



# COMMERCIAL SERVICE CHARGES

## The Occupier's perspective

### Introduction

This paper examines in depth the often-contentious issue of service charges from the occupier's perspective. The intention is to explain what should and should not be recoverable for the repair and maintenance and the provision of vital services, usually within multi-tenanted buildings.

Looking in the first instance at the United Kingdom in depth, many of these provisions are relevant globally. Examining different types of commercial property, the paper seeks to provide information to the occupier's Property Manager in relation to an area where costs tend to increase, and over which they appear to have little control.

It will then scrutinize the services usually found in differing commercial properties. Commentary is made upon the major variations globally from the UK.

Finally recommendations are suggested as to what influences an occupier can take to ensure that these charges are fair, reasonable, necessary for the development, and within the terms of the Lease contract.

### Background

After staff costs, property occupational costs are generally the largest expense which an occupier must budget for. These occupational costs include rent, business rates, insurance and often where there is more than one occupier to the building, a service charge. Whilst rent and rates are fairly predictable, service charges are prone to fluctuate, especially as properties age, resulting in increased expenditure to maintain the property to an occupational standard. Thus service charges are often more subject to the rate of inflation prevalent within a country, as they are based upon the cost of running a building, rather than property value.

In the modern property world, within multi-tenanted developments, such as shopping centres, retail parks, office blocks, and even in industrial estates/warehouses; the owner often retains the responsibility for certain items of common expenditure. These items, which, in the case of fully repairing and insuring leases are the responsibility of the individual tenant, are undertaken by the owner with costs being recovered from the individual tenants in the form of a service charge. This is good business practice, as the owner can ensure that all repairs are all conducted to the same standard, cost and contract efficiencies are secured and common services maintained.

Similar in operation to residential multi-tenanted properties, where an abundance of case law exists, these service charges will usually include such items as:

- The maintenance and repair of the structure and common parts of the building
- Maintenance, repair and replacement of plant and machinery, such as lifts, air conditioning, heating and cooling of the building, security and public address systems.
- The provision and associated costs of Security and cleaning the building
- Costs associated with administering and managing the building, however these should exclude costs associated with collection of rent.
- Energy costs for the common parts.
- Insuring the building to its full replacement value. Insurance will often include engineering and terrorism insurance, the latter increasing following recent world events.
- Promoting the development, in the case of shopping centres and retail parks.

In the United Kingdom most Leases under which a tenant occupies a property will permit 100% recovery of the Landlords cost via some type of service charge. In the modern Lease, the service charge clause will often run to two or three separate schedules, detailing precisely how the service charge is to be administered. This will usually include the method the service charge is apportioned between the individual tenants, what can and cannot be included, the provision of budgets and reconciliation statements at year end, and recovery for any shortfall from the tenant, or indeed, dealing with any credits due to a tenant.

In Continental Europe, there is an increasing trend towards all-inclusive Leases, where the tenant pays one figure to occupy the property. In this case,

it is vital that the Landlord accurately budgets for service costs in advance, otherwise a significant shortfall can occur, with problems in cash flow and projected profits.

Since the monies expended by the Landlord on service costs are recovered from the tenant, this is an area where contention can often arise. The Landlord's objective is to maintain the value and quality of his investment, whilst the occupier seeks quiet enjoyment, at a reasonable cost. In many modern Leases it is now provided that the service charge must be fair and reasonable, and it is implied in older Leases, however this term can be very subjective.

## **United Kingdom**

The UK Lease contract has some of the most specific and lengthy service charge provisions and hence is examined in depth.

In the UK, residential service charges are governed by Statute, first introduced in the Housing Act 1972, and have been replaced and updated by ensuing legislation. This is not the case in respect of commercial property however, where little Statute and case law exists.

Shopping Centres first appeared in the UK in the late 1960's, becoming more popular as the major shopping destination during the ensuing period. Office blocks instigated service charges earlier as the Landlords realised that this was the most effective method of ensuring that the property stock was kept to an occupational standard, and that one area of the building was not kept in better, or worse, repair than others.

Within the UK, service charges are treated as revenue expenditure by the Inland Revenue, and not as capital expenditure. This has led to confusion in the industry in many instances but can be understood in that revenue covers items of repair, maintenance and the supply of such services as cleaning and security. Capital expenditure includes improvements to a scheme, new items where such did not previously exist, and, to a certain extent, refurbishments, as this will enhance the value of the owner's investment.

