

Government consultation on Pub Companies and Tenants

Submission from the Office of Fair Trading, dated 14 June 2013

1. This document responds to the Government's consultation on proposals to establish a Statutory Code for the pubs industry and an independent Adjudicator to enforce that Code.
2. The OFT's response focuses on the following aspects of the Government's proposals:
 - a principle that 'a tied tenant should be no worse off than a free of tie tenant';
 - the Government's proposed method of ensuring that pub rents reflect this principle and the role of the Adjudicator in enforcing this; and
 - a 'mandatory free of tie option' for tied tenants.
3. The OFT has a remit to comment solely on the competition and consumer aspects or implications of Government policies. We recognise that the Government must weigh any concerns relating to competition and consumers against its wider policy goals.
4. The OFT recognises that the policy objectives behind the Government's consultation are to address complaints about unfair behaviour by some pub companies and to increase the transparency of the rent-setting process. The views set out here are not intended to challenge these aims. However, we have concerns about the potential effects on the market resulting from the adoption of a statutory code which: (i) mandates a specific method of setting rents in the pub industry; (ii) requires that tied lessees are not worse off than free of tie lessees; (iii) mandates a free of tie option.

Background

5. The OFT is an independent, non-ministerial government department, with lead responsibility for enforcing competition law in the UK and a key role in promoting and protecting consumer interests throughout the UK. Our mission is to make markets work well for consumers.

Markets work well when businesses are in open, fair and vigorous competition with each other for the consumer's custom. Our tools to carry out this work are the powers granted to the OFT under a wide range of consumer and competition legislation.

6. The supply of beer in the UK and the operation of the beer tie have been the subject of a number of previous assessments in the UK by competition authorities and also by the European Commission and European courts¹. The OFT also made submissions to inquiries held by predecessors to the BIS Select Committee in 2004 and 2009.
7. In 2009, the Campaign for Real Ale ('CAMRA') made a super-complaint to the OFT, which related to the operation of the 'beer tie' by larger pub companies. The beer tie is a form of 'supply tie', whereby tied tenants are required to source some or all drinks directly from the landlord or sources of the landlord's choosing². In particular, CAMRA's super-complaint asked the OFT to exercise its competition powers in relation to the wholesale prices and rents paid by tied tenants and the impact of the beer tie on suppliers who are unable to supply to tied outlets directly.
8. The OFT can only exercise its investigatory powers under the Competition Act 1998 if it has reasonable grounds for suspecting that the provisions of the Act regarding anti-competitive agreements (such as price fixing) or abuses of a dominant position have been infringed. The OFT can also carry out market investigations or ask the Competition Commission to do so where it has reason to believe that the structure of a market or the conduct of suppliers or customers may be harming competition.

¹ Further detail on these previous assessments and EU case law relating to the beer tie are set out in section 2 of our October 2010 report.

² There are a number of different types of lease and tenancy agreements offered by pub-owning companies.

9. In our response to CAMRA's super-complaint in October 2010, we set out that we had not found evidence of competition problems that would warrant further investigation. In particular, we found that at a national, regional and local level, the evidence indicated there is a large number of competing pub outlets owned by different operators and that consumers were benefiting from significant competition and a choice between different pubs. We also considered that in such a competitive market, any strategy by a pub company which compromises the competitive position of its lessees would not be sustainable, as this would be expected to result in sales and margin losses for the lessee and, in turn, for the pub company. Further, we found that large pub companies which supply beer to their tied pubs were generally sourcing from a considerable range of suppliers and there appeared to be significant opportunities for access by brewers to pubs and other on-trade outlets.
10. In our response, we noted that some lessees were clearly dissatisfied with the prices and rent levels that were payable to their pub landlord, and/or with the rent assessment process more generally. All of these issues are of understandable concern, but we do not consider that they stem from any failure of competition and/or would justify intervention by the OFT on the basis of its competition or consumer enforcement powers.³

Policy concerns regarding a principle that 'a tied tenant should be no worse off than a free of tie tenant' and the Government's proposed method for 'balancing the risk and reward' between pub companies and tied tenants

11. The consultation document sets out that the Government is considering action in this sector because it is concerned about unfair behaviour by pub companies during the rent-setting process. In particular, the consultation document refers to concerns that pub companies behave unfairly by providing lessees with incomplete or

³ We regard agreements between pub companies and their lessees as 'business-to-business' contracts, and therefore the OFT's consumer powers were not triggered in relation to the matters set out in CAMRA's super-complaint.

misleading information about the potential revenues of the relevant pub, or by imposing large rent increases without justification or overvaluing business services provided to the tenant. The consultation document notes that this is possibly due to an information asymmetry that exists in some situations, given that pub companies will have greater knowledge about the past performance of the pub and that the issue could be exacerbated by tenants who go into the pub sector as a 'lifestyle choice' rather than as a commercial decision. It also refers to concerns regarding low levels of literacy and numeracy amongst tenants.

12. In addition to addressing the transparency of rent negotiations, another key part of the Government's proposals is that the statutory code should address the balance of risk and reward between pub companies and tied tenants, and ensure that this is shared at an appropriate level between the parties.
13. The consultation document sets out that a statutory code would strengthen the existing industry code of practice so that it will include both an overarching 'fair dealing' provision and will also incorporate the principle that 'a tied tenant should be no worse off than a free of tie tenant'. The 'no worse off' principle seeks to ensure that higher beer prices paid by tied tenants are compensated for by lower rents.
14. We note that the proposals set out in the consultation document are based on an understanding that the rent calculation method used in the pub industry typically places tied tenants at a financial disadvantage to those that are 'free of tie' (i.e. can source beer and other drinks independently of the pub company that owns the premises). On this basis, the proposed statutory code prescribes a method for calculating rents (incorporating the 'no worse off principle') that would have the 'benefit and aim' of transferring £102 million per year⁴ from pub owning companies to tied tenants.

