SNOW REMOVAL EXPENSES

Managing Recoveries in a Modified Gross Lease Investment Property

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Are your property's year-end snow removal expenses indicative of an extraordinary winter season, comprising *multiples of historical average* snowfall events within the region? How does your building's annual snow removal costs compare to last year's snow removal costs? What about the previous three to five year average?

ANNUAL SNOW REMOVAL EXPENSES | BASE YEAR IMPACT

Extreme winter weather can cause as much disorder, to an investment property's operating expense recovery process, than to the operations itself. In a modified gross lease structure, the inclusion of greater-than-average annual snow removal expenses, in a tenant's base year, can negatively impact a property's long-term value. In certain applications, the manager's administrative adjustments, to wide variations in building expenses, can benefit both property owner and tenants, in the overall management and control of operating expense escalation.

If there's just a handful, of operating expense categories, that warrant the manager's year-to-year comparison, in order to discern expense anomalies, the snow removal expense category is one of them. In particular, during the establishment of each tenant's operating expense base year - "setting the base year", a comparison of the current year's and previous years' recorded general ledger expenses, will help ensure a "*true and accurate base year*" with consistent representation of operating expense inflation and escalation during subsequent "*comparison ears*". To that end, it would be prudent to review at least 2 - 3 years of general ledger operating expense history, in order to identify and account for anomalies within specific operating expense categories.

MODIFIED GROSS LEASE - OPEX ESCALATION | CONCEPT REVIEW

The term 'Base Year' is encountered when a landlord & tenant enter into a 'Modified Gross Lease'. With this type of lease, in addition to base rent, the tenant pays their proportionate (pro-rata) share, of the increase in building operating expenses (OPEX), above a base amount. The tenant's proportionate share represents the percentage of the tenant's leased premises area relative to the size of the entire building, e.g., 10%, 25%, 50% pro-rata share. The increase in operating expenses, above a tenant's base year, is generally referred to as operating expense 'escalation'.

Base year expenses are comprised of the building's operating expenses incurred, as stipulated in most modified gross leases, during the tenant's first full year of their lease term. In a base year escalation concept, the property expenses, that comprise the tenant's base year, are compared to property expenses in each subsequent 'comparison year'. If the comparison year's operating expenses exceed the operating expenses in the tenant's base year, then the tenant is responsible to reimburse the landlord for their pro-rata share of the increase.

While the intent, of the OPEX escalation concept, is to recover year-to-year operating expense inflationary increases, year-to-year snow removal expenses are generally arbitrary, because they are primarily driven by chance, based upon the total number of snow-events occurring during the year. The averaging and normalization, of base year anomaly expenses, will reduce or eliminate inconsistencies and deficiencies in the OPEX escalation process.

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Snow Removal Operating Expense (OPEX) Reconciliation | Multi-Year Comparison			
	Snow Removal Expenses	Year	Comments
Snow Removal Expenses **Multi-Year Average** "Normalize" 2017 expenses as a result of significant snow fall events	$56,790	2014	
	$48,204	2015	
	$43,808	2016	
	$86,946	2017	Higher Than Average Snow Fall
	$58,937	AVG	4 Year Average
	Adjusted 2017 Snow Fall Expenses	$58,937	2017 Base Year OPEX
	2017 OPEX Net Reduction	$28,009	($86,946 - $58,937)

BASE YEAR SUMMARY | A MACRO REVIEW OF MULTIPLE-YEAR DETAILS

Establishing a *"true and accurate"* tenant base year is critical to the consistency of subsequent tenant operating expense billings, improving the building's operating expense escalation recovery, and enhancing the asset's investment value. Because the tenant's base year is compared against subsequent escalation years, over the entire lease term, the manager's thorough review, of each tenant's base year operating expenses, is essential. An overstatement, or understatement, of base year operating expenses, has an amplifying effect over the term of the tenant's lease. While an understated tenant base year may generate additional operating expense recovery, it is contrary to the purpose of the escalation process and, at some point, it may be challenged, audited and amended. When an investment property sale is transacted, the capitalized value derived from the manager's initial calculation and establishment of the property tenants' base years, and subsequent net operating income, is significant.