GROSSING UP OPERATING EXPENSES

The office building industry has evolved the bill-back process to include the gross-up of expenses. The theory of the gross-up is to set the level of expenses at the full or near-full occupancy level and to even out the anomalies of the filling building, such as great swings in taxes, insurance, and variable operating expenses. This approach is said to benefit the property owner and the tenant and to be fair to each. In the case of a base-year lease, the gross-up is likely to benefit the tenant as well as the owner. In all other cases, however, the benefit of the gross-up belongs to the property owner. That is not to say that an owner should not use a gross-up if the market permits it, even with stop-clause or triple-net leases. Nevertheless, the property owner must be aware that this is an income-enhancing activity and that

it is not for the benefit of the tenant. When the market is strong, the owner can take every advantage available to improve the financial return on the building. When the market is weak, the property owner must suffer the consequences and settle for a smaller return than is desired—and in some cases, risk losing the building.

At first consideration, for a tenant to agree to gross-up provisions might seem unreasonable. However, there is logic to the position that the tenant should not benefit from—and particularly that the owner should not be penalized by—the fact that the building is not yet full. A particular tenant generally receives full utility and service benefits even though the taxes may not be fully assessed. Therefore, including the gross-up provisions is logical, because the tenant will end up paying its fair share rather than getting a windfall benefit from the vacancy within the building.

To be able to gross-up the expenses in an office building, use of the proper lease language is critical. The owner's attorney should check and approve the final language of the lease to be sure it accomplishes the desired objectives.

Base-Year Lease Provision

Under the terms of a base-year lease, the tenant is likely to benefit from the use of a gross-up provision. As mentioned earlier, though many of the costs start out very low, they increase as occupancy of the building increases. Real estate taxes are potentially contentious items under these circumstances. Generally, the building carries only an assessment for the land until the building is constructed. The taxes in the first year can be a fraction of the taxes when the building is fully assessed. If the taxes were $150,000 in the base year of a specific tenant's occupancy, and the next year taxes were raised to $600,000 on the completed building, the tenant could be subjected to its pro rata share of $450,000 worth of taxes, which was not the intention of the base-year clause.

On the other hand, if the taxes were grossed-up to the full occupancy level, the base year would reflect the correct amount of taxes for a finished building, and the tenant would be faced only with those increases for future years' assessments. Why would an item of fixed cost be grossed-up? In the operation of office buildings, several items can be fixed expenses, variable expenses, or both. A water bill for an office building can have fixed portions and variable portions. Many areas have a fixed minimum meter billing and a fixed sewer charge. The same applies to all expenses that are directly related to occupancy of the building, such as utilities, janitorial services, management fees, some insurance premiums, and the like. By use of the gross-up provisions, the tenant receives a reasonable level of base-year expenses and will then only face increases, as was the original intent of the lease provision.

Exhibit 3.1
Fixed Expenses (Actual)

Real estate taxes (fully assessed)	$120,972
Insurance (full premium)	14,400
Security	38,500
Management fee (fixed fee)	32,400
Elevator service (full contract)	13,200
Landscape service	28,600
Sweeping service	16,600
Payroll	32,500
Building repair	11,600
Total fixed expenses	$308,772
Annual per square foot: $3.13	

Expense-Stop and Triple-Net Lease Provisions

The expense-stop provision creates approximately the same situation as the triple-net lease. The result of using a gross-up provision with a stop-clause or a triple-net lease is that the tenant will pay more money. However, if the gross-up is done properly, the tenant is likely to pay only those costs it would have incurred if the building were fully occupied, so it does not benefit from the vacancy of the building. The leasing agent or property manager should explain that the tenant is not being penalized. Rather, the tenant is only paying its fair share.

The next sections detail two basic approaches to calculating the gross-up for an office building.

Calculation of the Gross-Up Allocation

In the first approach to calculating the gross-up allocation, the fixed expenses are generally taken at the actual cost and are included in the final calculations on that basis. The fixed cost determination must be about the same as it will be when the building is full. If the taxes are fully assessed at this point, they are generally included in the fixed-costs portion of the billing. Insurance, fixed contracts for landscaping, janitorial, and so on that are not tied to occupancy would be in the same category.

For the purposes of this sample calculation, assume a building of 98,600 square feet. Exhibit 3.1 shows the fixed expenses for the building's first year of operation.

