Original Article

A discussion of UK commercial property service charges

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ABSTRACT As certain types of property have become more complex and customers' or occupiers' perceptions and expectations have evolved, the services provided by the owners have had to be improved correspondingly. A modern service charge may include provision for the recovery of many different properties or facilities management-related services. The existing practice of service charges recovery for commercial properties is not transparent enough to enable the tenants to understand exactly what they are paying for. The service charge costs may include enhancement of the building, where it can be justified following the analysis of reasonable options and alternatives. The practice of service charge should rest on achieving equitable benefits for both parties: the owner and the tenant.

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COMMERCIAL SERVICE CHARGES DEFINED

All businesses have to pay for property-related overheads, or 'running costs' (RICS, 2008). The objective of a service charge is to enable the landlord to recover all likely anticipated expenditure not only for the property in its present form, but also envisaging any reasonable extension or alteration in the future (Philpott and Hicks, 1994). The basic principle of service charges lies in taking the perspective of both the landlord and the tenant. In most circumstances, both parties view the importance of service charges differently, which is definitely to their own benefit. Edward and Krendel (2007) show that the landlord will want to recover all expenditure from the tenant. The tenant on the other hand will try to limit the recoverable items to the necessary services for the property. Martin (1981) defined service charges as the cost to a tenant in indemnifying landlords against actual and anticipated expenditure on the protection, maintenance and replacement of those parts and structure, finishes and equipment of the property for which no tenant is directly

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responsible. Generally, the service charge apportionment between the landlord and tenant are specified in the lease. The inappropriateness of this definition was pointed out by McGee (1984), when he stated that it only focused on the expenditures on physical aspects of the property while neglecting the other important elements that made up the service charge costs, such as housekeeping, services for cleaning and security services. The centre for advanced land use studies (CALUS) report broadened the definition of service charges to:

An annual cost to the tenant of the landlord providing services to the building in compliance with his obligations under the terms of the lease. The fundamental of service charges rests on two main items which are 'works' and 'services'. Works refers to repair, renewal, replacement, maintenance and improvement whilst services on the other hand focus to the housekeeping elements which include but not limited to the cost of cleaning, security, fuel and other related activities.

Service charges also consist of other costs that are known as sinking, replacement and reserve funds. RICS (2006) defined briefly the meaning of the abovementioned funds as follows:

On top of routine expenses on services, owners and occupiers may need to make provision for occasional one-off outlay on replacing major items of equipment (e.g. a heating system). Major expenditure of a regularly recurring nature (i.e. external redecorations) can also cause significant fluctuations in the amount of service charge payable each year.

The contribution towards the fund is made through the service charges year by year, and when the need arises for such repairs, payment is made from the fund (Morley, 2008). The establishment of such funds are seen to benefit both the landlord and the tenant. As mentioned by Morley (2008), the advantage of imposition of such funds to the tenant is an assurance of cost certainty, thus dismissing the shocking peak charges at a go, as the contribution is made over the lease period. In addition, in the case of short-term tenancy, the new tenant is only required to continue the contribution that was made by the previous tenant and not to be totally burdened with the overall cost of repair and replacement of equipment should the need arise. The landlord on the other hand enjoys the benefit of funding certainty, thus eliminating tenant disputes over one-off high service charge in a year shall the cost is claimed as and when repairs are needed.

Moran (2007) provided a specific service charges definition for commercial properties. He pointed out that service charges in commercial buildings arise when there is multiple occupation of the landlord's premise. Shopping centres, office blocks, some industrial business parks and mixed-use buildings are the types of premises designed for multiple occupation. The charges are meant to recover the cost of maintaining unlet structures, common parts and the provision of other related services. The landlord is responsible for repair and maintenance of the property, but will require the costs he incurs on these matters to be reimbursed by the tenant (Butt, 2007). In essence, the service charge composition in commercial properties usually consists of the direct cost of the services to

the business, and often this includes a management fee payable to the person or company who administer the service (RICS, 2008).

The lease and the service charge

The basic element of any service charge provision in a lease is to ensure that someone is liable for the repair and maintenance of all elements of the building or the development. All landlords are in favour of a 'clear lease' that allows them to relinquish their obligation in funding the cost of providing necessary property-related services to the tenants (Edward and Krendel, 2007). Crosby and Murdoch (1998) emphasised that a 'clear lease' should also be a 'full repairing and insuring', or 'FRI' lease. In these circumstances, the tenants will assume all responsibilities (in payment terms) for the repair and insurance of the leased property to allow the landlord to keep the premises, and will reimburse the landlord for the cost of undertaking these tasks through the service charges.

The question of the magnitude and extensiveness of responsibility for repairs, maintenance and upkeep of the property between the landlord and the tenant is a very complex and delicate situation (Crosby and Murdoch, 1998). In the case of 'leases of whole', the liability of the tenant to undertake the cost of repair and maintenance of the premise is rather simplified, as the premise is entirely occupied by a sole tenant. However, for commercial properties where 'leases of part' involve multiple tenants, a well-drafted service charge provision in the lease is a crucial element that needs special attention by the tenant to avoid future disputes with the landlord (Edward and Krendel, 2007).

Moran (2007) highlighted that the typical provision of service charges in the lease should include

- i. A definition section at the beginning of the lease that defines 'service charges' and 'services'.
- ii. A specific tenant's covenant to pay service charges.
- iii. A landlord's covenant to provide services.
- iv. Details of service charges.

