

Out of alignment

Service charges continue to cause friction in commercial lettings. A recent study has found that the most important issue for tenants is the enforcement of the RICS code. By Saleem Jin and Svetlana Tsourikova

Research by London Business School (LBS) MBA students entitled the *Effects of the credit crunch on UK office property and service charges* was recently published. This considers the balance of power in lease deals and the delivery and management of services in multilet commercial property. It also discusses the application of the RICS *Code of Practice: Service charges in commercial property* and proposes ways in which its take-up and effectiveness can be improved.

The study is based on interviews with, among others, the RICS, the IPD Occupiers Property Databank, landlords, tenants, managing agents, consultants and lawyers. The financial crisis has seen a shift in market dynamics from landlords to tenants as demand for space falls and landlords are left with an oversupply of property. Dialogue between landlord and tenant has increased, particularly in the retail sector, where the downturn has prompted landlords to work with tenants to reduce the cost of services and increase the flexibility of occupational leasing arrangements. However, the alignment between tenants, their landlords and managing agents remains problematic. This is mirrored in the Occupier Satisfaction Index 2009 and a steady increase in the number of recorded disputes between landlords and tenants over the past 12 months.

There is also a difference of opinion concerning the resolution of disputes: tenants and the RICS believe that resolution is inadequate, whereas landlords and their agents are almost twice as likely to consider that disputes are being satisfactorily resolved.

Service charge issues

The 2008 *Service charges: Options for change* study, also carried out by LBS MBA students, found that the single most important issue for tenants in respect of service provision and management was the need to enforce the RICS code.

This year's research found that most interviewees reported a greater awareness of the code and a trend towards better code-adherence, at least by larger landlords and managing agents. However, there is no evidence that newly granted leases include covenants requiring the landlord to comply with the code.

Tenants feel that the code is not helping them to achieve value-for-money service delivery and perceive the RICS as favouring landlords and failing adequately to resolve service charge issues on their behalf.

A fundamental problem with service charges is that tenants can bear an inappropriate financial burden. Landlords invest in property because they choose to take on commercial property risk. However, although tenants are not in the property business, they may end up taking both the risk of their own industry and that of the commercial property market. As lease lengths have shortened, the use of sinking funds and depreciation charges has been

reduced or eliminated. Thus, when major works are required, a short-lease tenant might receive a large and unanticipated bill unless it was prudent enough to negotiate a service charge cap.

Many occupiers take the view that service charges do not offer value for money. Although the code has attempted to improve cost transparency and communication between the parties, tenants believe that poor procurement methods, inadequate supervision of suppliers by managing agents and sloppy accounting procedures lead to a poor deal. Additionally, institutional landlords are thought to be more remote from their

Figure 1

Do tenants have more leverage?

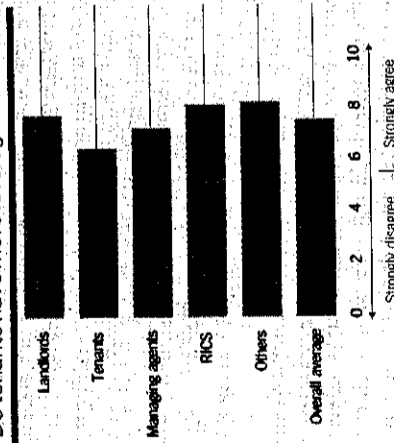


Figure 2

Does the code address service charges?

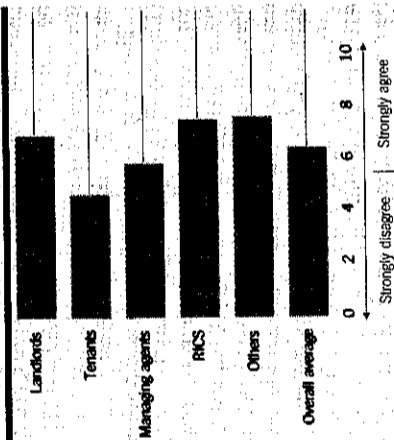


Figure 3

Do service charges provide value for money?

