749

The Secretary of State for Business Innovation and Skills
and President of the Board of Trade
Pubs Consultation
Consumer and Competition Policy
Department for Business Innovation and Skills
3rd Floor Orchard 2
1 Victoria Street
Westminster
SWH OET

12 June 2013

Dear Secretary of State

PUB COMPANIES AND TENANTS: A GOVERNMENT CONSULTATION

The Consultation paper invites individuals to make representations which will be considered as part of the Consultation and, accordingly, I take this opportunity of doing so.

I note from the foreword to the Consultation paper that the Government's goal is simply to ensure that the tied tenant should be no worse off than a free of tie tenant and the Consultation asks an open question as to how best to achieve this, For reasons which will become apparent in the course of the submission I do not believe that this is the correct approach. Please note

1. I am a solicitor in private oractice. I was a member and partner in , _,) which merged with ~ , I am, now, a member and partner in h~t nnnp.theless.make this submission in my own name and not on behalf of· . The reason that I am making this submission is that I have specialised in working for brewers and pub companies for more than 25 years and would like to make a contribution to this debate. I have not, generally, acted for tenants or lessees of brewers or pub companies, although that has happened from time to time, and it is worth my saying, at the outset, that I have one or more of the pub companies which are referred to in the Consultation paper as well as a number of family brewers and smaller pub companies.

2. My industry experience started at a time when the pub sector was, in the main, vertically integrated. Accordingly, my experience began with the introduction of Commission Regulation EEC *1984/83* (this is the European Block Exemption Regulation which first introduced the concept of SCORFA) and this was followed, some years later, by The Supply of Beer (Tied Estate) Order 1989, The Supply of Beer (Loan Ties, Licensed Premises and Wholesale Prices) Order 1989 {subsequently followed by The Supply of Beer (Tied Estate) (Amendment) Order 1997). The impact of the Block Exemption referred to and the statutory instruments which I have just listed produced a direct effect on the sector and I was called upon to advise on many issues which arose out of both the Block Exemption and those statutory instruments. I do think that it is

worth my while making a submission so that my views and experience could be taken into account or, at least. heard as part of the Consultation exercise. I continue with this specialism in advising pub companies, brewers and some smaller family brewers although I have not been asked to advise. specifically. in relation to submissions made in this Consultation. I should add. for the sake of completeness. that some of the comments that I have posted in articles online on the website of

3. Rather than mv recite points which have been made already in publications on the website of , please find attached as appendices to this letter copies of the following articles.

~

~

~

4. Can I draw your attention to the following significant points in relation to the sector

4.1 There can be little doubt that on-trade alcohol sales have fallen by material percentages over the last few years. The evidence of this is irrefutable and a report in the M&C report dated 31 May 2013 (this is the latest that I can find) states that on-trade alcohol sales have fallen by 46% over 10 years (according to the Office of National Statistics). The decline has mainly been attributed to a 54% fall in beer volumes from *2001/2002* through to 2011. In addition, the overall volume of alcoholic drinks purchased for consumption outside the home fell from 733ml to 394ml per person per week whereas the figure for the off-trade is 728ml per person in 2011 which comprises a rise of 38% since 1992. There can be little doubt that public houses have come under a great deal of pressure and the decline in the number of public houses (the number of pub closures make headlines every week) is a direct result of changing consumer habits. It would be an extraordinary thing if the effect of the Government intervention were to disrupt this market change. The extent of public houses being under pressure is underlined by the rise in coffee bars (some of whom now sell intoxicating liquor) and it seems reasonable to assume that the pressure on public houses will continue to grow because of these changes in consumer habits. It is not the job of the Government to support failing pubs.

4.2 The impact of the proposed changes by the Government amounts to an expropriation of private property. This country is. of course. a member of the European Community and European States have passed Article 1 of Protocol 1 to the European Convention on Human Rights which specifies the right to "peaceful enjoyment of... possessions". The protocol goes on to say that nobody should be deprived of possessions except in the public interest and then only subject to conditions provided for by law. It seems difficult to believe that this will allow for the expropriation of private property (profits which can properly be made under contracts negotiated at arms' length by business people are private property) and allocating that profit to the other contracting party. This is particularly so when the major challenge (and I refer to your foreword) is sectoral decline but where the single largest cause of the sectoral decline has been the financial crisis and economic slowdown as well as changing consumer

habits. It may be that the issues between large pub companies and tenants have been brought into sharp focus by this sectoral decline but that is more likely to be a symptom rather than the cause of that sectoral decline. It is extremely difficult to see how this transfer of pubcos' possessions can in any way be justified. This is particularly so when the issue of proportionality is considered. The proposed measure must be the appropriate one and where there is a choice of measures recourse must be had to the least onerous. The idea that pubco/tenant relationships can only be improved or mended by a transfer of value from pubco to tenant is clearly open to challenge. This is clearly so when there are alternatives - and one alternative is a fully turnover based rent (with shared risks and rewards) - which can more easily achieve greater fairness between the parties.