The tenant's covenants for service charges are usually set out in the earlier section of the lease agreement with details on the procedures for service charges administration. The landlord's covenant in the lease is specified in the later segment in the schedule of service charges, with a focus on the list of services provided, service charges apportionment, schedule of payments and penalty on late payments (McGee, 1984).

Singh (1996) pointed out that the lease will also dictate the format of the charge. It will usually give the dates of the service charge period. Usually the period is a year, but sometimes it is a half year or a quarter year. The lease will usually set out the percentage payable by the lessee, but sometimes the lease only stipulates a 'fair' or 'just' proportion. If different groups of occupiers benefit from different services, the imposition of service charges will vary accordingly. The lease will determine whether advance payments are to be made, and, if so, whether it should be based on the previous year's cost or on an estimated cost for the year to come. There will always be provision for a final

charge at the year-end when the actual costs are known. If interim payments have been made, and they exceed the actual expenditure, the final 'charge' will be a credit. If the leases in a block do not provide for interim payments, this can present a real difficulty for all concerned (Singh, 1996).

In commercial leases, the operation of service charges is exclusively governed by the lease adopted and accordingly the main reference must be the lease (Philpott and Hicks, 1994). Therefore, in a simple term service, charges for a business lease are more 'what you read is what you get' (Silman, 2007). Many have acknowledged this view, and have understood how instrumental the lease contents are in entirely shaping the service charges administration of commercial landlord and tenant relationship (Martin, 1981; McGee, 1984; Forrester, 2004; Edward and Krendel, 2007; Moran, 2007). The precise wording of the clauses create the landlord's obligation to provide services to the tenant, and thus entitle him to a service charge (Freedman *et al*, 2002). This is supported by Freedman *et al* (2002) in that some leases contain provisions entitling the landlord to vary the services or to discontinue the services that he considers obsolete entirely at his discretion.

However, Freedman *et al* (2002) noted that where the service charge is ambiguous and when dispute arises, the court will generally interpret this narrowly and determine the ambiguities or uncertainties in the tenant's favour. Therefore, despite huge empowerment given to landlord in varying the services in the lease, there is no presumption that it will recoup the landlord's entire expenditure. They further added that the only exception to full recoupment of service charges occurs when the lease allows for the services to be supplied by a management company that is controlled by the tenants.

Freedman *et al* (2002) further elaborated the two types of clauses that signify the chargeable service charges costs in the lease agreement. First, the traditional contribution clauses contain only brief and restricted contribution clauses, such as

to pay a fair proportion of the cost of maintaining and repairing party walls and structures, shared pipes and wires, and other things used in common.

The provision of such old-fashioned service charges clauses, which only focus on the replacement and maintenance costs of the physical aspects of the premise, failed to recognise true services elements (such as portage, heating, cleaning and other similar activities). In this circumstance, the tenant will not be charged based on true services activities carried out by the landlord, as it is not specifically addressed in the lease.

The second type is the modern service charges provisions. Freedman *et al* (2002) emphasise that there are three categories of service charges provisions that make up the clause of the lease:

- i. Those that directly link the service charge to the cost incurred by the landlord in performing his service covenants contained elsewhere in the lease.

- ii. Those that list the chargeable items (usually under the title of 'heads of charge' or similar) quite independently of the landlord's covenant.
- iii. A combination of (i) and (ii).

In the absence of any wording, neither a tenant nor a landlord can insist on including a service charge provision even when the landlord has undertaken obligations to supply the services. Irrespective of how the provision is stipulated in the lease, the primary objective of service standards should aim to achieve value for money and effective service, rather than lowest price (RICS, 2006).

What is service?

Service description is identified as 'one of the most difficult aspects of dealing with a service' (Shostack, 1992). Traditionally, customers have perceived value as the trade-off between benefit and sacrifice (Monroe, 1990), where quality is the benefit and price is the sacrifice. It has been defined as 'the consumer's overall assessment of the utility of a product based on perceptions of what is received and what is given' (Zeithaml, 1988). However, although highly accepted and vastly cited, this conceptualisation does not identify different value determinants (Heinonen, 2006).

According to Bandy (2002), service is unlike a manufactured product that has specific dimensions, measurements and features associated with it. Service cannot be easily quantified, as it is an intangible product. As such, it is difficult to ensure consistent results from those who are part of the service process because, in the absence of well-defined standards, people tend to operate from their own frame of reference, and provide the type of service they personally are comfortable receiving. As a result, it is difficult to isolate the service delivery process from the service recipient because the various expectations from the recipients themselves can affect the outcome of the delivery. Recently, it was argued that there is a lack of focus on service value scales even though there are scales for customer evaluations of product value (Petrick, 2002). Petrick (2002) developed a multi-dimensional scale for measuring the perceived service value, and identified five value determinants: quality, monetary price, reputation, emotional response and behavioural price (Heinonen, 2006).

Services to a tenant may be provided by the landlord, a management company or a maintenance trustee, depending upon expressed or implied terms of the lease agreement (Freedman *et al*, 2002). Theoretically, the landlord has to buy all the services before he is reimbursed. If the lease allows the landlord to recover interest, then at least one can afford to fund the costs. If not, it will cost the landlord to provide the services, which may make him reluctant to fulfil his obligations. Generally, in return for the ability to levy a service charge, the landlord is bound by an obligation under the lease to provide the services (Singh, 1996). It is noted by Singh (1996) that the headings of services in the provision of commercial services charges are as highlighted in Table 1.

