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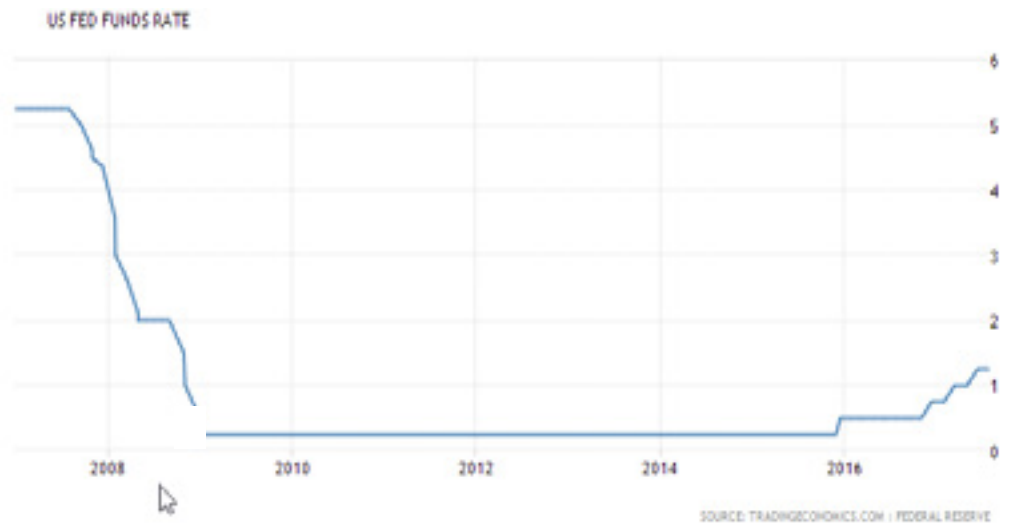
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Is Using the CPI Increase in Commercial Leases Archaic?

By: Cliff Hockley, President Bluestone and Hockley Real Estate Services, Executive Director, SVN | Bluestone and Hockley

CPI lease clauses have long been a practice of Landlords, and were originally added in the 1980s to keep up with inflation when interest rates skyrocketed to 18.5%.¹ These clauses remained relevant as interest rates were high - but interest rates have plummeted since the 2008 recession, following the Federal Reserve adjustment to jump start the weakened economy.²



Most importantly, the Federal Reserve has decided that a soft landing was critical to the economy and the stabilization of American business. This has been good for the country because it has lowered national debt payments, and made it easier for businesses to expand. This has directly affected the CPI, and resulted in lower annual CPI increases as well.

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¹ <https://finance.yahoo.com/blogs/just-explain-it/why-mortgage-rates-matter-152241574.html>
² <https://tradingeconomics.com/united-states/interest-rate>

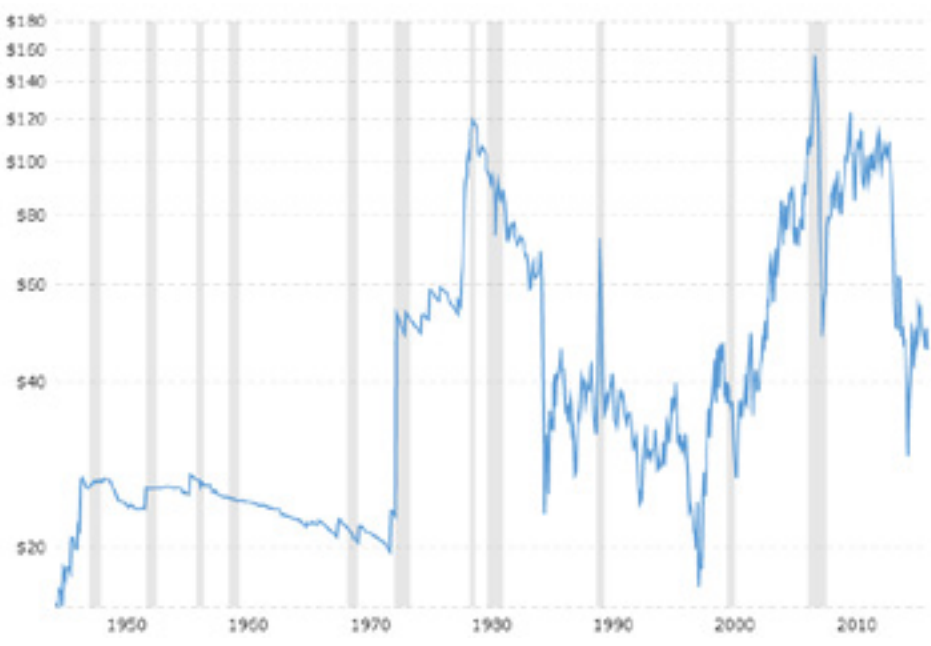
U.S. City Average, CPI Index, All Items, 1982-84=100, All Urban Consumers (CPI-U)³

