

For the attention of the

PUBS CONSULTATION

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RESPONSE TO CONSULTATION

**with specific regard to restrictive
gaming and amusement machine supply
imposed by pubco retailers.**

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Pub Companies and Tenants – a Government Consultation

With specific regard to restrictive gaming and amusement machine supply imposed by pubco retailers.

EXECUTIVE SUMMARY

1. is engaged in the supply of gaming and amusement machines to public houses and members social clubs in the UK.
2. In the past 15 years, the larger pubcos and most notably Enterprise Inns ('Enterprise') and Punch Taverns ('Punch') have been introducing new leases to their tied public house estates under which the tenants are no longer allowed a free choice of machine supplier but are obliged to choose from a list of suppliers nominated by the pubco.
3. Admission to the pubco list of nominated suppliers is conditional on an obligation that the supplier pays a substantial royalty per machine per week directly to the pubco retailer. This results in an inflated machine rent well above the prevailing open market rate to the pub tenant.

In addition to the royalty, the pubco retailer also takes a share of the remaining inbox income per machine per week, further eroding the tenant's income, therefore artificially inflating the cost base of running the pub, to the detriment of the tenant.

The transparency of the royalty paid per week by the supplier directly to the pubco retailer is composite in the rental terms and is therefore not made apparent to the tenants concerned, which in our view indicates a concealment on the part of the pubco retailer in deliberately not showing the royalty the pubco takes.

4. The operation of this machine tie leads to market foreclosure by restricting suppliers who are not admitted to the approved list from supplying the pubco tied tenants. Market foreclosure is further exercised by the pubcos by prohibiting marketing into its estate, even by its approved suppliers, without the express consent of the pubco retailer machine department. The aforementioned prevents the tenant from taking advantage of better or more competitive products, services, or terms that would be available with open market business competition, to the further detriment of the tenant and his consumers.
5. Competition law prohibits the imposition of a tie in respect of goods and services which are unrelated to the primary supply. Clearly gaming and amusement machines are not related to the primary supply and, as the tenant is already renting the premises and has to purchase their beers, wines and spirits from the pubco retailer at the pubco's enforced price list charging for non-related equipment and services is effectively a double rent.

6. I consider that because the Enterprise and Punch new style leases are long term, i.e. ten years or in excess of, the tenant is effectively tied in to the supply on the basis of dependence. The pubco tied estate signed over to the new lease is effectively closed to access by all machine suppliers outside the approved nominated list.

Four successive enquiries into the pub industry have concluded that the gaming tie serves no good purpose and should be removed. This recommendation has been put forward to the pubcos over the last 8 years and they have chosen to do nothing whatsoever to remedy this restrictive and unfair practice.

Background and Where We Are Now – Gaming and Amusement Machine Supply Pubcos to their Tenants

The Old Lease Terms relating to Machine Supply

The Supply of Beer Orders 1989 led to the large brewery companies having to convert their tied estates to full repairing long-term leases.

Under the terms of the Supply of Beer Orders 1989, ancillary ties (such as the machine tie) outside the beer tie were found to be anti competitive. This was also the conclusion reached under EC Competition Law, EC Regulation 1984/83.

Accordingly, the new tied leases allowed the tied tenant to choose his own machine supplier, subject only to the right of the landlord not to unreasonably withhold consent for machines to be placed in any pub.

The New Style Lease Operated by the Pubco Retailers relating to Machine Supply

Enterprise and Punch tied estates comprise principally of the acquired historical large tied estates previously owned by former brewers, i.e. Whitbread, Bass, Courage, Allied, etc.

Enterprise and Punch have acquired public houses comprising mainly of 10 to 20 year leases that allowed their tenants to source machines from suppliers of the tenant's choice allowing for no financial interest to the pubco retailer in the supply of this non-core equipment. Latterly the pubco retailer has replaced the old-style lease with the new restrictive machine tie leases in order to further profit themselves from the supply of this non-core equipment.

Upon the surrender of an existing lease or renewal of the same, both new tenants and existing tenants have no option but to agree to the tied machine clause if they wish to adopt or remain a tenant with the pubco retailer - there is no choice.

