OPERATING EXPENSES 101:

AN OVERVIEW

InspiRE

Commercial Real Estate Services

OPERATING EXPENSES

Overview

In most commercial leases, the tenant pays base rent – and is also obligated to reimburse the landlord for operating expenses at the property.

- Under most retail and industrial leases, the landlord pays for the costs to maintain the common areas – the landscaping, parking lots, sidewalks, and other aspects of the property that are shared by all of the tenants. As a result, these pass-through calculations are referred to as **common area maintenance pass-throughs** – abbreviated and known as **CAM charges**.

- Under office leases, the landlord typically pays for all of the costs associated with operating the building – referred to as operating expenses. Although some property managers refer to these calculations as "CAM charges," since they include more than just the common area costs, it is more precise to refer to them as **operating expense pass-throughs**.

There are many different ways to structure a commercial lease. However, regardless of the lease structure, a tenant's payment includes two specific components:

- The **base rent component** covers any non-operating costs, debt service (the mortgage), the owner's overhead, and the owner's financial return (profit).

- The **operating expense component** covers the cost of operating the building – including operating expenses (like service contracts, utilities, repair & maintenance, management fee, etc.), real estate taxes, and insurance.

Most office leases are structured as **gross leases**:

- The rental rate in the lease includes both the base rent component and the operating expense component.
- The tenant pays its pro-rata share of the ***increased operating expenses above the base year***.

Most industrial and retail leases are structured as **net leases**:

- The rental rate includes only the base rent component.
- The operating expense component is invoiced separately.
- The tenant pays their pro-rata share of the operating expenses. There is no base year[1].

The landlord and the tenant are free to negotiate the operating expense pass-through provisions of a lease. Still, most office leases are gross leases, and most industrial and retail leases are net leases. Sometimes, single-tenant office leases – where a single tenant occupies an entire office building – are treated as net leases because all operating expenses are attributable to that tenant. (There are also several forms of "hybrid" leases that blend the components of gross leases and net leases. For the sake of simplicity, we will focus on the pure gross leases and net leases.)

[1] "Pure" net leases (commonly referred to as "triple net" leases) have no base year. There are various hybrid lease structures where certain components are treated as "net" leases and other components are treated as "gross" leases. These might be called "industrial gross" leases (among other terms). Distinguishing between these hybrid lease types goes beyond the scope of this white paper.

For the most part, structuring the lease as a gross lease or a net lease does not change the tenant's payment to the landlord – it merely changes the method by which the operating expense pass-throughs are calculated.

It is the Same – But Slightly Different

Assume a landlord and a tenant are negotiating an agreement for the tenant to lease an entire office building. They are trying to determine whether the operating expense pass-through will be on a gross basis or a net basis.

The landlord would like to charge a base rent component of $23 per square foot, and the property manager estimates the operating expenses are $12 per square foot.

- Under a gross lease, the tenant would be charged $35 per square foot – which includes $23 per square foot as the base rent component and $12 per square foot as the operating expense component. (The $12 per square foot operating expense component is "built into" the $35 per square foot rent charge – so, in future years, the tenant would pay its pro-rata share of the increase in operating expenses above the $12 per square foot base year.)

- Under a net lease, the tenant would be charged $23 per square foot (the base rent component) and then its pro-rata share of the operating expense component. If the operating expenses in the first year or $12 per square foot, the tenant would pay a total of $35 per square foot. (The $12 per square foot operating expense component is separate from the base rent component – so, in future years, the tenant would be obligated to pay its pro-rata share of the operating expenses.)

Here is how each of these options would appear:

Gross Lease		Net Lease	
	Per Square Foot		Per Square Foot
Tenant's Invoice	$35.00	Tenant's Invoice	$23.00
Includes:		**Tenant Invoiced Separately For:**	
Base Rent Component	$23.00	Operating Expense Component	$12.00
Operating Expense Component	$12.00		
Total Billing to Tenant	**$35.00**	**Total Billing to Tenant**	**$35.00**

Ignoring any lease mandated rent increases, if the operating expenses in Year Two increased by $0.50 per square foot, the tenant's payment would change:

Gross Lease		Net Lease	
	Per Square Foot		Per Square Foot
Tenant's Invoice	$35.00	Tenant's Invoice	$23.00
Includes:		**Tenant Invoiced Separately For:**	
Base Rent Component	$23.00	Operating Expense Component	$12.50
Operating Expense Component	$12.00		
Operating Expense Increase	$0.50		
Total Billing to Tenant	**$35.50**	**Total Billing to Tenant**	**$35.50**

Operating Expense Prepayments

At the end of each year, the property manager could send an invoice to the tenant for its operating expense liability the prior year. However, that is impractical because:

- The landlord would be responsible to "front" the operating expenses of the building for the year.

- The tenant would receive a large invoice that would need to be paid as a lump sum – making collection a challenge.
- It would create a timing issue in terms of accounting – the tenant would be billed for operating expenses associated with the prior year.
- If the tenant goes out of business or if the tenant moves away, it can be a challenge to collect accounts receivable balances – especially large ones – because the landlord will have lost its leverage.