## **The Lease Contract**

The overriding elements of the service charge are the terms contained within the occupational lease contract. If the wording of the service charge clause allows an item, then the occupier must pay whether or not it is a repair and maintenance item or a service, or whether the item in question is in fact an improvement. Thus it is imperative that at the contract negotiation stage the occupier seeks to exclude such wording which may allow items of capital expenditure within the service charge. This is usually the only time a potential occupier can seek to control the inclusion of costs within the service charge.

In newer leases the service charge provision will often run to a number of pages. From the tenants' point of view, this should include a list of the items that are service charge recoverable. It is also normal for there to be a general sweeper clause to cover any item the property owner has not itemised as recoverable elsewhere, usually as expenditure deemed for the benefit of the development. This latter clause should only cover minor items of expenditure, as some Landlords have neglected to include promoting the scheme, which will be covered below, and seek to recover the significant costs relating to this activity via the sweeper clause.

Ideally the tenant's professional advisors should negotiate the most beneficial and long-sighted wording possible and should attempt to seek the following during the drafting of the contract.

1. The service charge clause should detail that the Landlord is to provide a budget, at least one month prior to the commencement of the service charge year.
2. The service charge on-account payments should be paid into a separate interest bearing account, held in trust for the tenants, with the interest accrued to be to the benefit of the service charge.
3. The service charge should not be reserved as rent. If this cannot be agreed, the Landlord may attempt to forfeit the Lease or distrain for rent should a dispute arise.
4. The account should be reconciled within 6 months of the end of the service charge year, and should be supported by a breakdown of actual expenditure. The breakdown should be prepared or certified by an independent qualified Accountant. This latter cost again is recoverable under the service charge.

5. Any credits due back to the tenant following reconciliation should be repaid to the tenant, and not offset against ensuing accounts.
6. Both the budget and certified accounts should set out the method of apportionment of the service charge and detail the tenant's share of the cost. Indeed an apportionment schedule should be included showing all tenants apportionments. There have been a number of cases where property owners have inadvertently recovered more than 100% of the service charge. Apportionment tends to be made upon one of the following:
  - A fixed amount detailed within the clause. This however can result in under- or over-recovery
  - A fixed percentage. Usually there will be the opportunity for the owner to vary this percentage if the development is extended for example.
  - Rateable value of the unit as a percentage of the total rateable value of all lettable units. This method can be difficult to administer in practice, as rateable values alter, with the occupier having the right to appeal against the assessed rateable value, which can take many years to resolve. Unless the lease contract provides otherwise, a tenant may demand, upon successful appeal, that their service charge apportionment is re-assessed and be reimbursed accordingly. This would then require the assessment of all other service charge apportionments within the scheme.
  - Floor area of the unit as a percentage of the total lettable floor area
  - Weighted floor area as a percentage of the total lettable floor area. This is common in many larger schemes to reflect the different costs involved in servicing different sized units. A weighting floor area will take into account that larger units are progressively discounted, as it will not cost five times the amount to service a 2,500 sq m unit compared to that to service a 500 sq m unit.
7. The tenant should reserve the right to inspect any vouchers in respect of the service charge.
8. All services should be appropriate to the location, use and character of the property. Services and expenditure should be at competitive rates. Tendering and/or benchmarking against the industry should be undertaken at least once every three years.

9. The property owner should be liable for the service charge payment in relation to vacant units, and also for any shortfall where a unit has the benefit of a capped service charge, or other concession granted.
10. Sinking/reserve funds. Ideally there should be no provision for this type of fund of any kind within the service charge. This item will be dealt with further.
11. The service charge should exclude any costs incurred in relation to any refurbishment or redevelopment of the building. Replacement of any item beyond economic repair is to be on a like for like basis.
12. The Lease clause should not include costs between the owner and any individual occupier, such as rent reviews, the collection of rent, letting of units and the costs associated with the enforcement of specific lease clauses.
13. The clause should also exclude any initial costs in relation to the construction and furnishing of the development, nor should they include any costs incurred due to an inherent defect.
14. The clause will normally include for a management fee, whether the property owner conducts this directly or by a firm of managing agents on behalf of the owner. This should at worst be restricted to a maximum of 10% of the costs of the services provided, excluding management fee. This cost should also be regularly market tested against the industry to ensure value for money is obtained. Again this will be examined in greater depth.
15. The service charge should exclude any notional rent in respect of any management office suite or residential accommodation provided for the building management staff.
16. Income derived from any service, activity or cost centre that is financed by the service charge should be treated as a service charge credit, and shown in the accounts
17. Details of future planned maintenance programmes, where financed by the service charge, should be provided to the occupiers. The programme should be reviewed regularly and condition of plant etc. regularly assessed and revised until such time as the works are necessary. These programmes are useful in supplying tenants with advance notice of major works envisaged, but should be as flexible as possible.
18. Promotional expenditure details should be supplied to the tenants prior to the commencement of the service charge year. Any promotional activity should be measured for its effectiveness. As both owner and occupier benefit from this activity, the parties should contribute equally; with the accounts detailing precisely how much is

