A Layman’s Guide to Office Escalations and Gross-Ups

ABOUT THIS GUIDE

The guys behind Alpha Office Escalations, Bill Brownfield and Larry Mayerhofer, know as much about office escalations as anyone in the world. In 1991, Bill realized that there was precious little information on the topic and wrote *The Escalation Handbook for Office Buildings: A Guide to Understanding, Preparing, and Grossing Up Expense Escalations*. Three editions later, with Larry’s accounting insights added, it remains the definitive book on this often misunderstood topic.

This guide describes escalations in broad strokes, from a layman’s perspective, to help you explain it to tenants. It’s not meant as a primer for anyone who actually handles the calculations and billing. If you’ve been in the commercial leasing game for a while, or want to get more into the nitty-gritty of escalation theory, then we strongly recommend you go straight to the book.

There’s a premise about communications that says a void of information is often filled with misinformation. We hope that, by giving more industry professionals a foundational understanding of escalations and gross-ups, we can help prevent misinformation from creeping into a process that depends on integrity and accuracy.

WHAT ARE ESCALATIONS AND WHY ARE THEY FAIR?

In the service industry, an escalation happens when an issue doesn’t get resolved initially and must be “escalated” to a manager.

In the wide world of office buildings, escalations have a very different meaning. In our industry, escalations refer to fair and accurate sharing of the property’s operating expenses, taxes, and other costs between owner and tenants. They define how they share those expenses per the terms of each lease, and the “rules” for figuring them out.

So that’s the what, but the how and why are more nuanced. “Grossing up” is usually the how (for variable operating expenses anyway), and fairness is the why.

“Grossing up” is not the best or even most accurate word for the actual process, but we’re sort of stuck with it. It’s sometimes called “deeming expenses” or “extrapolating costs” but those don’t exactly roll off the tongue either.

Variable operating expenses increase and decrease with occupancy changes. Both parties to a lease need to understand that gross-ups protect both the lessor AND the lessee by defining a fair and consistent process for sharing costs throughout the lease term. Pegging each tenant’s pro-rata share of the *full* building’s operating costs is the only fair method. This is what “grossing up” means.
**Why Gross-ups Are Fair**

The key to understanding gross-ups is to understand how variable expenses work in office buildings. Let's establish a few facts:

- A vacant building costs less to operate than one with tenants.
- Each new tenant's occupancy adds additional operating expenses for the building. These are called ‘variable” costs (e.g. utilities, janitorial costs, management fees, trash, etc.).
- Other costs are “fixed” and are not dependent on changes in occupancy (e.g. insurance, property taxes, payroll costs, security, etc.)
- Every office building aims for 100% occupancy, but for the typical multi-tenant building it is unattainable. However, it’s a useful way to predict total operating expenses.
- Occupancy during a building's life is likely to fluctuate, even for a full building, as there is down time between one tenant vacating and another taking its place.

Gross-ups make sharing expenses fair by spreading the total costs over the total building.

Because escalations and gross-ups are based on a pro-rata calculation, no tenant will pay more than their percentage share of the building if the methodology is applied correctly.

Example: If eight tenants with the same square footage occupy a ten-unit building, each one is only responsible for a 10 percent share of expenses, totaling 80%. The owner picks up the tab for the two unoccupied units, totaling 20%. Therefore, the owner never fully recovers all expenses unless and until the building is 100% leased for an entire year.

The bottom line? **Gross-ups are fair for the owners and tenants in an office building, as long as the methodology used is consistent with the terms of each lease.**
**ESCALATION ACCOUNTING**

As defined in each lease, escalations typically refer to the total of fixed and variable operating expenses. Some of these may vary with the number of tenants, such as trash collection, utilities, and general maintenance. Escalations may also apply to certain capital expenses defined in the lease.

Unlike an apartment lease, commercial leases are long-term (typically 3 to 10 years). The landlord needs to protect their return on investment from inflationary increases to operating costs. Also, only tenants benefit from the landlord spending money on operating expenses, so they should at least bear the burden of inflation associated with those costs.

Basically the landlord is saying, “I own this building and the land it’s on. If you want to rent from me, let’s agree on how we’ll share the costs associated with occupying the property. You pay for the occupied space, and I’ll pay for the vacant space.”

