

Getting Started with Performance-Based Leasing



July 2021

In 2019, New York City became one of the first U.S. jurisdictions to pass a building performance standard with Local Law 97 (LL97), which sets emissions caps starting in 2024 for most buildings over 25,000 sq. ft. By 2021, four U.S. jurisdictions had passed building performance standards that set performance targets for energy or carbon reductions for existing buildings, and several dozen other jurisdictions were interested in exploring similar policies.

These performance-based policies and laws will require changing how landlords and tenants interact with one another to drive better overall building performance, including through their leases. Recognizing this, the Institute for Market Transformation, a nonprofit organization focused on decarbonizing buildings through both policy and market support, partnered with Stuart Kaplan, a senior real estate partner at Blank Rome LLP serving in a volunteer capacity and Jeff Gracer and Meg Holden at Sive, Paget & Riesel, working on a pro bono basis with the New York City Climate Action Alliance, to create high-performance leasing guidelines to assist landlords and tenants in navigating the new waters of LL97.

This document is part of a toolkit on performance-based leasing, which seeks to remedy many of the barriers to improving building performance for all parties and advisors involved in commercial leasing transactions. It provides commercial building owners and their tenants with a high-level introduction to the growing trend of building performance-focused legislation; the impacts of such policies on traditional leasing structures; and the new concept of performance-based leasing. It is complemented by a technical memo on specific performance-based leasing clauses and a new model performance-based lease.

While this work was created in conjunction with New York-based entities and their requirements under LL97, it is designed to be applicable nationwide. The template is crafted to be customizable for use in other jurisdictions. The model lease and associated provisions are designed as living documents that will be updated as real estate evolves to tackle increasing building performance requirements.

To further explore performance-based leasing, visit imt.org/performance-based-leasing for a technical memo of sample leasing provisions, as well as a model performance-based lease template. To learn more about building performance standards in general, visit imt.org/bps.



What are Building Performance Standards?

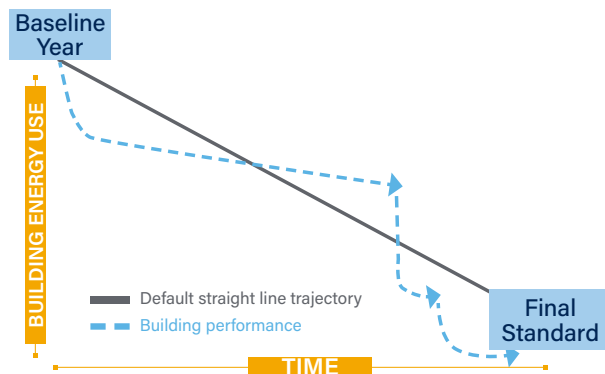
To date, more than 600 local governments in the U.S. have climate action plans that include greenhouse gas (GHG) inventories and reduction targets. Reaching these targets will require addressing energy use in new and existing buildings.

Nationwide, buildings currently account for almost a third of annual GHG emissions. In many cities, this percentage is even higher.

70%	80%	74%	64%	41%
New York City	STL	Salt Lake City	Atlanta	Los Angeles

Recognizing this, dozens of cities, as well as the federal government, are exploring building performance standards. This new type of legislation sets carbon and/or energy performance targets for buildings and deadlines for hitting these targets.

Building performance standards require landlords and tenants to demonstrate energy or carbon reductions over time.



Building owners are preparing now to make building and equipment improvements to get ahead of legislation and the competition.

A Need for New Leasing Structures

As more jurisdictions explore building performance standards, landlords and tenants are facing an unprecedented need to rethink how to create more flexible operating procedures to increase collaboration and ensure that buildings are prepared for the new legislative landscape. This means addressing current leasing practices.