Expenses that fluctuate due to occupancy, such as janitorial contracts, utilities for tenant spaces, HVAC service calls, and so on can then be adjusted by a formula that compares 100-percent occupancy to the actual occupancy. However, each of these variable expenses must be analyzed for components

Exhibit 3.2
Variable Operating Expenses (Actual)

Item	Actual Expense	Factor	Adjusted Expense
Building water	$ 9,420	1.92	$ 18,086
Trash removal	5,877	1.92	11,284
HVAC service	3,155	1.92	6,058
Pest control	5,200	1.92	9,984
Janitorial service	44,403	1.92	85,254
Misc. repairs	6,222	1.92	11,946
Supplies	4,720	1.92	9,062
Electricity	66,606	1.92	127,884
Total variable expenses	$145,603		279,558
Fixed expenses	$308,772		$308,772
Totals	$454,375		$588,330
Per square foot annual	$ 4.61		$ 5.97

The actual cost of operating this building in year one, which would be the base year for a base-year lease, would be $454,375, because the occupancy was less than 100 percent. The next sections look at the effect this would have on the property owner and the tenant, assuming a triple-net lease, a base-year lease, and a stop-clause lease.

that may be fixed and have nothing to do with occupancy. Air-conditioning may have a fixed component, in that it may not be possible to turn off the air-conditioning in vacant spaces; therefore, this expense will go on in spite of the vacancy factor in the building. The same argument applies to air-conditioning that serves the building's atrium or hallways. Electricity has a fixed component for vacant spaces, hallways, restrooms, and the like and must be considered when grossing up those expenses. For the sake of the example, assume that the building is currently 52 percent occupied and that the lease allows for the gross-up to 100-percent occupancy. For the sake of simplicity, the fixed portions of these variable expenses are not taken into account. Given all this, the relationship is 1.92. As a result, to gross-up the expenses to full occupancy, we would multiply each actual variable expense by the 1.92 factor, as shown in Exhibit 3.2.

Triple-Net Lease. With a triple-net lease without a gross-up clause, the property owner would bill the tenant at the rate of $4.61 per square foot for the actual operating costs of the building. However, since the true cost of

operating the building is $5.97 per square foot, the tenant is getting the benefit of a reduction of almost $1.36 per square foot in overall occupancy costs, solely because the building is not yet full. This tenant is not likely to be suffering any shortages of services or inconvenience to its employees or customers; therefore, it should pay its full pro rata share of the expenses it would pay if the building were fully occupied.

From the property owner's perspective, the gross-up helps cover, but does not provide full reimbursement for, the operating costs of the building. The gross-up eases the owner's financial burden until the building reaches full occupancy.

Base-Year Lease. If this were a base-year lease with no gross-up provision, this tenant would automatically have a rent increase in year two, due solely to the fact that the building was not fully leased up in the base year. The tenant's base-year expenses would be $4.61 per square foot. Assuming the building became full in year two, the tenant would owe the property owner an additional $1.35 per square foot because operation of the building in its partially occupied state did not cost $5.97 per foot. Had the first year been grossed-up, the base would have been in the area of $5.97 and the tenant would have saved a substantial increase over the term of the lease. The purpose of the base-year clause is not only to collect moneys from the tenant but also to protect the property owner from having inflationary operating costs destroy the value of the building.

Expense-Stop Lease. Assume the provisions of the expense-stop lease are negotiated at $5.40 per square foot. The tenant would not owe any additional moneys for the first year of operation and would have benefited from the low occupancy of the building even though the tenant would be unlikely to incur any loss. The property owner would not have the benefit of the reimbursement that would be afforded by a gross-up provision, which would have set the operating costs at the 100-percent level of $5.90 per square foot. Although the gross-up provision may not provide any benefit to the tenant in this case, it does allow for a reasonable allocation of the costs, and the tenant is paying no more than its fair share.

Alternative Method of Gross-Up Calculation

The second approach to calculating the gross-up allocation uses the actual variable expenses rather than using a relative formula for the calculation. An additional amount is added to bring that figure to the 100-percent expected occupancy cost, and that adjustment is then added to the actual costs to arrive at the total. The utility gross-up generally uses the actual consumption for the calculation rather than just the dollar amount of the billing.