Moran (2007) stated that the services provided will include (depending on the nature of the premises) repairing, decorating and maintaining retained parts, plants and machinery; heating, air conditioning and

Table 1: List of services*List of services*

• Lifts and escalators • Air conditioning system • Standby generator • Fire fighting system • Electrical installations • Refuse compactor • Automatic sliding doors • Flood gates • Automatic car park barrier gate • Façade gondola • Watchman's clock • Cleaning services • Security services • Landscaping • Name sign • Tenants directory • Swimming pool • Gymnasium/games rooms • Squash court/tennis court • Pest control • All general repair and maintenance carried out on the building • All sundry expenses incurred for the building	• All common area electrical consumption and central air conditioning electricity consumption. • All common area water consumption and sewerage charges • Car park license • Costs for fixtures and fittings • Lightning protection equipment: ◦ Repairs and maintenance, contract costs • Building automated systems: ◦ Repairs and maintenance, contract costs • Public address systems • MATV and CCTV systems • Music royalty • Advertising and promotions • Radio pager for management staff • Rental, license and repairs • Sinking funds • Financial expenses on money borrowed for the maintenance of the complex • Insurance premiums • Professional property management fees • All employment charges for labour directly employed for the management of the building

Source: Singh (1996).

lighting of retained parts; fire precautions and equipment; refuse collection; cleaning; garden and landscape maintenance; services to retained parts (water, gas, electricity, toilets); maintaining structural parts of the premises boundary features; signage; payment of outgoings for retained parts; legal and other professional fees; employment of staff to provide security; reception; management and administration; CCTV systems; and promotional activities (shopping centres only). He further added that the cost of the items may vary a great deal, with cleaning and security accounting for about half of the total expenditure.

A broad perspective of the services provided in the context of service charges is that it must be beneficial and relevant to the needs of the property, its owner, its occupiers and their customers (RICS, 2006). In regard to the promotion of uniformity of services within the context of commercial service charges, RICS (2006) introduced industry standard cost headings. There were 22 cost items that were categorised under eight main headings, and these were introduced in Appendix E1 of RICS Code of Practice for commercial service charges, summarised in Table 2. These headings are largely compatible with the Office Service Charge Analysis Report developed by Jones Lang LaSalle and the International Total Occupancy Cost Code and initiated by IPD, which RICS believes will ease and facilitate benchmarking within the property industry (Calvert *et al*, 2006).

However, the effort of RICS in promoting best practices in the introduction of common service headings are yet to be widely accepted by the industry. Calvert *et al's* (2006) research found that there are currently 2341 headings that are used by the respondents in his service

Table 2: Composition of headings in service charges

Service headings	Cost items
Management	1. Management fees 2. Accounting fees 3. Management resources 4. Health, safety and environment management
Utilities	5. Electricity 6. Gas 7. Fuel oil (Heating) 8. Water
Soft services	9. Security 10. Cleaning and environmental – internal and external cleaning, hygiene services, waste management, pest control and landscaping. 11. Marketing and promotions
Hard services	12. Mechanical and electrical services 13. Lift and escalators 14. Suspended access equipment 15. Fabric repairs and maintenance
Income	16. Interest 17. Income from commercialisation
Insurance	18. Engineering insurance 19. All risks insurance cover 20. Terrorism insurance
Exceptional expenditure	21. Building insurance 22. Forward funding – sinking funds, reserve funds and depreciation charges

Source: RICS (2006).

charge study database. Details of the most frequently used names in budgets and certificates are highlighted in Table 3. Inconsistency that exists in the service elements identified in Calvert *et al's* (2006) study shown that the current practice of commercial service charges are way behind best practice. Undoubtedly, this area of commercial service charges perspective would be an interesting avenue to be explored further.

COMMERCIAL PROPERTY SERVICE CHARGES – THE TENANT PERSPECTIVES

The good landlords will always generate higher rents and have higher occupancy. If they treat you as a paying guest rather than a financial instrument in occupation, it is more pleasant all round, and more profitable for them in the long term. People have memories and leases do expire
Kingsley Lipsey Morgan and IPD (2007).

Since McGee's (1984) study until the recent 2007 UK occupier satisfaction index findings, tenants' concerns over the quality of services provided by the landlord as compared to the service charges paid by them are remaining unresolved (McGee, 1984; Kingsley Lipsey Morgan and IPD, 2007),

At times when market is driving rents higher and higher, value for money will be a key issue for occupiers in the choice of property. Landlords will have to improve if they are going to survive in a hyper-competitive market.

