

# PRELIMINARY OPERATING COST ESCALATION REVIEW ANALYSIS

<b>TENANT NAME:</b> <u>SAMPLE CO., INC.</u> <b>BUILDING NAME:</b> <u>1000 CITY PARKWAY WEST</u> <b>BUILDING ADDRESS:</b> <u>1000 CITY PARKWAY WEST, SAMPLE CITY, CA</u>	<b>PREMISES/SUITE(S):</b> <u>240</u> <b>PROJECT RSF:</b> <u>181,853 (ESTIMATED - CALCULATED BY 4,505 / 0.0248)</u> <b>LANDLORD NAME:</b> <u>LANDLORD-THE CITY, L.L.C.</u>
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## BASIC LEASE DATA

<b>ORIGINAL LEASE</b> LEASE DATE: <u>4/1/99</u> COMMENCE DATE: <u>8/1/99</u> EXPIRATION DATE: <u>8/31/04</u>	<b>1ST AMEND</b> (NOTE: THIS AMENDMENT IS NOT A FACTOR IN THIS ANALYSIS) <u>1/23/02</u> <u>3/1/02</u> <u>1/31/07</u>
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## OPERATING COST ESCALATION DATA

OE TERM PERIODS	1/1/98 (BY 1997)	3/1/02 (BY 2002)
START DATE:	1/1/98 (BY 1997)	3/1/02 (BY 2002)
THRU DATE:	2/28/02	1/31/07
<b>PREMISES RSF</b>		
ORIGINAL LEASE:	4,505	0
1ST AMENDMENT:		8,498 (NEW SUITE 410 SUBSTITUTED FOR PRIOR SUITE 240)
2ND AMENDMENT:		
<b>TOTAL:</b>	<b>4,505</b>	<b>8,498</b>
<b>PRO RATA SHARE</b>		
PER LEASE:	2.48000% (NOTE: THIS % AMOUNT HAS BEEN "DEEMED")	4.36940% (ALSO "DEEMED")
CALCULATED:	2.48000%	4.67814%
<b>OE OFFSET INFO</b>		
TYPE OF LEASE:	BY 1997	BY 2002
OE AMOUNT:	\$1,015,727.97	TBD
RET AMOUNT:	\$178,279.02	TBD
OE/RET:	SEPARATED (PER PARA'S 27.(a) AND (b) OF LEASE, PAGES 9 & 10)	SEPARATED (SAME LEASE PROVISIONS)

### CURRENT LEASE:

**WHAT TENANT IS TO PAY:** TENANT IS TO PAY "TENANT'S PERCENTAGE SHARE OF THE AMOUNT OF ANY INCREASE OR DECREASE IN OPERATING EXPENSES ... OVER THE AMOUNT OF THE BASE YEAR" (PARA 27 (a)(i), PAGE 9). ALSO, SEPARATELY (BECAUSE THIS IS A SEPARATE PARAGRAPH), "TENANT SHALL PAY ... TENANT'S PERCENTAGE SHARE ... OF ANY INCREASE IN DIRECT TAXES ... OVER THE BASE YEAR" (PARA 27 (b)(i), PAGE 10). HENCE, ACCORDING TO THE LEASE, 1) THE COMPUTATION METHODOLOGY IS TO APPLY TENANT'S PRO RATA SHARE % AMOUNT TIMES THE OVERALL ESCALATABLE EXPENSES OF THE BUILDING (NOT BY CONVERTING THOSE EXPENSES TO A \$/RSF AMOUNT AS THIS LANDLORD HAS DONE AND THEN MULTIPLYING THAT BY THE TENANT'S RSF), AND 2) TAXES ARE NOT TO BE COMBINED WITH OPERATING EXPENSES IN THE COMPUTATIONS OF TENANT'S PERCENTAGE SHARE (WHICH SEPARATION IS TO THE ADVANTAGE OF THE LANDLORD). HOWEVER, LANDLORD HAS IN FACT COMBINED THE COMPUTATIONS (WHICH IS TO THE ADVANTAGE OF THE TENANT BECAUSE DECREASES IN ONE WILL OFFSET INCREASES IN THE OTHER).

**INCLUSIONS:** "OPERATING EXPENSES" INCLUDE "ALL DIRECT COSTS OF OPERATION, MAINTENANCE AND MANAGEMENT OF THE BUILDING AS DETERMINED BY GAAP" (PARA 27.(a)(iv), INCLUDING NORMAL OFFICE BUILDING EXPENSES PLUS SUCH ABNORMAL ITEMS AS: 1) ACCOUNTING & LEGAL EXPENSES; 2) BUILDING OFFICE RENT OR RENTAL VALUE. 3) DEPRECIATION ON PERSONAL PROPERTY SUCH AS WINDOW COVERINGS PROVIDED BY LANDLORD AND CARPETING IN PUBLIC CORRIDORS AND COMMON AREAS, PLUS AMORTIZED CAPITAL IMPROVEMENTS TO REDUCE OPERATING EXPENSES IN AN AMOUNT NOT GREATER THAN THE ANTICIPATED SAVINGS. "TAXES" INCLUDE NORMAL ITEMS (REF: PARA 27(b)(ii), PAGE 10). NOTE THAT "GAAP" IS CRITICAL HERE.