Let’s look at a quick scenario for a prospective new lease with relatively simple math. Here are the facts:

- The Grand Tower is an office building with 100,000 rentable square feet.
- It is currently 60% occupied (60,000 sq ft)
- Jones & Jones, LLC wants to lease 10,000 square feet (10% of the total)
- If Jones signs their lease, occupancy will increase to 70%
- Jones’ lease says that the current year (Year 1) will be their “Base Year”
  - Landlord is responsible for the Base Year expenses
  - Jones will pay their pro-rata share (in this case 10%) of operating expenses above the Base Year amount (i.e. Jones would pay NO escalations for Year 1).
- Assume that total current year operating expenses and taxes for the building would be $1,000,000 ($10 per square foot) IF it was 100% leased and occupied.
  - Fixed expenses are $400,000 (expenses that are not related to occupancy such as insurance, security, landscaping, etc.)
  - Variable expenses would be $600,000 (expenses that vary with occupancy such as cleaning, management fees, utilities, etc.)
- Since the building is only going to be 70% occupied with the new lease, the variable expenses will certainly be less than $600,000 ... so let’s peg them at $420,000 (70% x $600,000).
Now assume that occupancy rises to 90% in Year 2:

- Ignoring any inflationary increases, Fixed expenses would remain at $400,000, but Variable expenses would increase to $540,000 ($600,000 x 90%), so total Year 2 expenses would be $940,000.

As the tenant, would you want your lease to set your Base Year for expenses at:

(a) $820,000 ($400,000 fixed + year one's $420,000 variable expenses), which would reflect "actual expenses" incurred? -or-

(b) $1,000,000 to reflect the full building's expenses (a.k.a. grossed up to 100% occupancy)?

If you picked (a) for Year 2 you’d be obligated to pay $12,000 in escalations ($940,000 - $820,000 = $120,000 x 10% = $12,000) continuing each year throughout the lease term whenever expenses exceeded your $820,000 base year amount.

If you picked (b) you would owe nothing for Year 2 or any future year until expenses exceeded the $1,000,000 “grossed-up” base year amount. In this example, the gross-up provision saved you $12,000 in Year 2 (plus similar annual savings over a typical 5-year lease term) just by understanding gross-ups.

You can see how this gets very complicated very quickly, especially since every lease is different.

The difficulty and complexity of managing escalations for multiple tenants was the reason we created Alpha Office Escalations. It simplifies the math and ensures accuracy and fairness in the process, benefiting landlords and tenants alike.
**WHICH EXPENSES ARE ESCALATABLE?**

Most leases reference generally accepted accounting principles (GAAP) in the escalation clause. However, except for defining a capital expenditure vs. an operating expense, GAAP does not address escalations. Much of accounting depends on proper classification, such as determining whether an expense is fixed or variable. So where do you turn to for guidance in preparing your escalation invoices?

The Building Owners and Managers Association International, or BOMA, has its own methodology standards approved for commercial office leases. It’s a good idea to understand and adhere to their standards so that your company follows modern best practices — especially as they relate to escalations.

BOMA-approved methodology is critical for escalation theory because, as we’ll discuss, not all expenses are escalatable, nor should all escalatable expenses necessarily be included in a tenant’s invoice.

Let’s look at some examples.

**Operating Expenses**

*Operating expenses, like salaries, repairs and maintenance, cleaning, utilities and taxes, are basic costs of providing services to tenants. Tenants and landlords depend on each other for those services. If they went on a road trip together, for example, they’d probably agree to split the cost of gas, food, and lodging. Whoever owns the car will probably set those terms very simply, such as a 50/50 split.*

But now imagine that four roommates decide to share a car equally. For that arrangement to work, they need to decide how to split the costs of operating a vehicle. What if each is going to their respective hometowns, and they are traveling different distances? How do they divide maintenance costs or depreciation? Who pays for a car wash and when? What if it needs new tires?