contributed by the Landlord, i.e. Gross charge less contribution equals amount that is recovered via the service charge. This is particularly important, as tenants often feel aggrieved if the Landlord is not seen to be contributing towards this cost.

In mixed-use buildings, such as a shopping centre with offices above, there should be separate schedules within the service charge, as some occupiers will benefit from different services. In this example, the office occupiers may benefit from air conditioning plant and lifts, where the retail tenants do not. Costs should be apportioned to those tenants who receive the benefit accordingly.

The tenant should seek to avoid words such “provision”, “installation” “improve”. Unfortunately, many occupiers do not seek professional advice in relation to service charge clauses to their later detriment.

There has been much discussion in the UK over the adoption of a “standard” service charge clause, however this would be improbable in practice. Every property is different in nature and thus has its own distinct set of operational criteria. What may be correct for one development may not be suitable for another.

## **Commercial buildings**

Experience shows that the most complex service charges are usually in relation to shopping centres, and this section examines these in depth first; however many of the service charge provisions in relation to these developments are relevant to whether the building in question is an office block, an industrial unit, or located upon a retail park.

### **Shopping Centres**

During the 1980 boom period, many retailers paid the service charges demanded of them, with few questions asked. However as recession affected the profitability of shop units within centres, retailers showed growing concerns over the level of service charge invoiced. At this time, communication between Landlord and Tenant was poor, with little demonstration of value for money being obtained. Increasingly, disputes over the level of service charge grew from occupiers, with requests for greater

clarification of expenditure, demands for better value, and that the services supplied by the owner are indeed relevant to the particular development.

### The Services

As the age of existing centres increased, so the requirements to keep them in repair also increased, often resulting in major refurbishments of schemes that were beginning to appear tired, especially when measured against newer schemes within the local catchment. These have been the cause of many disputes between the parties over the years, where an owner has attempted to improve a scheme as part of a refurbishment. Certain costs under a refurbishment are properly service charge recoverable. For example, mall flooring may be breaking up in a number of areas, and the Landlord elects to completely replace the flooring of the centre. Only those areas that require repair should be recovered via the service charge with the Landlord bearing the remaining costs. This however can cause further problems in that the existing flooring may not be economically available, and adjustments should be made to what element is borne by the tenant (via the service charge) and what is borne by the Landlord.

A further example would be the case of closed circuit television (CCTV) systems. It may be that the existing CCTV cameras may no longer be available, due to improved technology, and the Landlord may have to replace existing fixed cameras with better types. An allowance to replace the existing cameras with like-for-like should be made, and recovered via the service charge, with the shortfall being met by the Landlord, as this in effect is betterment of the existing system. One factor to consider is whether the intention is to improve the existing system or to repair the existing system by replacement, even if the new system is an 'improvement' upon the old due to enhancements in technology. It may be that the 'improved' system will reduce costs elsewhere, such as reducing ongoing maintenance costs, reduced costs for increasingly difficult to obtain spares etc. and a view should be taken as to whether it is fair and reasonable for these items to be met by the service charge.

As a general rule, replacement of an existing item should only occur where that item is beyond economic repair, and should not include betterment to that system, unless such betterment would reduce ongoing maintenance and running costs demonstrably.

Owners will sometimes hire purchase equipment and recover the costs though the service charge, however, if this is the initial provision of such equipment, this should be deemed as capital expenditure and again irrecoverable.

Services that are labour intensive, such as cleaning, security and the administration and management of a building will usually include all costs associated with these items, such as pension contributions, vehicle provided for the building manager in relation to his or her role (if any) and this cost centre will in the current market include a fee for administering the payroll. This latter element usually includes costs associated with employer-related issues, and tends to be based upon a percentage of the Administration/Management cost centre.

