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# A New Way to Fund Energy-Efficiency Projects

**MESAs don't require landlord capital or increase operating expenses, they don't use cost recoveries, and they provide benefit without financial risk**

*By Steve Gossett Jr.*


*Managed Energy Services Agreements (MESAs) commit a landlord to pay historical energy use for a fixed period of time, and makes the energy-efficiency supplier responsible for paying the energy bill.*

Why aren't more property owners fixing up their buildings? Even though reducing energy use by 25 to 35 percent is very achievable with a comprehensive retrofit, there's *still* hesitation.

The first reason: Property managers usually can't recover those dramatic savings on their own balance sheets. A vast portion of commercial square footage in the United States is governed by leases that make the landlord responsible for capital expenditures and tenants responsible for rising operating costs.

Let's say that replacing a vintage 1980 chiller in a large office building could save $100,000 each year at a cost of $600,000 for a high-efficiency system – enough energy savings to pay for its replacement in 6 years. Leases for large tenants typically make the $600,000 upfront cost a landlord expense, but allocate the $100,000 annual savings to the tenants. If the landlord is permitted to recover capital expenditure (some leases allow sharing of this cost), it's typically required to amortize the charges to the tenants over the useful life of the new boiler. What looked like a 6-year payback to the landlord can become a 10- to 20-year proposition.

The second reason is that commercial mortgages prohibit commercial owners from taking on additional debt or accepting liens on equipment and systems. From the standpoint of the mortgage lender, those systems were financed when it underwrote the mortgage note. No other claimants can be permitted to take a security interest in assets that fall under the mortgage. The energy services company industry has never penetrated the commercial building market due in part to the leasing problem, but, even more fundamentally, because they rely on lease-purchase agreements and other forms of equipment finance that are impossible for commercial owners to accept.

**Change is Coming**
Two recent innovations are seeking to change these barriers. Both could change the dynamics of energy efficiency, but have drawbacks.

The first innovation is the green lease movement, which encourages green practices by eliminating the financial disincentive to landlords to invest in energy efficiency. Using a green lease will encourage landlords to invest in efficiency – but not immediately. Often, there's resistance from landlords and tenants to modify existing leases with a green amendment, leading both parties to table the issue until the expiration of the current lease. Absent some sort of policy mandate that forces landlords and tenants to address this issue, the green lease movement is likely to have little or no effect in the near to moderate term.

The second innovation is the recent push to use municipal bonds backed by a real property tax lien to provide landlords with a financing vehicle to fund energy-efficiency projects. (This is often referred to as a Property Assessed Clean Energy, or PACE, bond.) The PACE bond structure was conceived to provide financing for renewable energy projects in single-family homes, and wasn't designed for commercial real estate owners. Many fail to understand that PACE bonds are still an on-balance sheet obligation of the landlord subject to the debt and security restrictions of the first mortgage holder. It doesn't take a great deal of imagination to understand why the commercial mortgage industry isn't enthusiastic about the prospects of a new lender priming his/her position with a tax lien. Without gaining consent from the lender (which is unlikely), a landlord would be at risk of causing an event of default under his/her mortgage by opting into a PACE program. Like the green leasing issue, absent federal intervention, the standoff between lenders and landlords with regard to tax lien financing will be unresolved.

An original transaction structure that solves both of these problems without federal intervention – the Managed Energy Services Agreement (MESA) – commits a landlord to pay historical energy use, adjusted for weather and occupancy, for a fixed period of time, and makes the energy-efficiency supplier responsible for paying the actual energy bill. As a result, the landlord doesn't have to rely on restrictive capital recovery provisions in the leases. More importantly, the services contract doesn't impose any liens or debt on the building, preventing the problem of the primary mortgage lender. At the end of the contract, the building owner owns the energy-efficiency equipment and inherits substantially reduced energy bills.

But, with or without federal intervention, one thing is clear: The commercial real estate market and its approach to energy efficiency will be dramatically different over the next 5 years. MESAs can help property managers deal with these changes – they don't require landlord capital or increase operating expenses, they don't use cost recoveries, and they provide benefit without as much financial risk.

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