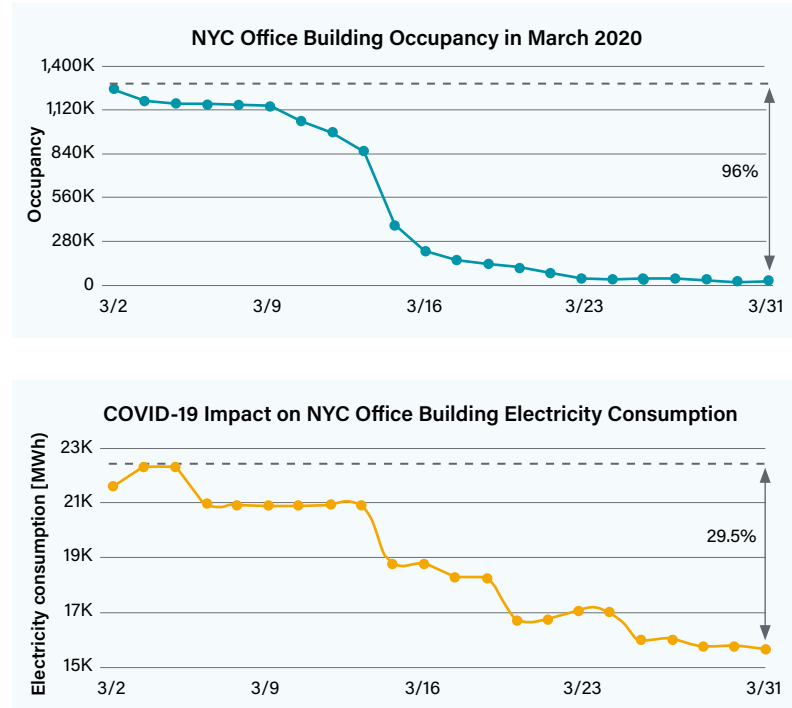
Leases are critical to incentivizing both tenants and landlords to reduce energy use and improve building performance. This collaboration is key to meeting current and future performance requirements.

Today, commercial leases generally fall into 3 types:
Net lease – Gross lease – Triple net

These leasing structures, however, fail to serve real estate in a growing landscape that requires action on carbon emissions by creating barriers to landlord-tenant collaboration, perpetuating split incentives and locking in inefficient practices.

For example, many leases split landlord and tenant incentives so that the party that pays to improve a building's performance often does not see the financial benefits. The Institute for Market Transformation found that leased space in the U.S. could be missing out on **\$1.7 billion to \$3.3 billion** in potential energy cost savings from these split incentives.

Traditional leases also lock in inefficient practices, such as heating or cooling buildings even when vacancy drops dramatically, as seen in the discrepancy between occupancy rates and decreases in energy use during the COVID-19 global pandemic.



Source: Graphics from Prescriptive Data, The Impact of COVID-19 on NY Office Buildings, <https://www.prescriptivedata.io/reports/covid-nyc-march-2020>

Unlike residential leases, commercial leases are generally much longer in duration (five- to 10-year terms, often, plus renewal options), with high penalties for noncompliance, with terms that are mostly cemented into practice until the lease is up for renewal. These lease structures will pose significant challenges for landlords who will be addressing emerging building performance standards.

Green leases begin to tackle the split incentive and inefficient practices. Established by IMT and the U.S. Department of Energy's Better Buildings program, [Green Lease Leaders](#) is a globally recognized program that provides the framework for implementing green leasing to foster collaboration between landlords and tenants and break down the split-incentive barrier to equitably align financial and environment benefits for both parties. Building on the fundamentals established in green leasing, performance-based leases provide a pathway to comply with new building performance standards.

What is Performance-Based Leasing?

Performance-based leasing seek to equitably align the costs and benefits of energy savings between landlords and tenants and position a property to comply with emerging building performance regulations.

Adding performance-based terms to a conventional lease can improve the business deal, make it more responsive to current conditions, contribute to a cleaner environment, and produce cost savings for both building owners and tenants.

Current challenges in traditional commercial leases include:

- **Negotiability and flexibility.** Commercial leases are generally subject to much more negotiation between the business owners and the landlord.
- **Fewer consumer protection laws.** Commercial leases are not subject to most consumer protection laws that govern residential leases—for example, there are no caps on security deposits or rules protecting a tenant's privacy.
- **No standard forms.** Many commercial leases are not based on a standard form or agreement; each commercial lease is customized to the landlord's needs.
- **Long-term and binding.** You cannot easily break or change a commercial lease. It is a legally binding contract, and a good deal of money is usually at stake.