Machine Terms of Supply – Comparison between Traditional Open Market Machine Supply and New Style Pubco Lease Terms of Supply

This complaint concerns gaming and amusement machines supplied to tenanted public houses. Amusement machines also include pool tables, pay/play music equipment, skill with prize machines, and video games.

Traditional Arrangements

Traditional open market supply of gaming machines constitutes an agreed rent between the supplier and the tenant, where the tenant holds the keys and is responsible in accounting for all of the income those machines derive. All of the machine income, aside from the rent and Machine Gaming Duty is retained by the tenant.

In respect of amusement machines, the aforementioned also applies with the only variation being that the supplier and tenant may agree income sharing as opposed to rental terms on certain types of machines, i.e. video games or music systems.

In open market machine arrangements, the supplier is responsible to service and maintain all equipment and change machines over by a joint consultation process with the tenant to ensure that equipment provided is appealing to the customer base, and this situation works well with direct communication between supplier and tenant. In addition, with open market arrangements, the supplier is always vulnerable to losing business by natural healthy competition as any other supplier can approach the tenant and offer a better deal or services to the advantage of both tenant and consumer.

Pubco Retailer – New Style Lease Restrictive Machine Supply

The pubco retailer will only permit the tenant to use the services of the suppliers nominated by the pubco retailer's machine department. Those chosen nominated suppliers charge rents to the tenant in accordance with an inflated rent list issued by the pubco machine retailing department, which allows for a substantial royalty to be paid across to the pubco retailer. In addition, the pubco takes a substantial share of the remaining income left after deduction of the royalty that the pubco has already received from the supplier. So in effect they claim both a top and bottom royalty and income share. In order to ensure the pubco retailer keeps careful control of all income generated from the machines, the supplier is forced to employ collection staff to empty the machines and create a financial audit trail required by the pubco.

Clearly the unnecessary expense of collection staff as opposed to open market arrangements, where the tenant holds his own keys, is a further expense burden placed on the supplier and tenant to the detriment of both supplier and tenant.

Furthermore, the pubco retailers expressly forbid any form of competitive marketing or offering of special deals or services that may benefit the tenant and consumer within its estate (even to include the pubco's nominated suppliers). Any change of supplier permitted by the pubco retailer is only allowed by the assent of the pubco retailer's machine department, thus totally negating a free and competitive marketplace.

The tied tenant receives less than 50% of the revenue from the operation of a machine in his pub, compared with what he would have received but for the machine tie.

The reasons given that the pubco retailers justify for the machine restrictive supply.

1. Sourced from their own surveys they state that, when comparing machine income to the free trade estate, machine income is substantially improved for the benefit of the tenant by way of selection of suppliers and controls exercised by the pubco retailer's machine department, resulting in optimising machine income and that predominantly only second tier machines would be available to the tenants in open market free supply.

I completely refute this statement as it is based on unsupported evidence produced by the pubco retailers themselves and not by independent expert analysis. (The House of Commons Trade and Industry Select Committee investigating the activities of the pub companies heard the above claims from Dr Martin Rawlings on behalf of the BBPA and it was dismissed by the Select Committee enquiry panel Chairman as the 'feeblest piece of evidence that we have listened to all afternoon).

2. The pubco retailer maintains there is a notional discount given on the rental payable of the public house premises in exchange for income enjoyed from gaming and amusement machines to the pubco.

I completely refute this also as there is no mechanism demonstrable to show how this notional discount is passed over to the tenant in exchange for machine income. So far as I am aware, the only support that the pubco retailer gives in respect of this statement is that, without the machine income, they would be more inclined to charge a higher rent for the premises. This hardly constitutes the notional discount to which they have referred to previously.

3. The pubco retailers maintain that, through their selection of approved nominated suppliers, this prevents unauthorised itinerant or unprofessional supply companies from operating machines within their estate.

I again totally refute the above statement as all operators of gaming machines throughout the UK have to be duly certificated by the Gambling Commission. It is hardly dependant on the pubco retailer to put themselves in a position above the Gambling Commission in the selection of approved suppliers.

In summary, I maintain that, were their tenants given the choice between open market traditional machine supply arrangements and the pubco retailer's restricted machine supply conditions, in nearly every case the tenants would choose open market machine supply arrangements.

If the pubco retailers are so convinced their tenants are better off under their restrictive arrangements, then it would hold no terrors for them to offer those tenants freedom of choice.

