# Achieving sustainable property objectives: The role of green leases

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**In September 2007, the IPF organised a workshop, hosted by DLA Piper, focusing on the concept of green leases. Fundamentally, a green lease is a lease for a commercial property that includes provisions to encourage the landlord, tenant or both to carry out their roles in a more sustainable way. The details of the provisions and incentives are negotiated between the parties, but typically relate to the achievement of specific targets for energy and water use and waste management. Such leases have been successfully adopted by some landlords and tenants in Australia where a number of occupiers, notably public sector occupiers, will now only take a building on the basis of a green lease.**

## What is driving the issue and why is it happening now?

Government policy, regulation and legislation are the major drivers of the requirement to own, manage and occupy buildings in a more sustainable way. In particular the introduction of energy performance certificates (EPCs) across much of the EU in 2008 has focused attention on energy efficiency. As ethical investment and corporate responsibility policies have filtered through to the property investment arena, investor pressure has emerged as a driver behind the requirement for more sustainable commercial property assets. However, in relation to green leases, tenant pressure has been an extremely strong force.

Why now is driven in part by the desire of some to be 'ahead of the game', given the focus of legislation and regulation – i.e. first mover advantage. But it is also driven by the heightened awareness within the market of sustainability issues and a search for mechanisms through which sustainability can be delivered by both the investor and occupier side of the property industry.

## What actions in terms of good management might be involved?

Typically, green leases are concerned with issues of energy, water, waste, carbon and sustainable construction/refit materials. In terms of the operational use of the building, simple measures might be encouraged by mutual agreement, for example:

- Energy efficiency: for landlords and their FM teams, reducing consumption by simple actions such as the installation of low energy light bulbs; efficient use of air-conditioning systems and monitoring energy use during hours of low-level activity such as weekends and over night. For tenants, switching off monitors and other small electrical equipment, providing information and awareness raising campaigns to support carbon reduction programmes. At the next available refurbishment the installation of energy saving plant and machinery might also be agreed such as movement-sensitive lights and smaller lighting circuits.
- Waste: landlords can provide recycling opportunities through building management and encourage the use of recycled materials (e.g. paper). Installation of mains supplied water fountains in place of bottled water coolers reduces the use of bottles and transportation. Consideration might also be given to the reduction in use of resources as well as recycling.
- Water: reducing consumption by monitoring and repairing leakages; installation of water efficient plant and machinery including spray taps and six litre flushes at first available opportunity.
- Pollution and contaminants: A commitment to ensure FM teams use environmentally friendly cleaning products and that materials used in refurbishment and maintenance work are similarly specified. Monitoring of leaks from air-conditioning systems would also be agreed as a standard requirement.

Where sustainability is a key element of an occupier or landlord's business or investment strategy, adherence to the green lease targets and service levels is likely to be strictly enforced. Where it is not, aspirational targets that enable the parties to measure performance and seek, but not be bound by, annual improvements might be more appropriate.

## Relevant lease terms

The lease terms most relevant to the negotiation of a green lease are: repair; user; outgoings; alienation/assignment; service charges; rent reviews and reinstatement.

### *Repair*

Under most commercial property leases granted in the UK the tenant has responsibility for some, if not all, repairs. A green lease might require such repairs to be undertaken to specific standards and/or using sustainably-sourced materials. Imposing more onerous repairing obligations was seen as potentially unrealistic as it could drive down rents or dissuade tenants from signing the lease unless the supply of suitable property was limited. Conversely it is also argued that some tenants might actually want such a clause as a demonstration of their corporate responsibility credentials. This has been the Australian experience, particularly from the public sector occupiers.

There is an argument that landlords should start granting inclusive leases under which they retain the repairing liability. With the shortening of lease terms, the life expectancy of even M&E plant and equipment is often longer than a single lease term and whilst is clearly in the landlord's interest to ensure the equipment is well maintained, ready for the next letting, the tenant has no similar incentive.

