JUSTIFICATION FOR Grossing Up Operating Expenses

by William H. Brownfield, CPM

What is Grossing Up?

How many times have you heard the question, "What do you mean when you tell me that you "Gross Up" expenses?" Do you remember the first time you asked it? Tenants frequently ask it, as do leasing agents and brokers, as well as all new property managers. Rarely is a satisfactory answer given. Most people new to the subject eventually become suspicious about the motives that an owner or property manager would have for talking about anything other than "actual expenses". Also, many real estate professionals who do understand the concept of grossing up have never had to actually sit down and perform defendable calculations. And a lack of current literature on the subject has created a significant and harmful information gap between property owners, tenants and brokers.

Grossing up is the process used to estimate what the probable operating costs would be if a particular office building was full, even though it is really only partially occupied. Actual expenses for the less-than-full building consist of two types —fixed and variable. When grossing up, the variable expenses are increased to the point they might have been if the building was fully occupied.

Why Is It Necessary?

Office building lease documents have changed over time to protect the respective needs of the landlord and the tenant. Grossing up expenses creates a stable foundation for making financial comparisons during the term of a lease. When grossing up is combined with the economic structure of the lease (Expense Stop, Base Year, Triple Net), the landlord is protected from inflationary risks associated with providing services to the tenant, and the tenant is protected from operating expense increases due solely to higher occupancy levels in a building.

Is It Fair?

Who wins by grossing up...the owner or the tenant? Actually, both win because when expenses are not adjusted, either the tenant or the owner may be treated unfairly. The conclusion that some people jump to is that the building owner unduly benefits by pumping up expenses above the level actually expended. However, each tenant only pays his pro-rata share of operating expenses (grossed up or otherwise), so the amount recovered by the owner is limited by the leased percentage of the building. Therefore, the owner never fully recovers all monies spent on escalating operating costs until the building is actually 100% occupied.

Financial Proofs

Three financial proofs are provided to support this contention:

1) Exhibit 1 illustrates the percentage of grossed up expenses that are recovered by a building owner when a triple net lease is utilized. The asterisk (*) line and the white area represent the level to which expenses should be increased when actual operating expenses are fully grossed up. The black area represents the total expenses recovered by the owner at any given percentage of occupancy (assuming that escalation collections are based on a pro-rata share of grossed up operating expenses).

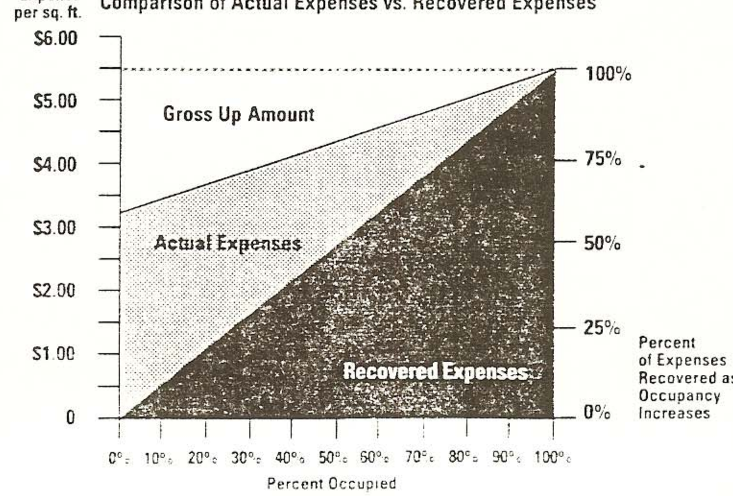
None of the areas or lines in the graph intersect until the building is 100% occupied. This clearly illustrates that the owner never collects more than is actually spent on expenses, even if they are grossed up.

Example: Consider the actual expenses and recovered expenses at occupancy levels of 10% and 90%. Exhibit 1 clearly shows that a building owner will incur actual expenses of approximately $3.45 at 10% occupancy, but will only recover $.55 (10% of $5.50 grossed up expenses per square foot). Even at 90% occupancy, actual expenses will be $5.45 per square foot while recovered costs will only be $4.95 per square foot(90% of $5.50).

2) There are costly effects of not grossing up, as illustrated in Exhibit 2. Assume that a new building is constructed and ready for occupancy, but remains vacant the entire first calendar year. Actual operating expenses for the empty building amount to $3.50 per square foot that year. On January 1 of the second year, Tenant A moves into 50% of the space. Tenant B takes the remaining 50% of the building on January 1 of the third year. Both tenants execute five year leases for the same base rental rate, and both negotiate expense stops based on the previous year's actual, rather than grossed up, operating expenses (Base Year Expense Stops). During this seven year period, no inflation occurs and all expenses remain flat.