Year	Average annual CPI Increase
1999	2.2
2000	3.4
2001	2.8
2002	1.6
2003	2.3
2004	2.7
2005	3.4
2006	3.2
2007	2.8
2008	3.8
2009	-0.04
2010	1.6
2011	3.2
2012	2.1
2013	1.5
2014	1.6
2015	0.1
2016	1.3
Average over 18 years	2.2

CPI Market Basket

The Bureau of Labor Statistics (the organization responsible for tracking the CPI) has continuously tweaked the CPI analysis and the CPI market basket, making it difficult to assess if landlords are actually receiving the correct information. Additionally, one cannot forget that heating oil and fuel for automobiles and airplanes are also part of that market basket, and has been subject to significant variation over the last 20 years. The price of oil (West Texas Intermediate) reached a high of \$113.03 per barrel on May 2nd of 2011 and then crashed to \$28.46 on Jan 19, 2016 - and has leveled out at about \$47.37 as of August 21, 2017.

Crude Oil Price History: 1950-2017⁴



³ https://www.bls.gov/regions/west/data/consumerpriceindex_us_table.pdf
⁴ <http://www.macrotrends.net/1369/crude-oil-price-history-chart>

What has changed as far as oil is concerned, is that the US is currently able to generate much of its own oil for domestic use, and is not as dependent on the worldwide suppliers (Venezuela, Russia and the Middle East.) According to the U.S. Energy Information Administration – a division of the U.S. Energy Department, “...since early 2011, the United States has been a net exporter (exports were greater than imports) of non-crude oil petroleum liquids and refined petroleum products.” This may mean that the market basket is at some sort of equilibrium, but it is still unlikely that its impact on the CPI accurately reflects the actual operating cost of commercial buildings.⁵

Is the CPI accurate?

Recent annual CPI adjustments are not keeping pace with commercial building costs. Annual CPI increases have been averaging 2.2% over the last 18 years (with a few exceptions), while commercial building operating costs have been escalating at a higher rate. Driven by increasing labor rates as well as tax and utility increases, we are seeing operating increases range from 7% to 38% depending on which US Metro you are in.⁶

Additionally, Turner Construction (a national commercial builder) estimates annual construction cost increases of almost 5% in the last 12 months - a consistent increase every year. What this translates into is that our capital expense budgets for commercial buildings have been increasing at a 5% rate as well.

Second Quarter 2017 Turner Building Cost Index⁷

Quarter	Index	% Change
2nd Quarter 2017	1031	1.18%
1st Quarter 2017	1019	1.29%
4th Quarter 2017	1006	1.11%
3rd Quarter 2016	995	1.22%
Totals	4051	4.8%

This seems to prove that the Consumer Price Index is not an adequate measure of inflation. The government has incentives to keep this statistic as low as possible - in fact, the CPI doesn't even measure inflation, rather a range of consumer spending behaviors - which changes by region. The CPI is perhaps one of the most important government statistics because it affects a number of public programs and is used as a benchmark to set public policy, but its accuracy is questionable.⁸

How does a building owner fight back?

In order to stay ahead, building owners must change the way they are doing business. First of all - they need to transition to NNN office or commercial leases so they can pass as many operating expense increases on to tenants as possible. Gross lease terms need to be limited to 5 years so that a Landlord can adjust lease rates more frequently (rather than being stuck with a 10 or 20-year lease term with no real increases), and conceptually landlords need to consider that a greater portion of tenant improvements need to be covered by tenants. Finally, there needs to be a fixed annual percentage increase (say 3% -5%) to keep up with the ever-burgeoning capital expense costs.

In conclusion, commercial building owners need to make a profit to keep up with the demands of the marketplace and the ever-increasing pressures for building improvements. Keeping the CPI increase in their arsenal of tools to keep up with market is out of date and archaic, it is time that that tool is phased out, just like buggy whips have been.

⁵ <https://www.eia.gov/tools/faqs/faq.php?id=268&t=6>
⁶ <http://www.reca.org/blog/post/austin-commercial-real-estate-sees-staggering-increase-in-operating-expense>
http://www.nycrbg.org/downloads/research/pdf_reports/pioc16.pdf
⁷ <http://www.turnerconstruction.com/cost-index>
⁸ <https://www.forbes.com/sites/perianneboring/2014/02/03/if-you-want-to-know-the-real-rate-of-inflation-dont-bother-with-the-cpi/#4a85db80200b>

MORE RESOURCES:

- <http://www.frbsf.org/economic-research/publications/economic-letter/1997/may/bias-in-the-cpi-roughly-right-or-precisely-wrong/>
- <http://www.gao.gov/products/GAO/GGD/OCE-98-2>
- <https://www.bls.gov/opub/hom/pdf/homch17.pdf>



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