INSTITUTE FOR MARKET TRANSFORMATION

Report on Meetings with California Commercial Property Appraisers

October 1998

I. Introduction

In September 1998, the Institute for Market Transformation (IMT) convened two extended discussion sessions with groups of commercial property appraisers. The purposes of these meetings were to elicit detailed firsthand information on the energy-related valuation practices of California commercial appraisers, and to investigate possibilities for enhanced recognition of energy costs and energy efficiency through improved documentation. This report describes results and findings from the two meetings.

II. Locales and Participation

The first such meeting was held in IMT's offices in San Francisco on September 9, 1998. The second meeting was held in Downey, California (near Los Angeles) on September 17, 1998, at the Energy Resource Center of Southern California Gas. Each session lasted four hours.

Each meeting included eight professional appraisers, all with experience in the commercial sector. All of the participants in the San Francisco meeting, and all but two of those from Downey, possess Certified General Appraiser licenses from the California Office of Real Estate Appraisers, the highest of five ranks of appraisal licensure in the state. The attendees represented a diverse mix of independent appraisers and representatives of major real-estate firms, banks, and financial consulting companies. Please see the accompanying participant lists.

IMT recruited these meeting participants through a combination of review of survey responses and solicitation of referrals from local chapters of the Appraisal Institute, a professional society. In order to ensure that costs of transportation and missed work would not be an excessive deterrent to attending, IMT offered a $100 honorarium to participants, plus lunch.

III. Findings

The appraisal industry encompasses a wide range of perceptions and approaches regarding energy, reflective of divergent personal viewpoints as well as service to distinct market segments. Even in IMT's relatively small discussion groups, participants voiced different and occasionally contradictory opinions. Nevertheless, the two meetings did reveal significant consensus on key issues, including the deficiency of current methods of energy-cost assessment and the general desirability of improved energy-performance documentation. In these areas, the meeting findings strongly corroborated IMT's

survey of California certified general appraisers. (See *Summary of Survey Findings on Energy-Related Business Practices of California Certified General Appraisers*, IMT, September 1998.)

The two meetings also yielded abundant information on appraisers' criteria for data quality and credibility; their potential receptiveness to specific types of energy-performance information; their view of how other market actors, including owners and buyers, behave; their relationships with lenders; and their concerns about liability.

Appraisal methods and the appraiser's role

The discussants unanimously noted that their commercial appraisals are based on a calculation of annual net income, which when divided by a capitalization rate, yields an estimate of present value.[1] Appraisers are expected to justify all factors in the net income calculation, including energy, with supporting evidence or reasonable assumptions.

The meeting participants also widely agreed that their role is ultimately to reflect what buyers in the current real-estate market would pay for the property, not what the appraisers themselves think the building is worth. As one participant put it, "Our job is to read the market, not to set it." Thus, the reasoning goes, if markets fail to make value distinctions among properties based on differing energy use patterns, then appraisers are also justified in ignoring such potential distinctions and treating energy use uniformly across buildings, even if actual cost patterns show otherwise. Several appraisers advised that because appraised value is ultimately defined by buyers' willingness to pay, attempts to transform the link between energy costs and property value should begin with education of owners, buyers, architects, and engineers.

Ideally, an appraiser would assess market preferences through a combination of sales data, market research, and discussions with prospective buyers. One appraiser in IMT's meetings insisted that such factors were the *only* basis for deciding how to treat value in appraisal.

But most of our other participants read the market differently. These appraisers said that even if there were no clear data on market preferences, a well-substantiated net income statement that persuades an appraiser about value can be reasonably assumed to persuade the average buyer as well. In other words, a calculated value based on convincing documentation of net-income figures can be deemed practically equivalent to the market's willingness to pay. This contention would presumably apply with particular relevance where buyers are preparing their own pro forma net income statements to inform their purchase decision.

We conclude that among a significant segment of appraisers, documentation of revenue and costs, including energy costs, can substantially influence the estimated value of a property, even where specific market preferences are not clearly known.

