



# fact sheet

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## Hidden costs in leasing

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This fact sheet provides Australian Government agencies with a snapshot of some of the 'hidden' costs in leasing that impact on value-for-money considerations in lease procurement.

From a financial perspective, lease procurement involves a consideration of:

- expressly identified costs such as rent and direct payment of specified discrete services such as telecommunications, separately metered power and registration fees
- a range of other actual or potential costs that arise as a direct or incidental consequence of lease provisions and which can vary from lease to lease. These are referred to as 'hidden' costs because, although these costs are not expressly identified costs, they extend the scope of express costs or give rise to an underlying cost.

To enable agencies to manage the value-for-money outcomes contemplated by the Commonwealth Procurement Rules (CPRs) a two-fold process is used:

- 1 Identify the costs that could arise from the terms of the lease (noting that these can vary widely based on different content of leases in the market).
- 2 Assess their cost implications for the value-for-money assessment.

Hidden costs can vary widely based on the various scenarios and provisions that reflect the different content of leases in the market. A few of the more common risk areas that can give rise to hidden costs are identified in this fact sheet.

### Key message

To ensure a fully considered value-for-money assessment is undertaken and to minimise the potential for unexpected risk and expenditure – look behind the 'basic offer' and carefully consider the full responsibility, cost and risk implications of the terms of the lease document.

Seek expert advice on the 'through-life' impact of lease provisions before committing to a site.

Avoid accepting an offer without clear agreement on the full content of the lease document (whether through heads of agreement or other correspondence) or without detailed completing lease negotiations.

### WHAT DO WE WANT TO LEASE?

#### Describing the premises

The way that the 'premises' are described in the lease has broad implications for the tenant. Greater levels of responsibility, risk and cost may be shifted to the tenant where a broader description of the premises is used. Generally, only those specific areas that the tenant wants to have exclusive

possession of should comprise the actual premises. A lease can still cover incidental rights (such as rights over common areas, shared utility areas and car parking) but usually these do not need to form part of the premises.

There is no right or wrong description of premises for all cases. What description of the premises is appropriate will depend on the actual needs and expectations of the agency.

Considerations include:

- the type of accommodation being leased – office accommodation for part of a building typically means that only internal faces of the area will form the premises, whereas above ceilings, wall cavities and external areas remain the responsibility of the landlord. However, a lease for a special-use facility may require a lease of the entire building and surrounding land to meet operational and security needs.
- which party is best placed to manage the risks associated with the area described as the premises – for most office accommodation, the landlord is best placed to manage above-ceiling areas and wall cavities and associated plant and base building services
- the degree of control needed by the agency – the agency needs to consider security and the need for specialised plant or equipment
- restrictions on ‘neighbouring’ use and access – there may be a need for the agency to secure exclusive use of adjacent areas, including open space.

*What potential maintenance and repair obligations may arise based on the description of the premises?*

- The more widely the premises are described, the greater the tenant’s maintenance and repair obligations. This in turn leads to increased costs and potential uncertainty about how the repair and maintenance obligations are shared between the landlord and tenant.
- Tenants should also consider their obligations under the Energy Efficiency in Government Operations policy. A broad description of the premises may impact on the respective obligations of the parties under the relevant Green Lease Schedule. For example, the landlord may argue that it should be relieved of its rating obligations because the base building plant is in an area leased and controlled by the tenant. This may pass on additional environmental obligations to the tenant and/or lead to increased energy costs.

*How will the description affect the tenant’s work health and safety obligations?*

- If the premises include areas of the landlord’s property that house base building services, shared services or facilities, the tenant may be responsible for the potential work health and safety risks associated with these areas. Leasing external areas of a site (such as the external or ‘public’ part of a building or an open area) also increases work health and safety risks, which may result in increased cost for the tenant.

*Will there be added costs in fulfilling make-good obligations?*

- Any costs associated with reinstatement or make-good obligations will extend to all areas described as the premises.

*Is there a greater risk of liability?*

- The risk of liability increases as the definition of ‘premises’ becomes broader. This is because tenants will assume responsibility for these areas and may potentially be liable for a range of claims for loss or damage to property, personal injury, trespass and the like related to those areas.
- The risk of a claim exists where the tenant fails to meet its maintenance and repair obligations for services or plant located within the premises and loss or damage is incurred by the landlord or other tenants because of a failure to meet this obligation. Depending on the terms of the lease, the potential exposure could be significant and may include consequential as well as direct loss.

