



## Pub companies and tenants: a government consultation - BIS April 2013

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Date: 13.06.2013

The support of the Economic and Social Research Council is gratefully acknowledged.



An ESRC funded Investment. The views and statements expressed are those of the author and do not necessarily reflect the views of the ESRC, nor of the ESRC Centre for competition Policy.

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## Response

### General comments on the (case for) intervention

Before responding to some of the questions of the consultation document it is worth reflecting on the aims and effects of the proposed intervention between tenants and pub companies.

According to paragraph 3.14, “The main benefit and aim of the policy is the estimated transfer from pub owning companies to tenants of £102m per year”. According to paragraph 3.9 “this is not a competition issue”. If this is so, it must follow that there are no consumer detriments from this intervention on how firms conduct business, making the intervention purely a transfer of rent from one part of the economy to another. BIS maintain that this is not a competition issue mainly because the Office of Fair Trading (OFT) very clearly stated on more than one occasion that there are no competition concerns in the sector; consumers are not harmed. However, that does not imply that the proposed intervention in the way in which a firm structures its organisational form does affect its costs and efficiency and hence does affect consumers. The intervention itself may well be anti-competitive by raising rivals costs, reducing the number of firms and increasing the prices to consumers.

As the intervention is expected solely to lead to a transfer the Impact Assessment shows no benefits arising from the proposed intervention. It does identify non-trivial costs so that the cost-benefit analysis of the proposed intervention shows a net loss. Given the adverse cost-benefit analysis, it is not clear why the interventions are considered further. This raises the question of what is special about the industry in question and whether we should expect similar interventions in other sectors where we observe a variety of different organisational forms [e.g. fast food; petrol retailing, hotels].

In paragraph 3.5 we learn about the characteristics of at least some<sup>1</sup> of the tenants who have experienced problems in their relationship with a pub company:

- Some of the problems are experienced by “tenants who go into the pub sector as a ‘lifestyle choice’ rather than as a commercial business decision”. In a time of austerity, how will BIS justify the use of government resources to support lifestyle choices and if it can do so, why focus on this particular group?
- Again from 3.5 “Many publicans do not shop around for pubs or invest based on business reasons; rather they choose a pub they like or on the basis of the attached living accommodation”. Should BIS be protecting business people who do not make business-based decisions?
- The same paragraph goes on “there have also been concerns raised regarding the chronically low levels of literacy and numeracy among tenants”. Such tenants may be perfectly well suited to run a successful pub, but why not let the market rather than BIS be the judge of that?

One of the benefits of a market economy rather than central planning, especially where markets appear to work well [as per OFT analyses], is that competition weeds out the poorly performing firms to the benefit of consumers. Will the proposed intervention ensure that more competent and business minded tenants come forward to run pubs? Surely both from a

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<sup>1</sup> The document does not reveal how many fall in the three categories, but if it is just a very small minority why mention them?

consumer benefit and a growth perspective we should promote top quality managers with a good business sense. If the majority of tenants protected by the proposed intervention fall into one of the three categories identifies in paragraph 3.5, the intervention may end up protecting those with less good business sense and BIS should think carefully before intervening.

In fairness to BIS, it is unclear why a reputable and experienced pub company would want to hire a tenant without good business sense. In particular, why would a pub company run its own business down rather than just closing it? And if the answer to this lies in planning law as suggested in paragraph 14 of the evidence base of the Impact Assessment, would it not be preferable to sort that out rather than interfere in the market mechanism. If people are taken advantage of there may be good reasons to pursue the pub company for identifiable business violations and possibly to introduce new or sharpen existing rules. However it is not a valid reason for introducing legislation to keep people with poor business sense afloat in the business.

Paragraph 3.4 sets out the problems facing some landlords as follows: “types of unfair behaviour that have been reported to the Government include: tenants at rent review being told of large rent increases without justification; misleading estimates of potential sales; and overvaluing additional services provided such as business development advice.” The first problem is one of opportunistic renegotiation of the existing agreement when the tenant does not have the freedom to say no; I will discuss this below. The second would appear to be a case of fraud and the law should be able to deal with this in a robust manner. The third could be either.