[1] Generally, all revenue and cost streams are subject to a single capitalization rate. In certain rare cases, where there is an easily differentiated component of the building with its own associated investment risk and/or valuable life, such a component may be assigned its own capitalization rate apart from the rest of the building.

Common methods for considering energy costs and energy performance

Our participants noted that in preparing estimates of net income, most often they rely passively on operating-cost information submitted by developers or owners. This information usually takes the form of financial statements or tax returns, not actual bills. (Utilities are sometimes lumped together, with energy indistinguishable from water, sewer, and other services.) Appraisers then apply rules of thumb based on experience or known standard references to determine if claimed energy-cost figures are reasonable.

Energy-cost numbers that fall outside of the expected range — as with an ostensibly highly energy-efficient building — need to be substantiated by other information in order to be included in the appraisal. In the absence of convincing additional evidence, appraisers' professional skepticism, conservatism, and technical ignorance often leads them to adjust the energy component of historical operating statements to reflect known regional averages.

Criteria for recognition of supporting energy-related documentation in appraisal

Most of the appraisers did say that low energy costs could be recognized in an appraisal if there were sufficient supporting documentation. IMT asked the appraisers what kinds of additional evidence they would be inclined to recognize, and what criteria they would apply in deciding whether to recognize such evidence. The appraisers showed no discernible preference for any specific kind of documentation, but did enumerate a number of criteria that the documentation would have to satisfy.

- **Accuracy**. Of course, a pivotal criterion for performance documentation is accuracy — that is, the likelihood that a predicted energy-use figure will be borne out in real future operations. Appraisers generally seek accuracy of approximately +/-5% in their estimates of other factors affecting value, such as future rent revenue. It seems therefore that similarly accurate tools for energy-performance assessment would meet appraisers' threshold for this criterion. (Note that existing methods, such as the use of regional averages, are probably much less accurate than this threshold range.) Accuracy of assessment tools should ideally be validated in field tests in a significant number of real buildings.

- **Ability to distinguish between anomalous operating conditions and actual efficiency**. Several appraisers expressed concern that records of low energy use in an existing building might not indicate above-average efficiency, but rather some anomalous condition such as unusual weather, low occupancy, or temporarily idle equipment. Evidence of installation of energy-efficient features in addition to low energy use would tend to allay this skepticism.

- **Impartiality**. Appraisers tend to be suspicious of the vested interests of owners, buyers, brokers, and lenders. Therefore documentation of lower energy costs would have increased credibility if it were provided by an unbiased third party.

- **Protection against input and calculational errors**. One appraiser argued that documentation must be "idiot-proof" — that is, equipped with built-in protection against input and calculational errors.

- **Technical legitimacy of information providers**. Providers of energy information must show evidence of technical competence — preferably, by showing appropriate professional certification or license in general engineering or specific energy-related subfields. More than one discussant noted that legitimate technical certification should be distinguished from unregulated, self-assigned appellations such as "home inspector."

- **Validation in actual experience**. Isolated cases of untested technology naturally prompt skepticism among appraisers. If high-performance claims were supported by an actual performance record of the relevant features (from the building itself or from other buildings), an appraiser would be more inclined to believe the claims.

- **Magnitude of energy savings**. The magnitude of owners' claims in itself affects appraisers' recognition of such claims in two contradictory ways. On the one hand, particularly bold claims of low energy use are sure to prompt especially acute skepticism. On the other hand, a claim of small savings relative to default levels may be dismissed as too small to matter relative to estimation error and to other components of value. One appraiser even contended that a claim of up to a 20% decrease in energy costs relative to averages would not warrant much attention, since ultimately it would be lost in rounding.

- **Convenience and clarity**. One appraiser told IMT that he had once received a thick, highly detailed report on a building's energy performance, but that it was so complicated and unclear that it was useless to him. Presentation of the most meaningful indices of performance, such as energy costs or energy consumption per square foot, along with brief, clearly-written justifications, would appear to favor recognition of a piece of energy documentation.

