OPERATING COSTS AND SERVICE CHARGES in Office Properties
2011-2018
With over 100 years of experience on the real estate market, Knight Frank is an international advisory group actively participating in the development and shaping of the global real estate market. The company is among the group of leading entities who provide services in all aspects of real estate as well as researching, analyzing and naming trends and directions. With its headquarters in London and affiliated with partner Newmark Knight Frank active in the United States, Knight Frank currently operates from a network of 523 offices in developed and developing real estate markets in more than 60 countries.

Knight Frank Poland is part of the Knight Frank Group and has over 30 years of experience in the Polish real estate market. The company provides both real estate services as well as market research and analysis. In the area of direct real estate portfolio management, we provide services both for office, office-retail, as well as industrial, warehouse and commercial locations.

When analyzing operating costs and service charges, we have access to data from real estate managed by us as well as from entire commercial properties markets in Warsaw and regional cities, successively collected in all areas. The analysis encompasses data from the years 2011 – 2018.

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1. Operating costs

Operating costs related topics have become the key issues for tenants, and in consequence, for commercial property owners. Leasing office and service spaces in commercial properties entails bearing expenses in the name of the owner which include: rent, service charge (often referred to as additional rent) and media costs. The amount of rent and service charges, as well as the media reconciliation are regulated in detail by the lease agreement.

The approach present in the vast majority of lease agreements is that operating costs and service charges borne by the tenant cover all of the landlord’s property maintenance costs. When analyzing leasing costs from the tenant’s point of view, the decisive part is played by the amount of the elements which they cannot directly influence: the rental rates and service charges. With relatively comparable rental rates, which are shaped by the market mechanisms of supply and demand, the decision to lease an area in a particular site becomes often dependent on the amount of service charges. An analysis of the costs which compose operating costs helps to identify components with greatest influence on their cost. In this way, it points out the areas demanding special attention when completing the current budget, and planning budgets for subsequent years as well as planning rational actions aimed at limiting the said costs.
Operating costs usually constitute the body of expenses carried by the landlord to maintain the property. They are covered by the landlord, and then reconciled according to the provisions of the lease agreement. These are usually based on monthly paid lump sums and an annual reconciliation. Service charges are the part of operating costs reconciled directly with the tenant in form of a monthly paid lump sum calculated per square metre of the leased area. Lease agreements include a list of service costs included in the service charge. The list is usually open and includes all types of ongoing property maintenance costs. All media costs are excluded from the list – both those borne directly by the tenant as a result of using the leased area, as well as the majority of media consumed by the ongoing functioning of the property. The amount of operating costs and the cost of the service charge per square metre of leased area depends on many factors. These include: location, property size, degree of technological advancement, geographic location, land ownership type, usage degree and many others. To illustrate the differences resulting from the property location, we have extracted data on the level of operating costs for COB locations in Warsaw, other parts of Warsaw, and in regional cities.

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating costs</th>
<th>Service charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>18.97</td>
<td>23.17</td>
</tr>
<tr>
<td>2012</td>
<td>19.70</td>
<td>24.20</td>
</tr>
<tr>
<td>2013</td>
<td>19.66</td>
<td>23.80</td>
</tr>
<tr>
<td>2014</td>
<td>18.87</td>
<td>22.23</td>
</tr>
<tr>
<td>2015</td>
<td>19.07</td>
<td>22.69</td>
</tr>
<tr>
<td>2016</td>
<td>19.76</td>
<td>22.36</td>
</tr>
<tr>
<td>2017</td>
<td>20.66</td>
<td>23.63</td>
</tr>
<tr>
<td>2018</td>
<td>20.45</td>
<td>23.41</td>
</tr>
</tbody>
</table>

**COMMENT**

In 2018, the total level of both operating costs and service charges was subject to minor changes by only 1-2%. Warsaw’s COB, the most prestigious location, has seen a slight decrease of costs, while other locations witnessed a slight increase.
3. Individual components of operating costs

When categorizing the basic operating costs groups, we distinguish between nine major groups:

1. Media
2. Facility management
3. Property management
4. Common areas cleaning
5. Security and reception
6. Insurance
7. Property tax
8. Perpetual usufruct
9. Other costs

Average division of operating costs in the years 2011 – 2018 (PLN/sq m/month)