Many property owners are moving away from directly employed personnel for the provision of cleaning and security services, preferring to utilise outside contractors. There are benefits to this in that, if the contractor is not performing to the required standard, the contract may be terminated (often with penalties incurred, which again may be service charge recoverable). One such benefit is the cover of long-term sickness. Personnel directly employed must be covered but still receive payment; whilst, in the case of a contractor, he must bear this cost yet continue to provide the requisite number of staff to adequately supply the service.

A further benefit of contracting out, and one which should be supported by occupiers, is that the service provider should be employed upon a performance contract. These standards should be established and measurable, and should be regularly reviewed with the service provider. The contract should specify the standard to be achieved, rather than the method, and thus the contractor is obliged to determine the process, particularly in light of tendering of the contract, which should always occur regularly for large cost services.

A relatively new initiative is that of the Facilities Management (FM) contract, whereby one contractor provides usually three of the basic services required at a building, generally security, cleaning and building maintenance. Often with one contractor in place, economies of scale can be achieved resulting in a reduced cost to the service charge, however in experience complacency can occur. Again, regular re-tendering exercises and performance reviews should be conducted by the building

manager to ensure that value for money and high standards are being achieved.

Energy costs in relation to common parts are also service charge recoverable. Recent alterations as regards competition made the market place more favourable for the consumer. Energy costs can be a significant item and the purchase of energy should be tendered using bulk buying and by negotiating the lowest possible tariffs. Major Landlords often effect substantial savings by contracting with one supplier to provide energy at all their schemes, and tenants should support this.

One particular area of contention between occupiers and owners of shopping centres is the issue of promotion. Many retailers have their own promotional campaigns, and are thus reluctant to spend increasing sums on this item through the service charge. Often these increases are incurred as local competing centres are increasing their own promotional activity. This often disgruntles tenants who occupy units in both schemes, as it can be seen as detracting from the sales at one unit, to increase sales at their other unit in the rival centre.

Promotions are intended to increase footfall within the scheme, thus increasing sales, and the occupiers' ability of paying a higher rent to the owner. Hence both parties benefit from promotional activity, and the cost of promotion should thus be shared between owner and occupier. Tenants should always attempt, at lease negotiation stage, to have promotional activity split equally between owner and occupiers, and the Landlord's contribution should be evident on service charge accounts.

At least a percentage of mall income received from areas such as promotional stands and mall barrows should be credited to the benefit of the service charge. These types of occupier normally operate under a licence and pay a single fee to the owner, however they benefit from the services that the tenants are paying towards. It is only equitable therefore for at least a contribution of the licence fee to be credited to the service charge.

Mall income is also generated in other areas, for example the use of public telephones, children's rides and photo machines. Where these items are a cost centre to the service charge the income generated from these activities should be 100% credited back. Over recent years public telephone income has seen a sharp decline with the increased usage of mobile phones, and the

property owner should attempt to minimise any shortfall, by, say, reducing the number of public telephones placed within the malls.

Cardboard and other recyclable materials, wherever possible, should be recovered in order to minimise the detrimental impact upon the environment. This will also assist in reducing the amount paid towards landfill tax, which is currently increasing at an alarming rate. Indeed, any initiatives towards making the building more environmentally friendly should be sought. One particular initiative that was supported by tenants was where a building manager sold waste produced at the scheme to a waste contractor, who then compressed the waste to be burnt in power stations. This had a two-fold effect in reducing the amount of landfill tax and generating a small income to the service charge.

Car parks can be a particular issue. Either the car park should be a separate cost centre not service charge recoverable and the property owner retains all income generated and meets the costs associated with the car park; or the car park income is credited back to the service charge with the costs associated being borne by the tenants. Expenditure in relation to lifts serving the car park, in the former case, will commonly be borne equally by the service charge and the property owner.

Many Landlords also provide general office services for the benefit of the tenants, such as conference room hire, fax and photocopying services. Again income generated from these areas should be shown as a credit on the service charge accounts, as they are a cost centre borne by the tenants.

Sinking funds and reserve funds are generally avoided in modern leases by both owner and occupier, however still exist in older leases. This is generally due to difficulties over taxation and accountability. A sinking fund is where the property owner builds up a fund for major items of plant to be replaced in forthcoming years. A reserve fund is built up to equalise expenditure in respect of regularly recurring items. Regardless of title, the fund should be held in trust on behalf of the tenants, as it is their money, and not the Landlords.