- **Comparability with other buildings**. Many of the participants emphasized the importance of being able to relate building energy-performance information to comparable buildings or to industry standards. Several voiced a strong desire for improved databases and a universally-understood rating system for energy performance in commercial buildings. At least one participant opined that indices from the Building Owners and Managers Association (BOMA), which are already widely used, are too highly aggregated and too regularly out of date to be useful as a comparison baseline.

Responses to specific proposed tools

Though there are numerous types of building performance-assessment tools representing a broad range of complexity, IMT sought appraisers' responses to only two specific types of tools: a system of normalized energy bills with statistical benchmarking (as with the proposed EPA ENERGY STAR Buildings Label and Benchmarking Tool), and a purely design-based simulation (as with an uncalibrated DOE-2 analysis).

Responses to the two tools were generally positive but mixed. Some said that normalized bills would have the advantage of simplicity and transparency, and would be more reliable than owners' statements or standard references. Others were more lukewarm, expressing concern that it would be difficult to benchmark normalized bills because performance levels would be a "moving target" that would change as the building stock evolved. All respondents did agree that a performance index based on normalized bills would be "better than nothing."

As for design-based modeling, appraisers said that they "would definitely consider" the results of a simulation, as long as the accuracy of the simulation tool were validated at a sufficiently high level — for example, at +/-5%.

Energy efficiency and real-estate markets

Appraisers agreed that the most convincing basis for assigning incremental value to efficient buildings would be actual evidence that buyers would pay more for them. To some extent, such consumer preferences may be in force even now, especially insofar as efficient features may yield non-energy benefits such as attractiveness, leasability, and an overall positive impression of newness. Still, actual statistical data on market recognition of these factors are difficult to find.

Participants noted that energy costs may sometimes, but not always, have a significant effect on net operating income. Where utility costs are passed through to tenants, for example, owners and buyers tend to care very little about energy. Furthermore, one appraiser commented, overall market conditions can strongly affect how energy is recognized. In a strong economy, demand for scarce real estate may be so intense that buyers would neglect details in their clamor for any suitable space. Current conditions in the Bay Area were presented as an example of such a tight real-estate market. On the other hand, in more difficult economic times, buyers may be especially aware of cost-saving opportunities and may therefore value them more readily. For their part, sellers in a slack real-estate market may promote specific building features, including efficiency, in order to differentiate their properties from other available spaces.

Appraisal and lending

The two meetings revealed important information about the dynamics among independent appraisers, appraisal reviewers in banks, and bank officials ultimately responsible for making commercial mortgage-lending decisions.

Most commercial appraisals are commissioned by banks that are considering making mortgage loans. According to a number of independent appraisers at IMT's meetings, banks effectively set the terms of appraisals and would strongly question any approach that appears unusual or yields anomalous results. Several participants agreed that if an appraisal showed lower energy costs than normal, "you're going to get called on it." Any proposed new methods for considering energy costs in valuation, noted the independent appraisers, would require approval by the lending institutions.

Notably, two of IMT's meeting participants are themselves appraisal reviewers for a major bank, and others had held similar roles in the past before opening independent practices. The bank officials made it clear that indeed they would be skeptical of all unusual claims regarding operating costs and net income — but if they the in-house reviewers can be persuaded to recognize these unusual claims, then officials explicitly responsible for loan decisions would not be likely to question the resultant effects on value. It appears, therefore, that the in-house appraisers at lending institutions are the key leverage point in determining whether energy-performance documentation will ultimately be reflected in the final value figure used in the lending decision.

(Encouragingly, the two bank representatives were generally quite supportive of the prospect of improved energy-cost documentation, and expressed overall willingness to recognize various possible types of new performance information, subject to their meeting aforementioned criteria.)

