



Tales of Gains and Losses

Why we make the choices we make

If you're like most people you're probably more motivated to avoid a loss than to pursue a gain. Consider the following example: You've just spent nine hours driving through summer storms to reach a lovely bed and breakfast where you and your wife plan to spend the next week relaxing. Right after you drift into a deep sleep, you're awakened by the innkeeper urgently knocking on your door. You've inadvertently left your car in a "no parking" zone and the police are about to write you a \$100 ticket. If you're like most people, you'll probably jump out of bed, get dressed, and run down to move your car to avoid losing \$100.

Would you react the same way if a fellow guest needed to move his own car, didn't want to venture out into the rain, and was offering \$100 to anyone who was willing to do it for him? Economists who study such things suggest that most folks would simply roll over and go back to sleep: even though the same incremental \$100 was at stake.

Gains and Losses

Understanding how people make decisions is critical to getting capital projects approved. With budget season just around the corner, could emphasizing impending losses rather than potential gains hold the key to getting energy-saving projects approved?

A recent Environmental Protection Agency (EPA) study entitled the *Financial Benefits of Energy Star Labeled Office Buildings* assessed buildings that earned the Energy Star label between 1999 and 2004. Source data for this study came from 1,422 snapshots of building energy performance, 305 Energy Star-labeled building profiles, and interviews with several notable Energy Star Partners.

A summary of this study authored by Greg Kats and Jeff

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Perlman of Capital-E concluded that Energy Star-labeled office buildings are one-third more energy efficient than average US office buildings. They have energy bills that are, on average, at least \$0.50 lower per year per square foot, or 35% lower than the average building.

Moreover, a sample of ten buildings that earned the Energy Star label in six consecutive years found that those buildings were 20% more energy-efficient in the sixth year than in the first year labeled. While that sample set was small, it suggests that buildings that focus on measuring their performance get even more efficient (and more competitive) over time.

Other benefits documented in the EPA's study include greater tenant comfort and occupancy, higher building valuation, reduced exposure to volatile energy prices, and savings in operations and maintenance costs.

If you're an energy manager responsible for an income-producing office building, you could communicate this information to your chief financial officer in one of two ways: "If we improve the energy efficiency of our portfolio, we'll gain the following financial benefits....", or "Our competitors have already made enhanced energy efficiency a priority, and

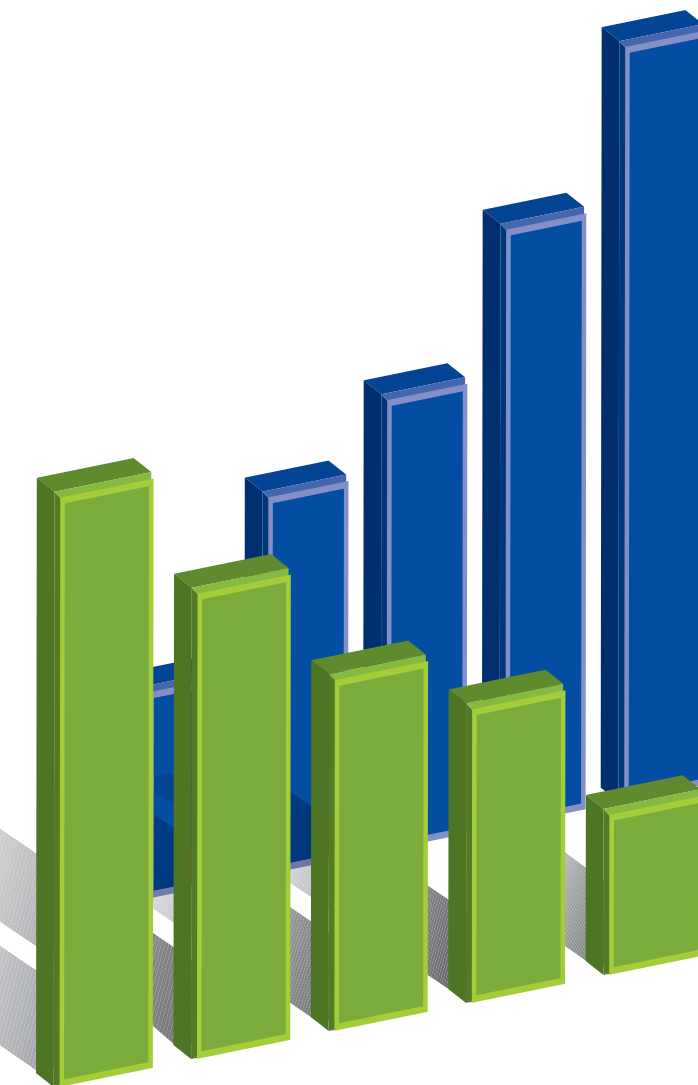
if we don't, we'll continue to have higher annual energy costs, rents, and vacancy rates than the competition. Higher energy costs are making our spaces more expensive to lease. Certain tenants won't even consider our buildings because they're not Energy Star-labeled. Without energy control systems, our spaces are less comfortable to occupy. Energy prices continue to rise and every time they do, the inefficiency of our building systems makes us even less competitive. At the end of the day, our capitalization rates are higher than the competition's, which means we'll get lower multiples of net operating income when we sell. Unless we do something soon, these combined losses could run into the millions of dollars for each building we own."

Real Examples

The competitive advantage of making energy efficiency a no-exceptions best practice was a hot topic at the RealComm conference in June. I was invited to participate in a series of panels discussing how state-of-the-art building technologies and best practices help buildings reduce their energy spend. One panelist volunteered that his LEED-Platinum-rated office building spent only \$0.99/SF on energy last year in a market that averaged \$2.05/SF.

Another panelist studies the energy efficiency of any building his real estate investment trust (REIT) considers acquiring. First, he benchmarks the building's historical energy performance. Next, he studies the existing leases and then models what would happen if he applied energy best practices. He wants to know how many overlooked opportunities to save energy could be harvested in the first year or two of outfitting and operating the building more sensibly than the seller.

One panelist focused on reducing energy costs in build-



ings with high tenant turnover. He explained that with fixed-base leases, the faster the landlord reduces energy cost per square foot, the lower that landlord's fixed energy costs will be for the duration of any new leases signed. Think of how much a landlord stands to lose if he does not minimize energy costs before signing the next handful of 10-year fixed-base leases.

Clearly, organizations that do not take a disciplined approach to controlling their energy spend will find themselves disadvantaged. Their more savvy competitors will enjoy lower energy costs, better rates of tenant attraction and retention, and ultimately higher asset values.

An energy manager can turn to other specialists to help calculate what's at stake if his building fails to become more efficient. For example, the leasing department might already see evidence of tenants lost to competitors that aggressively market their lower energy costs and improved ten-

ant comfort. In those cases, how much did the building suffer in lost rent and related costs, such as leasing commissions, tenant fit-out allowances and free rent periods for replacement tenants?

Fear of loss can be compelling in contexts far beyond commercial real estate. Any industry where energy is a major component of product cost could see competition reshuffled by market players who focus on reducing their energy expense. *e&pm*

About the Author: Bringing the perspective that comes with over 20 years in commercial real estate and 12 years in energy efficiency, **Mark Jewell**, founder and President of RealWinWin (mjewell@realwinwin.com), is a national expert on the role of energy-efficiency economics in commercial real estate.

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