*User Clause*

Within the user clause it could be possible to require tenants to undertake activities such as recycling, efficient energy usage and water management. However, the industry has experience of the difficulty in implementing clauses that require particular behaviour, e.g. keep open clauses. Some suggestions that have been put forward for energy efficiency, e.g. reduced use of lifts, are difficult to enforce.

*Outgoings*

The outgoings on a building, i.e. energy, water and local property tax bills, are an obvious target for green lease provisions. However, to place any restrictions or obligations on the tenant in relation to outgoings is considered difficult to enforce. Nevertheless, transparency with regards to outgoings is important to monitor performance effectively in terms of energy and water efficiency for both parties. This should perhaps be an area where attention is focused.

*Alienation*

The insertion of a restriction on alienation in relation to a proposed assignee's ethical or environmental performance and/or policy was discussed at the workshop and largely discounted as unworkable on the basis of negative value impact. Furthermore it was felt that for some landlords, engagement with poor environmental performers as a means of improving performance could be a positive strategy.

*Rent review*

Rent abatement at review is one of the means by which financial incentives can be incorporated into a green lease. This could be linked, for example, to benchmarks for energy and water usage and waste reduction and/or recycling. Both the landlord's service provision and tenant's operational activity would have to be monitored. Where the landlord fails to perform by providing services according to the lease provisions or the EPC Asset Rating falls below an agreed rating, a reduction in rent might be the penalty. The latter arrangement represents a substantial risk to the landlord as it is highly likely that over the course of a lease, the building will have to improve its performance to retain the same rating, as newer buildings come on stream and raise the level of the overall stock. Achieving the required performance level will therefore require expenditure on both active management and improvements to the building. A landlord is likely to require additional rent to take on this risk.

Alternatively, a landlord may require the EPC Operational Energy Rating to be no lower than say a 'C'. Continued achievement of a 'C' rating would require active management of the building and possibly behaviour change amongst tenants to ensure, for example, that lighting and climate control systems are used efficiently. If the building fails to achieve this rating, recompense could be through a premium on the rent.

One of the major difficulties with using rent abatement as a means of incentivising specified levels of performance is the potential it has to compromise the value of a commercial building. Where the requirement is tenant driven, the tenant is willing to share the additional burden through a rental premium and the strategy complies with the landlord's investment policy, both parties may see it as a positive arrangement. However, sufficient flexibility would need to be incorporated within the terms of the green lease to ensure it did not restrict the potential to market the property to alternative tenants.

Where the green leasing arrangement is landlord driven and related to a particular investment fund strategy or investor policy, the potential impact on value is equally significant since the property is likely to have to be offered at a lower rent that reflects the extra requirements placed upon the tenant. The extent of that reduction might be a product of the benefit to the investor of achieving the benchmark and the perceived additional 'cost' to the tenant in management and monitoring.

Rent abatement has negative value implications and could lead to over-rented properties and their attendant problems. However, it is also the most powerful means of incentivising both landlord and tenant to achieve the objectives of the green lease.

*Service charge*

Service charge provisions can provide a further or alternative mechanism for incorporating financial incentives since any savings arising through waste management, reduced water costs or energy efficient behaviour on the part of the occupier can be passed back through the service charge. This is particularly pertinent in retail centres where management of packaging waste can be a substantial element of service charges.

*General issues relating to lease drafting*

Enforceability by both parties is a key issue for green leases. It is important therefore that elements that might undermine enforceability are clearly established, including the means to demonstrate compliance, penalties for non-compliance and, crucially, what recourse is available to each party.

## Are green leases the answer?

To achieve sustainable property objectives requires a fundamental change in the landlord and tenant relationship and green leases could be part of this by achieving more sustainable commercial property management and operation. It is unlikely that a single green lease model will be adopted, but a system for tailoring different types of targets, responsibilities and obligations into an agreement which may or may not have financial incentives and penalties attached, could be a fruitful way forward.

There are issues to resolve with the regards the potential impact on rental and capital values and the willingness and/or ability of different types of occupier to accept such a lease. But the fact that the debate is happening shows very clearly how far the commercial property sector has moved on in terms of sustainability in the past five years, and how seriously it is taking this issue.