WHY SHOULD EXPENSES BE GROSSED UP?

Critical to the fair implementation of a base year structured lease is the gross-up concept, also known as extrapolation. A gross up provision allows – in fact, requires – the landlord to increase those categories of operating expenses which are affected by changes in occupancy to reflect what such costs would have been if the building had been fully occupied (the lease will typically define “fully occupied” to mean either 95% or 100% occupied). This will ensure the tenant’s “base year” expenses are reflective of a highly or fully occupied building and will protect the tenant from large increases in its operating expense obligations caused by increases in the building’s occupancy. For example, if a tenant’s base year is established during a year with low building occupancy, lacking a gross up provision the base year costs will only reflect the costs incurred for running a partially occupied building. If later the building is more fully occupied, the tenant would be responsible for paying its pro rata share of the increased expenses resulting from the higher occupancy level.

Similarly, costs that would have been incurred during the base year but, instead, were covered by a warranty should be included in the determination of the base year’s expenses. For example, in a new building if the elevators are covered by warranty during the base year, the landlord’s actual cost incurred for elevator maintenance during the base year would be $0.00. In the first comparison year, however, the warranty has expired and the elevator maintenance costs total $60,000. In such a scenario the tenant’s operating expense obligations are inappropriately impacted by the $60,000 difference. Consequently, the base year expenses should be adjusted as if elevator maintenance costs existed during the base year and the landlord should determine what the costs would have been if no warranty applied. In this case, if the elevator contract has a 5% rate increase from year to year, then the base year elevator expenses should have been 5% less than the first contract year, or $57,000. In other words, by implementing this “warranty” provision, the tenant would only be responsible to pay for its share of the $3,000 increase (i.e., $60,000 - $57,000 in the base year), as opposed to being required to pay for its share of the full $60,000 every year during the lease term.

When applied to both the base year and all future years, and calculated correctly, grossing-up the variable components of a building’s operating expenses will ensure the only increases in operating expenses chargeable to the tenant are those attributable to increases in wage rates, utility rates, contract rates and the like, but not those due to occupancy increases. The amount of a tenant’s operating expense obligation should not be dependent on the occupancy level of the building. Expense categories that are typically grossed up include cleaning (tenant-occupied areas only), utilities, management fees, and possibly (but not always) other costs such as trash removal, building personnel costs, electrical supplies and elevator maintenance, all depending upon the relevant circumstances. In addition, taxes should be based upon a fully assessed building, not necessarily a fully occupied building as the building could be fully occupied but not fully assessed.

There are several methods of performing the gross-up for each type of variable expense. For instances, electricity has a fixed and variable component. The landlord needs to accurately gross up the variable portion. Whichever method is used, it is important that a consistent application for the same categories of expense be maintained throughout the lease term and for a reality check to be performed to determine if the methodology used by the landlord has a sound basis.

Finally, many people ask if it is fair for the landlord to gross up variable expenses with an Expense Stop, Stipulated Base Amount or Office Triple Net lease structure. Provided the gross up calculations are performed in an accurate manner, it is fair and reasonable for a landlord to gross up the variable building expenses even with these other lease structures. The reason for this is straight forward: lacking a gross up adjustment, the landlord would not recover all of the occupancy-driven costs it actually incurred in providing services to a partially occupied building. By way of example, assume a 100,000 square foot building has only one tenant that occupies 50,000 square feet, or 50% of the building. The remaining 50,000 square feet is vacant. On an annual basis assuming it cost $1.00 per square foot to clean the occupied portion of the building, it would cost the landlord $50,000 to clean the tenant's space ($1.00 x 50,000 square feet). However, since the only tenant of the building can only be charged its pro rata share of the expenses (i.e., 50%), the landlord would only be able to recover $25,000 ($50,000 x 50%), despite the fact all of the cost the landlord incurred was for the benefit of the tenant. Therefore, the landlord should be able to gross up the janitorial cost to reflect what the cost would have been had the building been fully occupied such that it can recover its actual cost (i.e., the tenant will pay its 50% pro rata share of the grossed up costs of $100,0000 enabling the landlord to recover the $50,000 cost it incurred). Hence, grossing up variable operating expenses is viewed as a fair and reasonable practice even with something other than base year structured lease.