Instead, the property manager calculates the tenant's estimated operating expense obligation and invoices the tenant each month. If the tenant's operating expense obligation is estimated to be $24,000 per year, the property manager will invoice the tenant $2,000 per month over 12 months.

Reconciliation

At the end of each year, the property manager calculates the tenant's actual operating expense obligation and reconciles this against the prepayments the tenant made during the year.

- If the tenant's actual obligation exceeds its prepayments, the property manager invoices the tenant for the difference.

- Conversely, if the tenant's obligation is less than its prepayments, the property manager issues a credit to the tenant for their overpayment[2].

This is referred to as an operating expense reconciliation (for office tenants) or a common area maintenance (CAM) reconciliation (for industrial and retail tenants).

The Base Year or Base Stop

In gross leases, the operating expense component is determined by either a base year or a base stop.

A **base year** represents the actual operating expenses incurred at the building during a particular year. The base year is often the year the tenant's lease begins; however, the landlord and the tenant sometimes negotiate a different base year. (As an example, if a tenant moved into a building in 2019, it would be typical for the base year to be established in the lease as 2019. However, the parties might agree to set the base year as a different year – perhaps 2020. If this is the case, the actual operating expenses of 2020 will become the tenant's base year.)

In the example above, the property manager estimated the base year operating expenses – and thus, the operating expense component – to be $12 per square foot. However, when the lease is being negotiated, the base year is an educated guess based on the information that is available at the time. The base year is not finalized until the actual operating expenses are totaled at the end of the year. The actual operating expense component will almost certainly be different from the operating expense component contemplated in the lease negotiations. Sometimes, the calculations will be close – and sometimes they will be far apart.

Once the base year is established, the billing to the tenant does not change – but the allocation between the base rent component and the operating expense component does. As an example, if

[2] Note that, under a gross lease, the tenant is never entitled to a credit of any portion of the operating expense pass-throughs that fall below the tenant's base year. For example, it the tenant's base year is set at $12 per square foot and the operating expenses in Year 2 decline to $11.50 per square foot, the tenant is not due a credit. The tenant's operating expense payment will never fall below the base year amount.

the actual operating expenses for the base year listed above were $12.20 (instead of the $12 per square foot estimate in the lease), the new base rent component would be $22.80 per square foot, and the operating expense component (base year) would be $12.20 per square foot. Going forward, the tenant would then pay its pro-rata share of increased operating expenses over the newly established base year of $12.20 per square foot.

A small number of leases use a **base stop** instead of a base year. A base stop is simply a numerical representation of the tenant's operating expense component, and it is not based on actual expenses of a particular year. (In the case of the example above, if the lease called for a base stop of $12 per square foot, it would not matter what the actual expenses were in the base year – the operating expense component would be established in the lease at $12 per square foot.)

Regardless of whether the lease calls for a base year or a base stop, the intention is to create an operating expense baseline. Under a gross lease, once the baseline is established, the tenant must pay its pro-rata share of operating expenses above that base year or base stop.

Net Leases are Not Impacted

Because the tenant's operating expense component under a net lease is based on the tenant's pro-rata share of the actual operating expenses of the property, there is no base year or base stop to calculate. The tenant is simply charged its pro-rata share of the actual operating expenses incurred during a particular year.

GROSS-UPS

When a building is fully occupied (or close to fully occupied), it is relatively easy to calculate the base year. And, as long as the building remains fully occupied (or close to fully occupied), it is also relatively easy to calculate the tenant's operating expense liability in subsequent years.

However, when a building is not close to fully occupied, it becomes a challenge to calculate the tenant's operating expense liability fairly. Consider two scenarios:

- Assume the building was only 50% occupied during the tenant's base year – and the actual operating expenses for that year were only $9.50 per square foot. Without accounting for the vacancy, the tenant's base year would be established at $9.50 per square foot. If the operating expenses are $12.20 per square foot the next year – when the building is fully occupied – the tenant would be obligated to pay its pro-rata share of the increase in operating expenses over the base year ($12.20 – $9.50 = $2.70 per square foot). Because the base year was calculated in a year where the operating expenses were artificially lower, the tenant would owe $2.70 per square foot – a whopping 28% increase in operating expenses.

  In this case, the property manager should adjust the base year calculations to approximate the operating expenses as if the building were fully occupied that year.

- Conversely, if the building were fully leased during the tenant's base year and the actual operating expenses were $12 per square foot, what would happen if a major tenant moved out the following year and the actual operating expenses plummeted. Under this scenario, assume the operating expenses in Year Two fell to $9.50 per square foot because the building was only 50% occupied. In calculating the tenant's operating expense liability, the property manager would subtract the current operating expense calculation ($9.50 per square foot) from the tenant's base year ($12 per square foot). As a result, the tenant would not owe any additional operating expense liability. (In a gross lease, the tenant does not get any refund if the actual

operating expenses are lower than the base year. However, they are not obligated to pay any additional operating expenses under that scenario.)