Both funds are generally not considered popular amongst multiple retailers, however can be beneficial for single shop traders. The occupier may not realise the benefit of the contributions made towards either fund if he disposes of the unit. Major multiples tend to prefer not to contribute towards sinking/reserve funds as they would prefer to utilise the money locked up in

these funds, and can usually meet any increased contributions brought on by such increased expenditure. Smaller tenants may on the other hand welcome a sinking fund, as they even out cash flow over a period and avoid heavy demands. Tenants should always request details of the fund account.

Management fees were traditionally set at a percentage of the total cost of the services provided (excluding the management fee itself), usually 10%. This however can have a detrimental effect, as a managing agent or property owner who elects to manage in-house, has little incentive to control the cost of services. Indeed, an agent who seeks to drive the service charge downwards is penalised rather than rewarded. Hence there are now moves being made toward a flat fee plus incentivised bonus. Management of the development should be on a performance related contract and regularly benchmarked.

Where other professional advisors, such as a building surveyor, are employed to advise upon specific large items of expenditure, for example, replacement of the roof of a scheme, a management fee should not be levied upon the contract itself, only upon the professional advisor's fee. This avoids double counting of management, as the managing agent is only managing the building surveyor not the contract.

Sunday trading service costs are often apportioned between those tenants who elect to open, and recovered separately from the main service charge. However with more and more tenants electing to open it is generally accepted that the main service charge runs for a full seven-day period. This saves administration time and costs for both Landlord and tenant. This could encourage those tenants who do not open for trade on Sundays to revise their thinking, if they realise they are paying towards the costs. It can however be detrimental to smaller traders with low staff levels with rostering of cover.

## Retail parks

A more recent phenomenon than the shopping centre is the emergence of out-of-town retail parks, brought about by a number of factors including the lack of available, cheap land within town centres to permit construction, and limitations placed upon developers by Government planning constraints. Further, with the surge in private car ownership, and increased leisure time for the customer, access by the shopper was far easier than by reliance upon a slowly deteriorating public transport system. Hence edge- and out-of-town retail parks were deemed the answer, and growth in these developments was rapid.

Rents are historically significantly lower per sq. metre than for units within town centre based shopping centres. Retail parks tend to be constructed with large-space units, with single occupiers per unit, and the onus to repair and maintain the individual buildings is usually, although not always, placed upon the occupier. Common parts areas tend to be the management suites and car parks, although a number of retail parks also have areas more traditionally resembling a standard covered mall similar to a shopping centre.

Other costs and services resemble much the same as in shopping centres, including cleaning, security, administration etc. although energy costs tend to be substantially lower, as are costs associated with plant and equipment, since there are fewer of these items in place.

As more open A1 use retailers populate retail parks they demand a greater level of service provision than that traditionally offered, and the associated cost can be troublesome to the original tenants.

Now however the trend appears to have reversed, with the move centring again once more on the high street and the in-town shopping centre. Coupled with some relaxation on planning regulations, the development of new shopping centres is being seen, revitalising the main retail areas of a number of towns. This has had a knock-on effect on retail parks that are attempting to retain their customer base previously enjoyed during the boom for this type of development. Unfortunately this has often had a severe effect upon the service charge, and sizeable increases, particularly in relation to promotion costs, are being seen by occupiers at many schemes they are represented in, as the retail park attempts to compete. For the occupiers, many are represented both within the town centre schemes and the retail

parks, and sales are being 'cannibalised' to the detriment of one or more of their units to benefit the other, rather than increasing their overall turnover.

One major aspect where retail parks tend to differ from shopping centres is that of car parking. On the retail park this tends to be free, hence there is no income generated to the benefit of the service charge. As the car park deteriorates, tenants are being asked to meet large sums to place these back in good repair.

A further issue that has increasingly affected retail parks over recent years is a lack of security due to their open nature. Ram raiders, car cruising and travellers setting home upon the car parks are just some of the problems manifested. The costs associated with solving these problems can be high, and are normally recoverable via the service charge. Further such issues can detract from the customers feeling of safety whilst at the scheme thus reducing visitors and hence unit profit.

Cleaning can be particularly high for retail parks, since many of the areas are open, with wind-blown rubbish necessitating a higher than expected cost.

