What's Up With Escalations?

By William H. Brownfield, CRE, CCIM and Lawrence M. Mayerhofer, CPA

This year, everything about escalations is "up" due to four significant changes in the office building sector:

1. Costs are higher; so are escalations.
2. Standardization is increasing within the industry.
3. Vacancies are higher; so are gross-ups.
4. Escalation audits have increased substantially

Costs Are Higher; So Are Escalations

According to BOMA International's 2003 *Experience Exchange Report*, overall expenses in 2002 for operating expenses for office buildings increased at a fast-paced 5.1%. Not surprisingly, the expense category with the largest percentage increase is security (14.3%); followed by fixed expenses (12.2%), comprised mostly of property taxes and insurance; and administrative (8.0%). The industry's response to terrorism caused significant increases in security and insurance – in many cases doubling over the last two years. The property tax percentage increase for 2002 is not specifically shown, but there is little doubt that local communities relied heavily on property tax increases to offset the effects of a softening economy, which is in turn causing decreases in assessed valuations in some markets in 2003.

If operating expenses are up, then it follows that escalation billings have increased too, at least on a per-square-foot basis, rather than a tenant-by-tenant basis. The exceptions would be those buildings that had major changes in base years due to leases rolling over. Since the industry does not track escalation billings, we use the *EER's* "Table 1 – Income and Expense Comparisons: 2001-2002, U.S. Private Sector" (see page 15) to roughly estimate collective annual escalation expenses billed by U.S. private sector office buildings from year to year. Why do we care about the cumulative size of escalations? Because we believe that the industry will embrace standardization once it knows the true magnitude of escalation billings and their effect on tenant relations. Using BOMA's 2003 *EER*, we calculated 2002 escalations as follows:

2002 Escalation Income
U.S. Private Sector Office Buildings

U.S. Private Sector Office Space	13 billion sf
2002 Operating + Fixed Expenses	x $9.90 psf
2002 Total Expenses	= $128.7 billion
2002 Increase in Total Expenses	x 5.1%
2002 Estimated Escalations	= $6.6 billion
2002 + Prior Year (2nd year lease avg., cumulative)	= $11.9 billion

2002 categories with largest increase: security 14.3%; admin 8.0%
2001 and 2000 overall increases: 4.32% and 2.15%, respectively

As noted, 2002 experienced a 5.1% increase in total expenses, much higher than 2001's 4.32% increase and about double the norm for the previous decade. By our estimate, 2002 escalations were approximately $6.6 billion. That's equivalent to $.51 psf when spread across the 13 billion square feet of private sector office buildings. However, most lease terms average between 3 to 5 years, so actual escalation billings generally represent at least a two-year period. Therefore, cumulative escalation charges contained in 2002 billings could have been about $11.9 billion[1]. That's a huge number. On average, it works out to about $.92 per square foot nationwide.

Standardization Is Increasing Within the Industry

When discussing the magnitude of escalation charges, it's important to note that:

- The lease document defines the concepts to be used to determine escalations, but …
- The lease document does not establish exact methodology to be used when calculating escalations, and …
- There is no regulatory body providing guidance on how escalations are calculated (nor should there be, but many mistakenly believe that GAAP specifically addresses escalations; it does not).

Why do we make these distinctions? Because without standardized or generally accepted processes, billing errors can frequently occur if the methodology used is incorrect or inconsistent. These errors can lead to disputes with tenants and their auditors, and will ultimately diminish or even eliminate the level of trust that needs to exist between landlords and tenants. Experience has shown that tenants will complain about higher escalations, as we all do, but will also ordinarily pay these expenses if they trust the information they have been given.

Many landlords still rely on mathematical models or in-house Excel schedules that cannot pass muster in an audit, or make decisions that inadvertently create inconsistencies from year to year. In our opinion, the only way to minimize escalation errors is to use standardized methodology, meaning processes that are built on real numbers, supported by written contracts, when possible, or by accepted logic when necessary. These processes should be applicable to most situations and consistently applied each year.