Table 3: Most frequently used names in budgets and certificates

<i>Most frequently used names in budgets and certificates (Top 39 of 2341)</i>		
<i>Cost name</i>	<i>Number of documents</i>	<i>Mentioned percentage</i>
Management fees	1564	87.5
Electricity	1521	85.1
Cleaning	1227	68.6
Security	1086	60.7
Gas	1025	57.3
Water	984	55.0
Telephones	650	36.8
Insurance	650	36.8
Landscaping	626	35.0
Lift maintenance	621	34.7
Refuse collection	613	34.3
Window cleaning	607	33.9
Pest control	594	33.2
Health & safety	504	28.2
Staff costs	466	26.1
Professional fees	439	24.6
Lifts	424	23.7
Health and safety	405	22.7
Audit fees	398	22.3
External repairs	356	19.9
M&E maintenance	331	18.5
Security equipment	311	17.4
Internal repairs	260	14.5
General repairs	256	14.3
Repairs and maintenance	248	13.9
Rates	242	13.5
Sundries	240	13.4
M&E	233	13.0
Fire precautions	227	12.7
Building maintenance	211	11.8
Water treatment	208	11.6
Electrical repairs	205	11.5
Miscellaneous	205	11.5
Floral plant displays	201	11.2
External repairs and maintenance	194	10.9
Office running costs	190	10.6
Water rates	185	10.3
General maintenance	185	10.3
Cleaning contract	183	10.2

Source: Calvert *et al* (2006).

Gone is the time when the property owner insisted on the ideal ‘take it or leave it’ position. The landlord–tenant relationship has moved from a demand-driven space market to a paradigm where the landlord acts as a service provider and treats his tenants as valued customers. As noted by Dogge and Smeets (2004 cited in Appel-Meulenbroek, 2008), only satisfied tenants are committed to promoting a higher tendency of loyalty to their landlord. Failure of the landlords to envisage this basic fact will make tenants unhappy, and thus their decision to move is inevitable.

So what makes the tenants happy? It is instrumental for the landlords or the landlords’ agents to view this issue seriously, especially with no statutory protection to the tenants against service charges matters in the commercial lease (Forrester, 2004; Moran, 2007). The point is also raised by Cooke (2007), who mentioned that at present, the tenants’ views are that existing commercial leases are written on the basis of what tenant has

to do and what the penalties are should they fail. On the other hand, the landlords have all the intention to create a lease that provides a building that has to be fully maintained and where all the costs are to be met by the tenant.

If this perspective needs to change, perhaps it is worthwhile for the landlord or his agent to look at Hedley and Morgan's (2007) findings in the 2007 UK Occupier Satisfaction Index. This three-year research project measures occupier satisfaction across the retail, office and industrial sectors of UK property, and focuses on hard, rather than anecdotal, evidence of what occupiers really think.

The research revealed six critical factors that are important in the eyes of the tenants in nurturing a sustainable landlord-tenant relationship. The criteria on flexibility, partnership, responsiveness, sustainability, value for money and faster pace of change are found to be the key indicators. Based on this study, Hedley and Morgan (2007) summarised each criterion, as highlighted in Table 4.

Based on the summary, the issues that triggered service charges matters are specifically highlighted in two criteria regarding challenges, namely 'responsiveness' and 'value for money'. Generally, the respondents in the survey are frustrated by the landlords' slow response time. The tenants' agonies in 'responsiveness' are worsened by the poor standard of services provided by the landlords. The occupier, therefore, would like to see significant improvement in the area (Kingsley Lipsey Morgan and IPD, 2007). The Occupier Satisfaction Index 2007 report expressly prompted the issue of poor 'value for money' in service charges as major grievances by the tenants. The dissatisfaction of the leaseholders over this item is extremely intense, as they perceived that service charges are seen as a money-making agenda for property owners. The tenants in the survey are unanimously calling for greater transparency and accountability around the service charges. With the service charges' annual rise above the inflation rate, Kingsley Lipsey Morgan and IPD (2007) in OSI 2007 also reported that the occupiers have found that the service charges annual increase is not sustainable, and cry for the issue to be addressed by the property industry.

In a nutshell, it is proven that the devotion of customers and their satisfaction are two of the primary goals in most businesses. The case is also applicable to the UK property industry, as noted by Kingsley Lipsey Morgan and IPD (2007) in OSI 2007 that landlords do suffer when occupiers leave for various reasons. The OSI 2007 report also mentioned that tenant dissatisfaction over service-related matters such as service levels, service charges, speed of response and degree of support by the property owner are some of the notable factors that spark the decision for tenants to terminate their leases. It is instrumental for the landlords to foster a good relationship with their tenants by understanding what matters most in the eyes of the occupiers. According to Cooke (2007), the last thing that a respectable landlord would wish is to be accused by the tenant of being someone who spends his financial contribution on a building in which the occupiers have no real input regarding how the money is spent, nor in the appointment or the quality of the landlord's managing agent, the person appointed to oversee that expenditure.

