
7 Occupancy costs

The majority of concerns raised by participants to this inquiry related to the leasing arrangements, and the associated occupancy cost, for retail space *within shopping centres*. In some instances, concerns were raised over costs that are unique to the shopping centre model — such as redevelopment and fit-out costs. In other instances, matters raised, while pertaining to the broader tenancy market, appear to come into focus as tenant concerns in the context of shopping centres — such as rent determination.

In section 7.1, participants' views on tenancy matters relating to occupancy costs in shopping centres are provided. Section 7.2 presents evidence on the reported problems, with participants' suggestions for change assessed in section 7.3. Section 7.4 sums up the discussion and the Commission's assessment.

7.1 Participants' views

The direct costs to a tenant of leasing retail space is usually made up of a number of components (box 7.1). These components may be ongoing or regular, may be directly related to the amount of space leased, and may differ substantially in importance depending on the location of the leased space. Other costs are less frequent — for example, 'lumpy' items such as fit-out costs or costs incurred at the end of a lease.

Prior to the release of the draft report there were just over 50 submissions to this inquiry received from tenants. Of these, approximately 90 per cent were received from retailers who operated within shopping centres (despite only accounting for one-fifth of all retail tenancies — see chapter 2). Close to another 50 submissions were received from shopping centre landlords, shopping centre landlord groups and tenant organisations which focused on issues relating to shopping centres. The most common issues raised by participants related to occupancy costs and included:

- rent levels and determination;
- outgoing payable;
- fit-out requirements; and
- shopping centre redevelopments.

Box 7.1 Components of retail occupancy costs

Payments to landlords

Base rent: usually expressed as a dollar amount per square metre of retail space occupied by the tenant. Base rent is fixed in the first year, and incremented each year of the lease by some predetermined percentage — such as CPI plus 2 per cent.

Turnover rent: a component of rent that is determined as a percentage of the tenant's turnover during a specified period. Turnover rent therefore varies with the tenant's sales performance and can increase or decrease over the period of the lease.

Variable outgoings: expenses that can be directly or reasonably attributable to the operation, maintenance or repair of the building in which the retailer is located. Such expenses may include insurance, security, electricity, water, cleaning, garbage collection and land tax (in those jurisdictions in which the landlord can pass this expense on to tenants).

For those tenants located in shopping centres, additional variable outgoings such as fees for the centre manager, centre landscaping, and maintenance of carparks and other public amenities and facilities are typically included. These expenses are often allocated to tenants on the basis of their share of the total gross lettable space in the centre.

Marketing expenses: expenses related to attracting customers into the business. These expenses may be higher for those businesses seeking to be a retail destination rather than being dependent on surrounding foot traffic.

For retailers in a shopping centre, a marketing or promotions levy typically covers expenditure by the centre manager on centre promotion, advertising and market research. These expenses are often allocated to centre tenants on the basis of their share of the total gross lettable space in the centre.

Other costs

Fit-out costs: those expenses related to the preparation of the premises for retail operation. The extent of these expenses is likely to vary considerably with the requirements of each tenant and also according to any restrictions which the landlord may place on design or on the use of architects and trades people. For most tenants, there are further costs associated with returning the premises to a bare condition when they vacate ('make good' provisions in the lease).

Other possible financial costs of tenancy: Further costs associated with retail tenancy may be incurred by tenants in securing the information and advice necessary for lease renewal negotiations and in the case of shopping centre tenants, the tenant often pays some or all of such expenses.

Rent levels and determination

A number of retailers expressed concern about the large differentials between rents of anchor tenants and small retailers in shopping centres. For instance, one retailer, Brett Carlton, commented that it is:

... common knowledge that anchor tenants such as major supermarket chains and department store retailers pay rental amounts any where up to one tenth that of any other retailers on a per square metre basis. ... I can see little reason why all tenants can not pay an equal rental rate per square metre. (submission no. 80, p. 2)

The Real Estate Institute of Australia (REIA) indicated that a typical anchor tenant attracts annual rents of around \$340 per square metre, while smaller retailers face rents between \$400 and \$2000 per square metre, depending on the size of the shopping centre and size of the tenancy (submission no. 111, p. 6).

Given the nature of the retail tenancy market and the need to retain a balance of businesses in a centre, others observed that rent differentials would be expected. As stated by the REIA:

All large shopping complexes rely on the presence of 'destination' anchor tenants which are the primary attraction of the complex and which draw in the bulk of pedestrian foot traffic. Upon the inception of a new shopping complex, centre management will seek to persuade anchor tenants to establish their business at the outset, before it is certain whether or not the overall complex will be a success. In order to entice anchor tenants to take this risk, centre management may offer low rents or special tenancy conditions.

... Once anchor tenants are established, it is possible for smaller speciality stores to benefit from the pedestrian traffic likely to be generated by their presence. It is reasonable for centre management to seek a rental premium from prospective tenants in this situation.

... From the perspective of centre management, smaller retailers are more risky in terms of the likelihood of failure and require a greater effort to manage as a group due to their sheer number and diversity. (submission no. 111, p. 7)

Some participants pointed to observed differences in retail rents in Australia compared with the United States as an indication of a failing in the market (box 7.2). However, international rent comparisons are fraught with difficulties. Such comparisons ignore differences in location, quality and earnings potential, amongst other things. Also, simple rent comparisons do not establish a causal link between perceived problems and outcomes.

Concerns were also expressed over the potential for rent differentials to be 'anti-competitive'. Differences in rent by similar businesses were argued to inhibit competition. As stated by Associate Professor Zumbo:

... price discrimination may be anticompetitive, in that a small retailer simply is unable

to compete effectively and consumers are denied the benefits of vigorous competition between large and small, left to rely on any competition there may be between large retailers who ... may not have an incentive to price as aggressively as they would have if they were facing competition. So if high rents set a high price [of] doing business for the small retailer, obviously the larger tenants, the anchor tenants, would be aware that there's a considerable amount of space in which they may be able to compete or not compete as they choose amongst themselves or by following one another, parallel pricing at a higher level rather than a lower level if there was competitive tension by small retailers. (transcript, p. 330)

However, it should be noted that the presence of rent differences between stores does not signal market inefficiencies and, in fact, is required to efficiently allocate retail space (chapter 5).