According to data from the years 2011 – 2018, the level of highest operating costs is as follows: the highest costs are media (37%), facility management (11.04%) and security (9.92%). When taken into account that operating costs also include a part of media costs, which in practice is reconciled each month as a direct invoice, the real share of each cost group in the operating costs remains unchanged.
When comparing the costs constituting the entirety of operating costs in 2018, we observe that proportions and amounts have remained similar to the average values from previous years. Definitely, the highest costs were media (34.16%), taxes (13.61%), security (11.86%), and facility management (11.14%). A visible change in the amount of security costs is a result of the introduction of the minimum legal salary and the minimum hourly wage.

COMMENT

The highest costs within the analyzed timeframe in the group of operating costs is constituted by common area media (24.14%), followed by taxes (14.99%), facility management (13.53%) and security (12.64%).

Operating costs – average share of individual cost types including re-invoiced tenant costs in 2018

When comparing the costs constituting the entirety of operating costs in 2018, we observe that proportions and amounts have remained similar to the average values from previous years. Definitely, the highest costs were media (34.16%), taxes (13.61%), security (11.86%), and facility management (11.14%). A visible change in the amount of security costs is a result of the introduction of the minimum legal salary and the minimum hourly wage.
They constitute more than 1/3 of the operating costs. They include the costs of purchasing and delivering electricity, thermal energy or fuel (gas), as well as water consumption and waste disposal. The highest cost in that group is constituted by electricity cost, which are rising annually due to the higher purchase prices, greater demand, more appliances, and the rising number of systems using electricity. Annual costs of thermal energy/gas are also gradually rising. Maintaining the media costs on a level relatively comparable with previous years in 2018 was a result of changes introduced by landlords, managers and property users aimed at creating savings in media consumption (saving electricity and pro-environmental actions), paired with technological progress in energy consumption of properties and appliances.

When compared to 2017, the average level of media costs in 2018 did not change significantly. Warsaw experienced a decrease of costs, while the regions have seen a rise of ca. 7%. The current situation on the electricity market, the rising demand for energy and resources have led to an increase of the electricity price in 2018. This, in turn, will result in a significant rise of media purchasing costs in agreements signed in 2019.

Media consumption costs – or the cost of electricity consumption in the vast majority of cases – are excluded from the operating costs reconciled in the service charge. Instead, they are re-invoiced to the tenant basing on the consumption meters installed in the leased area and, more often, in the remaining (non-metered) part on a proportional basis to the space occupied. This results in lower advance payments for operating costs and decreases the very service charge. In the future, we can expect the tendency to exclude all remaining media costs from the reconciliation in form of a service charge. This will most probably result in a partial compensation of other increases and the decrease of the operating costs.
This group includes the cost of technical service (technical team dedicated to maintaining a particular property and/or mobile service), maintenance and technical installation checks. In the majority of cases full technical service of all property installations is performed by a selected technical company (FM), excluding maintenance of elevators and escalators commissioned to specialist entities.

In 2018, a significant increase in the area of technical service in Warsaw took place with a simultaneous slight decrease of the costs in the regions. The general rising trend was a result of the growing labour costs and raising of the rates for FM services. The main reason of the increase noted in Warsaw were the observed deficiencies in workforce, which lacked qualified experts with education and technical knowledge. We should experience a further increase of the costs this service in the coming years.

### Average facility management costs in 2011 – 2018 (PLN/sq m/month)

<table>
<thead>
<tr>
<th>Year</th>
<th>Warsaw CBD</th>
<th>Warsaw – other districts</th>
<th>Regions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>2.41</td>
<td>2.20</td>
<td>2.32</td>
</tr>
<tr>
<td>2012</td>
<td>2.50</td>
<td>2.30</td>
<td>2.56</td>
</tr>
<tr>
<td>2013</td>
<td>2.54</td>
<td>2.38</td>
<td>2.59</td>
</tr>
<tr>
<td>2014</td>
<td>2.72</td>
<td>2.08</td>
<td>2.74</td>
</tr>
<tr>
<td>2015</td>
<td>2.39</td>
<td>1.97</td>
<td>2.47</td>
</tr>
<tr>
<td>2016</td>
<td>2.46</td>
<td>1.61</td>
<td>3.10</td>
</tr>
<tr>
<td>2017</td>
<td>2.71</td>
<td>1.58</td>
<td>2.80</td>
</tr>
<tr>
<td>2018</td>
<td>3.09</td>
<td>1.64</td>
<td>2.60</td>
</tr>
</tbody>
</table>

