficiently will have real costs; there are still clear issues over who should bear responsibility for those costs and where the benefits will accrue. Such issues will become even more complex as discussion extends into full carbon accounting, including the embodied carbon within building structures and materials rather than just the energy and emissions associated with their use. But thinking about green clauses in leases does help promote discussion and collaboration over where progress can be made and mutual benefits shared, and ensures agreements are enshrined into enforceable contracts. As owners and occupiers alike look to move forward in decarbonising real estate, green clauses are set for a new lease of life.

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[1] https://www.mckinsey.com/industries/real-estate/our-insights/climate-risk-and-the-opportunity-for-real-estate
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