Box 7.2 International comparisons of shopping centre rents

A debate arose in the submissions between tenant groups and the Shopping Centre Council of Australia (SCCA) over the validity of international rent comparisons. Commenting on differences in rents paid by tenants in Westfield shopping centres in Australia and the United States, the Southern Sydney Retailers Association stated:

For such a discrepancy to exist there must be something manifestly wrong with the operation of the market for retail leasing in Australia. Yes, things are different in America – but other than the fact that water goes down the toilet in a clockwise spiral in the USA – how is it possible that retail rents in equivalent shopping malls are 134% higher in Australia. (submission no. 131, p. 3)

Responding to these claims, the SCCA noted that when 'better' comparisons were made, occupancy cost averages in Australia were approximately 16 per cent in 2006-07, compared with those in the United States of 14 to 16 per cent (submission no. 138). Amongst others, differences in occupancy rates — 90 per cent within Westfield's centres in the United States and 99 per cent in Australia — were cited as reasons for differences.

Despite the arguments on either side, if occupancy costs are found to be different, or the same in Australia and the United States, it does not provide any direct evidence of market failings. For example, the demand for and supply of retail space is likely to differ significantly and a number of external factors influence what returns landlords would expect (such as construction costs, geography, market risks, and the return earned on alternative investments) and as such what level of rent is paid. Also, if rents were found to be different, or the same, it would not provide evidence of a problem in the retail tenancy market in either Australia or the United States.

Given these difficulties, analysis of the market incentives, and those created by regulations, provide a more effective means to assess the presence of market inefficiencies.

Reporting of turnover data

The requirement of many shopping centre landlords for tenants to provide monthly turnover figures was a subject commented on by a numerous retailers operating in shopping centres and retailer organisations. Concerns related to how landlords use the turnover data, with many retailers expressing the view that landlords use turnover data to determine rents — in lease negotiations — according to retailers’ capacity to pay, rather than the ‘market’ rent. This view was consistently repeated during the draft report hearings.

The stated rationale for requiring turnover data is that leases include provisions for tenants to pay additional rent once turnover exceeds a particular threshold, so the landlord needs to know turnover in order that the agreed turnover rent can be assessed and collected. Some participants commented that, in practice, the thresholds for turnover rent are generally so high that they rarely apply, but landlords collect the figures just so they can extract additional rent on lease renewal, and so they can judge whether to change the tenancy mix.

The Australian Retailers Association (ARA) said:

The figures are used to gouge additional rent out of a sitting tenant at the end of lease term based on the landlord’s knowledge of these figures and the vulnerability of an economic captive who has his investment, goodwill and livelihood tied up in the business at the end of the lease term. (submission no. 119, p. 19)

Similarly, one retailer stated:

We see the reporting of sales as the most significant issue that creates the imbalance and abuse of the landlord’s power and creates an unfair advantage in the negotiation. (confidential submission)

The Retail Traders’ Association of WA stated in response to the draft report, that access to turnover figures allowed shopping centres to gain an unfair advantage when setting rents:

... as the calculating of profit margins is very easily extrapolated from these figures, thus fully exposing the marketing and financial position of the tenant. This imbalance can potentially have severe consequences on the viability and future entrepreneurial encouragement/growth opportunities for a small tenant. (submission no. DR171, pp. 1-2)

The Australian Newsagents’ Federation (ANF) also commented that, while historically percentage rent clauses were seen as a means of sharing the risks and benefits of a retail site between landlords and tenants, in practice landlords purely access tenants’ turnover figures to ensure that rental returns reflect the tenants’ ability to pay (submission no. 72). The ANF argued against the requirement to

provide turnover figures, indicating that a newsagency is typically characterised by high turnover and low margins (and the setting of margins for newspapers, magazines, lotteries and telecommunication products is fixed contractually).

On the other hand, shopping centre landlords argue that turnover data are needed (together with foot traffic) to determine the most appropriate tenancy mix in a centre, as well as to assess future development plans for centres. The SCCA submitted that:

Shopping centres require sales (or turnover) figures from retailers for the same reason that retailers do – to guide major expenditure and investment decisions. (submission no. 83, p. 2)

The Australian Property Institute also said:

The provision of turnover details to the Lessor of a shopping centre is not only used for the calculation of rent but more importantly, for the sake of monitoring shopping centre performance. It enables the shopping centre manager to optimise the shopping centre mix which is to the benefit of all tenants. It may highlight instances where a particular section of a centre is adversely affected by certain actions of the manager or conversely demonstrate where particular strategies are successful. It is therefore essential that lessors have the option of obtaining retail turnover figures whether or not a lease contains turnover rent provisions. (submission no. 70, p. 12)

Colonial First State Property Management (CFSPM) argued that rents are set by market forces:

Tenants often express concern that owners use sales information for setting rents. The reality is that rents for a new lease are set by market forces. ... it is in the owner's best interest to ensure that vacancies are minimised. (submission no. 78, p. 6)

In response to the draft report, Westfield further argued that limits placed on the collection of turnover data would limit their ability to manage centres and limit available market data:

Insofar as the submissions made advocate the prohibition of the collection of turnover data, such a measure would strike at one of the unique features of the shopping centre model which has underpinned the success of that model for both retailers and owners. That is the ability of the shopping centre owners to make informed decisions (assisted in a major way by the collection of turnover data) regarding the ongoing performance and market positioning of the shopping centre and its optimal tenancy mix. Further, it would eliminate the data base currently provided, not only to landlords but also available to individual retailers, industry researchers and retail consultants and advisers, which has enabled the appropriate benchmarking of the performance of shopping centres to be undertaken. (submission no. DR191, p. 9)

It was also submitted that reported turnover data do not necessarily provide an indication of what rent is achievable for a particular site. One landlord provided an

example in a confidential submission where, at the expiry of a retail lease, the premises were leased to a new tenant. The new tenant, who offered a different product and paid a higher rent, increased the sales achieved at the site and, as a result of increased customer traffic for that area of the centre, the sales achieved in the surrounding retail premises.