In all respects except one, both tenants and their leases are exactly the same. The only difference is that Tenant A moved into the building before Tenant B. Why then is Tenant A's escalation $5.00 per square foot higher (+125%) than Tenant B's over the five year term? The answer is simple. Tenant A's "stop" was tied to the expense level of a vacant building, at $3.50 per square foot. Tenant B's expense level of $4.50 per square foot benefitted from higher expenses caused solely by Tenant A's occupancy.

Exhibit 1
Operating Expenses
Comparison of Actual Expenses vs. Recovered Expenses



What can be overlooked in this situation is that not only is Tenant A paying more in escalation than it should, but so is Tenant B. Both tenants executed leases that provided for Base Year Expense Stops. Had they also negotiated the inclusion of Gross Up provisions, both tenants' "stops" would have been $5.50 per square foot. On that basis, neither tenant would have paid any escalation, because inflation did not occur and operating expense remained constant. Had each tenant's lease been negotiated

Exhibit 2
ESCALATION COST COMPARISON (PSF)
Tenants A&B in New Building Without Gross Up or Inflation

Years Open	Occupancy Rate	Tenants	Actual Oper. Costs	Base Year Stop (1)	A's Annual Escalation(2)	B's Annual Escalation(2)	Difference
1	0%	None	$3.50				
2	50%	A Only	$4.50	$3.50(A)	$1.00		
3	100%	A&B	$5.50		$2.00	$1.00	
4	100%	A&B	$5..50	$4.50(B)	$2.00	$1.00	
5	100%	A&B	$5.50		$2.00	$1.00	
6	100%	A&B	$5.50		$2.00	$1.00	
7	50%	B Only	$4.50		___	___	
			Term Escalation Costs.........		$9.00	$4.00	$5.00

Note
(1) Base Year Stop, per previous year's Actual Operating Expenses, remains constant throughout the term of each tenant's lease.
(2) Escalation is paid in addition to Base Rent. It is calculated by subtracting each tenant's Base Year Stop from the Actual Operating Expenses incurred for each year.

at a market Expense Stop, rather than a Base Year, they would have incurred escalation expenses over the term, but the cost would have been equal for both tenants.

An argument can be made that an early tenant in the building, with a Triple Net lease and non-grossed up actual expenses, could pay a lower amount of escalation expenses over the lease term. It is highly unlikely that this would happen, though, because the "market" dictates the total rent cost per year, not just the base rent. In other words, lower actual operating expenses would be offset by a higher base rent, and the total rent would be what the market would bear.

3) The previous example can be simplified by using just one expense category to illustrate the point more clearly, while using the same previous assumptions (Tenant A moves into the first 50% of the building at the beginning of Year 2, Tenant B moves into the second 50% at the beginning of Year 3, and no inflation exists). Further assume that the building contains a total of 100,000 rentable square feet, comprised of 10,000 square feet of common area and two 45,000 useable square feet areas for the tenants with each Tenant's rentable square feet stated in the lease as 50,000 square feet. Also, assume that cleaning costs equal $1.00 per actual square foot cleaned, and that each Tenant's first year of occupancy establishes its base year expense level.

The cleaning expense in Tenant A's first year is based on 55,000 square feet. The amount equals $.55 p.s.f. for the entire building (55,000 s.f. X $1.000 p.s.f., divided by 100,000 s.f.) rather than the $1.00 p.s.f. of unit cost.

If the base year cleaning expense is then set at $.55 p.s.f. and Tenant B moves in at the beginning of Year Three, the cleaning expense will then equal $1.00 p.s.f. at the end of that year. Tenant A will then be billed for $22,500 (50,000 X $.45 p.s.f. increase), in spite of the fact that the real cost of cleaning Tenant A's space did not change. This extra charge to Tenant A will reoccur every year until the end of the lease or until Tenant B moves out. During the term of its lease, Tenant B will not incur any cleaning expense charges on top of its base rent.

Had Tenant B never moved into the building, or had the base year cleaning expense rate been set at the grossed up value of $1.00, Tenant A would not have paid any extra cleaning charges throughout the term of the lease. Tenants A and B are placed on an equal footing because of grossing up, and that equality remains constant during inflationary and non-inflationary scenarios.

Conclusion

Grossing up expenses creates a fair deal for the landlord and all the tenants. Understanding the need for it and including it in leases will help foster better relationships among all parties involved in a lease transaction.

William H. Brownfield, CPM is vice president of operations at The Paragon Group, Houston, TX, and author of Creating a Fair Deal In Office Lease Escalations: A Guide to Adjusting Expenses for Occupancy Changes. *To order a copy, contact BOMA International at (202)408-2662. Price $35.00; BOMA International Member Discount price $30.00.*