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Understanding the Types of CAM/OE Escalations

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As any experienced commercial real estate professional knows, "*Operating Expense Escalations*" (also known as *Operating Cost Escalations or CAM/OE Escalations*) – the share of a property's/building's operating expenses charged to a tenant – can be the single most confusing, argumentative, and incorrectly applied element of a tenant's lease, both during lease negotiations and during a tenant's actual occupancy in the building. Most commercial landlord / property management practitioners, and generally most tenant executives, truly do not understand how such "escalations" actually work, ranging from the original intent of "escalations", to the application of the escalation provisions in a lease, to what "industry standard procedures" actually are. A greater practical understanding of this often-misunderstood area of the lease, therefore, can contribute significantly toward improved negotiation, billings, and cost control.

Types of Operating Expense Lease Provisions

Fundamental to this widespread misunderstanding is the common misconception of what the various types of leases are and how a property's/building's expenses are handled in each. For example, one often hears brokers, leasing agents, attorneys, and landlords' representatives refer to a lease as "Full Service Gross" when in fact what they are referring to is one of the four (4) versions of the "Modified Gross" lease. In order to improve one's understanding of basic operating expense concepts, therefore, it is essential that these and other widely used terms be clearly defined.

First, in the commercial real estate leasing world, there are three basic types of operating expense escalation methodologies that a lease could contain. They are:

Industrial Triple Net – Under this type of lease, the tenant is fully and solely responsible to contract directly with, and pay all charges incurred under such contracts directly to, the maintenance, utility, and service providers (e.g., "vendors") for a property/building. The landlord is not to incur any expenses for the property/building, and there are, therefore, no property/building expenses or CAM/OE Escalations billed by the landlord to the tenant.

Full Service Gross – Under this type of lease, the landlord is fully and solely responsible to contract directly with, and pay all charges incurred under such contracts directly to, the maintenance, utility, and service providers (e.g., "vendors") for a property/building without any subsequent charge to the tenant (i.e., CAM/OE Escalations). Under a true Full Service Gross lease there are no operating expenses escalated by the landlord to the tenant since such costs are "included in" the tenant's Base Rent. Inasmuch as these leases require the landlord to assume all of the risk of rising costs to operate and maintain the property/building, they are quite rare now because the landlords will seldom employ this form of lease document.

Modified Gross – Under this type of lease, the landlord contracts directly with and pays all of the vendors for the services they provide to the property/building, but they then pass those costs to (i.e., bill) the tenant for reimbursement of their share as stated in their lease. This billed reimbursement amount is separate from the Base Rent amount, and its calculation depends upon which version of Modified Gross lease has been entered into: *Base Year*, *Expense Stop*, *Stipulated Base Amount*, or *Office Triple Net*.

Base Year Lease

The intent and objective of a *Base Year Lease* is to confine the tenant's operating expense obligation to just it's share (i.e., the percentage amount stated in its lease) of the

increases of expenses experienced by a property/building *in excess of* a specified "base" level of expenses (i.e., the total expenses experienced at the property/building for a designated "base year" consisting of either a specific calendar year or fiscal year period), where both the Base Year's and each Comparison Year's expenses consist of the same (i.e., matching) type and quantity of expense component items. In addition, when the *Base Year Lease* is coupled with a "Gross Up" provision, the intent is to have the tenant only pay for its share of the increase in the property's/building's expenses *resulting from wage increases, contract increases, other cost-of-living type increases, etc., and not due to occupancy changes nor the addition of extra services*. For example, if the Base Year's expenses totaled $1 million and the following Comparison Year's expenses rose because of inflationary, cost-of-living increases to $1.25 million, a tenant with a *Base Year Lease* would be responsible to pay for its percentage of the excess $250,000.

This is the fairest *Modified Gross* method of calculating a tenant's operating expense obligation. Unlike the *Expense Stop Lease* method described below, in which calculations are performed on a dollar-per-rentable square foot basis and may not correlate at all to any actual expenses of the property/building, the *Base Year Lease* method utilizes actual expense information. The *Base Year Lease* methodology is <u>*not*</u> broken down to dollars-per-rentable square foot, a calculation method that frequently creates rounding errors detrimental to both parties.