Outgoings payable

On the issue of outgoings, promotional levies and other charges, a number of retail tenants expressed concern about the lack of transparency and accountability in claims for costs by shopping centre landlords. The Pharmacy Guild of Australia said:

There should be greater transparency in the composition of management fees for a centre, particularly in regard to ‘outgoings’ and the difference between maintenance costs and capital improvements. (submission no. 109, p. 5)

The Australian National Retailers Association (ANRA) also argued the need to better define the costs attributed to tenants and landlords:

... there is a need for greater transparency in the dealings between retail tenants and landlords. The direct and indirect costs of leases to tenants are often significant and complex and require further breaking down to understand and verify. Outgoings, category one works, costs of upgrades and management fees are all areas of concern. In addition there is a need to better define what can be attributed to leased premises as opposed to the landlord’s corporate overheads. (submission no. 92, p. 7)

The ANRA also said that, while historically outgoings were calculated at between 5-10 per cent of a tenant’s total rental costs and were specifically to cover the management costs of the shopping centre, over time they have become equal to the rental price with little or no accountability on the part of landlords. Examples given were:

- Complex managers can let a contract to new cleaners who charge 100 per cent more than the previous cleaners. This increased cost is passed directly onto tenants who have no recourse. Tenants cannot question whether the price they are being charged is based on a competitive process or if it is at a reasonable market value.
- Lack of tenant control over the amount the landlord can charge for management fees can result in one centre charging \$200 per square metre and another only \$25.
- A tenant can have three properties on one centre and be charged at different rates for the same outgoing. (submission no. 92, p. 7)

The counter claim, made by some landlords, was that retail property owners have a strong incentive to minimise outgoing costs. For example, CFSPM said:

There is a perception that retail property owners have little incentive to minimise

outgoing costs. However, the opposite is in fact correct. ... From an owner's perspective, the returns required to justify their outgoing investment in a centre is dependent upon ensuring that rents, preferably, increase over time. Consequently, it is in the owners' best interests to also ensure that outgoings are minimised (as they are purely a recovery of actual costs), so that as much of a tenant's total occupancy cost is derived from rent, resulting in real returns to owners. (submission no. 78, p. 5)

In general, while most tenants did not dispute that outgoings were a legitimate cost of tenancy within shopping centres, many felt that landlords were not accountable for their spending decisions made with these monies.

Fit-out requirements

In most shopping centres, tenancy leases require that fit-out, maintenance or repairs on shops be undertaken by designated contractors. A number of retailers expressed concern about the prices charged by designated contractors for these services and the lack of transparency in relation to the determination of such costs. ANRA, for example, said:

... during refurbishments landlords can use their preferred contractors to erect hoardings, despite the fact these contractors charge between three and four times the going commercial rate for such services.

Current invoicing processes do not detail all expensed items, which makes any attempts at auditing by tenants both costly and time consuming. ANRA would like to see greater clarity in how expenses and charges are categorised, with a consistent national approach. (submission no. 92, p. 8)

An argument put forward by shopping centre landlords is that designated contractors are required to meet safety and other centre standards. As one centre owner/manager advised the Commission:

It is common for landlords of shopping centres to require tenants to use the landlord's contractors to deal with service alterations. This practice is designed to ensure that the services of the centre are not damaged by an inexperienced contractor. (confidential submission)

Another centre owner/manager pointed out that retail tenancy legislation in New South Wales and Victoria requires landlords to disclose to tenants the cost of alterations to the services prior to signing the lease or alternatively to disclose a formula which sets out how the costs are to be calculated:

... this requirement achieves that balance between a landlord being able to maintain the integrity of the essential services at the Centre and tenants knowing in advance the likely costs of alterations to services for which they will be responsible. (confidential submission)

The Commission was also informed that offers made by landlords for a new lease are typically conditional on implementing a new fit-out of either the existing shop or one in a new location within the centre (if the tenant is required to move). The requirement of a new fit-out in the event of lease renewal raised concerns from some participants.

One participant cited a case in which a coffee shop operator was offered a new lease conditional on a full refit of the premises, despite having fully refurbished the premises three years earlier, which they claimed still presented extremely well. The retailer stated that the fit-out was expensive and that the landlord would not agree to contribute to the cost of the fit-out or offer a rent-free period (submission no. 89).

CFSPM stated that the reason for the general requirement for a new fit-out on lease renewal is that shopping centre owners need to keep centres fresh and modern to maintain customer numbers in the centre overall.

As a general rule, CFSPM requires tenants to conduct a complete refit of their tenancy upon the renewal of a lease in order to maximise a centre's customer appeal and market relevance. Given that leases are generally for a period of 6 years, the fit-out of a tenancy can easily become tired and dated. (submission no. 78, p. 5)

They also suggested that investment in replacement fit-outs generally benefit retailers.

... experience indicates that tenant sales generally increase by 10-30% following a refit - this again is not only a benefit to the tenant, but to the owner and the other tenants in the centre. A centre that does not adopt such a policy will quickly lose appeal with the customer to the detriment of all tenants and the owner. (submission no. 78, p. 5)

It appears that while most tenants believed that fit-out requirements contributed to both the success of the centre and their individual stores, they held concerns over the cost of these works and ability to source competitive quotes for the work undertaken.

FINDING

Retailers find it difficult to assess fit out costs and outgoings claims of landlords and to challenge the basis of these costs incurred under their lease.

The cost of shopping centre redevelopments

Shopping centres and other retail formats are subject to regular redevelopment. Landlords indicated that this is a normal part of business, recognised in leases, stating:

It is common for a landlord to include a demolition and/or relocation clause if the

landlord is contemplating an expansion of the centre. Without this clause, a landlord is not in a position to maintain the competitive edge of the centre.

It is clearly in the interests of the tenants of the centre (as well as the landlord) for the landlord to be able to maintain the competitive edge of the centre. (confidential submission)

Tenants, however, suggested that there were often instances where centre redevelopment adversely affected their business. The Commission was informed that tenants may be required to relocate to accommodate the redevelopment, or they may experience depressed sales as disturbance of the redevelopment temporarily reduces foot traffic. It was also submitted that some tenants experience a decline in trade after a redevelopment, particularly if there has been an expansion in the shopping centre and tenants face additional direct competitors. One participant, Bruce York, argued that:

... landlords generally do not accept when they refurbish or extend a shopping centre that the impact on existing tenants businesses should be considered as part of the cost of these works. While some state regulations make reference to compensating tenants there is no agreed formula for so doing. My observation has shown that for reasonably significant landlord works the tenants businesses will be impacted up to 5 per cent assuming a well managed change, but some landlords do not properly control their building contracts and a loss of business up to 25 per cent and beyond can be expected. (submission no. 18, p. 6)

In circumstances of redevelopment and relocation, some retailers argued that there should be access to rent review or short-term compensation in circumstances of changed conditions. The Pharmacy Guild of Australia, for example, suggested that the legislation should provide for access to a rent review on a market-value basis, where there is refurbishment of a complex, particularly where it continues over a long period of time and impedes traffic flow into a business (submission no. 109). These provisions already exist in most State retail tenancy regulations.

7.2 Evidence on occupancy costs

Occupancy costs of retailers are explored in this section, together with the case for regulating such costs.

