

11<sup>th</sup> June 2013

The Honourable V. Cable MP  
Minister for Business Innovation & Skills  
House of Commons  
Parliament Square  
London  
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Dear sir

### **BIS Consultation on Statutory Code for Pub Lettings**

I have read the consultation and draft code carefully and I am very concerned at the depth of misunderstanding in it of the role of the RICS, of valuers and fundamentally, of market economics.

The founding principles expressed in the consultation are:

- A fair dealing provision, and
- The tied tenant to be no worse off than a free of tie tenant

As a generality, the first objective aligns well with the RICS ethical code for all its members, so I do not need to comment any further on that. The second overarching objective can be rephrased to say "The free of tie tenant must be no better off than the tied tenant" because if the free of tie tenant remains or becomes better off, logic dictates that the tied tenant remains or becomes worse off; therefore this is a statement requiring perfect equality. The questions that must arise for pub valuers are "Who are these hypothetical tenants?" and "How can we tell that they consider the value of a tied letting to be equal to the value of a free of tie one?"

Considering the Sample Rent Assessment Statement on page 58 first, a rent review using the example workings will not have been conducted on an open market basis. The Executive Summary states, at the foot of page 6 of the Consultation:

*The proposed adjudicator will be based on the model of the widely-welcomed Groceries Code Adjudicator, and will have the power and function to... arbitrate individual disputes between large pub companies and their tenants, including about whether or not a rent review has genuinely been conducted on an "open market" basis, in accordance with the new statutory code.*

When that objective is translated into the workings shown on page 58 it is clear that the new statutory code does not expect the adjudicator and pub companies to use open market evidence as RICS valuers are guided to do by the Red Book, GN2 and GN67/2010. This Code would be predicated on adjusting the rent for tied lettings by way of a formula to reach an end result which the open market will not have reached on its own. It is fundamentally impossible to be both "open market" and "in accordance with the new statutory code" – the outcome has to be either open market or in accordance with this Statutory Code.

### **My commentary on the workings at page 58 is:**

It is not necessary to adjust tied rents to achieve both the founding principles. In valuation terms, if the tied package including both SCORFA and a fair level of tied liquor supply discounts did make "the tied tenant no worse off than the FOT tenant" (which also means that "the FOT tenant must be not better off than the tied tenant"), then tied and FOT rents would logically be the same – because open market bidders would place the same rental value on each. Valuers know they are not actually the same, so the open market rent gap gives the exact size of the perceived benefit of free of tie lease terms.

As with the Grocery Code, this is essentially a transfer pricing problem. There comes a point at which the perceived value of lower tied discounts and Special Commercial or Financial Advantages (SCORFA), both in terms of operating costs savings and lessee's risk alleviation, matches the perceived value of higher free trade discounts, no SCORFA, greater operational independence but greater exposure to downside risks. RICS GN67/2010 has addressed this. Section 7 discusses the tied lease market. At 7.18 it says that *"The tenant may compare its own property with the circumstances of being free of a supply tie...."*, then it says at 7.19 that *"the REO may have regard to the fact that free houses are available in the market"*. It then guides RICS member valuers by saying at 7.20 *"Valuations of tied leasehold interests reflect the terms of the lease and the contractual supply terms that are integral to the lease. When considering a value to be attributed within the rent calculation to SCORFA offered by a landlord, the REO would have regard to matters relevant to its business and the longevity of SCORFA..."*

The RICS guidance paragraph 7.21 brings this all back to the primacy of market evidence. If the participants in the pub lettings market have considered the comparative value of tied vs free of tie lease and supply terms packages *"There is nothing within this guidance that should result in rents in one sector being set at any advantage or disadvantage to another. In arriving at a market rental value it is preferable for analysis to be made of transactions relating to similar properties with similar lease terms. Indeed the efficiency of the market relies on transparent market evidence"*.

RICS has recently launched a quarterly benchmark report using transactional evidence covering over 1000 lettings per annum by three of the larger pub companies which demonstrates that there is an active tied pub lettings market during 2012/13 at a time when there have also been no shortage of free of tie pubs available to buy or lease. The report shows a stable level of tied rental values agreed by willing landlords and willing tenants when entering into those mutually-acceptable deals.