For a particular calendar year's expense escalations to be computed correctly under the "Base Year Concept", the following tests are required:

- ☐ <u>"12-months of services test" must be complied with</u> – each expense account in each of the property's/building's year-end general ledgers (for each calendar year) must be reviewed in detail, item-by-item, to ascertain whether or not a full 12-months of property services were recorded (depending on whether the particular expense account is subject to such a procedure). If not, the applicable number of months of expenses are to be either added or deleted to result in only a full 12-months of such expenses.

- ☐ <u>"Equipment/service free maintenance warranties must be accounted for as if payments had actually been made test" must be complied with</u> – any services or maintenance on any property/building equipment that were subject to a "free maintenance period warranty" (e.g., in the case of newly constructed building or the installation of new equipment, the property/building may not be not required to pay during the free maintenance period the normal maintenance costs that would typically have been incurred if the warranty didn't exist) must have a compatible expense amount imputed into the expense escalations for all calendar years covered by the warranty period, including any Base Year or Comparison Year.

- ☐ <u>"Free Rent must be adjusted out test" must be complied with</u> – in order to correctly compute escalatable "Management Fees" for any calendar year, all free rent or reduced rent given to tenants must be fully reversed, effectively resulting in the addition of the full amount of missing rent to the bottom line of "Revenues/Income". When this is done, "Management Fees" will correctly and more accurately reflect what they would/should have been for a "fully occupied and fully built-out property/building", and will not distort the escalations in either a Base Year (to the disadvantage of the tenant and to the advantage of the landlord) or a Comparison Year (to the advantage of the tenant and to the disadvantage of the landlord).

- ☐ <u>"Consistency in types and levels of services test" must be complied with</u> – each expense account in the property's/building's year-end general ledger must also be reviewed in detail, item-by-item, to ascertain whether the same type and level of services had been provided to the property/building (and its tenants) during the subject Comparison Year as were provided in the tenant's "Base Year" (i.e., there <u>*must*</u> always be an "apples to apples" consistency). If there is a difference, "adjustments" such as the following are required to either the tenants' Base Year amounts or to the subject Comparison Year's expense amounts. Note that such adjustments are required and especially important to do following the sale of a property because new owners typically operate the property differently (e.g., different level of staffing, different insurance coverages, etc.), thus mandating multiple adjustments to whatever was contained in a tenant's Base Year.

  - <u>If the scope of a particular service is added or increased in a Comparison Year</u> that will continue forward for many years but it was not present in the Base Year, the Base Year Amount must be "adjusted" (i.e., increased) by an appropriate amount (this is the more correct and easier process than the only other correct alternative – that of having to instead continually exclude the particular expense in the escalation of the future Comparison Year expenses). This "Base Year Adjustment" will ensure that the tenant is not paying an unfair amount for a new/increased service expense item that was not

that the future cost increases of this new/increased service are treated the same as all the others are being treated so that the tenant fairly and equitably shares in future rate increases (as is the intent of the Base Year Concept).

- Likewise, <u>if the scope of a particular service is deleted or reduced in a Comparison Year</u> and that reduced service level will continue forward for many years but it was present at the originally higher level in the Base Year, the Base Year Amount *<u>must</u>* be "adjusted" (i.e., decreased here) by an appropriate amount (again, this is the more correct and easier process than the only other correct alternative – that of having to instead continually add an inflated amount of the particular deleted/reduced expense into the escalation of the future Comparison Year expenses). This, likewise, ensures that the tenant is paying its fair share of the costs of the property's/ building's services and that the landlord is not having to absorb an unfair portion of the costs of the property's/building's services.

In short, this above-mentioned adjustment process is done simply to maintain equity and fairness for both parties in the "escalation of the property's/building's expenses" process, as was originally intended when both parties negotiated and executed this particular type of lease document. Additionally, landlords and their property managers are "ethically" required (per their moral and their licensing requirements) to perform such adjustments so that neither party is over-paying for what it contractually agreed to.