### Cleaning common areas

Common areas cleaning in commercial properties includes cleaning generally-accessible areas within the property, including car parks, and maintaining the external area. The standard costs of this service also include the purchase of necessary materials. Statistically, common areas in modern office properties constitute from 3% to 7% of the total building area which has significant influence on the amount of the cleaning costs.
In 2018, cleaning costs remained on a level comparable to previous years, despite following changes in minimal wages and hourly wages. We can assume this is usually the result of introducing rationalization and limiting hiring with a simultaneous increase of effectiveness and efficiency requirements for service providers. In 2018, an additional element influencing the overall cost of the service became more significant – the lack of workforce often resulted in a lowering of the service quality and big fluctuation of employees. Service providers from this domain began looking for support by hiring foreigners, which seems to become a rising trend in the years to come. This also carries the consequence of the service becoming less reliable. Even though in the previous years, hiring foreigners was aimed at creating savings, it became a necessity in 2018. This happened despite the fact that wages in this employee group became practically equal to the wages of domestic employees.

The last years have seen significant changes in the rules and scope of insuring properties, and their share in the costs for 2018 decreased slightly when compared to previous years. The decrease of the percentage share is a result of the slight decrease of the cost of the insurance policies with a simultaneous increase of the costs dependent on other individual components. Insurance belongs to the group of costs independent from the landlord, despite being negotiated by him and depends on the selected insurance company, volume of properties in the portfolio, as well as defining the franchise level for particular events.

The majority of insurance policies include clauses for loss of profit and insurance against terrorist events.
Property management in Poland includes a vast array of actions related to property management, much broader than in Western European countries. In Poland property management includes all ongoing administrative and technical actions, necessary for the good and safe functioning of a property, including operational budget planning and execution, oversight of capex budget execution, and a large portion of bookkeeping and financial activities such as reconciliation and collecting rent and operating costs (excluding financial services for the owner-owned special purpose vehicles). All services related to property management are usually entrusted to a single entity.

In 2018, after a period of decreasing the level from previous years, the market saw a slight increase in the area of property management costs – especially visible in Warsaw. The following factors had direct influence on the observed increase of the property management cost: rise in supply of ultra-modern office spaces and an increase in the lease of high rent areas connected to that, a further increase of the general amount of office spaces leased in the Warsaw area related to a growing concentration of tenants in this area.

The remuneration of the managing property is usually defined in practice as a fixed percent of the invoiced income from rents (excluding additional discounts and grants). However, in the last years we have observed many situations when the management fee was defined as a fixed lump sum aimed to secure both parties in case of emergencies. It has often led to a decrease of the real average remuneration. It needs to be said that the decrease of the management fee rates in the last years was not directly proportional to the increase of the scope of responsibility of the managing entity. As a result, the property manager’s scope of responsibility is defined by the individual property management agreement. As there is no legal definition of property management on the Polish market, the scope of services provided is defined by market practice. Initiating and introducing new legal regulations for real estate, growing client expectations and changes in the functioning of funds resulted in huge rise of expectations for property managers. As a result, clients need to accept the increasing cost of this service.
The role of the property manager has changed within the last 10 years. Even though the scope of responsibility became much broader, the role became less prestigious. This is a result of, first and foremost, Asset Managers who took over part of the role’s functions and whose role on the local market became more significant. So far, the majority of office property owners, usually foreign funds, did not have their representatives in Poland. Today, the funds who dispose of large portfolios, have organized their own teams on site. They more often reach out to tenants directly in order to build long-term relationships. Up until now, with properties fully taken up, the Property Manager would independently manage the property, and rarely use the help of other experts. Today, the market requires a greater degree of specialization, activity and engagement, focusing the actions on lowering the vacancy rate. A tenant-oriented market requires the property manager to focus more on strategic long-term actions, marketing and PR actions, rather than only on the ongoing maintenance of the property.

The property manager, who has been working independently so far, is now supported by a team of marketing specialists, brokerage agents, rent collectors, and facility managers.

