Inflation is Back, Should You Consider Consumer Price Index (CPI) Rent Increases in Your Leases?

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The Consumer Price Index (or CPI) is a set of indexes generated by the Bureau of Labor Statistics (BLS) that measures "the prices paid by urban consumers for a representative basket of goods and services." Historically, CPI has been used in commercial real estate leases and ground leases "escalation clauses" or "index clauses" in an attempt to fairly increase (or even decrease) the rent required to be paid by a tenant to correspond with changes in national or regional inflation. A basic articulation of such a CPI index clause would be a *prior year rent percentage change* where change is calculated using a formula of *(current index value – base index value) over base index value*. In recent years, many owners shifted to flat increases over set periods. However, with the return of inflation, CPI increase clauses are seeing a return into more prominent use.

CPI clauses have some inherent tradeoffs. On the good side, they are historically consistent, flexible in their application to specific areas, reduce disputes, and hold great practical influence in both business discussion and economic analysis. However, they have been subject to criticism as being narrowly focused on certain goods, failing to match the reality of the economy, failing to account for relative demand in a high demand area, and failing to accommodate consumer substitution of lower priced goods. Additionally, they tend to benefit tenants when inflation is low and landlords when inflation is high. Overall, however, they are still viewed as a credible form of indexing for leases.

Crafting a CPI clause comes with a number of decisions. There are several different CPI indices based on factors such as location, type of consumer, included goods and services, and base index period. Each of these is important to understand what is being measured and picking the right index can make a substantial difference in the long term. For example, a retail lease might want to focus on goods and services or consumer types in order to most closely align the increases with the sales of the tenant experiencing the rent increase. Similarly, making sure the index region is tied to the location of the real estate may also be important. A few areas require specific care and the crafting of a CPI clause must be carefully tailored to the terms of the lease.

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- **Selecting a Base Index Year (or month).** This is crucial to evaluating the floor of the change. Typically, the base index year is the year of execution, but some formulas pick different years to capture certain inflationary or consumer cycles. Also, any clause should consider changes to base index year.
- **Selection of a Specific Index.** As noted above, there are a variety of indexes and thought that should be given to the proper CPI index given the area, good, and term of the lease. Care should be taken to analyze the population group and item categories as well. Avoid seasonally adjusted indexes.
- **Timing and Frequency of Adjustment.** A key decision in a CPI clause is determining how often the adjustment will be made. Annually? Each lease term? Pay close attention to when the indexes are released and identify when the adjustment shall take effect.
- **Growth Caps.** Parties should also consider whether a cap on the increase is appropriate. If the index shows a 7% increase in one year, should the parties cap it at 5% in a year? Consider whether the lost 2% should be recaptured in future years.
- **Floors.** CPI index adjustments can go both ways or, as discussed above, not increase materially. Landlords should also consider floors in the calculations.

CPI clauses need to carefully drafted. An inaccurate or poorly conceived CPI adjustment can materially affect the value of the real estate it is tied to.