Also fundamental to the fair application of the Base Year method is the *Gross Up* concept, also known as extrapolation. Under this provision, if the property's/ building's occupancy is less than 95% (or whatever percentage the tenant's lease stipulates), then all categories of operating expenses that are affected by changes in occupancy are to be adjusted to reflect such costs as if property's/building's occupancy were 95%. This will give the tenant the cost base of a "fully occupied" building and protect it from large increases in operating expenses due to increases in building occupancy, yet at the same time it ensures that the tenant and the landlord are each paying their fair share of the property's/building's overall expenses.

When applied to both the Base Year and all future Comparison Years, and correctly calculated, "grossing up" will ensure that 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 <u>not</u> occupancy. Expense categories that are typically grossed up include nightly janitorial cleaning (tenant-occupied areas only), utilities, management fees, and possibly such other costs as trash removal, lighting supplies, and elevator maintenance depending upon the circumstances. In addition, property taxes should be based upon a "fully assessed and built-out" property/building.

There are several methods of performing the "*Gross Up*". Whichever method is used, it is important that a consistent application to the same categories of expenses be maintained throughout the tenant's lease term and that a reality check is continually performed to determine if the methodology has a sound basis.

<u>Expense Stop Lease</u>

Under the *Expense Stop Lease*, the tenant receives an offset against actual operating expenses, both of which are expressed in terms of "dollars-per-rentable square foot". According to this method of calculation, actual expenses are figured on a per rentable square foot basis and then reduced or offset by the assigned Expense Stop amount, and the excess is then multiplied by the number of rentable square feet within the tenant's premises to arrive at the tenant's operating expense obligation.

For example, if actual expenses of a 420,000 rentable square foot building totaled $5 million, then the per rentable square foot equivalent would be $11.9047, or $11.91 rounded (i.e., $5 million divided by 420,000). If a 100,000 rentable square foot tenant had a $10.00 Expense Stop, then its operating expense obligation would total $191,000.00 (i.e., the $1.91 difference between the actual expense amount of $11.91 and the assigned Expense Stop of $10.00, multiplied by the 100,000 square foot size of the tenant's premises).

This method is attractive from a landlord's perspective but not so attractive from the tenant's perspective because the assigned Expense Stop is often an *arbitrary* amount that may not be tied to actual expense levels experienced in the property/building. Since it is expressed in terms of dollars-per-rentable square foot, it can also result in rounding errors that often accrue to the benefit of the landlord. Unlike the *Base Year Lease*, once the Expense Stop amount has been designated, it is unlikely that it can be changed or adjusted to accommodate the addition of new escalatable services in later years.

<u>Stipulated Base Amount Lease</u>

The *Stipulated Base Amount Lease* is a hybrid of the *Base Year Lease* and the *Expense Stop Lease* methods of calculating operating expenses. Like an Expense Stop, the Stipulated Base Amount is usually an arbitrary amount that may not be tied to actual conditions; furthermore, once agreed upon and written into the lease, it is usually not

subject to change or adjustment. However, like a Base Year, it is expressed as a whole dollar amount and not broken down into dollars-per-rentable square foot.

As a example, assume that the Stipulated Base Amount assigned to a new lease is an arbitrary $750,000, although actual expenses for the year totaled $1.2 million. The tenant's operating expense obligation will be based on its percentage share of the difference between property's/building's actual expenses and the Stipulated Base Amount. If new escalatable services are added to the property/building in later years, no adjustment of the Stipulated Base Amount can be made; rather, it remains fixed, regardless of changes in escalatable services, over the entire term of the lease. However, since the Stipulated Base Amount is not susceptible to rounding errors, it is preferred over an Expense Stop.

Office Triple Net Lease

An *Office Triple Net Lease*, like an *Industrial Triple Net Lease*, offers the tenant *no* offset against operating expenses (i.e., essentially, its Base Amount is $0). Interestingly, it is now being increasingly used by landlords in the office leasing market. Unlike an *Industrial Triple Net Lease*, however, services are contracted and expenses are incurred by the landlord, rather than by the tenant, and "passed through" (i.e., billed) to the tenant for reimbursement. Since there is no expense offset, tenants pay their percentage share of expenses on a dollar-for-dollar basis.