Refer to House of Commons Trade and Industry Committee, second report, EV 44

The impact on machine suppliers as a result of the existing gaming machine tie

The existing gaming and amusement machine suppliers nominated to the estates of both Enterprise and Punch would be extremely reluctant to join in with this complaint for, by so doing, they sign their own death warrants. Their business within those estates would surely diminish or cease in time. (Please see veiled threat received most recently by email from machines manager to their machines suppliers – overleaf Page 7A)

Those suppliers who remain within the Enterprise and Punch estates trade between a balance of break-even to marginal terms as a result of the terms of nett rental left to the supplier after the royalties are paid to Enterprise and Punch pubco retailers.

A further negative impact upon suppliers is that, from a selection of at least 100 duly certificated and authorised gaming and amusement machine suppliers available throughout the UK, the overwhelming majority of these suppliers are locked out and prohibited from the potential of any supply opportunities to the pubco estates.

The impact on suppliers if the restrictive machine tie is removed with open access

Gaming and amusement machine suppliers will benefit in many ways from the abolition of the pubco machine supplier restrictive tie. Commercially they would be able to realign downwards their terms charged to the tenants as they would no longer be paying kickbacks or royalties to the pubco retailer. That realignment under normal open market operating conditions would enable them to be more profitable and by that tendency more proactive and offer better goods and services to those tenants concerned.

Further, with the introduction of open market conditions, the suppliers may indeed risk losing business by natural competition, that business would be lost on a piecemeal basis, i.e. if a tenant was unhappy with a particular supplier, he would be free to change to one of his choice.

I maintain that these open market conditions to a competitive supplier would be a positive benefit.

Suppliers would also be able to freely market and compete within the estates, which the pubcos forbid, thus the more proficient supplier will gain, not lose.

7A

I am currently putting together a proposal for machine management for our colleagues in . . . This may impact positively (or negatively) on our existing suppliers, but it is a natural part of our integration with the wider business. We have a great opportunity for knowledge transfer and if we can use our competitive advantage on machine income to secure trading agreements across the business, then we will do so. More to follow on this, I will no doubt pick your brains before I submit my proposal.

I must again make the point that these are challenging times for us all, not least in defending the existence of the tie, and we will constantly make **commercial decisions** in the best interests of our business. These are in no way personal decisions, the evolving process will ensure we always have the best partners to deliver for our lessees.

Many thanks, see you soon

regards

The impact on tenants if the restrictive machine tie is removed with open access

For the average tenant, family and staff, this differential in income is significant and can hardly be deemed as an inconsequential amount.

The positive impact on the tenants is that they will no longer be subject to a merry go round of gaming and amusement suppliers only nominated by the pubco. The procedure involved in changing that supplier via the pubco retailing machine department and the possible restriction of choice as to who is next awarded to be the future supplier may, in the tenant's mind, be six of one and half a dozen of another, and therefore restrict or thwart his enthusiasm to either get the best deal or the best goods and services from his supplier. In normal open market conditions, the tenant would have absolute freedom of choice and if he was disenchanted for any reason with his existing supplier would simply instruct them to remove and make his own decision as to who supplies him successively. The tenant should be perfectly proficient at making this choice. After all, he is responsible for running the working and business practice of the entire pub.

Further positive benefits to the tenant exist in that he will be able to take advantage immediately of any new goods or services on a competitive basis or better deals that any other supplier may offer him. It may be the case that he will select to have more than one supplier in the pub, which currently he is not allowed to do, taking the view that there may be a specialist in music supply or pool table supply or gaming machine supply; he therefore has total flexibility to his advantage.

It may well be that the tenant will select a local supplier for his premises and that supplier may be able to give more attention, a better deal, quicker response to machine changeovers or introduction of different equipment, than a geographically displaced or more national supplier is able to do who may be recommended by the pubco's machines department list of nominated suppliers.

The above list of positive benefits to the tenant by enabling him to raise the general standards of his pub and offer a more competitive deal to his customers, and it is perfectly within the bounds of good business practice that improvement in income in a well-run business is apportioned to growing that business, creating better and higher standards. In the case of a public house, there is no reason to suggest that this tendency would not prevail as well to the benefit of the customer who uses the pub.