Occupancy costs incurred by tenants

Occupancy costs (per unit of lettable retail space) vary substantially between retailers according to the location of the premises leased and the retail amenity provided. On average, occupancy costs are lower outside of shopping centres, with

only rents in the ‘prime’ retail strips approaching those in a shopping centre. For example, CB Richard Ellis (2007a and 2007c) reports that in the ‘prime’ retail strips of Surfers Paradise, Noosa and Sydney, annual occupancy costs can be in the range of \$2000 to \$3000 per square metre. This is equivalent to the occupancy costs (excluding the marketing levy) of some specialty tenants in the largest regional shopping centres (Urbis JHD 2007b).

Within shopping centres, occupancy costs can vary substantially between small and large retail tenants. Stockland submitted that:

Anchor tenants enjoy significantly lower rents per square metre upon entry into, and renewal of, leases than specialty stores. (submission no. 88, p. 15)

On explaining the factors that influence retail leasing arrangements between tenants, Westfield pointed out that:

Anchor tenants are critical to the viability of a shopping centre as they are:

- A major point of distinction between the shopping centre format and other retail formats.
- The primary drivers of consumer foot traffic in a shopping centre. Specialty retailers in a shopping centre are able to directly leverage their own businesses off that customer foot traffic as this, in turn, directly drives the sales that such specialty businesses are able to generate.
- Generally commit to a long term lease which often is 20 or more years.
- Usually occupy substantial areas within a shopping centre of up to 25 000 or more square metres as opposed to specialty retail shops which occupy an average area of 100 square metres.

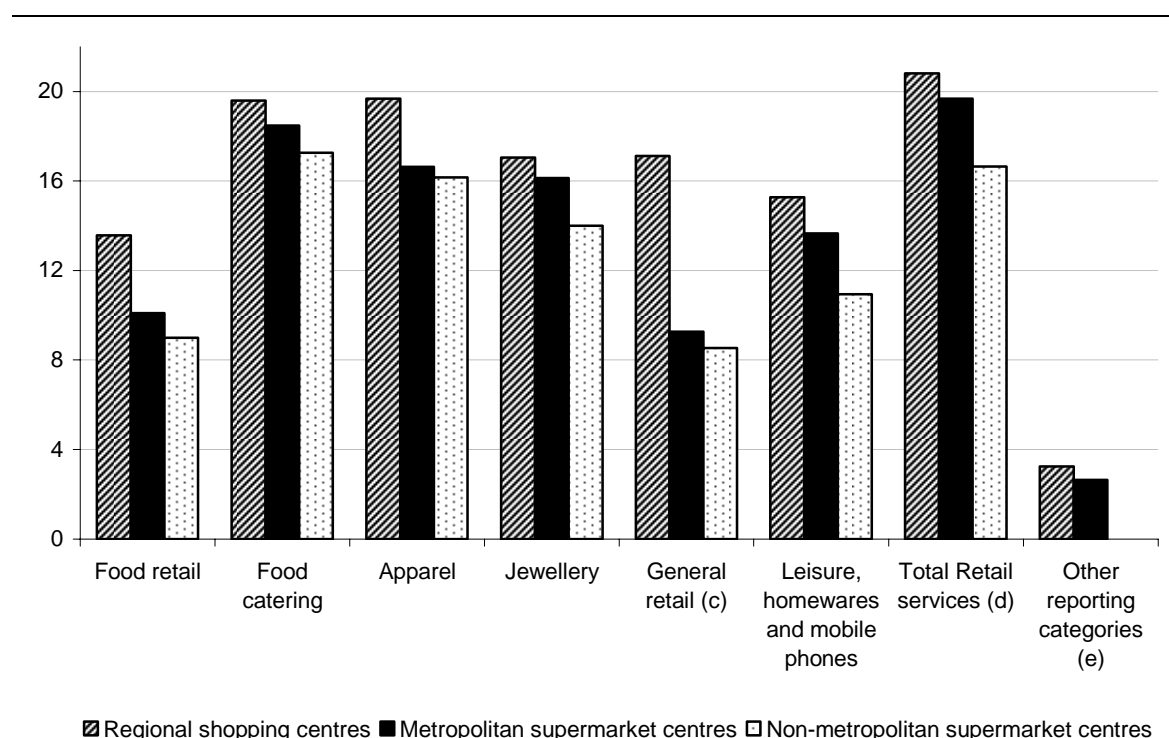
In addition, anchor tenants may also have the available alternative of locating outside a shopping centre on a stand alone basis. For all those reasons anchor tenants have greater leverage in leasing negotiations with shopping centre landlords than specialty retailers. This is an economic reality of the retail leasing market within shopping centres and it is a clear example of the application of supply and demand dynamics. (submission no. 85, p. 11)

As discussed in chapter 5, rents need to vary by store to be efficient. Because of the larger volume of customers attracted by anchor tenants and the higher average area of space leased, rents paid per square metre by anchor tenants would be expected to be lower than those paid by smaller specialty tenants.

Occupancy costs also vary substantially according to shopping centre type and the category of tenant (figure 7.1). Occupancy costs tend to be highest for specialty tenants (often operating from relatively small retail spaces) in the areas of food catering, apparel and retail services (such as optometrists and hairdressing). The variability reflects the influence of many factors including the demand for retail

space in these centres, the relative trading advantage of centre location for tenants in these sectors and the need for supporting services (such as waste removal for food stores). Prendergast, Marr and Jarratt (1998) found that in New Zealand, clothing retailers inside centres had higher sales turnover than those outside centres, and as a result paid higher rents. Indeed, as indicated by the variability in occupancy costs within centres, the cost of a lease is based on more than access to a particular location (box 7.3).

Figure 7.1 **Specialty retailer occupancy costs by centre and retailer type, 2005-06^{a,b}**
Per cent of turnover



^a Occupancy costs (rent, outgoings and marketing levy) as a proportion of turnover. Note, the marketing levy is typically around 0.5 per cent of turnover; GST is excluded from both occupancy costs and turnover. ^b Regional shopping centres include the PCA categories of Super Regional, Major Regional and Regional centres. ^c General retail includes giftware, pharmacy and cosmetics, discount variety, florists, pets, toys and miscellaneous. ^d Retail services are key cutting, shoe and watch repairs, optometrists, hairdressing and beauty, other retail services. ^e Other reporting categories are travel agents, lotto, automotive accessories and other.

Source: Urbis JHD (2007b).