**EXCLUSIONS:** TYPICAL SHORT LIST OF "INTEREST EXPENSE, ADVERTISING COSTS, LEASING COMMISSIONS, DEPRECIATION ON BUILDING, OR COST OF CAPITAL EXPENDITURES (EXCEPT FOR THOSE TO EFFECT OPERATING EXPENSE SAVINGS)" (REF: PARA 27(a)(iv), PAGE 9)

**GROSS UP AMOUNT:** 95% GROSS UP

**MANAGEMENT FEES:** "MANAGEMENT FEES" IS MENTIONED AS AN INCLUDABLE COSTS, BUT NO LIMIT TO THE AMOUNT WAS ESTABLISHED. ADDITIONALLY, THE LEASE ALLOWS "RENTAL VALUE OF THE MANAGEMENT OFFICE", A HIGHLY QUESTIONABLE, AND ABUSED, ITEM, ALTHOUGH NO EVIDENCE OF SUCH ABUSE IS OBSERVED IN THIS CASE.

**CAP ON EXPENSES:** NONE.

**TENANT AUDIT RIGHTS:** ALTHOUGH PARA 27.(a)(iv) (LAST SENTENCE) STATES "STATEMENTS OF OPERATING EXPENSES PROVIDED BY LANDLORD SHALL BE FINAL AND BINDING UPON BOTH LANDLORD AND TENANT", THE NEXT PARAGRAPH PROVIDES THE FOLLOWING AUDIT RIGHT FOR TENANT: "TENANT SHALL HAVE THE RIGHT TO CAUSE LANDLORD'S BOOKS TO BE REVIEWED BY A CPA (ACCEPTABLE TO LANDLORD) NOT LATER THAN 20 DAYS FOLLOWING TENANT'S RECEIPT OF SUCH STATEMENT ... IF SUCH AUDIT DISCLOSES [AN ERROR] IN EXCESS OF 10% ... THE COST OF THE AUDIT SHALL BE BORNE BY THE LANDLORD". HOWEVER, THE NEXT SENTENCE STATES "IF TENANT SHALL NOT REQUEST AN AUDIT IN ACCORDANCE WITH THIS PARAGRAPH WITHIN 20 DAYS OF RECEIPT OF LANDLORD'S STATEMENT, SUCH STATEMENT SHALL BE CONCLUSIVELY BINDING UPON LANDLORD AND TENANT". LANDLORD SENT THE 2001 STATEMENT ON 7/2/02 (WITH ADDITIONAL BACKUP INFO ON 10/1/02). HENCE, THE DEADLINE TO OBJECT WAS 7/22/02.

## ANNUAL OPERATING EXPENSE COMPARISON

	1997	% DIFF	REMARKS	2001	PROBLEMS
REPAIRS & MAINTENANCE	\$ 8,764.00	3451%	SEE "PROBLEMS"	\$ 311,166.00	1) BASE YEAR vs COMPARISON YEAR ITEMS ARE NOT CONSISTENT; 2) 2001 CONTAINS GAAP CAPITAL ITEMS
HVAC	\$ 19,485.85	133%	SEE "PROBLEMS"	\$ 45,469.00	1) BASE YEAR / COMPARISON YEAR ITEMS ARE NOT CONSISTENT
JANITORIAL	\$ 132,840.19	25%	OK - UNION	\$ 165,971.00	1) PROBABLY OK SINCE UNIONIZATION OCCURRED; 2) HOWEVER, WAS "GROSS UP TO 95%" DONE RIGHT???
ELEVATOR MAINTENANCE	\$ 27,937.02	26%	??	\$ 35,268.00	1) PROBABLY OK; 2) HOWEVER, MIGHT BE "GROSS UP TO 95%" ISSUE(???)
SECURITY	\$ 57,209.59	51%	??	\$ 86,662.00	1) PROBABLY OK (=5 YEAR WAGE INCREASES); 2) HOWEVER, MAY HAVE BASE YEAR vs COMP YEAR ISSUE
UTILITIES	\$ 453,298.22	23%	OK - SCE RATES	\$ 559,703.00	1) PROBABLY OK (= SCE RATE INCREASES); 2) "GROSS UP TO 95%" DONE CORRECTLY??
REAL ESTATE TAXES	\$ 178,279.02	-1%	OK	\$ 176,246.00	1) OK
INSURANCE	\$ 33,669.37	83%	OK - GEN'L INCR	\$ 61,475.00	1) OK (= GEN'L INSURANCE INDUSTRY INCR'S) [NO EVIDENCE OF "BY/CY CONSISTENCY" ISSUE RE: EARTHQUAKE]
ADMINISTRATION	\$ 180,109.00	-13%	OK	\$ 156,151.00	1) OK
MANAGEMENT FEE	\$ 102,414.73	2%	OK	\$ 104,613.00	1) OK
TOTAL	\$ 1,194,006.99	43%		\$ 1,702,724.00	[MATCHES THEIR AMOUNT => THEIR NUMBERS ADD OK!]
LESS TT'S BASE YEAR AMOUNT:	(\$1,194,006.99)			(\$1,194,006.99)	
TT'S AMOUNT TO SHARE IN:	\$ -			\$ 508,717.01	
TIMES TT'S PRO RATA SHARE %:	2.48000%			2.48000%	
TIMES TT'S OCCY DURING YEAR:	100.00000%			100.00000%	
TT'S TOTAL SHARE OBLIGATION:	\$ -			\$ 12,616.18	
TENANT'S SHARE PER BILLING:	\$ -			\$ 12,618.05	
BILLING DIFFERENCE:	\$ -			\$ 1.87	[CLOSE ENOUGH EVEN THOUGH THEY USED WRONG CALCULATION METHOD ("\$/RSF" vs "% SHARE OF TOTAL \$")]
[DUE (TO) / FROM TENANT]:	\$ -			\$ -	