⁴ BIS's impact assessment uses certain figures from the OFT's 2010 decision in relation to CAMRA's super-complaint to support this estimate. However, this does not take into account part of the counterfactual. In our 2010 report, we found that the higher beer

15. We would make the following observations in response to these proposals:

- First, in our 2010 report, we did not find any evidence that rents were set in the pub industry in a way that would systematically operate to the detriment of tied tenants. Rather, we found that, having taken into account the various aspects of pub rents,⁵ there was no clear difference in the overall rent levels paid by tied tenants as compared to those that were free-of-tie. Given these findings, the extent of the rental adjustments envisaged in the consultation may not be necessary to achieve the Government's aim of ensuring a similar position as between the level of overall rent paid by tied and free-of-tie tenants.
- Second, the rent agreed between a pub company and a tenant is the outcome of a commercial negotiation between a pub company and a tenant. The OFT considers that where a market is considered to be competitive, interventions involving price regulation should be contemplated only in exceptional circumstances given the potential for such interventions to distort markets and have a negative impact on productivity.
- Third, the ultimate impact of the 'no worse off' principle will depend upon the detail set out in the statutory code and the adjudicator's interpretation of it. We are concerned that, in the

prices paid for by tied lessees (minus financial benefits) are already offset by lower rents compared to free of tie lessees. This is not referred to in the impact assessment. Therefore, the draft code appears to be skewed towards tied lessees receiving a downward adjustment to their rent, in circumstances where the rent paid by a tied lessee may already have reflected the higher beer prices that they pay, compared to free of tie lessees.

⁵ Including wet and dry rents, and any relevant benefits provided by the pub company to the lessee.

event that adjustments are made systematically⁶ to tied pub rents to ensure consistency with the rent payable by a hypothetical free of tie rent, such an approach has the potential to result in significant rental adjustments.⁷ If this is the case, this could result in a market distortion that may lead to consumer detriment. In particular, to the extent that the proposed changes to rent calculations mean that pub companies decide that running a tied outlet is no longer its most profitable option, they may choose to adopt an alternative business model (for example running a 'managed' pub or a free of tie leased pub)⁸ or consider selling or closing the pub. To the extent that pub companies are incentivised to adopt a business model that is less efficient than they would have otherwise adopted, this has the potential to increase supply costs and result in higher prices to consumers.

Policy concerns about a mandatory free of tie option

16. The BIS consultation also asks for views on whether pub companies should be required to offer tied lessees the option of removing the supply tie from a lease or tenancy so that only 'dry rent' is payable (a 'mandatory free of tie option'). The consultation document states that this could be a way of achieving the principle that a tied tenant should not be worse off than a free of tie tenant.

⁶ Our understanding is that the consultation document envisages that whenever a pub company is offering SCORFA benefits whose value is less than the 'wet rent', the 'no worse off' principle would systematically require a downward rental adjustment to ensure that the tied lessee's retained profits are equivalent under that tied and free-of-tie scenarios.

⁷ It is also possible that, subject to the approach that the procedural adjudicator takes in relation to such adjustments to tied rents, their impact will be easy for companies to forecast and it will be possible to pre-empt and 'game' its effects. To that extent, such adjustments would become ineffectual in achieving the Government's objectives.

⁸ The pub company may also choose to sell the outlet, which may result in the pub closing.

17. We would make the following observations in response to this proposal:

- First, we note that the second and third advantages referred to at paragraph 5.36 of the consultation document do not appear to be focussed on fairness to tenants, but relate to access to retail outlets by microbrewers and consumer choice in pubs. We would note that our own recent work in this sector found that large non-brewing pub companies already source beer/drinks from a wide variety of suppliers and that there is already a great deal of fragmentation at the brewing level of the supply chain.
- Second, we also note that such a proposal would be likely to result in pub companies losing some of the economies of scale that are currently achieved through centralised purchasing (as described in our 2010 report) which could in turn could result in higher beer prices for tied lessees, which may be passed on to consumers.
- Finally, removing the supply tie (and, to a lesser extent, requiring a pub company to offer a guest-beer provision) would significantly alter the nature of the contract that had been agreed between the pub company and the tenant. There are many other industries where exclusive purchasing obligations are commonly used as a form of distribution of goods and/or services and may fall within the scope of the European Commission Block Exemption Regulation for Vertical Agreements and Concerted Practices⁹ (subject to certain market share thresholds). Requiring pub companies to offer a free of tie option and alter legal contracts (where they do not breach competition laws) would also set an unhelpful precedent for other industries and give rise to uncertainty for businesses that use this distribution method.

⁹ Commission Regulation 330/2010.

Summary

18. The OFT welcomes the opportunity to respond to the Government's consultation. We trust that the above observations are of assistance.

19. The OFT recognises the Government's objectives to address concerns regarding the fairness and transparency of pub rents. We are supportive of targeted proposals that are aimed at improving the clarity and transparency of the rent setting process, such as ensuring that tenants are able to obtain full and accurate information regarding the estimated performance of a particular pub and are able to seek independent professional advice before entering into a lease agreement (and at rent reviews). However, we have reservations about more far-reaching proposals, as set out above.

20. To the extent that such measures are introduced, we recommend that the Government carries out a review of the impact of any adopted policy within a relatively short period.