Historical data also show similar variations in occupancy costs between centre and store types. In Western Australia, JHD (2002) found in a report for the SCCA, that occupancy costs were higher in regional centres compared to smaller supermarket centres — 17 versus 11 per cent of turnover in 2000-01 (JHD 2002, p. 32). Similarly, data from Victoria over the period from 1995-96 to 1999-00, show that occupancy costs followed a consistent pattern to those in figure 7.1 and those from Western Australia (JHD 2001).

Box 7.3 Leasing within shopping centres

The cost of a lease within a shopping centre represents more than access to a particular location. Particularly for larger shopping centre, tenants pay for the overall centre management and promotion — intended to bring customers to the centre. These costs are usually passed on in the form of outgoings.

Speciality tenants also pay for the foot traffic that is created by the larger anchor stores. That is, they pay for the passing trade that is created by the tenancy mix. This cost is not embodied in any particular 'outgoing' but in differences in base rents. Base rents represent both the physical location component and the foot traffic passing that location. Thus, it would be expected that those tenants who rely more heavily on passing trade and discretionary purchases would pay a higher base rent along with those in busier corridors, whereas those who are drawcards and attract customers to the centre would pay a lower base rent. Such price discrimination is efficient (chapter 5) and necessary for the shopping centre model to be viable.

However, it has been argued that such price discrimination between tenants inhibits competition. Smaller tenants, because they are paying higher rents, are less able to compete on price with larger tenants. But the ability to compete does not solely depend on the rent paid. Businesses, large and small, compete on a range of factors from the product sold (such as bread bought from a supermarket and that from a bakery next door) to the service provided (purchasing shoes from a discount store versus a small shoe store). Further, to the extent that some anti-competitive pressure is created by rents paid, this should be diminished given sufficient competition between shopping centres, as centres will compete with one another to attract consumers and tenants. These competitive pressures can be diminished by restrictions on the number of centres that can be built (though zoning restrictions), and if so, appropriate attention should be given to reducing such restrictions.

Fit-out costs

The design, requirements and cost of a fit-out are likely to vary considerably according to the type of goods or services retailed by the tenant, the location of the tenant and the requirements of the landlord. For example, while an apparel shop may operate successfully with standard display units, counters, a fitting room and store room, a food retailer may also require refrigeration and additional electrical or plumbing connections while a retailer of electronic equipment could require extensive electrical wiring and connections.

The ARA submitted that fit-out costs are typically in the range of \$2500 to \$3000 per square metre (submission no. 119, p. 5). These costs are incurred not only at the start of a lease — there may also be changes to fit-out during the lease at either the tenant or landlord's instigation. The actual cost to the tenant depends on any contribution by the landlord as an incentive to attract or retain the tenant.

‘Make good’ costs on the fit-out may also be incurred at the end of a lease. Retail leases often contain provisions for the tenant to restore the premises to an empty or bare state at the end of the lease if the tenant is vacating. The ARA indicated that removal and disposal of fit-outs typically involves expenditure in the order of \$20 000 to \$30 000 (submission no. 119, p. 24).

FINDING

As would be expected in a well functioning market, occupancy costs vary substantially between tenants according to the location of the premises, the retail amenity or services provided by landlords and the type of tenant.

Occupancy costs and business failure

An argument put forward by a number of tenants is that high occupancy costs have led to higher than ‘normal’ levels of business failure, in particular, for those who operate within shopping centres. It is argued that this occurs because landlords seek to create excess investment of capital in retail businesses. In order to capture this capital, it was suggested that landlords act in a predatory fashion, exploiting retail businesses through high occupancy costs. It is claimed that these high occupancy costs lead to business failure, allowing the capital invested in the failed business to be captured by landlords through the use of personal guarantees.

However, there is limited evidence to support this proposition:

- overall retail business exit rates (while not specific to shopping centres) are not significantly different to other service industries (chapter 2);
- the majority (75 to 90 per cent) of retailers operating in shopping centres have their leases renewed (chapter 6); and
- failure rates of small businesses operating within managed shopping centres across Australia are quite low (chapter 2).

Similar results were reported in New Zealand, where a study found that retailers who operated in managed shopping centres had lower failure rates than those who did not, despite higher occupancy costs in shopping centres.

7.3 Assessing the case for change

In assessing the case for government intervention in relation to setting occupancy costs, it needs to be shown that impediments exist in setting rents (or occupancy costs as a whole) that constrain retail space being effectively allocated to those

tenants who value it most. If a case for regulation is found, the benefits of intervention must exceed the compliance and administration costs, or any efficiency losses created. Interventions should also not impinge on the flexibility of rent setting, including the ability of landlords to vary rents between tenants and tenants to negotiate the best deal for their business (chapter 5).

A number of inquiry participants advocated government intervention to regulate occupancy costs. Some suggestions involved greater legislative limits on what a landlord can charge and how rent is determined, while others put forward non-regulatory solutions. The suggested options for change include:

- regulating rent setting and outgoings;
- placing greater reliance on turnover rents;
- regulating fit-outs;
- prohibiting the direct reporting of turnover data; and
- making greater use of collective bargaining arrangements.

Regulating rent setting and outgoings

A number of submissions advocated greater regulation of rents and of what can be charged under outgoings and marketing clauses. A shift away from commercial negotiation toward a rent setting procedure mandated by legislation was the focus of most of the suggestions (box 7.4). Although the issue of ‘what is included in rent’ potentially exists in all tenancy arrangements, the suggestions were almost exclusively made in the context of shopping centres.

Regulation could be used to limit what can be charged as outgoings and limit the ability of a landlord to transfer risks associated with owning the physical asset to the tenant. For example, charging the landlord’s insurance cost (a cost associated with the risk of the asset) to tenants could be viewed as an instance of risk transfer. Indeed, legislative controls on outgoings brought into Queensland’s retail tenancy legislation were in response to these concerns (see chapter 3). However, it is not likely that broad regulations could be developed to prescribe the efficient allocation of outgoings for each tenancy agreement.

To the extent that there is ‘cost creep’ in outgoings, regulations requiring efficiency auditing have the potential to increase the scrutiny of expenses incurred by the landlord. This may, in turn, place downward pressure on the cost of outgoings as landlords respond to the increased scrutiny.

