

Operating Expense Pass-throughs

Tenants in the San Francisco Office Marketplace face much more than expensive rent, they also face 50-70 page leases that require intense scrutiny. These leases are full of landlord friendly language that, when not fully understood by a tenant prior to signing, can drastically affect the costs associated with leasing office space over time. Typically, there is very little a tenant can do to negotiate these costs down, or eliminate them all together, other than choose a property carefully. Therefore, it is critical that these potential expenses are understood, planned for, and expected. The following is an explanation of the major source of cost increases for tenants; Operating Expense Pass-Throughs.

What are Operating Expenses? In the San Francisco Office Leasing Marketplace, typical leases are constructed as “Full Service”, meaning the tenant pays no portion of building expenses beyond their listed base rent. This is also called the “Face Rate” of a lease and it is usually spelled out clearly and early in the lease. Under these circumstances, the landlord is not being generous in paying for things such as electricity, janitorial, water, building maintenance, trash, and property taxes. They have merely included these costs in the “Property Operating Expenses,” and taken them into consideration when they negotiate the face rate of the actual lease. In a “Class A” San Francisco building roughly \$15-\$20 per square foot annually from rent covers these expenses. The balance pays down the debt of the property, interest on the property, and, of course, profit.

In fact, the “Property Operating Expenses” includes much more than that. This category encompasses almost every dollar that is spent in almost any way for the building. Property managers salaries, commissions on leasing, elevator service contracts, property taxes, building insurances, advertising, window washing... essentially anything that is a normal expense and not considered a “Capital” expense. Capital expenses are big ticket items like a new wing or roof.

What are Pass-Throughs? Operating Expense Pass-Throughs are the landlord’s way of passing along the costs associated with the yearly, normal increases in operating expenses. Landscaping bills always go up, security guards get raises, electricity bills increase year to year, and property insurance definitely does not go down. Therefore, because of the way leases in San Francisco are structured in today’s marketplace, these increases get “passed-through” to the tenants of the building. The building management calculates the property expenses from last year, then they calculate what they think property expenses will be this year, and spread that difference (increase) out over the entirety of the tenants, based on each tenant’s square footage leased. So, if the increase in the expenses is \$500,000, and you take up 5% of the building’s square footage, you will see a bill for \$25,000.

Proposition 13: Watchout! Prop. 13, passed in 1978, is the biggest unknown cost increase haunting tenants today. Because of this legislation, the way that a building’s property tax is assessed can be very dangerous for a company’s occupancy costs. Buildings in California today are only reassessed on sale, or improvement (an admittedly vague term, look for more on this at a later date). If they do not sell or get reassessed, then the tax bill is legally stopped from increasing more than 2% per year. For instance, if a building has not sold in twenty years, the building is assessed based on the value from twenty years ago, plus small yearly increases that certainly have not kept up with the value increase.

Typically, when the building sells, the tenants see a huge jump in their yearly overall rental costs. This is because property tax is a part of a buildings operating expenses, and therefore passed-through to tenants. We have seen a tenant’s costs increase \$0.52 per foot per month, or over \$6.00 per foot yearly when this takes place. For a 20,000 square foot user, this number can be over \$100,000 per year. Of course, this number is extreme and not typical, but I assure you it was quite shocking for those that did not see it coming.

What Can Be Done? Unfortunately, very little. Landlords do not like to grant Prop 13 protection in leases unless a tenant has a lot of leverage through size and credit, and the language allowing expense pass-throughs in leases today is normal and accepted. The best medicine is prevention in today’s office market. When choosing between comparable buildings, taking into account when the property was last sold is an effective strategy, choosing a tenant representative that makes it his or her business to pay attention to these things is important, and asking to see a copy of the past couple of year’s operating expense reports prior to signing a lease is advised. In my opinion, the most important thing is to read the lease carefully to ascertain what the management considers a property expense and a capital expense. I have fought successfully on behalf of clients to remove from the “Operating Expense” category items such as the salary of a Vice President in another state, and the right of a landlord to build another building on a vacant, adjacent site while including the construction costs of the new property in the first property’s expense pass-throughs.



Real value in a changing world

©2008 Jones Lang LaSalle IP, Inc. All rights reserved. All information contained herein is from sources deemed reliable; however, no representation or warranty is made to the accuracy thereof.

Thomas Poser
Leasing Director, LEED AP
1 Front Street, Suite 300
San Francisco CA 94111
+1 415 395 4941 direct
+1 415 421 3058 fax
thomas.poser@am.jll.com