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Michael M. McClune, RPA®, FMA®, is the President and Managing Principal of MKC Asset Management, Inc., a Long Beach-based commercial real estate property management firm. With over 25 years in the commercial real estate industry, and also as the former Chairman of the Board of BOMA of Greater Los Angeles, and Board Member of BOMA Orange County, BOMA California, and BOMA International, he has an in-depth knowledge of commercial real estate industry practices. He frequently consults for various well-known landlord and tenant entities, assisting them in property acquisition due diligence, property management, operating expense escalations, lease abstracting, and lease administration.

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Mickey McClune is the President, Broker, and the Managing Principal of MKC Asset Management, Inc., a Long Beach-based commercial real estate property management firm. As President, Broker, and Managing Principal, Mickey is esponsible for all activities of the firm, including new business acquisition, oversight of all property management activities, and the performance of all of the firm's commercial real estate consulting services. He is an experienced commercial real estate property management, asset management, and leasing specialist with an extensive institutional owner and corporate user background.

Mickey began his career in commercial real estate in the early 1980's with the preeminent national real estate firm, LaSalle Partners (now Jones Lang LaSalle), as its General Manager for all of the office and industrial properties that it had acquired in the Los Angeles and Ventura County areas, and as its Asset Manager for various client portfolios in the Western U.S. While at LaSalle, he was recognized for numerous accomplishments both by the company and the commercial real estate industry. In 1993, he left LaSalle to form his own property management company, New America Asset Management Services, where he was the President and the senior partner of this Long Beach-based commercial real estate property management firm. In late 1997, LaSalle acquired NAAMS and its two million square foot management portfolio, and Mickey then served as LaSalle's Regional Vice President for the Southwestern U.S. In 1999, he joined EPS Solutions, a national corporate services consulting firm, as a Director of Real Estate Services. While at EPS Solutions he assisted property owners with their property acquisition due diligences, their properties' annual Operating Expense Escalations, and with the abstracting of their tenant leases, and he assisted tenants by performing over 50 CAM/OE Escalation Audits for them of their landlords' billed rent charges. In 2001, he again formed another commercial real estate property management firm, MKC Management Services, where he served as CEO and senior partner. Soon thereafter, MKC merged with New York City based Newmark & Company Real Estate and became its California-based Asset Management Group. In mid-2003, Mickey was instrumental in merging Newmark & Company's California-based Asset Management Group's operations into a new start-up entity that then became known as RiverRock Real Estate Group. At RiverRock, Mickey was its Senior Managing Director, where he established all of the firm's property management systems, oversaw selected property management teams, and was responsible for all of the firm's consulting business. In early 2006, Mickey left RiverRock to start MKC Asset Management.

Over the course of his 25+ year career in commercial real estate property management, Mickey has personally managed and leased well over 18 million square feet of commercial office, industrial, and retail space, abstracted over 5,000 leases, performed over 400 annual CAM/OE Escalations for landlords' buildings, saved clients well over $4 million in cash savings, received four (4) "Management Excellence Awards" from LaSalle Partners, was a LaSalle Partners' "Manager of the Year", and was awarded by BOMA of Greater Los Angeles four (4) "Building of the Year Awards" (in "100,000-250,000 SF" and "Over 500,000 SF" categories) and two (2) "Special Achievement Awards" including one for "Overall Design Improvement".

Prior to entering the real estate industry, Mickey was commissioned as an officer in the United States Air Force and spent 11 years in the USAF and private industry with Hughes Aircraft Company specializing in the business management of major aerospace industry programs.

Mickey has a California Real Estate Broker License, and is RPA and FMA certified by the Building Owners and Managers Institute. He is a past Chairman of the Board and past member of the Executive Committee and Board of Directors of BOMA of Greater Los Angeles, has served on BOMA Orange County's and BOMA California's Executive Committees and Boards of Directors, and on BOMA International's Board of Governors and Strategic Planning Task Force. Mickey graduated from the University of Southern California with a Bachelor of Science degree in Civil Engineering and a Master of Business Administration (MBA) degree.