Box 7.4 Tenants' suggestions about regulating rent setting in shopping centres

A number of retail tenants suggested that limits should be placed on what can be charged in terms of outgoings or the level of rent that could be charged. Suggested options include:

- regulations to ensure all tenants within a particular shopping centre pay (near) uniform rents (submission no. 63);
- mandatory external rent setting at 'market rent' (submission nos. 8 and 94) including at renewal time (confidential submission);
- extensive limits on what can be charged as outgoings (such as prohibiting landlords from passing on land tax and insurances) (confidential submission);
- limits on what can be charged to the tenant at the time of lease renewal or establishment (such as the landlord's legal fees) (submission no. 118); and
- mandating that outgoings be independently audited and a breakdown provided to all tenants (similar to a provision that exists under the franchising code of conduct) (submission no. 76).

Despite this, regulating rent setting, or occupancy costs more broadly, has a number of shortcomings. Adding prescriptive regulations to rent setting or occupancy cost determination has the potential to create barriers or disincentives for parties to contract. For example, mandating uniform rents within a centre could severely limit the ability of shopping centre managers to alter the tenant mix by altering rents in response to consumer demand (for example, lower rents for a retailer that sold a particularly desired product in order to induce them into a centre). Such regulation would ignore differences between tenants in the use of management services and any spillovers in terms of foot traffic created by larger anchor tenants and would represent a significant loss in efficiency in the market. Regulation would also increase compliance and administration costs as business and authorities attempt to monitor business arrangements and make judgements on individual costs paid as part of leasing contracts.

Overall, regulating rents and other outgoings making up occupancy costs, and how they are determined would not be feasible or appropriate as such measures are likely to:

- reduce the incentive for businesses to enter into negotiations;
- reduce market flexibility in setting rents; and
- inhibit the allocation of retail space to those tenants who value it the most.

The Commission's assessment is that all forms of occupancy costs should be the

focus of commercial negotiation. For efficiency audits, as they have the potential to improve the transparency of outgoings, and potentially place downward pressure on these costs, such measures could be the focus of collective negotiation (exemptions permissible under the TPA) between centre tenants and their landlord or comprise part of an industry negotiated code of conduct.

Adopting a single charge or ‘effective rent’

Given that occupancy costs comprise a number of components within shopping centres, some participants argued that there may be scope to move towards a concept of effective rent (box 7.5), inclusive of occupancy costs. Further to this, some participants suggested that an effective rent should be set at the beginning of the lease and only varied in response to agreed reviews (for example, with the consumer price index) (submission nos. 118 and 119).

The concept of effective rent would potentially provide a stronger incentive for landlords to minimise the costs of their outgoings over time. In the case that landlords were required to fix the level of outgoings at the beginning of the lease, they would be required to make commercial judgements of possible outgoings and costs at the beginning of a lease, fixing the monies raised to cover these charges over the life of the lease. As stated by the ARA:

A gross lease would not only lead to a more efficient and cost effective system but also would place upon the landlord an obligation to manage his outgoings rather than just passing on the costs. (submission no. 119, p. 22)

However, requiring landlords to ‘set’ outgoings would require landlords to estimate foreseeable costs (and the method of escalation). This would transfer additional risk to landlords, who would have an incentive to increase initial rents to cover this risk.

Instead, the disclosure of an effective rent at the beginning of a lease (but not including the requirement for outgoings to remain fixed) could increase the transparency of the cost of a lease and make it more comparable to other leases outside centres and between centres. Retailers would have the potential to make more informed decisions about their own commercial prospects when entering a lease and comparing different retail locations.

During the hearings it was suggested that the use of an effective rent for the base year of a lease was becoming more common. These leases were termed ‘semi-gross’ leases and were advocated as they made the total occupancy cost more transparent and allowed tenants to negotiate annual increases in outgoings paid. As stated by Bruce York:

One of the things that people do nowadays is — often the common practice amongst

the majors — is to have what they call semi-gross leases where you actually have all your first year's outgoings lumped in and you pay increases over the base year. You're never exactly sure what the base year is going to be [cost] until the base year has gone, but it tends to ... mitigate that [uncertainty] because a lot of your outgoings are included in a known lump gross lease amount and you're just paying increases. You'll also quite often cap those leases at CPI or CPI plus 1 or 2 per cent, to try and control the outgoings. (transcript, p. 230)

Box 7.5 The concept of 'effective rent'

Effective rent can be seen as analogous to the comparison rate used to improve transparency and comparability of home loans. The introduction of a comparison rate for home loans was designed to take into account both the interest rate and all other fees and charges that related to a loan. The mandatory comparison rate was introduced as part of the *Consumer Credit Code* and commenced in 2003. The comparison rate includes costs known at present but excludes:

- government charges such as stamp duty or mortgage registration fees;
- fees and charges which may or may not be charged because they depend on some event which may or may not occur (for example, fees for early repayment or redraw fees); and
- fees and charges that are not ascertainable at the time the comparison rate is provided (The Consumer Credit Code 2007).

Extending the comparison rate analogy to effective rents for retail tenancy agreements in shopping centres, would mean effective rents would include (expressed as a weekly, fortnightly or monthly amount):

- the rental charge taking into account any rent free period or fit-out contribution; and
- the cost of all outgoings payable taking into account any payment free period negotiated.

The effective rent figure would not include government charges or the cost of fit-out as such costs would not accrue to the landlord. Also, costs associated with redevelopment of the centre (such as the cost of relocation or a new fit-out) including changes to shopping centre colour schemes, make good clauses and any costs associated with changes in services based on changes in service providers as these charges would be unknown and be dependent on events which may or may not occur during the life of a lease. But, for the retail tenant, these contingent costs would still need to be considered when entering into a retail lease.

For effective rent to be accurate, all side deals would need to be included. However, this may not occur in practice. For example, landlords and tenants could enter into side deals which are not tied to the use of retail space and thus limit the accuracy of effective rent disclosure.

The Commission's assessment is that while outgoings, their levels and changes over time must remain a matter for commercial negotiation, lease transparency could be improved through the disclosure of an effective rent. Improvements to lease transparency such as these could be negotiated as part of an industry developed code of conduct for shopping centre leasing.