Refurbishment has become the modern standard. The lobby will now be modernized after the very first few years of a property’s life. Investing in ecological solutions is commonplace. More attention is put on collecting liabilities, which is why rent collection services have become necessary. All the said actions are always supported and coordinated by the property manager.

Reporting is now much more complex. Property owners keep a close eye on all aspects: financial, technical and operational. The quarterly reports from the past have been replaced by monthly reports, often accompanied by additional quarterly, annual and theme-based reports (i.e. eco-friendliness of a building).
In January 2018, the legal regulations on wages were changed once again. The minimum wages rose, and the minimum hourly wage was raised to PLN 14. As a result, direct costs for entities providing security services, constituted mainly by costs of employing staff, rose by ca. 15 – 20%. No direct proportional transfer of this increase on the final cost of security for the client took place. Perhaps due to the actions of property managers and investments of the owner, new technical solutions were introduced to some properties (i.a. additional cameras, gates etc.) which allowed to optimize the number of security staff necessary to provide the service, and to lower the increase of this cost. It seems that the target solution would be to maximally lower the number of security staff by replacing them with complex electronic system monitoring solutions (CCTV, SSWiN, etc.). This, however, requires additional costs to be carried by the property owners both in the area of security and access monitoring systems and remote property technical installation monitoring systems. Currently, security staff not only provide security services, but also monitor the correct functioning of power, property installations, media installations, and anti-fire installations (SAP) after the working hours of technical staff. Today, only a limited number of the most modern properties are starting to be equipped with technical solutions which enable to fully resign from physical security staff outside of the tenants’ regular working hours.
Land, property, or their parts connected to business activity or construction, are subject to tax. Based on the collected data and the rates announced by the local government,

In 2018, the maximum possible tax rate in the majority of town and communities rose to the level of PLN 23.10 per square metre of property area, and to PLN 0.91 per square metre of land area. Amongst the main regional cities, only Wrocław and Lublin decided to use the maximum rate.

Warszawa: 23.10 0.91  
Poznań: 23.10 0.91  
Wrocław: 22.66 0.89  
Gdynia: 23.10 0.91  
Kraków: 23.10 0.91  
Łódź: 23.10 0.91  
Lublin: 22.76 0.91

This is the cost group with the most diverse composition which depends on the type and specifics of the property, technical infrastructure and the general technical condition. It also includes costs such as: repairs, ongoing maintenance, emergency removal, exploitation material costs, maintenance costs for selected systems and installations, DDD services, controls and checks required by law, seasonal works and decoration, outdoor works in green areas, snow removal and so on.
Perpetual usufruct of land is a form of land ownership popular in a number of countries in Central Europe, including Poland. The State Treasury or the local government authority (community, county, voivodship) remains the land owner, and defines the value of the land by performing a valuation. The standard annual fee for land covered in commercial properties is 3% of the valuation worth on an annual scale.

Perpetual usufruct costs amount to over 11% of operating expenses. As a result, a possible change in law abolishing these charges could probably have a significant effect on the amount of operating expenses and service charges. In June 2018, the government presented the Parliament with a project of an act to change perpetual usufruct of residential built-up land into land ownership. The proposed changes were supposed to streamline the process of transitioning perpetual usufruct of land for residential purposes into ownership in order to provide citizens with a ‘stronger’ right to property and to avoid conflicts resulting from the updated perpetual usufruct fees. Today, the change of perpetual usufruct into ownership is limited only to built-up land for residential purposes (including service properties, car parks, other sites and construction devices, which enable the correct and rational usage of residential properties). According to the Minister of Investment and Development, the government will ask the European Commission for the notification of a ‘reform changing all types of perpetual usufruct laws into ownership law upon payment below the market value of the land ownership law’.

