



THE DEVELOPMENT OF CORPORATE SERVICES PRICE INDICES FOR REAL ESTATE SERVICES AND PROPERTY RENTALS

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Introduction

The UK Office for National Statistics has established a range of Corporate Services Price Indices that cover just under half the corporate services sector in the UK. “Corporate services” are those services provided by businesses to other businesses (including government) to support them in their usual line of activity. There is a programme for developing new indices which should ensure a high proportion of the sector is covered by 2002: sufficient to support the publication of a top-level CSPI as a reliable indicator of inflation for corporate services in the UK.

A quarterly summary of the prototype top-level index, along with some 20 industry-specific series, is currently produced and published in the ONS publication “Economic Trends” and is also made available on the National Statistics web-site (enter www.statistics.gov.uk and search for “CSPI”).

Renting and real estate services are currently covered in the Corporate Services Price Index (CSPI) as follows:

1. A series for “**Property rental payments**” (relating to the renting or leasing of owned non-residential property) is included amongst the series available in the published summary.
2. A series for “**Real Estate Agents**” (covering selling, letting and acquisition activity) has been under development and is expected to be added to the published set shortly (acting as a proxy for all real estate activities).

The first uses an index of the rental income from investment properties provided by an external organisation (the Investment Property Databank - IPD) and which is treated as a proxy for the industry as a whole. The second combines data on commission rates collected from real estate agents with indices of capital values and rental values, also provided by IPD.

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Classification

The indices covered by the UK relate to two sectors within the Renting and Real Estate categories ("Real Estate Services" on the United Nations' Central Product Classification - CPC), as shown in the following table:

<u>Index</u>	<u>(SIC 92) UK</u>	<u>ISIC</u>	<u>CPC</u>
1. Property rental payments	70.20 ("Letting of own property")	7010	72112 ("Renting or leasing services involving own or leased non-residential property")
2. Real estate agencies	70.31 ("Real estate agencies") within 70.3 ("Real estate activities on a fee or contract basis")	7020	72222 ("Non-residential buildings and associated land sales on a fee or contract basis")

As the UK's Corporate Services Price Index (CSPI) is measuring the changes in prices of services from businesses to other businesses only, services relating to residential properties are excluded (and are covered in the Retail (Consumer) Price Index.)

Property rental payments (letting of own property)

Coverage of this particular sector is currently by means of indices produced by the Investment Property Databank (IPD) measuring *gross incomes from rents*. There are three component indices of IPD's gross income index: retail; office; and industrial properties. Further details of IPD's indices are given later in this paper.

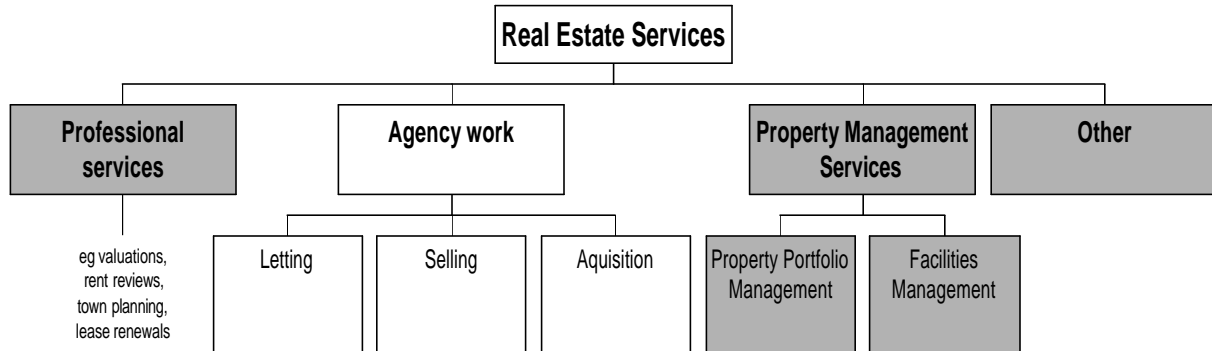
Each index acts as a proxy measure of the rental burden placed on businesses in that market sector. The three are then weighted together to produce the series of property rental payments. The indices are derived from a sample that is composed of approximately 20% new contracts and 80% ongoing contracts.

Renting to private tenants is covered by the monthly Retail Price Index (RPI). This index is made up of private rentals and local authority rents collected from local authorities.

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Real Estate Services: Industry structure and coverage

The present coverage of the industry is indicated by the white cells on the industrial “family tree” shown below, i.e. the UK currently has partial coverage of real estate services.



Separate indices for *property management services* and other *professional services* are yet to be developed. Consequently the existing index for “agency work” is treated as a proxy for the whole industrial sector. Agency work accounts for approximately 40 per cent of the total turnover for real estate services. Letting is the dominant area of agency work, followed by selling and then acquisitions.