External electrical equipment, such as CCTV systems will often require a greater degree of repair and maintenance as the equipment is more exposed to the weather, again increasing costs.

Many occupiers are thus seeing rapidly escalating costs where they occupy a unit on a retail park, often significantly above the rate of inflation, which is disadvantageous to both Landlord and tenant. The tenant sees a decrease in store profit, which could result in empty units, and this in turn reduces the amount of rent they are able to pay, resulting in a decrease or at the least a nil increase at rent review, hence the Landlord is unable to realise the value of their investment.

## **Offices**

Service charges in today's modern office blocks run in a similar fashion to shopping centres. In the main there tend to be fewer common parts within an office block to a shopping centre, and thus staffing levels required to run the building efficiently are lower.

The Services (as they differ to Shopping Centres)

Occasionally the property owner will retain the liability to conduct repairs to the structure and maintain any plant even where the building is let to one tenant, with the occupier then bearing 100% of the service charge. Where the building is multi-tenanted, apportionment should follow the clause within the Lease contract, and the occupier should check this.

Lift costs can create friction between the parties. For example, a tenant may only occupy the ground floor of an office building, and thus does not benefit from the lifts within. At lease negotiation stage, as in every case, only those tenants who receive a benefit from the service should pay towards that service, but it will be incumbent upon those tenants' professional advisors to negotiate beneficial terms into the Lease.

Some Landlords will include all energy costs in relation to areas of the building demised to tenants, and apportion accordingly via the service charge. However, some occupiers may have different levels of energy usage, and care must be exercised over this. For example, one occupier may require the use of air-conditioning 24 hours per day, and it is inequitable to expect all tenant to bear this increased usage. This can also have a knock-on effect upon the expected life of the plant, so the owner must then apportion the increased depreciation costs accordingly. When analysing service costs, the occupier should remove energy costs relating to individual demise, to obtain a true picture of the service charge.

Insurance costs over recent years have increased far in excess of inflation, due to problems within the insurance industry, particularly after the catastrophic events in New York of September 11<sup>th</sup> 2001. The Landlord may elect to recover all insurance premiums, including demised areas, via the service charge, and this is acceptable, but the tenant, when analysing their service costs should remove these from the equation, to eliminate a major distortion of any cost trends.

Expenditure upon items of a capital are not generally service charge recoverable, however the occupier must always refer to the terms of the individual lease contract. For example, a Landlord may attempt to recover redevelopment of reception areas, and only those items that are in relation to repair or maintenance of existing should be borne by the service charge, as opposed to betterment.

Car parks are often provided within modern office developments, and are usually required to enable the building to be let more successfully. Individual tenants may have a number of car parking spaces let to them, under the lease contract, or more often under a separate agreement. Service costs in relation to car parking are usually apportioned by the number of car parking spaces occupied by the individual occupier, expressed as a percentage of the total number of spaces within the car park. Normal costs included within the car park schedule include security (if provided), repairs and maintenance, lighting, cleaning etc.

Modern office buildings are occasionally located within a number of blocks all owned by the same Landlord on one estate. In this case it is normal for the services supplied to the individual office block to be covered under one schedule, with a further 'estate charge' being recovered. The estate charge will usually include costs that are common to all buildings on the estate, for example, landscaping maintenance. The occupier should determine that the correct apportionment applies to both the office building they occupy and also in respect of the estate charge. The latter charge is usually shown on the same account, and, when analysing the overall service charge should be taken into account.

### **Industrial estates/warehouses**

In the main, service charges associated with these developments are not as complicated as either shopping centres or offices, usually as the individual buildings that comprise these are occupied by one tenant. The lease contract will usually place the onus upon the tenant to repair and maintain the fabric of the building, and pay for the other services used within the demise, such as supply of electricity.

The Services (as they differ to shopping centres)

The service charge will usually relate to repair and maintenance of common parts, such as roads, where these are still in private ownership, security provided for the benefit of the estate (if any), lighting of the roadways etc.

Car parking may be demised to individual tenants or shared. In the latter case it is normal for costs (generally only repair and maintenance) to be administered via the service charge.

Repair and maintenance of signage such as estate occupier boards, as opposed to individual tenant signage, is again service charge recoverable, however the provision of such signage, where it did not previously exist, should be deemed capital expenditure and not recoverable. The supply of water and drainage is also an item generally included within service charge.