This form of land ownership is held by more than 50% of property owners in major cities (the majority of them in Warsaw). In the regions, this phenomenon applies to a smaller number of properties.
As the presented table indicates, properties without any costs resulting from perpetual usufruct the percentage share of property tax related costs is higher. Still, when we compare the absolute values and take into account that the analyzed property groups have an almost identical GLA sum, the amount of property tax costs is very close, and the distribution of costs similar.
CHANGES IN LAW

COMMERCIAL PROPERTY TAX

On January 1st, 2018, a new commercial property tax was introduced to Polish law. The commercial property tax is a fee in the form of a tax introduced on June 15th, 2018 by the Act on Income Tax Change for Corporate Entities, and the Act on Lump Sum Income Tax on Certain Incomes Earned by Natural Persons (Dz. U. poz. 1291). The legislator aimed at closing gaps in the provisions of the Act on Personal Income Tax from Natural Persons, and Income Tax from Corporate Entities, and introduced the so-called minimal income tax with regard to taxpayers owning commercial real estate with an initial value not exceeding PLN 10M. The amendment is a step made by the legislator to counter tax optimization which is performed by property owners who lower the tax base. The tax introduced was supposed to provide the influx of the minimal tax to the National Treasury from every entity conducting such a business. Office, retail and mixed-used properties became subject to taxation. From January 1st, 2019, some changes were introduced to the controversial tax. First of all, the name of the tax was changed to ‘property income tax’, which will probably clear many doubts whether it can be part of the property’s operating expenses. The list of property types subject to taxation has also changed. Apart from shopping malls, shops, commercial and service properties, and office properties, the list now also includes warehouses and production sites. The tax will not be accrued when the leasable space of property does not exceed 5%. The tax rate did not change and remained on the level of 0.0035% of the tax base, which is the income total from particular properties reduced by PLN 10M. The 10 million limit has changed. Before, it referred to the initial value of the property. Now, it refers to the very taxpayer – his income from rent, leasing and tenancy. It applies without regard to the number and worth of owned properties. Taking into account the standard lease agreement provisions, there is no reason to include the said tax in the operating expenses of a property. It needs to said, that the tax was introduced as a change in the Act on Income Tax, and that it applies to CIT or PIT taxpayers who are leased property owners. This makes it possible to consider this tax as income tax. The introduced tax was heavily debated on the real estate market: how to reconcile it and whether it can be included in the operating costs borne by the tenants. Market practice shows that the majority of commercial property managers aligned with property owners, and did not introduce the commercial property tax amounts due and amounts paid (property income tax) in the 2018 reconciliation. They did not decide to classify it as an operating costs to be reconciled in the 2019 budgets, even if the general and non-specific clauses of the lease agreement would allow them to do so.
A couple of years ago, new legal rules regarding waste disposal were introduced. Since then, commercial property managers are struggling with constant problems. This applies mostly to Warsaw, where waste disposal companies are unable to cope with the amount of waste to be collected. They often don’t collect waste from selected locations at all. It is almost impossible for waste disposal companies to keep their schedules and is a source of stress for the property managers. The reason behind all the chaos are the new rules and the obligation to hand over the waste to the community. The communities do not feel responsible for the waste, even though they collect fees in form of tax and re-direct users with problems to the appropriate waste disposal companies. There is a chance to restore order from before the new legal changes. The Parliament is currently working on an amendment to the Act on Cleanliness and Order Maintenance in Communities from July 1st, 2011. The changes will enable property owners to sign a direct contract with the receiver and freely choose the company with the best financial offer, eco-friendly waste collection forms, segregation, recycling, and possessing international certificates. From the property manager’s perspective, the receiver’s agility is crucial, both in terms of collection hours, time of day, and collection type.

THE MEGA ACT

Nine years ago, the Act on supporting the development of telecommunications networks and services, or the so-called Mega Act, was introduced. The rules give telecommunication companies many options for easier access to properties. They also severely limit the rights of property owners resulting from property law. The aim to introduce the act was general access to telecommunication services, Internet mostly. The reason were the problems telecommunication companies had in negotiating with developers, and mostly the lack of residential buildings. In commercial properties, owners are keen to provide services of many companies to stay competitive. Unfortunately, the provisions of the new act impose new obligations on the owner, together with additional costs and risking the safety of the property and leased offices, not only from the technical aspect. Last year, a new amendment of the act was prepared, which will additionally introduce a number of new obligations for owners, perpetual usufruct users, and property managers. The legal changes have a big impact on the legal status of properties (limiting ownership rights, unlimited access to properties for telecommunication companies, taking over the duties of the current owner by the new one by law, etc.). The actions of commercial property owners and property managers led to a debate about the changes with the legislator. It will most probably result in introducing changes positive for commercial property owners to the Mega Act.
LESS IS MORE

The ‘zero waste’ or ‘less waste’ approach which translates into ‘zero garbage’ or ‘less garbage’ is becoming more and more present in our everyday lives. It applies not only to what we buy and eat, but also how we travel, take care of ourselves, what clothes we wear, and how we function as a society. ‘Zero waste’ aims at limiting waste production as re-cycling has become too little in the process of waste management. A growing number of synthetic materials is not suitable to be recycled. As a result, limiting the use of plastic in favour of multiple use materials is now necessary.