Real estate services: development status and nature of transactions

The approach in the UK to monitor the price movements of real estate agents charges has been to combine an *index of estate agents’ margins* (i.e. the percentage commission charged for selling, letting and acquisitions) with an *index of average property prices or rental values*. The present index has been under development for over 3 years and appears to be sufficiently well established to warrant inclusion in the published series as a proxy for all real estate services. A review of its development so far is being carried out - presentation and discussion at Voorburg being part of that review process.

An estimated 80 per cent of all UK real estate agency work is charged for on the basis of commission rates, i.e. a percentage fee of the sale value or a percentage of the rental charges. Smaller contracts are more likely to be charged on a fixed fee basis though.

Professional services are often charged for on a commission rate although certain services will be charged for on an hourly or other basis, e.g. for rent review work, agents will often receive a percentage of the savings accrued. Extra details would therefore be needed for suitable coverage of the professional services and the development of a suitable approach has been deferred (pending the outcome of the commission rate approach for letting, selling and acquisitions).

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Property management services tend to be charged for on a contract basis and the contracts tend to change in detail from one quarter to the next. So with this difficulty, and with the commission rate approach being unsuitable for this area of activity, property management services are not yet covered specifically by the UK CSPI.

Real estate services: pricing methodology

The rationale for combining commission rates with property value indicators is recognised internationally, e.g. by the National Accounts Working Party's Task Force on "Price and volume measures for real estate, renting and business services". For the record though it may be worth reiterating briefly here.

Monitoring estate agents' margins only could produce misleading results, e.g. if margins remained constant at 5% say, the index would remain constant. However, if property prices are increasing then the income earned would be increasing – and so this needs monitoring too to enable a true measurement of estate agents' charges.

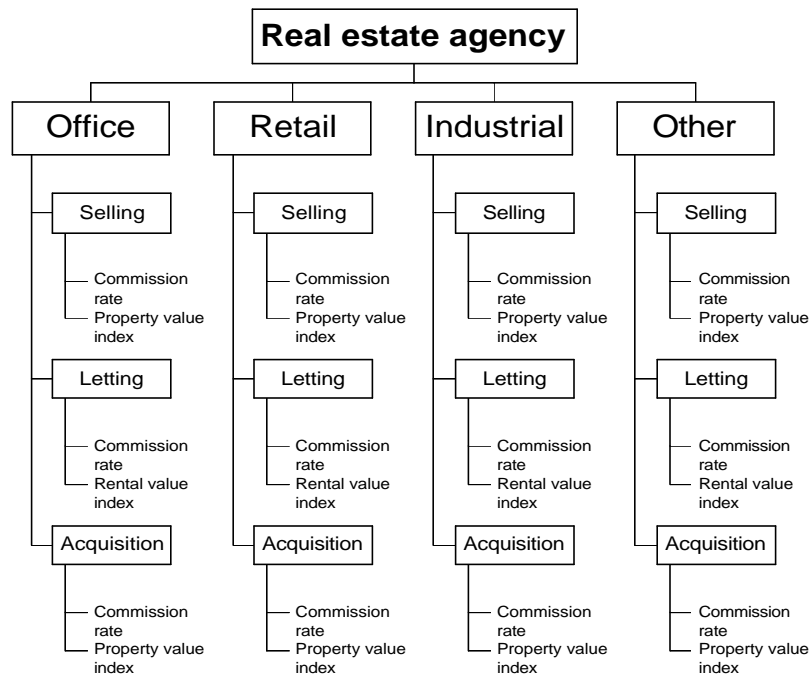
An example follows of an index of estate agents margins (=average commission rates) with an index of average property prices (for selling property, say):

Period	Ave property price	Property price index	Estate agents' margins	Index of agents' margins	Estate agents' charges	Index of estate agents' charges
1	70,000	100.0	5.0%	100.0	3,500	100.0
2	74,000	105.7	5.1%	102.0	3,774	107.8
3	78,000	111.4	5.2%	104.0	4,056	115.9
4	82,000	117.1	5.3%	106.0	4,346	124.2
5	86,000	122.9	5.4%	108.0	4,644	132.7

In the example above, both the average property prices and margins are rising so the increases in agents' charges would be underestimated if only one of the component indices was used.

The approach chosen - to cover real estate agents' activity only - is intended as a proxy for the industry as a whole (for the time being at least). Commission rates are collected for each of the categories shown in the diagram that follows:

Sample structure for price collection (for each region)



The commission rate figures are then combined with a property value or rental value index as appropriate. For sales and acquisitions, the property index used is the Investment Property Databank's "Capital values index". For lettings, the IPD's "rental value index" is used, (see page 8 for more information). The indices are available for each of the specific market sectors shown above (office, retail and industrial). Commission rates in the "Other" sector are combined with the average index for all market sectors.

In the survey, a "representative" commission rate is asked for. Therefore there is a need to deter contributors from quoting *average* commission rates if possible: an arithmetic average rate will be more easily distorted from quarter to quarter by changes in the property mix.