In summary, the tenant will be entirely at liberty to review his supply arrangements to his advantage on a number of decisions that currently he is prevented from taking.

The above list of positive benefits to those tenants is not exhaustive.

LEGAL ANALYSIS

The Infringement of the Chapter 1 Prohibition

Section 2(1) CA98 ('the Chapter 1 Prohibition') provides as follows:

"(1) ... agreements between undertakings, decisions by associations of undertakings or concerted practices which;

(a) may affect trade within the United Kingdom; and

(b) have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom"

The new pubco leases described are clearly agreements between undertakings and the machine supply tie is a restriction on competition since it:

- (a) restricts the tied tenant from obtaining machines from alternative suppliers;
- (b) restricts suppliers outside the pubco's approved list supplying machines to the pubco's tied estate, thus foreclosing access to those customers; and
- (c) prevents suppliers within the pubcos's approved list freely negotiating terms of supply with pubco's tied tenants.

Consumers to have fair share of benefit

The consumer receives no benefit from the machine supply tie. On the contrary, if the tied tenant is to cover the increased costs imposed on him by the pubco machine supply tie, this can only be achieved by reducing services to the consumer or passing on the cost in the form of higher prices.

No possibility of excluding competition

The pubco machine supply tie eliminates independent machine suppliers who are not on the pubco's approved list from competing in that market and there can be no competing cross-pollination within that market by the pubco's approved suppliers in the form of more competitive deals or services. *There is simply no freedom of competition allowed;*

The Infringement of the Chapter II Prohibition

Section 19 CA98 ('the Chapter II Prohibition') provides as follows:

"any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom".

The pubcos are in a dominant position viz-a-viz their tied estates in relation to the imposition of ancillary ties contractually permitted under the terms of their lease by virtue of their dependence and contractual obligations.

The result of the pubcos dominant position by way of the restrictive machine supply arrangements result in their tied estate tenants earning less than half the amount achievable from supply of machines in the ordinary way of competitive led open market free supply.

The TISC Report December 2004

In its review of pubcos 2004/2005, the TISC recommended that the machine supply tie should be removed.

The TISC recommended that the BBPA, the trade association representing pubcos, amended its Code of Practice to achieve this. The BBPA has failed to do so and have no intention of complying with the TISC conclusion.

The House of Commons Trade and Industry Select Committee Report on pub companies 2004 – 2005.

Extract in conclusion of the machine tie from the summary of recommendations of the Trade and Industry Select Committee report as published on 21st December 2004 by the Authority of the House of Commons, London.

“The machine tie improves tenants’ takings from amusement with prizes machines (AWP). However, as free of machine tie tenants retain 100 percent of these takings as income, while tied tenants by pubcos’ own admission receive an average 50 percent of these takings, it appears from the information the pubcos have themselves submitted that in many cases free of tie tenants make more money from their second tier machines than tied tenants do from their more up-to-date models. In our opinion, pubcos do not add sufficient extra value from their deals to justify their claims to 50 percent of the takings from AWP machines. We remain unconvinced that the benefits of the AWP machine tie outweigh the income tenants forgo and we recommend that the AWP machine tie is removed.”

Over 8 years have passed and the pubcos have done absolutely nothing.

CONCLUSION

I request that the government establish a statutory code and adjudicator in order to ensure that tenants are treated fairly and that tied tenants are no worse off than free of tie tenants.

A statutory code and adjudicator should make the appropriate orders forthwith requiring the pubcos to terminate their restrictive and controlling supply of gaming and amusement machines, enabling the tenant to enjoy the same rights as a free of tie tenant.

Pubco retail tenanted pubs are not managed and not franchise operations. So far as I am aware, in a normal landlord and tenant lease, the landlord would not be able to tie his tenants in to controlled secondary goods or services. With a normal landlord and tenant lease, the tenant would be responsible only for paying a market rental for the premises, insurance of the same, keeping the premises in a good state of repair – end of story. I am sure it could not be upheld in a court of law if a landlord was to tie in a tenant if that landlord has commercial interests tying in secondary goods or services.

For the above reasons, the existing nominated gaming and amusement machine tie should be ceased immediately in order for a free and open market competition to prevail for the benefit of both the tenant and the customer base – i.e. the consumer.