Using Fixed Percentage Rent Increases as an Alternative to Operating Expense Pass-Throughs

Insights • August 15, 2025

In both office and retail leasing, landlords and tenants are increasingly considering an alternative to traditional operating-expense pass-throughs: fixed annual percentage increases in base rent (e.g., 2–4% escalations per year). This structure can simplify administration and make long-term occupancy costs more predictable, but it also carries meaningful trade-offs. Below is some practical information for understanding some key benefits and risks of fixed rent escalations vs. operating expense pass-throughs.

Benefits of Using Fixed Percentage Increases

Predictability and Budget Certainty

- **For landlords:** Fixed increases create stable year-over-year revenue without relying on fluctuating operating expenses such as real estate taxes, utilities, insurance, and labor.
- **For tenants:** Predictable annual escalations eliminate unexpected reconciliation spikes—particularly valuable in inflationary markets or jurisdictions prone to tax volatility.

Administrative Simplicity

Fixed escalations eliminate the need for annual statements, audits, and reconciliations. This reduces accounting burden and minimizes disputes over CAM categories, controllable expenses, and gross-up calculations. Administrative clarity is especially relevant when negotiating **Commercial Lease Agreements** or structuring long-term landlord–tenant relationships.

Lower Risk of Disputes

- Fixed increases substantially reduce common areas of friction:
  - Allocation issues (usable vs. rentable, base year manipulation).
  - Inclusion/exclusion of capital expenses.
  - Transparent versus opaque management fees.
- A simple percentage escalator tends to produce fewer accounting challenges and legal disagreements.

Cleaner Underwriting and Portfolio Modeling

Investors and lenders prefer predictable, contractual rent growth. Fixed escalators make it easier to model NPV, DSCR, and cash-flow stability—important during disposition or refinancing. For financing considerations, see our **Real Estate Finance** practice.

Strengthens Tenant Appeal in Competitive Markets

Retail tenants, especially national brands, and smaller office tenants often find fixed increases more "tenant-friendly" than variable pass-throughs. This can improve lease-up velocity and reduce friction in smaller footprints or neighborhood retail corridors.

Risks and Trade-Offs to Consider

Mismatch With Actual Operating Cost Increases

- Operating expenses (especially taxes, utilities, security, and insurance) often rise faster than standard 2–4% escalators.
- Landlords risk margin compression if expenses spike above the fixed percentage, particularly in:
  - Reassessment years
  - Periods of wage inflation
  - Properties with high energy usage or capital needs

For verified historical expense trends, see authoritative sources such as the **U.S. Energy Information Administration** (utilities) or **FEMA/NFIP** (insurance).

Loss of Expense-Recovery Protection

Traditional pass-throughs provide a risk-sharing mechanism. Fixed increases shift risk to the landlord, who can no longer recover extraordinary costs such as:

- Major insurance premium increases
- Unexpected municipal charges
- Compliance costs (e.g., ESG, Local Law 97, ADA upgrades)

Potential Pricing Inefficiencies

To compensate for lost pass-throughs, landlords may start with a higher base rent or higher annual escalator. If future expenses rise slowly, tenants may overpay relative to a true-up model.

Less Transparency for Institutional Tenants

Large tenants often require detailed annual pass-through statements for internal controls, audit rights, and budgeting. Fixed escalators can feel overly simplistic or inadequate for these needs.

Resale or Refinance Considerations

In assets with volatile costs or major upcoming capital improvements, buyers or lenders may prefer traditional pass-throughs. Fixed increases can reduce the perceived ability to maintain NOI, affecting valuation metrics such as cap rates or lender DSCR modeling.

Hybrid Approaches Becoming More Common

As clients seek predictability without fully sacrificing cost-recovery protections, hybrid structures have grown increasingly popular.

Fixed Bump + Limited Pass-Throughs

Landlords apply a 2–3% annual increase while still passing through specific categories such as:

- Real estate tax increases
- Insurance increases
- Uncontrollable expenses

Fixed Base Year

A modified gross lease starting with a landlord-favorable base year, followed by fixed annual escalators.

Caps on Expense Exposure

Tenants pay their proportionate share of increases, but with caps on controllable expenses or limits on categories such as janitorial, security, or management fees.

These blended models offer better alignment where landlords want predictable revenue but cannot fully absorb rising operating costs.

Practical Guidance for Landlords and Tenants

Landlords Should Consider:

- Projected tax reassessment cycles and volatility
- Insurance market conditions (currently hardening)
- Energy-efficiency compliance (e.g., Local Law 97 in NYC)
- Whether valuation metrics (cap rate buyers, lenders) prefer traditional pass-through recovery
- Adjusting initial base rent if taking on expense risk

Tenants Should Consider:

- Sensitivity to unpredictable year-over-year costs
- Internal budgeting preferences
- Likelihood of major property-level capital expenditures
- The profile of the landlord (institutional vs. local owner) and its pricing assumptions

Practical Takeaways

- Fixed escalations provide predictability but shift expense risk to landlords.
- Ideal for small office suites and neighborhood retail where simplicity is valuable.
- Not always advisable in markets with volatile taxes, insurance, or energy costs.
- Hybrid structures often strike the best balance between stability and protection.
- Both parties should model multi-year scenarios before abandoning pass-throughs.

Bottom Line

Replacing expense pass-throughs with fixed percentage rent increases can be a powerful tool for simplifying leases and creating predictable economics, particularly in small-suite office and neighborhood retail settings. However, fixed increases shift operational cost risk onto the landlord and require careful pricing to avoid future margin compression.

In markets with rapidly changing operating expenses—taxes, insurance, labor, energy—landlords should analyze future cost exposure before agreeing to forego pass-through protection. Hybrid models often provide the most balanced outcome.

before acting on the information. Sending or receiving this alert does not create an attorney-client relationship.

RELATED PRACTICES

1031 Exchanges and Net Lease Investment Acquisitions

Office Leasing/Landlord Representation

Office Leasing/Tenant Representation

Real Estate Acquisitions and Sales

Real Property Management and Asset Management

Retail Leasing/Landlord Representation

Retail Leasing/Tenant Representation

Sale-leaseback Transactions and Net Lease Investment Sales

Specialty Leasing