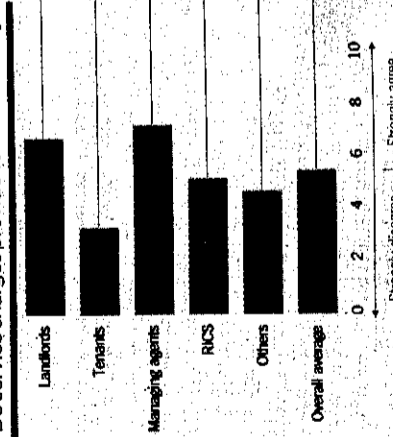
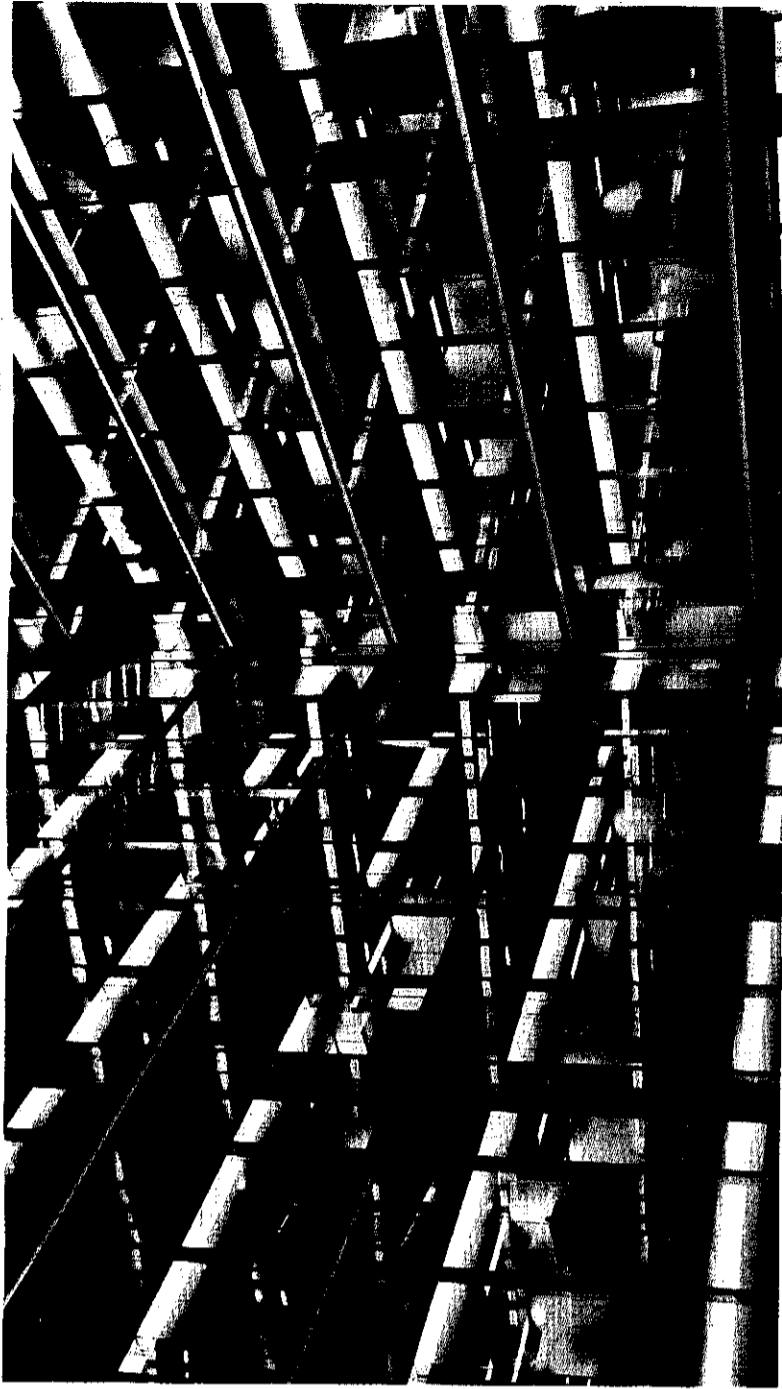
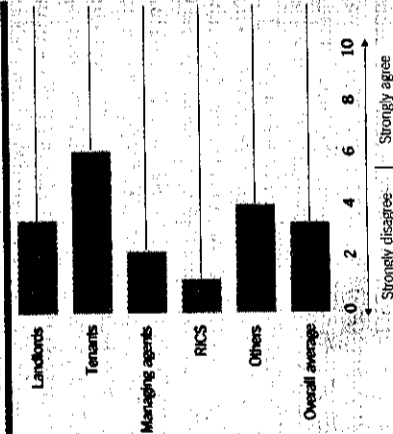