4.3 The contracts between pub companies and brewers and tenants are, generally, negotiated at arms' length and are, essentially, business to business transactions. Whilst it might be appropriate for a Government to intervene in order to ensure consumer protection (and there are many examples of this) it is less obvious that the Government, in accordance with the general or public interest, could or should intervene in transferring profit under a commercially negotiated contract from one contracting business party to another. This is a very risk strategy for the Government which is bound to be challenged. Freedom of business people to enter in to contracts should not be undermined.

5. actually, the report is pointed at 2 companies - namely Enterprise and Punch. The references to these pub companies, but predominately Enterprise, far outweigh the references to smaller pub companies and regional brewers. an exchange between Brian Binley and Ted Tuppen and, whilst it is clearly the right of the committee to vigorously question those appearing before it, these exchanges do appear to show a material degree of prejudging of the issues if not outright hostility. It will not be necessary for me to recite to you the antagonism, recorded in a number of articles, between Greg Mulholland MP and Ted Tuppen (the Chief Executive of Enterprise Inns Plc). It would be extremely unfortunate if legislation, applicable across the patch and to all pub companies, was generated by issues with two companies, albeit the largest pub companies in the UK.

6. In paragraph 5.32 of the Consultation paper, under the heading "Unintended Consequences" it is stated that the Government is very mindful of the dangers of unintended consequences and the paper accepts that the last Government intervention, namely the Beer Orders, led to the unanticipated rise in the major pub companies and, arguably, at least some of the concerns that the industry faces today. It is, therefore, important that the possible consequences of legislative intervention be properly considered. I take this opportunity of suggesting what some of those consequences could be and which should be avoided.

6.1 It would not help the sector if the trading tie is materially undermined. This may appear as heresy to the lobby which wants to abolish the tie but it must follow that the abolition of the tie will leave the supply of beer and other drinks to pubs in the hands of the brewers and wholesalers. This WOUld‡hen, be returning to the position that we found ourselves in prior to the Beers Orders. The impact of the Beers Orders. apart from a full scale assault on vertical integration (which was successful), was to take away from the brewers the wholesaling profit for quite large swathes of UK licensed premises. It would be something of an irony if the unintended consequence of this statutory intervention was to reverse some of the effects of the Beer Orders and return the wholesaling profit to brewers! This equally applies in respect of the proposal to allow a guest beer rather than a cask-conditioned product.

6.2 If there is to be a transfer of value from pubcos to tenant an effect is likely to be that large pub companies abandon the trading tie. The advantage of the trading tie is that it is a model where risk is shared. The key point in this is to ensure that rent is kept within a *given* percentage of turnover (although there are other tests) and then low or poor performance of the public house is shared by the pubco as well as by the tenant. If the advantages of this model of shared risk is taken away this can only be to the detriment of the operators at the public houses in question. If pub companies and brewers cannot take advantage of the returns from the trading tie then this is likely to lead to a model which is free of tie. This will automatically remove from tenants the benefit of shared risk (see above) and also the other and many advantages of the trading tie (a discussion of SCORFA is dealt with below). I notice that the press roundup from M&C Report over the weekend of *2/3* June 2013 predicts that pub companies will convert to tax efficient trusts if Government "reforms" go ahead, in a move which will deprive the treasury of millions of pounds in revenue. It is stated, and I do not know whether this is in fact the case or not, that Enterprise Inns Pic, Britain's biggest pub company, may plan to become a REIT if the Government effectively breaks the tie. This would not be to operators' advantage.

