Expanding the retrofit market requires a broader definition of risk

In order to understand the current state of the energy efficiency market, we think that the definition of risk must be expanded slightly. As generally defined, investors tend to think of risk purely in the context of whether potential returns justify the risks inherent in an investment. What we should be asking is, "are these investments worthwhile for the building owner?"

This broader definition of risk for building energy efficiency points at many of the reasons that retrofits do not happen – the barriers facing building owners – rather than the implied financial risk inherent in executing the individual projects. Three of the core issues that are creating barriers for building owners are: (1) can the building owner recover her invested capital, (2) retrofits are potentially very time consuming, and (3) retrofits are generally outside the core focus of the owner.

The split incentive is real. Arguably the single largest reason that efficiency retrofits do not occur today in the privately owned real estate market is the split incentive. Under a large portion of commercial leases, building owners are responsible for capital investments, and tenants reap the benefits of operating expense reductions. Triple net leases, often abbreviated as NNN leases, indicate that all expenses are passed through to the tenants. In many cases, owners literally can't recover the money invested in retrofits. There is no risk to assess, because there is often no chance of returns.

But even putting aside the split incentive, when a building owner looks at a 12 to 15% return on a building energy efficiency retrofit, the basic reaction is not "hey, 12 to 15% return sounds pretty attractive, and not too risky. Where do I sign up?" Rather it's generally "gee, 12 to 15% sounds intriguing but my core business is owning real estate and making my asset as valuable as possible, and that primarily means attracting and retaining tenants.

All this energy efficiency stuff seems like a questionable use of my valuable time, and would require a lot of effort for me to learn about how building energy efficiency retrofits work." What the building owner is implicitly saying is that 12 to 15% is attractive, but probably isn't worth the time and effort needed to actually make it happen. Culturally, building owners tend to look mostly at investments that will directly result in higher rent or increased occupancy by higher quality tenants.

Although there are many indications that energy efficiency retrofits will help to do this, there is not yet a robust and statistically sound set of data to prove the hypothesis. Additionally, building owners tend not to attempt to pioneer new techniques, so building retrofits go undone in the face of more traditional investments like lobby renovations.

To compound matters, the opportunity from energy efficiency retrofits represents a relatively small portion of a buildings' total operating profile. In a standard building, energy expenses might be only 2-4% of the building's total operating expenses.

In some cases, this may stretch to 10%+, but it is generally not considered to be a major line item by most property owners. Unfortunately, great returns on a tiny base don't matter to many owners. If energy costs are reduced by 30%, and they make up 4% of annual expenses, this only represents a total reduction in building level expenses of 1.2% percentage points.

Nice, yes, but must have? Depending on the time and effort involved, the answer from building answers is often "no". It's also worth noting that many buildings are owned to produce steady, stable, low-risk income. Building owners and investors as a class are notoriously risk adverse. Many are currently unwilling to jeopardize the current set of cashflows through a seemingly intrusive retrofit, even if that investment presents a compelling economic opportunity.

What does this mean for building energy efficiency investments?

Appropriately understanding the actual challenges facing the adoption of energy efficiency investments makes it significantly easier for the industry to determine the nature of viable solutions. This fact underscores one of our fundamental hypotheses –that retrofits are about real estate. Without the real estate component of the deal, there is no retrofit. As an industry, we need to focus on the building owners and deliver solutions to them that both meet their needs and are presented in their language.