A New Leasing Strategy Is Emerging

Performance-based leasing builds upon collaborative strategies in green leases to further clarify the landlord-tenant relationship in addressing building performance as it relates to potential building performance standards or regulatory compliance needs. Specifically, it:

- Sets energy performance targets to meet carbon reduction goals;
- Equitably distributes landlord and tenant responsibilities to meet building performance standards;
- Ensures landlord-tenant transparency and accountability by tracking energy use and implementing building performance goals;
- Offers continuous monitoring via periodic recommissioning studies, and mitigating plans where necessary; and
- Presents remedies should either party fail to meet building performance goals.

How Lease Types Compare

	Traditional lease	Green lease	Performance-based lease
Landlord-tenant relationship	Transactional and impersonal: Traditional leases negotiate separate priorities for landlord and tenant, and do not seek to align opportunities for improved operations.	Provide sustainability contact and/or information: Green Leases identify a point of contact and or method for sharing sustainability information to tenants on an ongoing basis.	Ongoing communications with tenants: Performance-based leases meeting with tenants monthly or quarterly to review energy performance and mitigate performance issues as they arise.
Investing in efficiency	Split-incentive challenges: Typical leases landlord incurs capital expenses investing in energy retrofits to their building, tenant soften receive the monetary benefits of reduced operating expenses without contributing to the initial capital expense.	Cost recovery clause: Green Leases amortize and recoup capital costs for energy-efficient improvements made to the building and common areas and share the long-term savings and efficiency by both parties.	Efficiency investments by tenant: Performance-based leases reward tenants who design and operate their space efficiently with an energy bonus in the form of reduced rent and or lower operating expenses.
Tenant fit-out	Inefficient tenant fit-out: Traditional leases do not require tenants fit-outs to incorporate energy efficient design	ENERGY STAR for Tenant Spaces: Green leases require tenants to design to the ENERGY STAR for Tenant Spaces standards.	Energy consumption limits: Performance-based lease require tenants to design and operate their spaces to an energy consumption limit, which is their allocated share of the power available to the building. This limit is calculated from the performance goal set by the local law requirements.
Operations	Sustainable operations are not prioritized: Traditional leases rarely outline how either party will improve building performance through efficient design and operations.	Landlord energy-management best practices: Green leases implement energy-management best practices in base building systems and common areas to reduce energy waste and operating costs.	Landlord-tenant energy-management best practices: Performance-based lease holds both parties accountable for their energy and water uses by implementing energy-management best practices for base building, common area and tenant spaces to reduce energy waste, operating expenses and meet local law and government requirements.
Tracking and reporting	Monitoring building performance: Traditional leases where tenant has direct control of utility services, the lease lack provisions allowing the owner to track whole energy and water performance.	Track and disclose energy and water performance: Green leases track common area energy and water consumption and disclose performance to tenants and/or investors.	Track, verify and disclose energy and water performance: Performance-based leases perform continuous monitoring of landlord and tenant systems via periodic recommissioning studies, develop and execute short-term mitigation plans, financial and allocated landlord and tenant roles and responsibilities.

Getting Started with Performance-Based Leasing

To get started with performance-based leasing, building owners should complete the following steps:

step 1

Establish baselines and set a performance goal.

The building performance goals are unique to each building and will be based off the local law building limit(s) for each compliance-reporting period. Building owners should engage an experienced energy expert to survey the building to determine currently deficiencies, identify recommended energy conservation measures (ECMs) and a timeline for implementing the recommendations. The goal should evaluate all potential carbon reduction initiatives in the short and long-term:

- Base building HVAC
- Common area lighting
- Sensors and controls
- Tenant lighting, plug loads and HVAC

step 2

Develop an action plan.