Table 4: Six critical factors of a sustainable landlord and tenant relationship

Challenge	Facts	Summary
Flexibility	<ul style="list-style-type: none"> Two in a three say that they are able to find commercial property of the right size and location. Four in five are satisfied with the specification and build quality. One in two is dissatisfied with the lease flexibility and ability to break their leases. One in four thinks that the availability of lease terms at a price that they are willing to pay is poor. 	<ul style="list-style-type: none"> The majority of occupiers can secure property of a type, specification and quality that meet their needs. Only minority of occupiers complain about rental levels – two out of three occupiers feel that they receive 'average' or good value for money for the money of rent they pay.
Partnership	<ul style="list-style-type: none"> One in five thinks the level and style of communication is good. One in two thinks the property industry's understanding of their needs is poor. One in two does not feel a valued customer of the property industry. Six in 10 think their business has stronger relationships with supplier outside the property industry. 	<ul style="list-style-type: none"> Occupiers do not feel 'valued customers'. They aspire to a style of relationship they receive from other major business suppliers. Occupiers want property owners to show a greater understanding of their needs and more direct contact with their landlord. Smaller occupiers feel particularly undervalued in the property market.
Responsiveness	<ul style="list-style-type: none"> Only one in two thinks that responsiveness in the property industry can be described as good. 	<ul style="list-style-type: none"> Some occupiers believe that they are paying for inefficiencies through higher rents and service charges. Occupiers feel frustrated by the lack of responsiveness from property owner and managers.
Sustainability	<ul style="list-style-type: none"> One in two thinks that the property industry has made poor progress in environmental initiatives. 	<ul style="list-style-type: none"> Environmental initiatives have become important to occupiers, who want a more innovative approach to be taken by the property industry. They feel strongly that property owner should at least share the cost of meeting the new environmental standards.
Value for money	<ul style="list-style-type: none"> One in two thinks that service charges represent poor value for money. 	<ul style="list-style-type: none"> Occupiers stress the need to keep property costs down with particular emphasis being placed on accountability in service charges.
Pace of change	<ul style="list-style-type: none"> One in three thinks that the UK property industry provides poor value for money. Four in 10 say that their satisfaction has improved over the past 3 years. 	<ul style="list-style-type: none"> Occupiers perceived that the UK property industry is becoming more customer-focused, but pace of change is perceived to be too slow. Commercial property in the United Kingdom is perceived to be expensive when compared to the global market. All landlords are not the same – some large landlords are seen to be more responsive and willing to change.

Source: Hedley and Morgan (2007).

THE ISSUES AND CONFLICTS OF COMMERCIAL SERVICE CHARGES

As certain types of properties have become more intricate, and both customers and tenants' expectations have changed, building owners are challenged to provide quality facilities-related services (Calvert and Lockyer, 2005). The service charge element that is imposed on a tenant as part of the rental rate should explicitly justify the value and quality of

SERVICES CHARGES ARE:

Described by Lawyers drawing up the lease,
They are incurred by Building Managers,
They are paid for by Accountants and
They are allocated to Tenants by Managing Agents.

The business term for this is 'not joined up'

Figure 1: Confusion over service charges.
Source: Calvert and Lockyer (2005)

services rendered to at least meet the perception and expectation of the tenants and building occupiers.

Calvert and Lockyer (2005), as highlighted in Figure 1, further stated that the trouble with service charges is that they are variable in name, variable in nature and variable in the timing of their impact on the tenant's budgeting and accounting processes, and that the matter is getting worse. The industry has no enforceable code of practice, every lease is different and there are few legal requirements. Rents are clear, but service charges are the added extra, and sometimes hidden, cost of being a tenant.

Taking the issue further from the Calvert *et al* (2006) study, the following issues are identified as crucial matters that need serious attention in the commercial service charges industry

Issue 1: Service charges apportionment

There are several methods that are used in determining the service charges for commercial buildings. The approaches vary from a simple straightforward method to one that requires a complex formula of calculation (Freedman *et al*, 2002; RICS, 2006; Edward and Krendel, 2007; Moran, 2007).

Fixed sum or fixed amount method

The fixed sum method is the simplest method of service charge apportionment. The advantage of using this method for both landlord and tenant is the clarity and certainty of the amount that is charged (that is, £1000 per month) (RICS, 2006). As noted by Edward and Krendel (2007), the landlord enjoys the advantage of elevating his management expense, as no calculation is required in the determination of the charges. Tenants, on the other hand, will also benefit from this approach, as the cost variables are unlikely to vary significantly, with little risk of unforeseen expenditure, especially in the short leases tenancy (RICS, 2006). However, this method is seen to be rigid and inflexible. It will easily lead to under- or over-service cost recovery, which is a definite disadvantage to either the landlord or the tenant, respectively (RICS, 2006; Edward and Krendel, 2007).

Fixed proportion

This approach is also known as the fixed percentage method (Freedman *et al*, 2002; RICS, 2006). The fixed proportion apportionment method shared similar advantage as the fixed sum approach in that it is unambiguous. Edward and Krendel (2007) noted that the charges will

require some calculation, as each tenant is required to pay the sum according to a fixed percentage of the total cost incurred by the landlord in providing property-related services. The method provides a clear computation of the cost distribution; however, it fails to factor in the difference in service use that exists between each of the tenants. In his criticism of the technique, Edward and Krendel (2007) shows that a tenant might find himself subsidising another tenant whose use of the services is higher than average. The suitability of the approach is restricted to small commercial premises with a few similar units (Moran, 2007).

Fair proportion

The lease sometimes indicates that the service charges are to be apportioned as 'fair' or 'reasonable' or 'proper'. The fundamental element of this approach is to ensure that no occupier is disadvantaged (RICS, 2006). Therefore, Freedman *et al* (2002) suggests that the interpretation of 'fairness' must take into consideration other relevant factors such as the length of unexpired terms and the limited benefit that tenants would obtain from such expenditures. Usually, the lease will also indicate that the apportionment will be derived by a landlord surveyor that acts as an expert to avoid any discrepancy in the calculation of service charges (Freedman *et al*, 2002). The landlord in these circumstances enjoys the benefit of having full flexibility via full recovery of service charge costs (RICS, 2006). The potential drawback of using this method is the justification of the fairness element adopted in this approach, as Edward and Krendel (2007) highlighted the fact that what seems reasonable to the landlord might not be acceptable to the tenant.