Real estate services: the business population

There have been some difficulties with estimating the business population of real estate agents. The main cause relates to the industrial classification on the ONS's Inter Departmental Business Register (IDBR) as many estate agents are also qualified chartered surveyors and are often recorded as such in a different industrial category (such as Engineering Consultative and Design). In addition, the real estate agents have not been available separately on the classification used on the IDBR (housing associations have been included with them, for example).

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An external source was used to set up the initial sample frame, i.e. the Estates Gazette Directory. The sample was designed to reflect known regional differences in the behaviour of prices: 10 regions within Great Britain were identified. These regions have been grouped in to 4 areas for which commission rates are collected, viz. London, Southern England, Midlands and Wales and Northern England and Scotland (Northern Ireland is currently excluded). Currently there are 26 contributors providing over 250 price quotations every quarter. Certain contributors provide a large number of quotations covering all regions in the sample.

An assessment of the sample's current coverage is being made and a strategy for its enhancement is being devised.

Real estate services: Commission rates

In view of the preference to avoid collecting *average* commission rates, data are collected on *representative* commission rates. "A representative commission rate" is asked for on the survey form and for each market sector in which the contributor does business. It is defined as a rate which reflects as far as possible any movement in commission rates for the sector as a whole. Where there is a range of rates for a market sector then the pre-dominant or median rate is provided (it is up to the contributor to decide what is the most appropriate, although they are asked to note their method on the form). The following example is provided as a general guide to contributors:

Value of industrial property sold in South Wales	Commission rate
< £150,000	2.25%
£150,000 - £300,000	1.75%
>£300,000	1.50%

In this case 1.75% is quoted as the median commission rate – assuming the same number of sales in each price band. Average rates are accepted though if the contributor is unable to provide anything else. If the vast majority of sales were in just one price band then the contributor has the flexibility to quote the commission rate for that category if they judge it to be the most representative (so this would more likely relate to the true median if numbers of sales are taken into account).

Real Estate services: Other issues

Occasionally contributors have had difficulty in quoting rates for agency work as it can be part of an overall package provided to clients. In these cases charges for any one particular service can be influenced by those for others, e.g. agency work could be partly affected by any valuation or consultancy work carried out at the same time. In such instances, quotes are provided for specific transactions which do not reflect the full range of business of the contributor.

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There have been a few difficulties with contributors interpreting the *representative* commission rates that are required. For example one contributor took an average of 10 transactions for each market sector and calculated the average commission rate for each sample. However, quarter on quarter changes tended to be caused by changes in the mix of properties in those samples rather than market pressures on their own. The contributor was asked to pick out typical transactions for each market sector and report on those each quarter, e.g. the commission rate for the letting of a 5,000 square foot office property in a particular kind of location.

The Investment Property Databank (IPD) indices

The IPD indices are compiled from valuation and management records for individual buildings in complete portfolios, collected direct from investors by IPD. All valuations used are conducted by qualified valuers working to RICS (Royal Institute of Chartered Surveyors) guidelines and relate to what the property would attract if it was put back on the market for rent or sale.

The data used to compile each index are derived from a sample of over 1,000 properties which are independently valued each month. The valuations IPD indices represent about 5% of the commercial property market, are widely used by industry and are recognised by the RICS as being the industry standard. IPD's clients also include the Bank of England and HM Treasury.

The *capital value index* is derived from figures for capital growth: the change in capital value from one valuation to the next net of any capital flows, divided by capital employed. (Capital employed is the capital value at the start of the year plus half of any net capital flow, and half of income receivable, i.e. flows of capital and reinvested income are assumed to be spread evenly throughout the year.)

The *rental value index* is based on IPD's estimates of rental growth which are the percentage changes in the rental value used in the valuations from one year to the next.

The *gross income index* used for property rental payments is derived from calculating the changes in gross rent receivable.

Estate agents' services for residential property

Estate agents' fees for the sale of residential property are covered by the UK's Retail Price Index (RPI). The percentages charged by estate agents for average house prices are collected monthly by region. The regional average house prices are obtained from house price indices produced by the UK's Department of the Environment, Transport and the Regions (DETR). The percentage fees are combined together to form regional averages and these are weighted together using DETR data on volume of house transactions by region to construct a national average

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percentage charge. This is then applied to the national house price to work out an average cash price.

Further developmental plans (based on quality assurance findings so far)

The regionalisation of the existing sample will be examined and an assessment will be made of how well regional factors in price changes are being accounted for.

There will be attempts during the next 18 months to extend the coverage of real estate services CSPIs to include professional services and property management services (possibly by monitoring a sample of typical ongoing contracts).

The effectiveness of the current methodology will be examined as part of the quality assurance process that all industries covered by the CSPI are subject to. There will be particular emphasis on the usefulness of collecting the data on commission rates. The theory of collecting such data and combining it with information on property values (as described earlier) seems fairly sound. However, what appears to have happened so far *in practice* is that commission rates do not usually change and, if they do, they are as a result of a change in the service being provided (and so a specification change or quality adjustment ensues). Changes in the index over its period of development have therefore been in relation to changes in the property and rental value indices that are used.