Greater reliance on turnover rents

Within the submissions to this inquiry there was considerable debate over the desirability of landlords charging turnover or percentage rents. Some participants argued that turnover rents (payable when turnover reaches a threshold amount) be prohibited. As stated by Kingsley's Chicken:

The payment of turnover rent should be banned as the lessor is usually not in partnership with the lessee, and turnover rent is payable by tenants for successfully increasing their turnover, although this may be done without increasing gross profit. (submission no. 9, p. 5)

Others, however, suggested that a system of turnover rents (where all rent is based on turnover) be compulsory for all shopping centre tenants. Soothill & Associates recommended:

... a system of Turnover Rent be mandated in all shopping centre leases. That is that rent may only be levied on a percentage of turnover basis. (submission no. 121, p. 8)

Turnover rents are purportedly aimed at sharing market risks between tenants and landlords — when sales drop, so does rent (and thus overall business costs) transferring some of the trading risk to the landlord. The opposite is true when sales increase. As the Newsagents Association of NSW and ACT and Newsagents Australia argued:

Whilst it is realised that property owners deserve a return on their investment, there needs to be a greater share of allocation of risk to reflect external changes which impact on landlords and their tenants. (submission no. 75, p. 2)

Soothill and Associates explained that:

Turnover Rent has the benefit for the lessee that if turnover falls for some reasons beyond the lessee's control, such as economic downturn or failure of the shopping centre to properly promote, then the rent also falls as a dollar amount, but in such a way that the proportion of turnover paid on rent remains the same. That will not assure a business' viability, but it does add a layer of protection. (submission no. 121, p. 6)

Turnover-based rent can also provide incentives to shopping centre managers to improve management practices to increase sales across the centre. The REIA observed that:

One of the main benefits of a turnover rent arrangement is that it provides a powerful and enduring incentive for the landlord to work towards the success of all tenant businesses. (submission no. 112, p. 12)

The use of turnover rents provides a potential mechanism to align tenant and landlord incentives, with the added attraction of potentially reducing opportunistic or predatory behaviour of landlords.

However, the use of turnover rent transfers risks to a landlord which are related to factors outside the landlord's control, such as a tenant's retail trading and managerial ability. With the potential to shift some of the costs of poor business performance during a given lease period to the landlord, the selection of 'less risky' tenants at lease renewal is likely to be encouraged. Tenure could also become less secure as landlords are likely to become more reactive to poor performance than under fixed rents.

Greater use of turnover rents would also provide tenants with a clear incentive to under report turnover figures to minimise rent payments. Such under reporting could erode the return to centre owners and the incentive to invest in services such as marketing and maintenance (although this would be offset by measures taken by landlords to minimise the prospect of this type of rent 'erosion').

The mix of pre-determined and turnover rent should, in the Commission's assessment, be a matter for commercial negotiation between tenants and landlords. Government intervention in this area would reduce the flexibility of retail tenants and landlords to negotiate a mutually beneficial lease under prevailing commercial conditions.

Prohibiting the direct reporting of turnover data

To address concerns that the reporting of turnover data in shopping centres is used to set rents at 'non-market' levels, some tenants suggested that landlords be prohibited from collecting turnover figures, or alternatively, that turnover figures be reported through a third party and aggregated at the store category level. For example, the ARA stated:

... an independent body should be responsible for the collection of such information [turnover figures] if it is to be collected. It should be collated in a format that does not identify any individual retailer and available to all at cost. The cost of such collection would be borne by the industry. This would make the information freely available to all and would be in a form that did not give one party to the contract a decided advantage in the negotiations. It would also remove the number one issue of dispute between the landlord and the retail tenant. (submission no. 119, p. 21)

Prohibiting the collection of turnover data, or mandating that it be reported in an aggregate fashion, would limit the ability of landlords to take past performance into account in determining site rent for the future, including where the outgoing tenant is seeking a new lease. Such provisions would also preserve the commercial confidentiality of retailers, potentially leading to a perception that lease negotiations were ‘fairer’. However, it should be recognised that this ability is already limited as landlords do not have access to an individual retailer’s cost figures. In addition, the performance of a tenant over a lease may not be the best indicator of the market rent potential of a site; indeed it could be a poor indicator if alternative tenants could make better use of the space and pay higher rents. While it is widely known that landlords use turnover data in the rent discovery process (through assessments of incumbent tenants ‘capacity to pay’), such a practice does not, of itself, generate market inefficiencies.

If turnover data were being used by shopping centre landlords to set occupancy costs at unsustainable levels, vacancies rates in these centre would be high. Evidence of vacancy rates, however, does not support this. Indeed, vacancy rates are lower in larger regional shopping centres than in other retail formats, indicating strong demand for this type of retail space (which suggests that retailers benefit from operating within shopping centres, including from their management). This strong demand for space is also likely to be a significant determinant of occupancy costs.

It should also be noted that within shopping centres, landlords seek to increase overall centre performance (to obtain the highest rental return possible) to maximise both centre income and the value of their asset. The Commission was advised that one way this is done is by altering the tenant mix at the individual store level and intervening in a store’s operation where assessed as appropriate. Altering the tenant mix may not only involve changing the number of stores in a given category, but also include non-renewal of leases of poorly performing tenants and replacing them with tenants that generate greater turnover. To date, the close management of shopping centres, including through the use of turnover information for within-and between-centre ‘benchmarking’, has proved a successful business model.

Prohibiting the collection of turnover data, or mandating that it be provided at a store category level, could limit shopping centre owners’ managing their assets optimally. This could limit the performance of centres, ultimately disadvantaging centre tenants and consumers. Also, while the reporting of turnover data was one of the most contentious issues raised during this inquiry, it is very unlikely that any means to prohibit the collection of turnover figures would materially ameliorate the expressed concerns (chapter 6). Given information on vacancy rates, and that it is likely shopping centre managers could gauge a tenant’s performance and turnover

through other means, it is not clear that prohibiting the provision of turnover data (or legislating the fashion in which it is provided) would materially affect occupancy costs. The Commission's assessment is that the provision of turnover data, and its use by landlords should be the subject of commercial negotiation between the parties to a lease.

FINDING

Prohibiting the reporting of turnover data would be unlikely to lower average occupancy costs.

Regulating shopping centre fit-outs

A number of participants suggested that regulations governing shopping centre fit-outs be established. Suggestions included controls on what landlords can request and caps on fit-out costs. One frequently suggested option was to mandate competitive bidding for fit-outs by prohibiting landlords requiring that tenants use a particular group of builders, architects and suppliers (sometimes in-house). What landlords can request of tenants in terms of fit-outs was also perceived as a particular issue for franchisees as it was felt that brand recognition was limited by some fit-out requirements.

Prohibiting landlords from stipulating who can provide a fit-out for a retailer, and under what conditions, is likely to introduce greater competition into fit-out contracts. As long as fit-outs are consistent with a shopping centre's design and relevant building and labour market regulations, it is reasonable to contend that the use of alternative builders, architects and suppliers to those recommended by the landlord may lower the costs faced by retailers. The achievement of lower fit-out costs could lead to a number of advantages, including:

- a greater ability for tenants to amortise the cost of the fit-out over their fixed lease period;
- lower set-up costs and thus the potential for lower debts or levels of personal guarantees for individual retailers; and
- due to lower costs, a potential for lower prices to consumers and/or higher rental returns to landlords.