Rateable value

The method of ascertaining service charge as a proportion of the rateable value of the commercial premises is also one of the approaches, that is, to be based on calculation (Edward and Krendel, 2007). The occupier's service charge proportion is to be ascertained as the percentage that the rateable value of the unit occupied bears to the total rateable value of the lettable parts (excluding common areas) of the premises (RICS, 2006). Many writers have spotted disadvantages of adopting this method (Freedman *et al*, 2002; RICS, 2006; Edward and Krendel, 2007; Moran, 2007). Among the criticisms highlighted by Moran (2007) is the failure to identify a specific correlation between rateable values of a property and the cost of providing property-related services to the tenant. He also mentioned that this technique has the tendency to create undue administrative and accounting difficulties for the reimbursement of charges paid if the tenants successfully appeal the assessment made by the valuation office. In addition, the determination of service charges has become more complicated in the event of property revaluation and property value, and the determination of the rates can change outside the control of the interested parties (Singh, 1996 and Edward and Krendel, 2007). The disadvantages of using this method have surpassed its benefits for both landlords and tenants. The complexity of the approach to justify fairness to the occupiers has made it a less favourable method of service charge apportionment (RICS, 2006).

Floor area

There are two methods that fall under this category. The first method as described by Edward and Krendel (2007) is also known as simple unit proportion. In this approach, the overall costs are divided evenly by the total units in the development.

The second technique is based on the floor area occupied, where the service charge payable is proportionate according to the floor area occupied against the total floor area from time to time (Freedman *et al*, 2002). This method is the most common method used in the practice of service charge apportionment, and is deemed the fairest by many authors (Singh, 1996; RICS, 2006; Moran, 2007). Moran (2007) started that the standard floor area is used as the ratio of the unit to the lettable part of the premise. However, the ratio needs to be recalculated in the event of any alteration made to the building that changes the floor space (Freedman *et al*, 2002). Freedman *et al* (2002) mentioned the usage of two means of measurement that are used in the calculation of floor areas. First, the office and retail property will use net internal area as the ratio of calculation. Second, the industrial premises will use gross internal area as a basis of measurement. RICS (2006) added that the industrial and warehouses, including ancillary offices may alternatively use gross external area as the basis of the ratio. Freedman *et al* (2002) also highlighted the fact that the calculation method must be consistent and ideally specified in the lease. To sum up, he suggested that a provision for verification of the measurement must be made by a competent and qualified surveyor appointed by the landlord as a measure to avoid disputes by the tenant.

Weighted floor area

The weighted floor area apportionment method is a sub-category of ratio floor area, and is usually used to even out the use of services in multi-let premises such as shopping complexes (Freedman *et al*, 2002; Edward and Krendel, 2007). In current practice, there is no standard weighting formula that is applicable to specific premises. Among the most common weighted mechanisms that are used is the discounted points system, reducing scale of percentage and the discounted multiplier method (Freedman *et al*, 2002; RICS, 2006). Freedman *et al* (2002) further indicated that the lease would normally specify how service charge points are allocated to each unit according to the space occupied. The floor is set on a reducing scale, and the service charge is apportioned to the total score of the tenants. In retail property, Freedman *et al* (2002) and RICS (2006) show that the weighted floor area is also used to reflect the benefit that anchor tenants bring to a shopping centre. The common basis of argument by the small tenant is that the anchor tenant should be charged a higher service charge cost, as their customers are more in numbers if compared to the customers of the smaller retail occupiers. In resolving the 'chicken and egg' dilemma faced by the tenants, the commercial service charges codes introduced by RICS (2006) clearly specified that the concession given by the landlord to the anchor tenant will be met by the landlord and not be distributed among the other tenants in the shopping complex.

Uneven share services basis

Undeniably, not all of the tenants in a premise enjoy an equivalent level of services provided by the landlord. In coping with this issue, Singh (1996) and Freedman *et al* (2002) noted that this method of apportionment is more equitable, as it uses a differential rate for each tenant depending on their access and utilisation of relevant services. Freedman *et al* (2002) added that in most situations, the approach is commonly applicable to a mixed-use commercial building. In tandem, the lease must clearly specify the usage of this method, rather than a common practice of single percentage of total cost. Otherwise, none of the tenants are able to challenge the matter, despite not enjoying any benefits from the service provided by the landlord.

Varying fixed proportion

This method of apportionment arises in the situation where the landlord needs to alter the service charge provision and wishes to proportionate the new costs among the tenants (Freedman *et al*, 2002). According to Freedman *et al* (2002), there are two avenues that empower either the landlord or his surveyor to vary the service charges proportion. The first circumstance is when the landlord is able to obtain the prior consent of all tenants. The second scenario that allows the landlord to vary the services is when he can secure a court decision, in the event that the tenants refuse to accept such variance.

Specially requested services

This type of apportionment is usually imposed particularly to the tenant who wishes for specific services that might not necessarily be required by the majority of tenants in a commercial property. Freedman *et al* (2002) stated that in the case that there is no provision for recovering the cost of providing such services through a 'sweeping clause', the landlord has to make an arrangement for the tenant who requested the services to pay the entire additional cost.

Indexed service charges

In this method, the calculation of service charges is linked to a published index such as an oil and gas price index and inflation rate (Freedman *et al*, 2002). However, Freedman *et al* (2002) indicated that this approach is only applicable to the specific industries. For example, property that heavily relies on oil and gas such as factories or plant and machineries, the service charges are linked to the oil and gas price index. The other limitation of applying this method is the heavy dependability of the method on the body that computes the index. As the variables are not within the jurisdiction of the lease, any drastic changes in service charge calculation will lead to tenants' grievance and dissatisfaction.