6.3 One of the provisions of the Beer Orders was to ensure that brewers sold off pubs, broadly, in excess of 2000 pubs within their ownership. The result of this was that brewers did, in fact. reduce the size of their estates and this was in accordance with the clear wish to break vertical integration within the sector. It would be undesirable to impose a restriction on numbers which had the effect of ensuring that managed operators did not pass on the benefit of their managed house experience to leased or tenanted operators. There is evidence, in the past, that managed operators and leased or tenanted operators sat quite well together in that the tenanted or leased estate would gain the benefit of knowhow and experience of retailing gained in the managed estate. The formulation of numbers within the Consultation could easily result in a managed operator deciding to dispose of the minority of his pubs which are leased or tenanted on the footing that they are more trouble than they are worth. If the impact of any legislative change is to have a managed operator sell off the tenanted or leased estate this is unlikely to be to the long term advantage of the tenanted or leased estate.

6.4 The Consultation paper draws no distinction between types of operator. There is a certain profile of operator who simply does not need a transfer of benefits from the other contracting party. These are financially strong, often multiple, operators. They are perfectly capable of negotiating a rent. discount level and other terms to suit their own best needs. They simply do not require the protections that might, otherwise, be afforded to consumers. There is little point in devising a system which transfers benefits, at the expense of one party, to another party which is an equally sophisticated business operation (with no disadvantage in bargaining position) and which is perfectly capable of deciding what contracts to enter into or not. I accept this may not be true for all cases where there is a lack of business sophistication and/or inequality of bargaining position. The effect would be encourage pubcos to take those outlets into management and deprive tenants and lessees of the business opportunity.

6.5 It would not be sensible to devise a scheme which relies on tenants or lessees to invest. Many tenants or lessees do abandon premises and walk out on their obligations at quite regular intervals. This is as true of lessees as it is of shorter term tenants. Transferring value from pubcos to operator. in such circumstances, is not going to lead to investment but will merely go into the pocket of the operator who does not necessarily intend to use it for the benefit of the public house. It has to be said that the assumptions in the Consultation paper are slightly naive in this respect. The profile of a tenant who is likely to invest is actually likely

to be a financially strong multiple operator and this is probably not the person that the Government wants to benefit through its proposed transfer of value.

6.6 It would not be desirable to take certain protections away from the lessee or tenant in relation to machine supply, I have recited, in the latest of the attachments to this submission, an explanation of why the machine tie can help. It would, obviously, be ludicrous for the there to be double-counting and I entirely agree that there should be different percentages sharing of profit depending upon whether machine income for the tenant is included in the divisible income or not. Nonetheless, the protectlon of some tenants and lessees from unscrupulous machine suppliers, not to mention elements of organised crime and unwise contracts, is a matter of the utmost importance.

6,7 It must be pointed out that this exercise runs the risk of a serious legal challenge. It seems to me that this could be followed by:

6.7.1 A challenge that the expropriation of profit under a commercially negotiated contract at arms length with an independently advised contracting business party falls foul of Article 1 of Protocol 1 to the European Convention on Human Rights. There is a quite a lot of case law on this and I do not doubt that the legal advisor the Department has brought all of this to your attention (see paragraph 4.2 above).

6.7.2 There is, not surprisingly, quite a lot of law relating to the principles to be undertaken in a consultation and these are generally referred to as the Gunning principles. These include:

(i) the consultation must take place when the proposal is still at a formative stage; and

(ii) the product of consultation must be conscientiously taken into account.

The obvious point, potentially running through both of those two Gunning principles together is that the decision maker cannot consult on a decision that has, in reality, already been made. The particular issue, in this case, is whether the Government has, in fact, prejudged the Consultation. The Government appears, according to the foreword, to already have decided that a tied tenant should be no worse off than a free of tie tenant but it is by no means obvious that this is the only answer to (a) sectoral decline (b) lack of investment in the sector or (c) the restoration of the relationship between pub companies and tenants. The foreword goes on to say that the Consultation asks an open question as to how best to achieve the desired results (namely that the tied tenant should be no worse off than a free of tie tenant) and this indicates that, in that respect, the Consultation has already been decided.