The differences in pub lease and tenancy rents reflect not only any difference in wholesale drinks supply prices but also differences in operational risk, one of which is the benefit of having lower fixed tied rent in a trading downturn. This is a SCORFA benefit of the lower rent itself. Applying the formula set out at the bottom of page 58 becomes a circular argument; the tied rent reduction of £10875pa should be completely negated by open market letting evidence which says that the conventional tied rent valuation of £28518pa already reflects the reduced risk inherent in paying £28518pa for a tied lease instead of £39393pa for the same business in the same pub run on free of tie terms. The page 58 re-calculation of a tied rent (after adjustment) of £17643pa, which equates to a rent bid of 31% of the Divisible Balance, is not in line with open market tied rent evidence provided by the RICS pub benchmark report.

The fundamental role of a valuer is to be a market scorekeeper, not a market maker. This Code, as drafted, seeks to intervene to overturn evidence-based open market rental values by way of a formula that uses a end adjustment of all tied rents to re-allocate resources from pub companies to pub operators. Valuers would not be able to participate in this process whilst also complying with RICS valuation guidance.

The history of rent control in the residential lettings market of the 1960s/70s and in agricultural tenancies tells us that an unintended consequence of such rent controls is to take supply out of those markets whilst increasing demand. In classical economics price (rent) should increase when increasing demand interacts with reduced supply. As I have said already, a mechanism to artificially limit tied pub rents is unnecessary – the issue of fairness can be related to the price of tied liquor supplies and both the EU and MMC have already determined that the existence of ties in pub leases and tenancies is not harmful per se.

The projected transfer of value from lessor to lessee in this example is a rent reduction of £10875pa for a pub with less than average turnover of £265000pa. This shows that the assessment of a transfer of £4250 per pub per annum, totalling £102m pa shown at 3.14 of the Consultation, then also detailed in the Impact Assessment, is based on flawed assumptions.

## **The rest of the Consultation Draft**

### **1. The adjudicator**

The Consultation para 4.2. The RICS could justifiably ask "Is there any evidence that RICS guidance is not being followed?" I know there is a disagreement with (as I am handling the lessor's case for the rent review at the pub he leases) about its interpretation but that should be resolved by case law, just as judicial interpretation of any new Act of Parliament or Statutory Instrument would be.

The Consultation para 4.8 (a). "Redress" is the wrong word here. An open market rent is a dispute resolution based on arm's length evidence. It is not about achieving redress to either party.

The Consultation para 4.8 (a). Who will this adjudicator be? Will they act as an expert or an arbitrator? Arbitration is bound by statute and is inevitably more expensive than the industry's own PIRRS expert process. Delivering an open market rent review as expert or arbitrator requires training and qualifications in both valuation and dispute resolution and the delivery of such expertise is a long-acknowledged role of the RICS, embedded in most UK leases. This paragraph of the Consultation specifies that the arbitrator would deliver an open market rent review, which is not the same as the working sheet at the end of the consultation. How would an RICS-qualified person be able to reconcile this? The trigger for reference to the adjudicator is very open-ended. Whilst both parties should have the right to trigger this to be equitable when rents could either rise or fall in line with market trends, the more difficult question would be "What is the valuation date?" if these disputes can be referred to the adjudicator at any time, regardless of the rent review dates specified in the lease.

Would the adjudicator have the skills to deliver an open market rent review? Presumably they would have to engage a RICS valuer, so what would the adjudicator add to the process even for aggrieved lessees, apart from extra cost? I would suggest that the adjudicator should be tasked only to assess whether, on evidence from lessees, and responses from lessors, there has been a breach of the two fundamental principles. If it is determined that there has been, the re-assessment of rent could then be ordered, from an effective date determined by the adjudicator, to be agreed by the parties within 21 days, failing which it is put to mediation, PIRRS or arbitration using the existing tried and tested processes.

### **2. Which Companies should the Code apply to?**

The split between owners of more or less than 500 pubs (for which there is a problem of definition – "What is a pub – is it a restaurant, a cocktail bar, a wine bar or a nightclub?) places a disproportionate burden of Red Tape on selected larger businesses and unintentionally could put tenants of pub owners of less than 500 pubs (free of tied) at a disadvantage. If a new "low rent, tied pub" market is created artificially using the method shown on page 58 all competent publicans will want to migrate away from the "high rent, narrow brand range tied" family brewers' pubs to this new "rent controlled" sector, potentially driving down the family brewers' rents as well and causing their estates to become more unstable.

This idea is designed to protect the family brewers but all sorts of other organisations and investors own freehold investment pubs with very commercial attitudes to their tenants.