Despite the numerous apportionment approaches that are noted in this paper, there is still limited research that was carried out in understanding the suitability of each of the calculation methods for commercial properties. As mentioned by Karas (2005), the landlord action in ascertaining a proper mechanism remains one of the critical dispute areas in the administration of commercial service charges. Calvert *et al*'s

(2006) study also emphasised a parallel view to Karas' (2005) opinion. He stressed that the basis of service charges apportionment between tenants is often unclear.

Issue 2: Best practice guidelines for commercial service charges

In the United Kingdom, RICS code of practice 'Service Charges in Commercial Property' came into force on April 2007. The later version of the same code for Scotland and Northern Ireland came into effect on 11 September 2007 and took effect commencing April 2008 and any date thereafter (RICS, 2006). The code is promoted by RICS as a set of guidelines of best practices in the administration of service charges for commercial property. It contains nearly ninety recommendations that rest on the basis of service charge transparencies and 'not for profit, not for loss' (Rodrigues, 2006; Silman, 2007). This new guideline, produced through years of best practice implementation, derives the elements for cost classification by managing agents through strict monitoring by the appointed government agency. The guide encourages landlords and tenants to use it in the interpretation of service charges clauses and in resolving differences. The recent version of the RICS code expects the practitioner to use the recommendations even though it is not binding (Moran, 2007).

The focus of the newly introduced RICS code is to harness a solid relationship between the owners and the tenants of commercial properties. According to White (2006), the code aims to achieve three objectives. The first intention is to minimise conflict that exists between the parties with service charges scope. The second intention is to ensure that the total service charge provision is on a 'break even' basis. Finally, the code is established to encourage better communication, and generate transparency between the landlord and the tenant. The code focuses on the role of both the owner and the manager in promoting best practices towards duty of care to the occupiers, with empowerment to the tenant to challenge the cost distribution, if necessary (Silman, 2007).

Silman (2007) noted that all 86 recommendations highlighted in the code are divided into six main headings, as follows:

- Management
- Communications
- Transparency
- Service Standards and Provision
- Administration
- Additional Shopping Centre Services

Under each heading, the roles and responsibilities of various parties in service charges provisions are thoroughly explained. The code also cleared up several ambiguous areas that have been noted as sensitive areas of service charges disputes between the landlords and the tenants. The code clearly explains elements such as expenditure on fabric, plant and equipment that imposed by the landlord to the tenant, landlord responsibility to continuously benchmark the prices of services rendered to occupiers, treatment of income generated from the general areas,

service charges method of apportionments and matters concerning sinking and reserve funds. These are the common grounds of service charge disputes between the landlord and the tenants. Nonetheless, the code also provides access to alternative dispute resolution for any disagreement over service charges (Silman, 2007).

However, the newly introduced code is not intended to override existing leases, and the service charges provision in a lease will still prevail as the ultimate source of reference that binds the commercial landlord and tenant (Silman, 2007). The other valid concern on the effect of the code was spotted by Barass (2006), wherein he mentioned that the principles in the code are intended for the new leases and lease renewals commencing in April 2007 for the United Kingdom and Wales and a year after for Scotland and Northern Ireland. There are no specific guidelines given in relation to leases that are entered into before the code commencement date.

Even for new leases, the commercial property industry is yet to view the application of the code in real action (Silman, 2007). Calvert *et al* (2006) addressed his apprehension over the magnitude of problems that RICS underestimated before implementation of the standards. The study led by him in 2006 revealed that the industry is unlikely to achieve the standards that are set by the code in a short period of time. The summary research undertaken by Calvert *et al* (2006) on the achievement of the industry against the code expectation is summarised in Table 5.

Perhaps the result of his study at that juncture was limited to the six-month time frame after the code was introduced in June 2006. Nevertheless, Calvert *et al's* (2006) recommendations in his research are worth looking into should all parties in the commercial property industry wish to elevate the existing service charges practice to a better standard. The setting of his view across major stakeholders is detailed in Table 6.

Issue 3: The financial aspects of commercial service charges

The business value for commercial service charges in the United Kingdom is enormous. As an example, Calvert *et al* (2006) stated that the figure for multi-let office service charges alone for 2005 gives an average actual service charge bill of £6.64 per sq ft. Therefore, an estimate of total 2005 office service charges in England and Wales of £4.41 billion is an increase of £820 million (22.8 per cent) over the previous year. He further added that the UK Government figures put total office space for England and Wales in 2005 at 871 million sq ft (Department for Communities and

Table 5: RICS code requirements

<i>RICS code of requirement</i>	<i>Current achievement</i>
Budgets must be delivered 1 month before the start of the year	4%
Certificates must be delivered within 4 months of the end of the year	21%
Management fees must be a fixed cost	22%
Interest must be credited to service charge accounts	13%
Apportionment basis clear	79%
Standard cost headings to be limited to 22	2341 headings used
Budget accuracy. Budget should be within 2% of actual costs	15%

Source: Calvert *et al* (2006).