Even in this simple analogy, there are decisions to be made about how expenses are shared between a group of people with a mutually beneficial relationship. You can see how a large commercial building with dozens or hundreds of tenants complicates things, but you can also see there are similarities.
Capital Expenditures

Capital expenditures are defined by GAAP as a major investment that will provide benefits for longer than one year. Not all capital expenditures are escalatable to the tenants. In fact, most will be borne solely by the owner (unless specifically allowed in the lease). Some typical escalatable capital expenses include:

- Lighting retrofit
- Energy management
- Power factor capacitors
- Window film
- Accommodations to changes in laws or code

These types of capital expenditures provide a tangible benefit to tenants and their employees in the form of reduced energy costs or compliance with new regulations such as wheelchair ramps. If they are not recoverable, a landlord will have no economic incentive to make these improvements. That’s why most leases include cost-saving and code compliance costs in the definition of what is escalatable.

THE TENANT PERSPECTIVE

Anyone with leased commercial space has sat across from a leasing agent and been presented with a stack of paperwork to sign. Some of us have been on both sides of that table.

Major financial commitments like these are exciting but a bit scary. They often represent significant chapters in life. The agent comes to the table armed with knowledge about the paperwork and its many legal implications, while the client or tenant just wants to get that part out of the way and start moving in. Unless they intend to read and comprehend every single word of legalese, they rely upon the owner’s leasing agent and their own attorneys to explain the terms of the lease.

Of the many lease provisions, escalations and gross-ups are among the hardest to explain. In a residential lease, various expenses shared by tenants can be lumped into the rent or billed as a separate line item like a “recreation fee” or “cable TV.” In an office environment, it’s not so simple.

It’s important to appreciate where the tenant is coming from. Someone with an MBA and 20 years of experience in business will probably understand terms like “capital amortization” or “base year” but a recent college grad opening a coffee shop might not have acquired the same language that a property manager or leasing agent uses every day. Those of us who work in commercial leasing and office building management would do well to keep this in mind.
You may know that everything behind the scenes at your company is above board and follows industry-approved methodology. You may know that you calculate escalations exactly as the lease requires for every tenant. That’s great, but a prospective tenant may not even know that these things matter.

They may feel very accountable to the investors who provided capital. They’re probably concerned about keeping costs down. Unless they have a personal relationship with you, they’re not going to know that you’re on the level. Confusion leads to distrust, and that’s no way to start a relationship.

On the flip side, you might be dealing with very experienced tenants signing their 10th commercial lease. They might come to the table knowing exactly what’s negotiable and what’s not. And while they’re at it, one thing that experienced tenants will try to negotiate are expense caps.

**EXPENSE CAPS**

An expense cap benefits tenants by limiting the increases in operating expenses they might have to pay. Caps are negotiated on a tenant-by-tenant basis and are represented by a percentage increase, either year over year based on the previous year in the lease term (annual) or using the first year only, compounded annually over the term of the lease (cumulative).

The landlord is constrained less with a cumulative cap, while an annual cap is more appealing to the tenant. Market conditions may give tenants more or less leverage in negotiating a cap.

Although landlords are reluctant to agree to apply cap expenses, they will often limit the cap to only those expenses it can control. The “uncontrollable” expenses (typically taxes, utilities, insurance and snow removal), are left uncapped.
COMMUNICATIONS AND BILLING

If you do a good job explaining escalations, it will pay dividends when you do your EOY reconciliations. Not only will you spend less time on the phone explaining the math, but your tenants will recall your discussion and know that they can trust your accounting when they see the numbers in black and white.

As with any situation where communication is critical to success, an ounce of prevention is worth a pound of cure. If your last meeting of the day is with a new tenant and you rush through the nitty-gritty of escalations and gross-ups, expect some angry calls down the road.

As noted earlier, confusion leads to fear and distrust — two things that can damage the owner/manager and tenant relationship. This guide is written in the simplest possible terms so that you, the commercial real-estate professional (owner, asset manager, property manager, or property accountant), can explain escalations without using language your tenant hasn’t acquired.

But while escalation billings are simple in theory (e.g. each tenant pays its share of taxes and operating expenses), it can get complicated in practice.

Explaining escalations to the uninitiated would be like explaining baseball to a Hungarian attending his first ball game. He would get the gist of the game that each team is trying to score more runs than their opponent, but the rules and nuances of the game would be very confusing (e.g. what is: a balk, the DH, the infield fly rule, why sometimes a runner is out when you step on the base and other times you need to tag him, catcher’s interference, etc.).