*Are the premises relevant to insurance arrangements?*

- The degree of responsibility and risk also increases where a broader definition of 'premises' is adopted and agencies should ensure that their insurance or Comcover arrangements are adequate.

*Does the definition of 'premises' impact on rent reviews?*

- A broader definition of 'premises' may have unexpected financial impacts where a market rent review is undertaken. Ultimately, the particular form of the rent review clause will determine this, but it is a financial contingency that needs to be considered in the value-for-money assessment.

**Key message**

Avoid leasing more area than is necessary.

Decide the accommodation needs and assess the obligations, risk and financial implications based on the described premises as part of the value-for-money assessment before committing to the proposed lease deal.

**Outgoings**

Agencies should consider the impact of the outgoings arrangement on the value-for-money assessment during the procurement process. The extent and type of costs will vary depending on the type of outgoings arrangement specified by the lease.

**Net leases**

Net rental options can have unforeseen cost implications. Unexpected expenditure may be incurred where the heads of outgoings are broadly described by the lease. Broadly described heads of outgoings may capture a range of costs that were not originally contemplated by the tenant at the time of lease procurement and it may be difficult to quantify the potential financial implications. Heads of agreement or leases that are worded to include 'all the usual building outgoings', 'all rates, taxes, imposts, levies and charges', 'all fees, costs and expenses' or provisions that allow a landlord to alter or add to common areas (not uncommon where the lease confers redevelopment rights on the landlord) create open-ended liability and can lead to unexpected outcomes. This should be carefully considered when a landlord may seek to rely on a broad outgoings clause to claim an escalating range of expenses.

A recent list of outgoings will indicate past outgoings but this does not avoid the risk of unforeseen costs if the lease terms are broad enough to allow the landlord to introduce a wider range of outgoings in the future. If the specific heads of outgoings are agreed to in the early stages of a lease procurement, tenants may avoid or limit the risk of additional expenses in the future and will have a more accurate value-for-money assessment.

**Gross leases**

Commonwealth agencies often prefer gross rental leases because of the predictability of costs during the life of the lease and the ability to make a more informed value-for-money assessment. However, hidden costs may arise where the lease provides for fixed-percentage gross rent escalations and where increases in outgoings are payable.

Tenants need to take care when agreeing to a gross lease where 'increases' in outgoings are payable over a defined base year amount threshold and where there is a fixed-percentage increase in the rent, to avoid 'double-dipping' by the landlord. As the rent is 'gross' this means the fixed-percentage increase in the rent will already incorporate a component for both rent and outgoings and therefore this should be taken into account in calculating the 'increase' for the relevant year.

**Key message**

Value-for-money assessment of the proposed rent structure is about more than net-versus-gross rent. The detail in the lease clauses may tangibly impact on the financial risk. Scrutinise the precise lease terms relevant to the rent and outgoings regime and subject them to a considered value-for-money assessment before the lease offer is accepted or before other accommodation options are lost.

**LIMITATION OF LIABILITY**

Limitation of liability clauses are commonly used where the landlord is a property trust and have potential cost implications. Limitation of liability clauses generally provide that:

- the landlord is acting in a certain capacity such as a trustee, custodian or responsible entity
- the landlord is not liable in its personal capacity under the lease
- the landlord's liability is limited to the extent that it is indemnified out of the assets of the trust.

This may create a risk for the tenant where the tenant brings a claim against the landlord for an amount greater than the value of the assets of the trust. In these circumstances, the tenant may be prevented from recouping the full amount of the claim, even if the trustee or landlord has sufficient assets in their personal capacity to pay the claim. For tenants, this creates the risk of incurring liability for loss or damage that it may normally be able to recoup from the landlord.

Agencies can reduce this risk by:

- ensuring that the value of the assets of the trust is sufficient to cover the cost of most potential claims
- requiring the landlord to hold relevant insurances (public liability and property replacement) to improve access to funds to meet any potential claim brought under the lease
- where there is a trustee and a responsible entity, making both these entities parties to the lease (the responsible entity is responsible for managing the scheme under the corporations legislation, so there is usually no justification for it not to be a party)
- ensuring the lease contains an express right for the tenant to rectify the landlord's breach and to set-off the amount against the rent.