In this case, the property manager should adjust the Year Two calculations to approximate the operating expenses as if the building were fully occupied that year.

In both of these cases, significant vacancy had an unintended impact on the operating expense calculations. It is all about fairness. Under a gross lease scenario, the landlord and the tenant are incentivized to compare "apples to apples" when calculating the base year and when reconciling operating expenses against the base year in subsequent years. If the comparison is not "apples to apples," one of the parties will be negatively impacted.

Gross-Ups

To solve this problem, commercial leases typically include a "gross-up" provision, which allows a landlord to project operating costs for a building with significant vacancy as if it were fully occupied. The clause allows the property manager to "**gross-up**" operating expenses to a predetermined occupancy level – often 95%. The goal is to normalize the operating expenses to estimate the expenses of the building accurately had it been at least 95% occupied.

This means that any time the building's occupancy falls below 95%, the landlord is permitted to adjust the operating expenses to approximate the actual expenses the building would incur if it were at least 95% leased. (95% is a common gross-up threshold, but each lease can be different. Some leases require the property manager to gross-up expenses if occupancy is less than 100% - others might require a gross-up at or below 90% occupancy.)

Using the examples above:

- Under the first scenario, the tenant's base year would be calculated by grossing up the actual operating expenses to reflect the approximate operating expenses that would be incurred at 95% occupancy.

- In the second instance, the actual operating expenses would be grossed up to reflect the approximate operating expenses that would be incurred at 95% occupancy. The tenant's base year would then be compared against the grossed-up operating expenses to determine its liability.

What to Gross-Up?

Operating expenses are comprised of both fixed expenses and variable expenses[3].

- **Fixed expenses**, as the name implies, do not fluctuate with building occupancy.
    - Examples include landscaping, snow removal, fire alarm and sprinkler monitoring, and many service contracts. Since fixed expenses do not change in response to building occupancy, they are not usually included in any gross-up calculations.

[3] The lease might also include language to break out "controllable" and "uncontrollable" expenses. In this case, controllable expenses are, as the name implies, under the direct control of the landlord – like janitorial costs, maintenance costs, etc. On the contrary, uncontrollable expenses are those outside of the landlord's control – like snow removal or real estate taxes. The lease language might require the landlord to separate controllable from uncontrollable expenses when calculating a tenant's operating expense liability. This additional step goes beyond the scope of this white paper.

- **Variable expenses** change in direct relation to building occupancy.
    - Examples include utilities, property management fees (based on a percentage of income collected from the property), janitorial costs, and specific repair and maintenance costs.

Certain expenses include both fixed and variable components. As an example, certain common area utility costs are fixed (exterior lighting, parking garage lighting, common area lighting, and base building HVAC) and also variable (occupancy–related lighting and HVAC). When evaluating the need to gross-up utility expenses, the property manager needs to separate the fixed costs and only gross-up the variable portion of those costs.

Remember that the goal is to be fair – to accurately normalize the operating expenses so that, in years where occupancy is less than 95%, the tenant is charged correctly.

When the building is stabilized and the fluctuations in occupancy are reasonable, the property manager needs to only focus on the most common variable expenses – those that are directly impacted by occupancy. However, certain gross-up calculations require additional considerations – particularly in new buildings that are occupied for the first time and buildings that are experiencing significant swings in occupancy.

Operating expenses associated with a newly constructed building are unique:

- Most building systems are under a one-year contractor's warranty, and the contractor is responsible for all repairs and maintenance during the first year of operation. Thus, the repair and maintenance budget will be lower than in a "normal" year.

- Many landlords include certain startup expenses as operating expenses in the first year. For example, they may choose to code all of the new engineering and maintenance tools as operating expenses in the first year – even though they will be used for many years. In this case, the tools line item will be artificially higher than "normal."

- Building systems take some time to be optimized, so they are likely to be operating less efficiently when they are first installed and turned on.

- When the occupancy is very low in the beginning, certain expenses are commonly deferred. As an example, sometimes staffing levels are often adjusted based on occupancy. New properties are usually managed by a skeleton staff of property management and engineering employees. Over time (and as leasing improves), additional employees are hired to fill out the on-site team. As a result, first-year staffing costs are typically very low compared to stabilized staffing costs.

- Sometimes other abnormalities require additional consideration. For example, if the building is empty, snow removal might be limited to just clearing fire lanes to provide for emergency access.

CONSIDER GROSS-UPS TO BE TEMPORARY UNTIL CONFIRMED?

As you can see, gross-up calculations are quite subjective – particularly when the building is new or when there is significant vacancy.

You will not know how accurate your gross-up calculations are until you can compare them to a year or two of actual operating expenses.

Consider communicating to your tenants that the gross-up calculation – especially if it creates the tenant's base year – is temporary until the calculation is verified.

Remember – the goal is to be fair. Re-evaluate your gross-up calculations in subsequent years to make sure they are accurate – and then officially "lock them in" with the tenant.

If the property is new or experiences a significant swing in occupancy, the property manager needs to be extra vigilant when grossing up operating expenses.

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