



Operating expenses: Those 'something extra' costs

By JASON HUGHES

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Six summers have come and gone since the power crisis of 2000 wreaked total havoc throughout the state as residential and business consumers struggled to survive through rolling blackouts and power bills that, in some cases, rose twofold in as many months.

At the time, I counseled office tenants via this column to "take flashlight in hand and fetch their lease agreement out of the filing cabinet to find out how increases in utilities ... are to be handled." Most tenants, in particular those who had no real help in negotiating their leases, were under the assumption that their "full-service" leases would cover the increased power costs. They thought whatever they were paying per square foot was pretty much their rent.

They were soon to learn otherwise in the form of operating expenses -- those "something extra" costs that surface later, causing many an office tenant to wince. Probing these hidden costs will help explain and put them into perspective.

An office tenant signs a lease after negotiating the rent for the lease term -- say, a 10,000-square-foot space at \$2.50 per square foot -- thinking the rent will be \$25,000 a month. Buried well into the lease agreement, however, is a provision that allows the landlord to charge the tenant with any operating costs beyond what is typical after the first year of occupancy.

Most downtown high-rise building office leases are "full-service gross," meaning the rent the tenant pays each month covers everything including the base rent itself -- casualty insurance, common area maintenance, property management fees, janitorial services, maintenance, gas, water, sewer and electricity.

But wait, there's more to the operating expense matrix. It gets a little complex since the size, location and the sales price of the building come into play.

Assume that the tenant is located in a 300,000-square-foot building in downtown San Diego that was sold in 2001 for \$60 million, or \$200 per square foot. Under that scenario, the building's annual property tax bill would roughly be \$795,000 for 2006, taking into account the maximum 2 percent increase allowed each year under Proposition 13. The tenant has been able to adjust to his or her share of the tax bill under that scenario. Now, the building sells for 2.5 times the 2001 price -- \$150 million -- or \$500 a square foot, which sends the new annual property tax amount to \$1.8 million -- more than \$1 million over the already increased 2006 rate. Under this scenario, our 10,000-square-foot tenant will be paying an additional \$2,800 *per month* in rent simply because the building was sold for that price while he or she was a tenant.

It's a "win-win-lose" deal. The former building owner who sold the building wins big time, considering the new and higher rent this and other building tenants are paying helped to justify the hefty sales price. The new landlord wins -- or at least, doesn't lose -- since his higher property tax obligation is being absorbed by, guess who? The county wins by collecting an additional \$1 million a year in property taxes for doing absolutely nothing in terms of providing any additional services. It is the hapless tenant who thought the \$2.50-per-square-foot rate was a fair deal who ends up feeling the brunt of the excessive sales price of the building and the accompanying property tax increase.

What's doubly ironic in this all-too-common scenario is the fact that the 10,000-square-foot tenant no doubt employs a good number of workers. His or her ability to be able to continue to do so depends on being able to control costs. It's this kind of situation that literally bites the hand that feeds the region's economy.

The scenario pertains to the typical office tenant. The large and extremely attractive office space users sometimes are able to negotiate property tax protection in their leases; but even so, there are numerous games landlords pay to manipulate operating expenses in their favor.

Even the very definition of operating expenses is often subject to liberal interpretations on the part of landlords. For example, in some situations "utilities" cover gas, water, electricity and sewer while in others utilities are confined to only electricity.

At the very least, office lease documents need to carefully specify the appropriate expenses that can be charged back to lessees in order to provide tenants with legal remedies in the event landlord charge backs are abused.

Office leases are labyrinths of staggering complexity, requiring an expert advocate to protect tenants from being skewered with myriad hidden costs. Tenants often don't even know the questions to ask, much less the answers. They need competent help. Need I say more?

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