**Key message**

Assess the legal nature of the landlord as part of the pre-lease due diligence as well as the limitation of liability clauses for risk as part of the value-for-money assessment of the lease proposal. The degree of risk depends on the form of the limitation clauses, the assets in the relevant trust and the insurance and overall risk-sharing regime in the lease.

**WORK HEALTH AND SAFETY**

Agencies have a duty to ensure, so far as is reasonably practical, that the workplace, the means of entering and exiting the workplace and anything arising from the workplace does not create a risk to the health and safety of people using these areas.

This duty may potentially give rise to significant costs in the lease context. An agency may bear statutory repair and maintenance obligations not apparent on the face of the lease or the costly prospect of relocating or carrying out urgent works to deal with immediate risks to health and safety. This risk can arise where a lease broadly describes the premises or imposes onerous repair and maintenance obligations on the tenant.

Agencies can protect themselves against the risk of incurring these costs by:

- ensuring that the costs of complying with statutory work health and safety obligations associated with base building infrastructure included in the premises are considered during negotiations
- ensuring that the terms of the lease place clear and specific obligations on the landlord to service base building infrastructure and to eradicate the potential risks of hazardous diseases or chemicals
- requiring rights to monitor the landlord's relevant obligations

- requiring abatement rights for the agency if the premises become unsafe to occupy, which will prompt the landlord to act quickly to restore the premises to the necessary condition
- including termination rights that can be exercised in the event that work health and safety risks cannot or will not be remediated
- including warranties that require the landlord to make a representation as to the state of the premises.

### Key message

Assess the health and safety implications in the context of the particular lease document and, as part of the value-for-money assessment, factor in both the direct cost of compliance and the likelihood of the indirect cost arising from the landlord limiting its obligations or shifting risk to the tenant under the terms of the lease.

### MAKE-GOOD AND REINSTATEMENT OBLIGATIONS

Make-good and reinstatement obligations can result in significant cost at the end of a lease. As well as reducing tenant costs, a lease-end arrangement which allows the tenant to leave its fit-out and fittings in situ better meets sustainability objectives, as it encourages adaptive reuse and avoids environmental wastage. The extent of potential cost varies widely and is governed not only by the particular lease clauses but also by the nature and size of the tenant's fit-out.

Factors that may indicate costly or onerous requirements include:

- a broad description of premises that includes base-level infrastructure
- obligations to use specific materials, especially if the lease is for a longer term and the materials are likely to become unavailable
- obligations to reinstate the premises to 'base building', 'as new' or 'as at commencement date' standards
- uncertainty regarding make-good obligations and, in particular, whether permitted modifications must be reversed
- absence of reasonable sustainability measures allowing for adaptive reuse of some or all of the fitout or tenant's fittings.

Some approaches for managing the risk of unexpected costs include:

- clearly agreeing and documenting the state to which the premises are to be restored
- confirming the scope of works required and the timeframe for performing them
- placing a cap on the maximum amount of the tenant's spend
- inserting provisions for payment in lieu of reinstatement and the mechanism for determining that amount.

### Key message

Analyse the proposed reinstatement or make-good regime and factor the financial and other consequences into the value-for-money assessment and procurement decision.

### OTHER ISSUES TO WATCH OUT FOR IN LEASES

- broad release and indemnity provisions that shift a higher level of risk from the landlord to the tenant (including for matters out of the tenant's control)
- unlimited payment-of-costs clauses, such as open-ended obligations to pay the landlord's costs associated with request for consent under the lease or for the lease negotiation, settling and execution
- unfettered discretion in the landlord to refuse assignment or sub-letting, which leaves the agency with a potential 'dead-rent' situation if the premises are no longer needed or unable to alter arrangements to reflect machinery-of-government changes

- waiving Commonwealth immunity and agreeing to comply with laws that do not apply to the Commonwealth
- unduly onerous interest obligations for late payments
- lack of or insufficient rights to rent abatement for the landlord's failure to comply with its safety, maintenance and operating obligations for the premises, building and services
- insufficient termination or rent-suspension rights if the building is destroyed or damaged
- erosion of the rights to quiet enjoyment.

### More information

If you need more information about leasing issues, please contact one of the AGS experts listed below:

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