So take your time to answer their questions to make sure they know what each term and clause means. It will help avoid questions and disputes when they receive their first year-end reconciliation invoice.
Yet another reason to make sure you and your staff have a solid grasp of escalations is the possibility of an escalation audit.

If you’ve never been through one, it can be a nerve-wracking and, frankly, disruptive exercise. But good auditors don’t have a hidden agenda — they’re making sure that landlords are following the lease language and best practices, and that those actions are producing fair and accurate invoices for tenants.

Not only are audits important to ensure the accuracy of your accounting and billing practices, but they also represent an opportunity to reinforce your integrity and ethics — or to harm them.

Auditors are interested in answering two key questions:

- What does the lease say about who pays for which expenses?
- Were escalation invoices calculated in accordance with the lease language?

There are different types of auditors that do this work. They tend to fall into one of three categories:

1. CPAs and accounting firms
2. Internal auditors
3. Contingent-fee auditors

The Escalation Handbook gets into more detail about auditors, but it’s important to mention that, in our experience, contingent-fee auditors actually DO have an agenda: Make money for their clients and themselves by finding as many “errors” as possible. They’re paid according to how much they recover but often have little or no actual credentials or training.

That’s why we strongly recommend modifying your audit clause to prohibit contingent-fee auditors. In addition, your audit clause should include specific language about the minimum professional requirements for an auditor, confidentiality of records required for the audit, and limits as to the scope of the audit, meaning how many years the audit may cover (try to limit it to the current year in question). Again, the book gets into greater detail about this.

When the audit is completed, the auditor sends a report to the landlord with a point-by-point review of their findings. The landlord reviews the report, agrees or disagrees (with rationale), at which point the landlord should circle back with the tenant and auditor to discuss a final resolution. Keep in mind that the tenant is your client too, so take the lead on resolving any issues the audit brings up.
SUMMARY

Escalations and gross-ups are complicated. Success in commercial leasing and management doesn’t depend on understanding all of those complexities, but few aspects of a commercial lease prompt more questions or disagreements. A working knowledge of escalations helps both landlords and tenants understand each other better.

For a much deeper dive, we recommend you read *The Escalation Handbook for Office Buildings: A Guide to Understanding, Preparing, and Grossing Up Expense Escalations, 3rd Edition*. It is the definitive book on this topic. In addition to a variety of charts and sample spreadsheets, it also includes details about sustainability and “going green” with an office building, as well as an extensive Q&A section comprising many questions we’ve fielded over the years at BOMA-sponsored escalation seminars and webinars.

We estimate that as many as 50 percent of escalation billings contain errors (some large, some small). This isn’t a reflection on the people doing the calculations so much as the tools they typically use. It might shock you to learn that most office building staff still uses ordinary spreadsheets like Excel in order to calculate lease-specific escalations, manually passing the data from there to their regular accounting software.

Suffice it to say, this method is fraught with potential errors. As powerful as spreadsheets can be, they’re ill-suited to the task of calculating escalations and gross-ups. Moreover, they are often created and maintained in a proprietary, “keeper of the keys” kind of way that makes transparency and billing difficult, and introduces a great deal of human error — the kinds of errors that lead to audits and makes them a nightmare to deal with.

Our cloud-based Alpha Office Escalations software takes human error out of the equation and dramatically streamlines the escalation process, ensuring fairness and accuracy for both parties in a lease.

As summer winds down and we get closer to EOY billings, you should take a close look at how you explain and invoice escalations and what supporting information you supply to your tenants. How do you prepare tenants for that aspect of the lease, especially if they’re new to commercial leases? How often do your escalation invoices contain errors that cost you (or your tenants) money?

Knowing the answers to these questions can help you identify the “leaks” in your escalation accounting and plug them before they grow out of control.
Alpha Office Escalations (AOE) is a flexible, cloud-based application that simplifies calculating invoices for each tenant’s share of operating expenses in multi-tenant office and industrial properties of all sizes. AOE is flexible enough to accurately handle each lease’s unique clauses for expense gross ups, expense caps, and capital amortizations, while also generating 20+ reports that help you maximize income.


For more information, visit www.alphaofficeonline.com.