There are practical difficulties arising from the fluidity of pub ownerships. What should happen if a pub owned by a large pubco is sold as a tied investment to a small pubco, or vice versa? What should happen to pubs owned by "under 500" owners if two merge, or if one such owner gets a batch of previously-sold head-leases back under privity of contract, taking the whole estate above 500?

For valuers this challenge is not hypothetical. If the tied rent and SCORFA are different between pubs owned by small owners and ones owned by large owners, who is the "hypothetical lessor" for the purpose of any Red Book valuation. Does the capital and rental value of the same pub differ depending who ACTUALLY owns it? If valuing a large

pub estate is the value based on the Statutorily-constrained earnings potential of the pub to the current owner or the value of the pub to a bidder in the open market where there is no artificial ceiling on rents? Would the asset value be different if the leases permit any new owner immediately to change the supply terms and trigger a special rent review to remove the Statutory capping as quickly as possible?

### **3. Application of the Code to Free of Tie pubs**

Paragraph 4.24. The reasoning to apply the new Code to free of tie pubs is completely wrong. The authors seem to think that “there would be nothing to stop a pub company from removing the tie and immediately increasing the rent to well beyond market rent values”. This concern is based on ignorance of contract law.

Yes, most tied leases do allow the pub company to free all or part of the tie (then prevents them reinstating those ties) but that will not enable them to get ANY increase in rent at all except by negotiation, or by RICS–managed expert adjudication or arbitration. Then, whichever dispute resolution basis is used, the rent can ONLY be increased to the open market rent for the lease on the amended tie terms, not “to well beyond market values”. This concern is already fully resolved by existing contract law.

Therefore there is no good reason to include any free of tie pubs (many of which are owned by foreign investors, pension funds, landed estates etc and let to pub companies as the TENANT, giving rise to new statutory protection for the large pub companies which the authors surely could not have intended!) in a new Statutory Code arising only from disputes in the tied trade.

A rent increase cannot be imposed on any free of tie or tied tenant. Rent reviews are governed by the provisions of the lease contract to be determined via whatever dispute resolution process is written into the lease. There is no need for new legislation to cover matters which are already covered by contract law.

Furthermore, a split between FOT investors with over 500 and under 500 pubs would make no sense at all – there is no history of lessee complaints at either level.

### **4. Unintended Consequences**

The consultation asks respondents to consider what might be the unintended consequences of these proposals.

When any pub is let, on tied, part tied or free of tie terms, the rent agreed represents a meeting of minds between a willing lessor and a willing lessee. The price agreed reflects a decision by both parties not to pursue other choices. For the lessor those include selling the pub for redevelopment, running the pub under direct management or letting the pub tied or free of tie to somebody else. For the lessee those other choices include not becoming a publican at all, renting a tied pub from another company, renting a free of tie leased pub or securing funding from bank or family to buy a free-house.

- Any “rent control” process that enables one party to revoke terms freely agreed with another party when entering into a new lease is, by any standards, fundamentally unfair.
- Any “rent control” process that uses a formula at rent reviews which denies the evidence of open market lettings is un-workable within RICS valuation guidance.
- Any “rent control” process which is successful in promoting a loss of earnings for the owners of pub property let on tied leases will incentivise owners not to offer tied pub lettings to the market. This is likely to lead to the loss of community pubs into other uses.
- Any “rent control” process which provides a windfall increase of profits for existing tied tenants of assignable leases will be likely to increase assignment premiums by a corresponding amount. The assignor takes the increased premium out of the pub trade as they leave the pub and the assignee gains a lower rent, but

suffers increased interest charges to fund the assignment premium, bringing their overall earnings back to where we started!

### **Conclusion**

The form of calculation posited in this Code does not let the market decide the balance of risk and reward in each tied letting. It is very likely that the outputs from this model would bear no relationship from the outcome of new tied lettings as evidenced in the RICS benchmarking report.

Not all SCORFA is quantifiable as direct operating cost savings to the lessee in the P&L. Much SCORFA affects the "price" (the rent) of the business-to-business transaction of a pub owner letting a pub to a pub operator on terms specified in the lease and supply price list, which is represented only by the variable of rent vs divisible balance. Only the analysis of direct evidence of open market letting transactions can reliably guide valuers as to how the total of all SCORFA and the tied supply terms is perceived by potential pub lessees and rentalised by them.

Yours sincerely

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, Enterprise Inns plc