Table 6: Recommendations by Calvert *et al* (2006)

Parties	Recommendations
RICS and others	<ol style="list-style-type: none"> 1. Implement a centralised data collection system of uniformly coded service charge data and make this data publicly available to allow industry analysis and benchmarking. 2. Integrate and publish annual progress reporting against the performance benchmarks set out in the Code. 3. Publish a policy document on the use and benefits of sinking and reserve funds. 4. Promote a Law Society/Inland Revenue initiative on taxation of sinking funds to resolve the problem highlighted in the O'May and others v City of London Real Property Co Ltd case (1982). 5. Publish a standard management contract for managing agents. 6. Instigate a Law Society/RICS initiative on model service charge clauses in new and renewed leases. 7. Monitor and review the effectiveness of ADR for service charges disputes. 8. Consider appropriateness and industry perception of independence of referrals to the RICS and Chartered Institute of Arbitrators. 9. Review selection criteria and process for experts sitting on the RICS service charge panel.
Landlords	<p>Carry out an audit of each building that they own. Each audit should consider:</p> <ol style="list-style-type: none"> 1. How well each building meet the Code – not just in those areas measured above, but across the range of requirements set out in the Code. 2. What changes need to be made for each building to meet the Code. 3. What changes need to be made for each building to meet the Code. 4. What the impact might be on both services and service charge as a result of the changes necessary to meet the Code. 5. Develop a costed proposal and programme for implementing the necessary changes. Provide tenants with copies of these audits. Discuss and agree the necessary changes before they are enacted.
Tenants	<ol style="list-style-type: none"> 1. Request service charge audit report from the landlord for each building. 2. Seek proposals from the landlord for any shortcomings against the RICS Code of Practice. 3. Monitor service charges over £5.18 per sq ft. 4. Investigate service charges over £8.01 per sq ft. 5. Promote increased communications with landlords.

Source: Calvert *et al* (2006).

Local Government). The Occupiers' Property Databank estimates that 76.2 per cent (664 million sq ft) of that space is multi-let – attracting service charges.

Calvert *et al* (2006) revealed that service charge costs have shown an inclining trend throughout the last decade. In business terms, this incremental enigma is a worrying signal, especially when the rise in service charges cost surpassed the inflation rate, coupled with the poor level of tenant overall satisfaction with the service provided by the landlord, as indicated in the 2006 Tenant Satisfaction Index (Calvert *et al*, 2006).

As service charge costs are additional to the tenant's business operations expenditure, they must be properly budgeted by the occupier on top of the rental cost. Therefore, the service charge annual budget and certificate produced by the landlord is an extremely vital financial control instrument to enable business occupiers to plan their property-related costs effectively (Calvert *et al*, 2006). It is the obligation of the landlord to produce the service charges budget and certificate on time to enable the tenants to plan their property-related financial obligation effectively (RICS, 2006). However, the ideal situation as set by RICS in the code is far beyond reach. Based on the results of Calvert *et al* (2006), only 4 per cent of the tenants in his study who received the budget 1 month before

the beginning of a financial year, as stipulated by the RICS code. A further 22 per cent of the budgets were received by the start of the year, while 72 per cent were received during the year. The remaining 2 per cent of the tenants received the budget after the financial year ended. Calvert *et al's* (2006) study also reported the nightmare encountered by the occupier due to the lateness of the service charges certificate issued by the landlord. Only 21 per cent of the landlords complied with the requirement of the RICS code to issue the service charges certificate within the 4-month time frame after the year ended. A further 24 per cent were only received within 8 months, and 43 per cent only arrived by the end of the following year. The shocking part is that 12 per cent of the certificate was issued more than 20 months late, and one can imagine the hassle of accounting reconciliation measures that a tenant suffered when dealing with service charges matters.

The other financial element that leads to the service charge dilemma is the accuracy of the budget prepared by the landlord. Based on Calvert *et al's* (2006) study, the estimation in the service charges budget is to be based on accurate prediction of actual expenditure. Even the RICS code indicated that any variances in the actual service charges incurred should not exceed 2 per cent above the budgeted figure (RICS, 2006). However, Calvert *et al's* (2006) research findings show that the budget preparation is way above the tolerance level set by RICS (Figure 2). With roughly the same numbers of respondents practicing under or above budget variance, it was found that only 15 per cent of certificates were within + or - 2 per cent of the budgets.

There are several other notable matters that were mentioned in Calvert *et al's* (2006) reports within the scope of financial aspects of commercial service charges. Among these issues are the management fees that create a potential conflict of interest, as they are charged based on a percentage of the service charges cost. He also pointed out the treatment of interest earned, as it has to be credited to the respective service charge account as required by the code. However, his study revealed that only 13 per cent of the service charge certificates declare any interest earned. With an annual UK service

Figure 2: Budget accuracy.

Source: Calvert *et al* (2006).

charge cost of £4.1 billion at stake, it is not too hard to understand why there are not too many landlords in favour of revealing the interest gained from the money contributed by the tenant through service charges.

MOVING FORWARDS

Perhaps the introduction of the RICS Code of Practice for Service Charges will act as a starting point in uplifting the standards of how each stakeholder play his role in making service charges a 'win-win' mechanism in the UK commercial property arena. There have been mixed reactions to the code since it was introduced a year ago. Some have welcomed the standard as the solution to one of the long-overdue nerve-racking problem that has taken ages to be resolved. The other side of the camp, however, viewed this voluntary code as a 'mission impossible' attempt by the RICS to achieve real improvement.

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