Actual Consumption Example. For example, consider a building of 135,420 rentable square feet. Assume that the electrical company or a consultant has advised that the building will use an average of 28 kilowatt hours (KWH) per square foot per year and the average cost per KWH is .0742. The calculation would be as follows:

Building rentable square footage × Average KWH per sq. ft. = Total building KWH:

135,420 × 28 = 3,791,760 KWH

Likely annual cost for electricity for a full building (100% occupied):

3,791,760 KWH × .0742 = $281,348

Actual cost 2005 (52% occupied): $146,301
Gross-up: $281,348 − $146,301 = $135,047
Per square foot of net rentable area:

$135,047 ÷ 135,420 = .$1.00 per sq. ft.

This amount is then transferred to the gross-up allocation sheet for the final annual expense summary.

Occupancy-Related Expense Example. A janitorial contract is a good example of an expense that is tied to occupancy. Assume that the contract is for 6 cents per square foot per month of usable area of the building and that the building has 122,000 square feet to be cleaned and 135,420 square feet of rentable area. The calculation to gross-up this contract would be as follows:

Net rentable area: 135,420 sq. ft.
Occupancy: 58,500 sq. ft.
Area to be cleaned: 122,000 sq. ft. @ .06 per sq. ft. per month
Total potential annual expense: 122,000 × .06 × 12 = $87,840
Times gross-up (100%): $87,840
Actual cost: 58,500 × .06 × 12 = $42,120
Gross-up amount: $87,840 − $42,120 = $45,720
Per square foot of net rentable area: $45,720 ÷ 135,420 = .34

The gross-up year-end allocation would then show the actual cost of janitorial service as $42,120, along with all of the other actual costs. The adjustment sheet to show the gross-up items is shown in Exhibit 3.3.

Gross-Up versus Non-Gross-Up Example. To illustrate the inequity created if the gross-up process is not used, the example below compares the janitorial expenses in another building—first using even dollars and square footage and then using the gross-up numbers.

Exhibit 3.3
Gross-Up Adjustment Sheet

Gross-Up Adjustments

Actual variable expenses for calendar year 2005		$4.32 per sq. ft.
Gross-up adjustments		
Janitorial services	.34	
Utilities	.17	
HVAC gross-up	.22	
Management fee	.13	
Supplies	.08	
Trash removal	.28	
Pest control	.09	
Total gross-up		1.31 per sq. ft.
Total 2005 escalation adjustment		5.63 per sq. ft.
Less expense stop (if applicable)		5.40 per sq. ft.
Net due		$0.23 per sq. ft.

Using Even Dollars and Square Footage. First, consider the scenario in which the expenses are not grossed up:

Building: 100,000 sq. ft.
Janitorial costs: $1.00 per sq. ft.
Building 50% occupied; actual janitorial expenses: $50,000 (50,000 sq. ft. × $1.00 per sq. ft.)
Tenant: 10,000 sq. ft. (10% of building)
Janitorial costs: $50,000 (actual expenses) × .10 (tenant pro rata share): $5,000
$5,000 ÷ 10,000 sq. ft. = $.50 per sq. ft.

In this example, using even dollars and square footage, the tenant only pays $0.50 per square foot for janitorial services although the actual cost of janitorial service is $1.00 per square foot. In this case, the tenant is not paying its pro rata share of the actual cost of cleaning the building or the tenant's premises.

Using Gross-Up Provisions. Consider the same building as in the previous example. Using the gross-up provisions, the cost of janitorial service for the building would be $100,000 at full occupancy. The tenant would pay 10 percent of that total, or $10,000, divided by the tenant's square footage of 10,000.

$10,000 ÷ 10,000 sq. ft. = $1.00 per sq. ft.

Thus, under the gross-up provisions, the tenant would pay its fair share of the janitorial expenses at $1.00 per square foot.

The management company or property owner can elect to calculate the expenses and present them to the tenants as a grossed-up amount without the calculations showing the actual cost plus the gross-up amount. The result is the same as the preceding approach, but it does not give the tenant any information about how the numbers were calculated. Experienced tenants may want to see the calculation; if they find it to be reasonable, they will generally go along with the approach.

Gross-Up Summary

In an office building lease, the gross-up provision fills a legitimate function in the fair and reasonable allocation of operating expenses to the tenants. With the exception of the base-year approach to the allocation of building expenses, the gross-up process does not benefit the tenants, but it does not penalize them either. If the gross-up provision is used to establish a more reasonable base for the allocation of expenses, it can be a distinct benefit to the tenants. In all cases except the base-year approach, the gross-up provisions benefit the property owner in providing a more fair and equitable reimbursement of expenses. However, even with a gross-up provision, the property owner it is not likely to actually make money—or break even—on anything less than 100-percent building occupancy.