As in both shopping centres and offices, it is reasonable for a management fee to be levied, but should be fair and reasonable, and not excessive. It should bear a relationship to the amount of management time involved to manage the development and include a fair and reasonable profit for the Landlord/Managing agent.

## What to check for

Upon receipt of service charge documentation the occupier should check the following:

1. The Landlord should supply both the budget and reconciled account with a breakdown of the specific cost centres, and reasons for the expenditure
2. Check the service charge account against the terms of the occupational lease contract
3. Check that the correct apportionment in relation to the occupiers demise has been applied
4. If the tenant has the benefit of a service charge cap ensure that this has been adhered to and correctly applied
5. Ensure that no items of capital expenditure have been recovered
6. Check the reconciliation against the budget previously supplied, and query any major over- or under-spends. Compare against the previous history for the building to establish trends.
7. Seek professional advice from experienced service charge managers where applicable. A number of chartered surveying practices are able to offer this service including CBRE.
8. Once it has been established that a manifest error is contained within the service charge, and advice has been taken, do not pay the whole charge but pay at the previous rate pending resolution of the dispute on a 'without prejudice' basis. It is vital that the property owner is notified of this immediately and, if possible, the tenant or their representative should arrange to meet with the Landlord/Managing Agent to resolve the matters.

Under no circumstances should payment be withheld if the Landlord has fully adhered to the terms of the lease contract, as this may result in forfeiture of the Lease.

## Communication

Improved communication between owner and occupiers results in the smoother operation of the building and hence the service charge. Effective communication is the key to good management. It must be remembered that the property owner is spending the occupier's money and the latter has the right to know that this is being spent effectively, is necessary, and within the terms of the Lease.

Budgets and reconciled accounts should include explanations of what is recovered under each cost centre, an explanation of variances, a comparison with previous years' accounts, and should also include contact details of the building manager, the credit controller responsible for the development and the managing agent/Landlord. Ideally details of the responsibilities and roles of the on-site staff should also be summarised.

Regular meetings should be held with the property owner/agent and the tenants to discuss service charges. At many UK shopping centres, service charge forums have been instigated between tenants (or their professional advisors) and the Landlord, and should include the building manager. This has assisted in developing the Landlord/Tenant relationship. Often held on an informal basis, aside from the service charge discussions these also involve local issues which may affect the development, marketing, proposed refurbishments etc.

Within the UK shopping centre industry, the Property Manager's Association (PMA), a group of multiple retailers, has its own service charge sub-committee. This committee is the main retailer-led lobbying body on service charges and has within its membership most of the major retailers operating within the UK.

The PMA has been instrumental in producing a guide to service charges (Service Charges in Commercial Property - A Guide to Good Practice) with the second edition being published in August 2000. This guide is available in a downloadable format from the website ([www.servicechargeguide.co.uk](http://www.servicechargeguide.co.uk)).

The guide is relevant to all types of commercial property within the UK, as opposed to shopping centres and is endorsed by the British Council of Shopping Centres, the British Council for Offices, the British Property Federation, the British Retail Consortium, the Shopping Centre Management

Group, and the Royal Institution of Chartered Surveyors. Both Landlords and tenants should ideally aspire to the good practices the guide contains.

Also currently in production by the PMA are guides relating to the management of, and marketing within, shopping centres.

## United States

Within the US there is a trend towards inclusive rents to be paid, but in the main these tend to be Government occupational leases. America has continually refined and updated the systems used over the years, however it is not always apparent the division between rent, and the repair and maintenance and service costs levied. One note is that unscrupulous Landlords may indeed treat the element of overall rent intended to be expended upon the services as their own income, and fail to maintain the development to the required standard. All inclusive rent lease contracts tend to be linked to the Consumer Price Index (CPI), which will increase as inflation increases.

Generally the US operates a similar system to that in the UK in that the Landlord will charge a base rent plus a charge for the operational cost of the services supplied to a building, often termed fully net leases. Again there is the capability for budgetary provision and reconciliation of operational costs on an annual basis. Increasingly there appears to be a trend towards linking operational costs to CPI.

One of the major differences between the US and the UK is the length of lease contract. Typically the US has shorter terms, usually 3 to 5 year, with each way break clauses. This permits the tenant to walk away from an onerous service charge, and also permits flexibility of the tenant mix within a development for a Landlord.