Fortunately, BOMA International publishes standardized methodology that is flexible enough to be used by almost any office

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building. It has established gross up methodology that is fair to both the landlord and the tenant and which is readily accepted by most auditors. The software version incorporates this standardized methodology and generates standardized reports, cover letters, and tenant invoices. The software version stores each year's information for future reference, which can be of great assistance in subsequent audits. For more information, see www.boma.org. More information is also included on page 24 of this issue.

There are good examples to follow in the industry too, and there is evidence of a growing body of property owners converting to standardized escalation processes. For years, Equity Office Properties Trust, the nation's largest office REIT, has been using BOMA-endorsed methodology for its portfolio of 12,000 leases. Their escalation processes are highly standardized and serve as both a means of minimizing errors and for building trust with their tenants and auditors. As part of their commitment to clarifying lease language, Equity Office recently modified their standard lease document to include language stipulating that escalations will be prepared "*in accordance with the methodology specified by the Building Owners and Managers Association*." Comparable language has been popping up in other landlords' leases too, including several recently executed in Texas. Other real estate companies would benefit by taking similar steps with their methodology and their leases.

Vacancies Are Higher; So Are Gross-Ups

Occupancies in most major U.S. cities have in recent years been historically high, so grossing up variable expenses has not been necessary for many buildings. Declines in occupancy will now force many owners to gross up expenses for the first time in several years. Their property management personnel and tenants may be unfamiliar with the gross-up concept, and questions are sure to arise.

Both should remember the following: owners who do not gross up may have meaningful reductions in escalation income due to occupancy-related drops in operating expenses. In addition, failure to gross up will certainly harm tenants due to understating base year amounts. When combined, these two statements reflect the inherent fairness of the gross- up concept.

There is not much more that needs to be said about higher vacancies, except that the decisions that property owners make today about escalation methodology will have significant effects on them and their tenants for years to come.

Escalation Audits Have Increased Substantially

In a soft economy, all prudent businesses look for ways to cut costs. After a slowdown in lease audits during the office boom of the late 1990's, tenants are exercising their audit rights with a vengeance, with many landlords seeing substantial increases in requests for audits of their escalation invoices.

Larger tenants often have staff dedicated to annually auditing their leases. Other tenants might typically engage a lease auditing firm to review their escalation bill. These outside auditors can range from a Big Four CPA firm to a small, one-man operation. Unfortunately, not all lease auditors are equally competent. The better ones will focus on the large dollar issues (e.g. real estate taxes, gross-ups, capital improvements, etc.), while less effective auditors will bore down to a meaningless level of detail, by reviewing every invoice, service contract, or payroll record.

Dealing with lease audits can be a frustrating and time consuming experience, so why increase the probability of one occurring? Errors, overcharges, and undercharges are less likely to occur if property owners and management staff follow these steps:

- Prepare escalation invoices in accordance with the terms of the lease (it might be time to update your lease document).
- Use a standardized methodology, consistently applied from year to year.
- Include a cover letter that explains expense increases, especially large category changes.
- Supply adequate supporting documentation upon request.
- Communicate openly and frequently with both the tenant and the auditor.

The Importance of Standardized Methodology

2002's escalations have set new highs, influenced as much by geopolitical and national economic factors as by local property conditions. Owners and tenants should recognize that it might take several years for these themes to play themselves out. Only an economic recovery that creates jobs will increase office occupancies. With time, concerns about terrorism should diminish and eventually stabilize cost increases for security and insurance.

In the meantime, office building owners and managers should focus on developing and using standardized methodology that will decrease the probability or impact of escalation audits. As a result, tenant trust levels might increase at a pace even faster than expenses.

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1 $6.6 billion plus the $5.3 billion we estimated for 2002. These estimates ignore the effects of leases rolling over as well as the higher expenses of triple-net leases. It is assumed that these two issues offset each other to some extent.