

A Model Energy Aligned Lease



Detailing language to help solve the split incentive problem

The Split Incentive Challenge

Under most current commercial lease agreements, owners of buildings are responsible for paying for energy efficiency upgrades. Tenants, however, are the beneficiaries of those upgrades, in reduced energy costs. Because owners do not get to share in this benefit, they have no reason to make the upgrade in the first place.

Until now, the split incentive problem has been a major impediment to adopting energy efficiency improvements in buildings. And this is not just a problem in theory. In a survey of large building owners, sixty percent of commercial real estate owners have reported that split incentives are a major obstacle to making energy efficiency retrofits. With large buildings making up 45% of New York City's carbon emissions, reducing energy use in existing buildings will be crucial to meeting PlanNYC's goal of reducing New York City's carbon footprint by 30% by the year 2030.

Solving the Split Incentive Challenge

Working with industry, the Mayor's Office of Long-term Planning and Sustainability developed language that solves the split incentive problem for the most common type of commercial lease in New York City. The key breakthrough in this lease language is that it moves beyond the idea that lease negotiations are a zero sum game where one party loses whenever the other wins. The language allows both parties and the city of New York to win whenever energy efficiency improvements are made.

This model language solves the split incentive problem by correcting a flaw in existing provisions of the current model commercial lease, allowing tenants and owners to share both upfront costs of improvements and get the benefits of energy efficiency improvements.

While many current leases already allow owners to pass-through capital costs, the time horizon for recouping the costs under the current language makes it prohibitively difficult to recoup costs in a timely fashion, resulting in little use by owners across the city. The model energy-aligned lease language makes existing provisions actually useful while highlighting their potential for savings through energy efficiency.

The language contains two key innovations which will unlock the power of mutually beneficial energy efficiency savings. First, the language guarantees that the owner can recover the costs it invests in energy efficiency from the tenants. By using savings over the length of the projected payback period of a project, and not over the useful life of the improvements, the language shortens the amount of time it takes for owners to recoup their investment. This provides a significantly greater incentive for owners to invest in the first place.

Second, it provides significant assurances to tenants that the improvements made will actually result in such significant cost savings that they can split this benefit with owners and still come out ahead. After energy efficiency improvements are made, tenants continue to accrue actual savings while they agree to pay the owner 80% of the projected savings, as assessed by independent engineers. This 80% creates a buffer if the projected savings do not exactly equal the actual savings. Moreover, using projected savings avoids having to monitor actual savings, which can be prohibitively expensive. Finally, after the payback period compensates the owner for the initial investment, the tenant will continue to accrue all of the benefits of the energy savings.