Also, in relation to retail, shop fits tend to be of a significantly lower standard than that in the UK. The recently opened Bull Ring centre in Birmingham in the UK has major tenants spending £2m on their fit-outs. No tenant would expend this type of figure on a short-term lease in the US.

Some institutional lease contracts in the US contain a clause that any lease auditing procedures in relation to operating service costs are to be conducted by one of the major accounting firms as opposed to surveying practices. However to advise on the actual nature of the service charge, as opposed to accounting procedures, surveyors would be better placed to advise clients.

Thus the provisions for analysis of service charge occupational cost in the UK will generally apply in the States.



## **Continental Europe**

Within Continental Europe in certain countries the trend is towards inclusive leases, although not always the case. Germany and Italy have systems very closely linked with that in the UK, but often without the extensive lease contract clauses, which can lead to disputes as to items being recovered via the service charge. Many of the provisions that are particular to the UK are also relevant here.

## **Central and Eastern Europe**

Experience has shown that certain of these regions have in effect all-inclusive turnover rent provision, which will include service costs, although the UK systems are seen in these regions too. The occupier pays a percentage of the unit's turnover to the Landlord as rent, repairing and service costs. The occupier knows in advance what he is exposing himself to prior to signing the lease. In Moscow for example the traditional service charge is virtually unknown.

Turnover rents may be the way forward, in that both owner and occupier take the risk, however could be difficult to operate in practice, as required repairs to a property may not be carried out if occupier's turnover is particularly poor.

The nature of a Landlord financing a development is unlikely for turnover rents and shorter-term Leases in the UK, since this is guaranteed by the security of income over a substantially longer period than is experienced elsewhere globally. Financing a new shopping centre would be impossible if the major anchor store could walk away after three years.

## **Asia**

Experience has proven that property owners reveal very little of the operational costs in relation to a development, and there is little opportunity to challenge service charge in this region.

In this region, many lease contracts are of an all-inclusive type, or contain pre-agreed sums. The questions raised are such that whether these sums are fair and reasonable, and whether the costs paid by

occupiers reflect the actual expenditure incurred. The danger is that, if there is a shortfall between the sums recovered from occupiers and the amounts required to provide the services, and repair and maintain the development, then these services may be cut back by the Landlord, and the building may not receive adequate services to enable the basic operations vital for its continued use and enjoyment.

## **Benchmarking**

Service charges should be benchmarked against the industry within the country/location relevant to the property, however data available for countries will vary extensively. As with any survey, the larger the sample, the greater degree of accuracy in the results. Local property professionals should be able to provide an indication of benchmark data.

Caution must also be exercised when benchmarking a property's service charge however, as each building has its own distinct set of operational criteria, and further investigations as to why a particular development exceeds (or is below) the benchmark will be required. A benchmark is purely a guide to the reasonably expected operational costs, and not that a particular development should meet or exceed this figure.

## **Conclusion**

In the modern business world, with service costs linked more closely with various inflationary pressures rather than with property values, the profitability of a unit can be severely affected by increasing service charges. Hence the analysis and management of operational costs is ever more at the forefront of the property manager's brief. This is the case whether the unit in question is a large retail outlet in a prestigious shopping centre, a floor or part floor of an office block, or a small industrial unit on an estate.

CB Richard Ellis employ their own experts in the minefield of service charge management, and are able to effectively analyse and manage these occupational costs on behalf of tenant clients, having the global expertise to advise and negotiate on occupational service costs. We have achieved substantial reductions where service charges have been inappropriate, or outside the terms of the lease contract, including in the UK alone:

- £115,000 reduction in one client's liability for redecoration/repair costs at a shopping centre and transferred to a Landlord's capital budget
- £65,000 saving to a client in respect of incorrectly apportioned and allocated service charge
- £46,000 negotiated saving on service charge demands following increased plant usage at client unit

- £19,500 reductions due to re-addressed security arrangements within an office block, utilising recent technological advances
- £11,000 reduction in service charge following Landlords improvements to a shopping centre, which was Landlords capital expenditure
- Negotiation on budget to a service charge resulting in benefits achieved to all tenants represented within the scheme

It is not CBRE's aim to antagonise property owners, but rather to promote a working partnership with Landlords/Managing Agents, in progressing service charge management, whilst ensuring that operational costs are legitimately and properly recovered from the client and that the client benefits from the provision of these services. We are committed to adding value to our clients' business.

Peeter Pargma  
30 January 2004