Figure 4

Is legislation the best option for change?



It is necessary to rethink how services are supplied, managed and administered; if stakeholders fail to do so, legislation might be the only option

investments and occupiers than property company landlords. Tenants feel that since the performance of managing agents is not measured and they are not encouraged to improve, they lack the motivation to improve the quality of service delivery.

Most stakeholders did not support the use of legislation to make services management fairer and more orderly. They felt that this could worsen the situation, producing complications and unintended consequences. The interview results show that tenants took the view that legislation might be the only way to regularise the imbalances and inefficiencies of the present system.

Research conclusions

The research concludes that it is necessary to rethink how services are supplied, managed and financially administered. The study advocates a three-pronged approach:

- Ensure that all leases are code-compliant. The RICS should agree with the Law Society that all new leases and all lease renewals are overtly code-compliant.
- Empower the code by raising its status from a guidance note to that of a practice statement, thereby making it mandatory for RICS members to adhere to it.
- Ensure that managing agents owe an equal duty of care both to landlords and tenants. Managing agents should have a contractual relationship with the tenants for service provision and management that is separate to that with the landlord.

RICS members might consider mandatory adherence to the code to be

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unfair and uncompetitive as against non-member property managers. However, if, over time, all leases become expressly code-compliant, this initial issue will fall away because all property managers will have to adhere to the code.

Ensuring universality in code-compliant leases will be a matter on which the Law Society and the RICS must mutually agree. It is hard to reconcile landlord concerns that valuers might down-value code-compliant leases. However, it is for the RICS to mandate in the *Red Book* that the value of such leases is not negatively affected.

It also appears to be within the regulatory mandate of the RICS to require that managing agents should owe a contractual duty of care to the landlord and the tenant where services and management fees are charged to the tenant.

- The research also recommends that:
 - The cost uncertainty of occupation would be removed if an all-inclusive leasing option were available, so that tenants would be paying a known rental inclusive of a non-fluctuating charge for services.
 - Landlords and managing agents should communicate more with tenants; the

tenant's money is being spent and it is reasonable that accurate budgets, detailed invoices and fully audited accounts are provided in a timely manner. Tenants would appreciate more effective procurement of services and management of delivery, which would help landlords to retain tenants at lease renewal, thereby enhancing investment value.

- Tenants should be better advised about the pitfalls of taking leases. They must understand the services to be supplied, the management and charging arrangements set out in the lease and the financial consequences. An office tenant forum would be welcome; this could lobby for changes in leasing conventions in favour of the occupier.
- A reliable and detailed benchmarking service is required to enable landlords and tenants to identify professional service excellence by managing agents, code-compliance and the level of servicing costs across buildings.

Some may consider the recommendations in the study to be radical. In general, however, the body of interviewees believes that unless the profession takes concerted action, the government may introduce legislation and, almost unanimously, it is felt that this would be an undesirable outcome.

A summary of the research can be found at www.property-solutions.co.uk

Saleem Jin and Svetlana Tsourikova were MBA students at the London Business School; their research was sponsored by Property Solutions

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