7. We must then consider what would be the correct way forward. Nothing that I suggest now is to override the voluntary system that has recently been put in place and will continue to work for regional brewers etc. Set against the backdrop of reducing on-trade sales, the issue is not to transfer value from one party to another but to procure a system whereby the necessary investment is made in public houses and the people who run them in order to ensure their survival in the future. It is simply not the task of Government to support public houses which are probably going to fail and the people who are best placed to decide whether a pub will succeed or fail are the pub company and the tenants or lessees. Accordingly, we should ensure that the system supports the good operator, supports the good pub company and encourages the

investment that outlets and operators need to survive and succeed in the future. Accordingly, I would recommend and propose:

7.1 That the Government accepts that there is a category of tenant or lessee who simply does not require the protection that the Government is currently considering. The exceptions, therefore, to statutory protection would be the following:

7.1.1 An operator who is running two or more pubs and has done so for at least the last 12 months.

7.1.2 An operator who has run two or more pubs each for a period of at least 12 months.

7.1.3 A public house where the turnover in the last full year of trade has been at a certain minimum level. If the turnover is at a given level then it should not be beyond the wit of a good quality operator to run the premises and make a reasonable profit.

It is not for the Government to decide what profit is acceptable for the tenant or lessee to make out of the running of the public house but, if the potential is there for the tenant or lessee to make a good profit (and there are many pub tenants who make six figure incomes etc), the Government should accept that these operators are perfectly capable of entering into contracts which suit their needs. It is the not the responsibility of Government to protect seasoned business people from entering into contracts of their choosing. I realise that the level of turnover would require some consideration. The existing voluntary code should, of course, continue to apply to these cases.

7.2 The Statutory Code only applies to pubcos with tenanted or leased estates over 500 pubs even if they have managed outlets which take them above that level. This runs the risk of them selling off the excess but this may happen in any event.

7.3 Although the Government has stated that its goal is simply to ensure that the tied tenant should be no worse off than a free of tie tenant this assumes that the correct measure of comparison for any tied tenant is a free of tie tenant. This is not always going to be the case and people take leases or tenancies of public houses for a whole range of different reasons (e.g. lifestyle, financial return, location etc) and it is simply not true that the comparison in every case should be to that of a free of tie tenant. The tied model is fundamentally different from a free of tie lease or tenancy and the points of difference are too numerous to mention. Accordingly the proposals need to get away from the notion that there must be a fully countervailing benefit in terms of special commercial or financial advantages (SCORFA) afforded to the tied tenant or lessee. There is no such enshrined principle in law. The phrase was first used in Regulation *1984/83* and, in that Regulation, there is nothing to expressly state or indicate any intention on the part of the legislature to suggest that SCORFA benefits should be fully countervailing benefits. Specifically, the Government has assumed that SCORFA benefits are the values which are directly applicable to the tenant and which are handed to the tenant. This does not, however, address the issue which is that public houses in the UK require investment (in many cases continuous investment) both in the fabric of the property, the style of the offer and the training of the people who will deliver the offer. It must follow from this that the investments etc do not necessarily end up as cash in the hands of the tenant notwithstanding that the tenant can still benefit from them.

7.4 However, if the Government is fixed with the notion of its goal of equating tied to free of tie, as set out in the foreword:

7.4.1 It should allow for an opt out from the Statutory Code for leases or tenancies which are turnover based. There are operators in the UK who use this model and it has proved that it can be successful. This has allowed landlord and tenant to share in the success and also bear the risk and impact of underperformance of the outlet. It IS, genuinely, a partnership (although not in the strict legal sense). It is, generally, necessary to agree a percentage of turnover with (a) an agreed turnover level to start with and (b) rights to terminate on either side if it doesn't work out and, in particular, jf turnover falls below a given level. This can be formulated in a number of different ways. Both sides share the downside and the upside but it is, of course, possible for the tenant to be rewarded for exemplary performance by him having a particular share of profitJturnover beyond a certain level. This may not be popular with pubcos which will want minimum returns or tenants who want minimum incomes.

7.4,2 Distinguish carefully between what might colloquially be called "hard" SCORFA and "soft" SCORFA. "Hard" SCORFA might easily be viewed as the identifiable costs which are incurred by the pubco and which can be taken into account in the equation, and "soft" SCORFA might be some of the less easily quantifiable benefits. The single most important of these is the price payable by the tenant for entering into a risk sharing arrangement under a tied lease or tenancy. So far as I am aware nobody has been able to successfully identify what this cost should be and perhaps the easiest way of dealing with it would be as a percentage of turnover.

7.4.3 The cost of investment and the cost of training might not, generally, be viewed as classic SCORFA items. If those costs are borne by the pubco there should be an opt out from the transfer of value. The investment in the fabric of property, the offer and the people running it is a matter of critical importance and, this is what the Government should be promoting and not handing cash to the operator.

Yours faithfully

[Annexes 1, 2 and 3 withheld]