But fit-out activity, as with any other construction, can be highly disruptive. Thus, landlords may legitimately seek to minimise these disruptions through mandating that tenants use preferred suppliers with, in their judgement, proven qualities and familiarity with the centre. Also, for those shopping centre-wide systems, such as security alarm systems, maintenance/installation by the nominated contractor may

be required to obtain consistency and effective functioning. Landlords may also require particular fit-out styles in order to develop a theme for a shopping centre with the aim of maximising overall sales, which in their judgement, is best achieved through the use of selected suppliers. This aim, if achieved, is designed to benefit all tenants within a centre. Also, excessive fit-out costs are likely to reduce retail tenants' profitability and capacity to pay a given market rent. As such, landlords should have a strong incentive to avoid such cost imposts being paid to third parties.

Fit-out requirements of tenants in shopping centres represent a conditional aspect of trading in this type of retail concentration. Requirements are unique and vary by both store type and shopping centre, making a 'one-size-fits-all' regulatory solution either unworkable or needing a range of exceptions which would make interventions largely ineffective or even counter productive. Such interventions would introduce a range of rigidities into contract negotiations, frustrating negotiations and imposing compliance costs, hampering the negotiation of efficient outcomes.

The Commission's assessment is that these matters should be determined by negotiations between tenants and landlords. However, there would be scope for opening up competition for fit-out contracts, particularly for non-centre wide systems to place downward pressure on fit-out costs. Such matters could be individually or collectively negotiated by centre tenants with relevant landlords.

Greater use of collective bargaining arrangements

Collective bargaining by retail tenants was suggested as an alternative to calls for more prescriptive regulation of rents and other occupancy costs. The Australian Competition and Consumer Commission (ACCC) has encouraged retail tenants to make greater use of collective bargaining provisions under the *Trade Practices Act 1974* (TPA) (submission no. 128). This has been supported by recent changes to collective bargaining applications, reducing the cost of application and the time taken for approval.

The ANF suggested that landlords should be compelled under legislation to undertake collective bargaining, stating that:

... collective bargaining provisions be further amended to compel participation from both parties and to provide for independent arbitration in the event that negotiations fail. (submission no. 72, p. 6)

The perceived advantage of collective bargaining by retail tenants in shopping centres is to redress the imbalance in negotiating power between the large landlords and small retail tenants. Negotiating collectively has been promoted as potentially

providing a means for tenants to moderate rental increases on renewal, or high rents on initial leases. Further, as stated by the ACCC, collective bargaining could:

... lead to a number of potential benefits, such as allowing greater input by small businesses into their contract terms leading to more efficient outcomes. It may also address the information asymmetry that may exist, by improving the information available and increasing access to additional data. These are issues that may be relevant to small business tenants. (submission no. 128, p. 16)

Also, collective negotiations have the potential to lower the individual costs of lease negotiation. Instead of a series of individual negotiations, retail tenants and landlords may save time and legal expenses through a single negotiation process that covers multiple tenants.

More generally, collective bargaining may provide tenants with an avenue to influence centre management and the trading environment faced by retailers.

Despite this, characteristics of the retail tenancy market suggest that collective bargaining is not likely to be a widely adopted negotiating tool for retail tenants. Indeed, a number of significant impediments exist to the use of collective bargaining within the market for retail tenancies. For example, as stated by the ANF:

... the failure of small business tenants to participate in collective negotiations results from the limitations of the collective bargaining arrangements as follows:

- The authorisation process remains cost prohibitive for most small business retailers;
- There is no compulsion for the other party to participate in negotiations rendering authorisation potentially meaningless;
- There is no independent arbitration if negotiations fail; and
- There is no protection from retribution by landlords. (submission no. 72, p. 6)

Even if participation of landlords were compulsory, it is likely that in the highly competitive retail environment, retail tenants would not have a sufficient shared interest to make meaningful collective bargaining feasible. Also, there may only be a small number of leases falling due at the same time in any given centre limiting the number of firms that are likely to engage in the bargaining process. While, in principle, there might be scope for similar shops within a centre to negotiate collectively, in practice, due to competing interest over lease occupancy conditions including rents and store location (all would be vying for the best position in the centre at the lowest cost to themselves), collective negotiations are unlikely to be successful.

The Commission's assessment is that while there is potential for tenants to use this process to negotiate common costs, such as management charges and the efficiency

auditing of those costs, it is less likely to be a useful tool in negotiating rents due to divergent interests. The formation of tenant groups to undertake collective bargaining under the provisions of the TPA would be a matter for tenants or their representative organisations.

FINDING

Collective bargaining over individual rent is unlikely to be widely pursued due to competing interests of retail tenants. Nevertheless, such bargaining may be practicable for centre-wide costs and conditions.

Would these possibilities constrain efficient market operation?

The possibilities for change suggested by tenants and their representative organisations primarily focused on occupancy costs within shopping centres and, in some cases, involved more regulation of what was allowed to be included within retail tenancy leases and how charges would be set. Such regulatory change would have little relevance to the broader retail tenancy market. In particular, if applied, many of the options to regulate occupancy cost setting would significantly constrain the ability of the market to price retail space efficiently through commercial negotiations. Regulatory limits on what shopping centre landlords can and cannot do, in relation to the setting of occupancy costs, have the potential to limit overall centre performance to the detriment of all stakeholders.

Overall, it is the Commission's assessment that the suggestions for change that involve greater regulation of what can be included in leases, such as those that dictate rent setting, would constrain the efficient operation of the market. Moreover, some options, if applied more broadly to all retail tenancies, could limit and frustrate the majority of the commercial negotiations in this market that take place outside shopping centres.

FINDING

Creating legislative limits or controls on occupancy costs in retail leases would impede the efficient operation of the market.

7.4 Summing up

Most of the issues and reform possibilities raised in the context of occupancy costs related to tenancies in shopping centres — a segment that accounts for only 20 per cent of leases in the retail tenancy market. There appears to be little evidence that the current process of negotiating occupancy costs is constraining the efficient

operation of the market for retail tenancies. It is unlikely that there would be net community benefits from attempts to further regulate occupancy costs. The conditions that govern business operations, in particular the cost of tenancy within shopping centres and other retail formats, should remain a matter negotiated between tenants and landlords.