The bank officials noted that incremental energy-related value, if recognized in the final appraisal figure, could stimulate expanded lending even without creation of a special new category of "energy-efficient" commercial loans. Mortgage lending decisions for commercial properties are based on a number of factors: loan-to-value ratio (which ensures that the bank, should it have to foreclose, can recoup the costs of the loan), the borrower's net income and credit (which reflect the reliability of debt service), the remaining economic life of the property, as well as general market trends and so on. Incremental value based on well-supported documentation of lower energy cost would lead to larger mortgage loans through simple loan-to-value arithmetic. Lower energy costs could also favor expanded loans because of debt-service considerations; lower costs mean higher net income, leaving the borrower more cash in pocket to service more debt.

The two bank representatives noted further that lending officials rarely complain when new methods yield incremental value, implying that larger loans are justified. Larger loans represent a greater volume of business and greater profit potential for the bank. (Insofar as the job performance of lending officials is measured in part by total transaction volume, such officials may even have a personal stake in supporting recognition of incremental energy-related value.)

Finally, one bank official suggested that there might be a program linkage for IMT with the federal Small Business Administration's 504 loan program. This program lends money jointly with commercial banks to small enterprises making capital purchases, including land and buildings. The bank officer advised that SBA might be interested in participating in a pilot energy-efficiency recognition program in the spirit of promoting public environmental and economic benefits.

Dissemination of new energy-related appraisal practices

IMT's discussants generally felt that promotion of new methods of energy reporting in appraisal among professional appraisal societies would be less effective than obtaining the prior approval of bank officials. Integration of new energy-related requirements into the Uniform Standards of Professional

Appraisal Practice (USPAP)[2] would surely transform practice because appraisers would then be legally bound to observe them. Participants disagreed, however, about whether such changes in the USPAP would be desirable; about half said that they would welcome additions to the standards, while the other half expressed general opposition to new regulation. In any case, it is not clear whether the Appraisal Standards Board, which issues the USPAP, would judge that energy considerations are already required by general language about thorough assessment of operating costs.

Liability

A number of meeting participants observed that some appraisers would avoid newfangled information tools for fear of added vulnerability to litigation, which, as one put it, is "a death stroke." When pressed, however, the participants generally agreed that the risk of litigation from use of energy-related documentation would be no worse than from use of third-party information sources in other areas, and that the usual disclaimers, especially when combined with evidence of technical credibility of the energy-documentation provider, would provide sufficient protection. Integration into state or national appraisal standards could also help to protect appraisers. Indeed, one participant envisioned that if standards required use of enhanced energy documentation, an appraiser could be accused of negligence for *not* using such information.

IV. Conclusions and Next Steps

IMT's meetings and survey strongly imply that among a significant segment of commercial appraisers, there are informational deficiencies in consideration of energy costs in property valuation. Appraisers appear to be generally receptive to improved documentation of energy costs and energy performance. Such documentation would likely have to fulfill a number of criteria, including accuracy, impartiality, technical legitimacy, comparability across buildings, and other factors. Performance-assessment results from emergent or existing tools, such as normalization of energy bills or DOE-2 design-based simulation, would constitute improvements over appraisers' existing information sources, and if presented to appraisers, would probably win widespread acceptance.

To the extent that enhanced documentation would prompt appraisers to recognize incremental value in some properties, this value could apparently lead to expanded financing even without creation of special new categories of commercial loans. Appraisal reviewers in banks, and not officials responsible directly for loan decisions, appear to be the ultimate arbiters of whether to approve new methods of energy documentation and their resultant effects on value.

IMT is now evaluating a wide array of existing and prospective energy performance-assessment tools and assessing their compatibility with appraisers' stated criteria. We plan to prepare a set of recommendations to appraisers and lending institutions about their recognition of such tools and

[2] The USPAP is a mandatory standard for appraisal practice in the United States. Developed by the Appraisal Foundation, an oversight group established by Congress, the USPAP is enforced by state licensing boards.

integration with valuation practice. These recommendations may also lead to proposals for amendments to the USPAP, or to requirements or recommendations at the state level.