Zero waste can apply to any aspect of our lives, because we constantly consume and use resources, thus producing waste. This is true both for our private lives and for our workplace. That is why zero waste means not only buying less products, choosing better quality goods, using multiple use products, and choosing eco-friendly packaging. It also means buying locally-produced goods, supporting sustainable production, or avoiding ordering products via the internet to limit the carbon trail connected to transport and goods logistics. Reducing the use of plastic has the greatest benefit on the amount of waste in our environment. Its popularity is a result of its qualities, durability and considerably low production cost. Simultaneously, plastic is a one of the materials hardest to process. Even when re-cycled, it gradually loses its features. What’s more, only 5% of plastic in the world is re-cycled. This means that 95% of it is used only once. According to the Main Statistics Office data, the average Pole produces about 311 kg of communal waste a year, 29 kg of which is plastic. As re-cycling plastic is ineffective, we need to start at the source of the problem and limit its use as well as provide for a maximal possible re-cycling of the rest of materials into resources.

The question remains, how can we help make it happen? The place to start implementing the zero waste approach is our office, where we spend most of our time each day. The company’s operations as well as the administrative back office consume a lot of resources. However, correct actions may contribute to limit the impact on the environment and help reduce the cost of running a company and using office space.

We have developed 5 categories of actions in the office to reflect the zero waste approach. They will effectively help limit waste in the workplace. Further examples refer to company actions and solutions implemented for all employees. They also include initiatives which individual employees can start in order to limit waste production.

Environmental pollution is currently becoming out of scale. An example of that is the Great Pacific Garbage Patch drifting on the waters of the Pacific Ocean. It is made up in 99.9% of plastics. Its size is estimated at roughly 1.6M sq km, which is almost equal to the combined areas of Poland, Germany, Czech Republic, Slovakia, Hungary, Ukraine and Belarus. However, this is not the only waste adrift in the oceans. Other patches can be observed at the shores of i.a. South and South-East Asia.

The Baltic Sea receives via rivers all types of waste from an area of 1.7M sq km populated by some 80M people. Cleaning the Baltic is difficult as it is a closed sea and there is a very limited exchange of waters with the North Sea and the Atlantic Ocean. That is why the people of the Baltic States should turn their attention to products they use and throw into the sea.
REFUSE

- Refuse to accept gadgets or accessories from providers which are not necessary in the office.
- Change regular subscriptions to digital subscriptions.
- Do not accept paper catalogues from providers – ask for a digital version.
- Don’t accept and give out business cards – save contacts in your phone.
- Do not use disposable dishes or gadgets.

LIMIT

- Stop using bottled water. Use a water distributor instead.
- Print only what you need to print. Print company papers on double-sided paper.
- Issue digital invoices whenever possible.
- Use the coffee machine with freshly ground coffee. This will help to limit the use of capsules. Ground coffee can be re-used as flower fertilizer.
- Buy only the office materials you really need.
- Do not collect disposable pens. Instead, use a pen with a changeable refill.
- Do not use post-its. Take digital notes.

RE-USE

- Use high quality office materials, so you can use them longer.
- Choose office materials containing the least amount of plastic possible – i.e. pens with a paper or bamboo casing.
- Create a platform for employees to exchange non-used objects i.e. an office library of announcement forum.

SEGREGATE

- Segregate waste in the office.
- Organize a workshop or online training on how to segregate waste.
- Refrain from having a bin at your desk to minimize the number of garbage bags.
- Do not have a the bin at your desk, to minimize plastic bags.
- Throw waste into dedicated containers.

COMPOST

- Create a composter for bio-degradable waste.
- Use only re-cycled paper to print.
- Use printed paper as a notebook.
- When bringing lunch to the office, use multi-use plates jars or wrappers.