## OBSERVATIONS / CONCLUSIONS

### OBSERVATIONS:

- CALCULATIONS PERFORMED INCORRECTLY BY LANDLORD (SEE ABOVE & BELOW DISCUSSIONS ON "METHODOLOGY"), BUT NO SAVINGS FROM THIS.
  - LANDLORD DID NOT SEPARATE OE FROM TAXES. IN THIS CASE, HOWEVER, THE REDUCTION IN TAXES HAS OFFSET INCREASES IN OE (WHICH BENEFITTED TENANT).
  - LANDLORD USED THE INCORRECT "CONVERT OE DOLLAR AMOUNT TO \$/RSF" METHODOLOGY, BUT NET EFFECT IS NEGLIGIBLE.
- BIGGEST PROBLEM IS "REPAIRS & MAINTENANCE" ACCOUNT. REFUNDS DUE TO TENANT BECAUSE OF THIS SHOULD BE A CERTAINTY HERE:
  - "R&M" BASE YEAR AMOUNT CLEARLY IS MISSING SOME COSTS, AND HAS LESS SERVICES INCLUDED THAN ARE NOW IN COMPARISON YEAR 2001.
  - LEASE IS VERY CLEAR THAT "NO CAPITAL COSTS CAN BE INCLUDED" AND THAT "OE MUST BE PER GAAP". THE "R&M" ACCOUNT FOR 2001 ALSO HAS PROBLEMS IN BOTH OF THESE AREAS. IN FACT, THEIR SUPPLEMENTAL "EXPENSE BREAKDOWNS" CLEARLY IDENTIFY OVER \$80,000 OF "CAPITAL": RESTROOM RENOVATION; LEASING OFFICE REPAIRS; LOBBY REMODELS, ETC. (THEIR OWN WORDING!!!)
- "HVAC" BASE YEAR AMOUNT MAY HAVE SIMILAR "SERVICES CONSISTENCY" PROBLEMS, AND THE 2001 COMPARISON YEAR AMOUNT MOST CERTAINLY INCLUDES COSTS THAT ARE DEFINED AS "CAPITAL REPAIRS", "CAPITAL IMPROVEMENTS", ETC., THAT ARE THEREFORE NOT ESCALATABLE TO TENANT UNDER THIS LEASE.

### CONCLUSIONS:

- POTENTIAL OF \$200,000 - \$250,000 ADJUSTMENT TO "EXPENSES" TRANSLATES TO \$5,000 - \$6,000 REFUND FOR 2001 ALONE
- HOWEVER, THERE ARE 2 MAJOR PROBLEMS WITH ALL THIS:
  - AN AUDIT WOULD COST MORE THAN THE POTENTIAL REFUND THE TENANT COULD RECEIVE, ESPECIALLY SINCE IT MUST BE PERFORMED BY A CPA ACCEPTABLE TO LANDLORD (NOTE: MOST CPAs DON'T HAVE A CLUE ABOUT THIS STUFF!);
  - THE LEASE STATES THAT THE BILLING IS "FINAL AND BINDING" UNLESS THE TENANT OBJECTS WITHIN 20 DAYS. THIS TIME HAS PASSED.
- IN SPEAKING TO A MAJOR OPERATING COST AUDITING FIRM, THEY STATED AN AUDIT "IS NOT WORTH IT & CAN'T BE DONE NOW ANYWAY".