This step is essential to providing a transparent process to achieving the building performance goals and should be shared with tenants. An action plan should include the following:

- The method used to calculate the energy consumption goal and energy consumption limits for the building and tenant spaces.
- The whole-building performance improvement plan for the near, medium and long term, including capital improvements, design, and operational requirements, operator and occupant training.
- A clear description of how the plan will be executed by building owner, operator, and tenant(s).
- A list of recommended Energy Conservation Measures (ECMs) for tenants.
- A description of how the recommissioning plan will be executed. This should be broken down by user type, landlord, and tenant responsibilities, and include compliance milestones as defined by local law.
 - Consider an easy-to-execute recommissioning scope for tenants. Determine how much of the information needed for recommissioning can be supplied by submeter data, and consider an occupant use survey and a list of tenant equipment. Determine if the tenant will have the capacity to execute all tasks on their own or will require a consultant to complete the tenant portion of the scope.

Set an energy consumption limit.

Building performance standards require the entire building's energy and/or carbon consumption to drastically reduce. With tenants consuming 50% or more of the energy in a leased building, it is critical to understand tenant energy consumption related to whole-building energy performance. To accomplish an accurate calculation, landlords should evaluate plug loads, lighting, and heating and cooling loads and set an energy consumption limit.

The method for determining this limit will vary greatly. It is best practice to establish separate common area and tenant energy use consumption limits, and the methodology used to determine a tenant's energy use should be shared with tenants.

The energy consumption limit should include all the elements controlled by the tenant, such as watts/sq. ft. limits for tenant lighting loads, HVAC, and plug loads.

Set a plug load standard.

Plug loads can account for 25% of the total energy consumption in buildings, therefore it is important to set design and operational parameters to reduce and control this load. Fortunately, there are various strategies and evolving technology that can automate, track, and report energy usage. Consider implementing the following strategies:

- Build out standards including advanced controls
- Aggregate plug and process loads (PPL) to dedicated electrical panels. This step allows the building's control systems to turn off PPLs during nonbusiness hours. This additional step can easily submeter plug loads, analyze energy use patterns, and provide feedback to tenants during monthly landlord-tenant check ins.
- Control plug loads from switches. Install switches, vacancy sensors, or timed disconnects to control 50% of receptacles as per ASHRAE, including outlets at workstations and in common areas.
- Tenant procurement best practices
 - Upgrade all equipment to low-energy or ENERGY STAR-certified equipment. Require all tenant equipment to be energy efficient or have an upgrade plan to replace old equipment with ENERGY STAR-certified equipment at end of life.
 - For projects that cannot integrate advanced controls, require all plug loads to use advanced power strips (APS). Follow the National Renewable Energy Laboratory's [how-to guide](#) on properly installing an APS in an office setting.

Implement design criteria

Design criteria should focus specifically on strategies that optimize tenant energy consumption and work with the building to meet the whole-building performance standards. At a minimum, require the following:

- Tenant to comply with ENERGY STAR [Tenant Spaces criteria](#).*
- Implement the [Urban Land Institute's Tenant Energy Optimization Process \(TEOP\)](#), including developing an energy model during early schematic design and integrating recommended energy measures into the final design and construction.*
- Tenant space compliance with premise criteria, energy consumption limit, and plug load standard by commissioning lighting, HVAC and smart controls post construction and before tenant scheduled move in.

*Both ENERGY STAR for Tenant Spaces and Tenant Energy Optimization Process provide complimentary process to achieve deep energy savings in tenant spaces. See how they integrate by visiting the [ULI website](#).



Develop a mitigation plan.

This is most important step as it clearly outlines the landlord-tenant relationship and continuous review of energy performance goals and requirements through ongoing communications. The steps outlined here will remedy issues that would potentially cause the building to fall out of compliance and potentially incur penalty expenses. Recommended actions include:

- Schedule monthly meetings with tenants to review building and tenant energy consumption. Communicate capital improvement plans and recommissioning timelines.
- Review with tenant how the building is on track to meet the performance goal and local law compliance requirements.
- Address unexpected capital improvement cost, provide detailed accounting of expenses, impact to tenant including equitable cost share allocation.
- Schedule regular emails, newsletter or announcements highlighting building performance and relevant efficiency best practices.
- Disclose during monthly meetings when either party's energy consumption begins to drift outside of the energy consumption limit. Proactively work together to develop a plan to address the drift in energy performance.



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