KEEPING A LID ON EXPENSES

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When negotiating rent for an office lease and you feel that you have obtained a good deal for the base rent, remember only half of your work is done. Base rent can be set at the low or high end of what the market bears at any particular time, and then set for the entire lease term. A much more volatile and potentially costly component of the rent that the tenant representative must pay close attention to is that associated with operating costs.

In particular Property Taxes, utilities and insurance costs have been increasing significantly in recent years. The reasons for this are many and varied and would be too voluminous to get into here.

The most obvious way to help mitigate some of these excessive expense increases is to negotiate a cap on expense increases in your tenants' lease. Fix the increase to a certain annual percentage. For example, not to exceed 5% per year or Consumer Price Index for that particular region. This type of language will generally work for most operating expenses such as janitorial, repairs and maintenance or landscaping. If you can use this type of cap to include "all operating expenses" that would be great, unfortunately most landlords are savvy enough to exclude "non-controllable" expenses such as insurance, real estate taxes and utilities in the cap language.

There are other ways to help control these "non-controllable" costs however, and the following are some suggestions.

Utilities

- Require that no premiums are added to utility costs. Some landlords like to add "administrative charges" to utilities. Pay only the rate that the landlord has negotiated with no mark ups. (In fact, some states prohibit the landlord from making a profit on the distribution of electricity to his tenants.)
- Arrange to have your utilities separately and directly metered by the utility company. This ensures that the tenant can negotiate the best rate available (with deregulation there are some options available now that were not available in the past) and not have to rely on the landlord's negotiating skills. (He may be less inclined to go out of his way to find the best deal since he is passing the cost on to the tenant.) This is risky however as there are some up front costs and a substantial landlord could get volume discounts not available to smaller users. There are some firms out there that specialize in shopping for the best rates available. They usually get a percentage of the demonstrated savings.

Real Estate Taxes

- With real estate taxes, exclude valuation increases tied to the sale of the building. In other words, increases in taxes should only be includable to extent that they are related to rate increases and scheduled city/county wide assessment adjustments.
- If the tenant is substantial, they can often require (or at least request) the landlord to do regular tax protests to ensure the assessment is not over inflated.
- Exclude excessive improvements (especially as they relate to other tenants) that increase the property value, but do not benefit your client.

Insurance

- After September 11th 2001 insurance costs in general and especially in the northeast, have skyrocketed due to the inclusion of terrorism insurance. If it is a legitimate landlord expense and the lease allows for the pass through, there is not much you can do. Most people never even heard of terrorism insurance before 9/11.
- Ensure that the landlord does not carry excessive insurance. The best way to do this is to only allow for insurance that is required by the mortgagor. Earthquake and flood insurance is not necessary in those areas where these events don't occur and can be excluded when appropriate.
- Rental insurance should be excluded as a landlord/ownership expense.

Regular lease audits, to ensure that all of the hard fought expense exclusions stated have been followed, is a good idea.

Of course, if you can negotiate gross rent to include all expenses and fix the increase, that is the best alternative.

*"Anthony Collura has been with **CRS** for over 15 years and has over 20 years of experience in internal auditing, asset and revenue accounting and financial management."*

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