Where the power between contracting parties is very unequal, opportunistic renegotiation is a danger, but quite possibly a danger which the contracting parties are aware of. Where the powerful party is dealing with only one person, the temptation to make use of this power may be too strong because the mistreated person has no comeback. Where the powerful party contracts with a lot of people, mistreating one will have repercussions on how all the others will behave. Thus the problem of hold-up identified by BIS should be greater the fewer, not the more, agreements a pub company has. Moreover, if one party has the possibility to engage in hold-up, other individuals may be unwilling to engage with this individual. For a pub company to be able to commit not to hold-up tenants when they have the opportunity is very valuable, both in terms of the sort of tenants they can employ and the sort of agreement they can get the tenants to sign up to. Put differently, at least some of the potential tenants must recognise that the pub company may be tempted to hold the tenant up at some later point and hence be reluctant to work for a pub company with a track record of giving in to this temptation. These prospective tenants are also likely to be the ones with the most business sense. A pub company who can build up a reputation for fair dealing should in theory attract the best tenants and this is easier to build up a reputation with a large number of pubs. The reason is that with a large estate of pubs, the pub company is at any given time more likely to be looking for a larger number of new tenants, so the cost of losing reputation is much more severe. Intuitively one would then expect the problem of hold-up to be much more severe for pub companies with small estates not, as argued in the consultation, for pub companies with very large estates.

Another aim, stated in paragraph 5.9, is to ensure a fair balance of risk and rewards.<sup>2</sup> Is it the role of the government to design the optional risk allocation contract? What would the intervention do to safeguard incentives for efficient production? If the intervention gets this wrong, the consequence will be lower efficiency and higher prices.

The cornerstone of the policy is an argument that tied tenants (T) are treated no less favourably than free-of-tie tenants (FoT), see also question 7 below. The document does not make clear the precise difference between T and FoT nor does it ever offer any reason why this cornerstone is sensible. However, the consultation document in paragraph 4.20 does recognise that there are many different forms for organising production and retailing and usually this is so for a reason. The stated aim that tied tenants are treated no less favourable than free-of-tie tenants only makes some sort of sense if the tie conveys no value at all. If it does not, why are 7 out of 10 willing to sign up again with their pub company [paragraph 3.6]? Paragraph 4.24b is both instructive and confusing. In explaining that the code should cover all non-managed pubs, it states that “were the Code to cover only tied pubs, there would be nothing to stop a pub company from removing the tie and immediately increasing the rent to well beyond market rent values.” It must follow from that sentence that the tie has a value to the pub company since it is willing to forgo a substantial rent increase which it could obtain simply by removing the tie.<sup>3</sup> The nature of this value is not entirely clear, but since the number of complaints is relatively small compared to the number of tied houses, it cannot simply stem from the amount of money which the pub company can extract from the tenant who accepts the tie.

While fraud should be prosecuted, it is hard to see that it is sensible for the government to get involved in determining how firms should organise their production and retailing. Removing the discipline of the market is rarely a good idea, especially in an industry which is supposedly competitive. That can only harm consumers. In most sectors there are people who make poor business decisions. Protecting them from the down-side risk is unlikely to help them make better decisions. The banking crisis should have taught us that if we protect those who enter agreements without due care and attention, then we create moral hazard – they will be even less inclined to take care.

While the proposed intervention is not aimed at a competition issue, it is very likely to have competition effects. The two most likely effects of the intervention is to raise costs in the industry which given the competitive nature of the specific market will be passed on to consumers in the shape of higher prices and to reduce the discipline of the market on the quality of tenants with a further adverse effect on costs or quality or both.

## **Answers to specific questions in the consultation document:**

*Q.1 Should there be a Statutory Code?*

**No** – see reasons given above regarding the effect on consumers.

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<sup>2</sup> The Impact Assessment talks about “fair share of profits” as if this is a well-defined concept. It is not.

<sup>3</sup> Though to be fair the document offers no evidence to support the idea that the rent could be increased significantly if the tie was removed.

The reason self-regulation does not work appears to be that the market does not benefit pub companies who abide by it, nor punish those who flout the regulation through allocating the best landlords to those who keep to the rules. If this failure largely arises because not enough of the prospective tenants do their homework properly before signing up, the proposed intervention does nothing to increase the incentive for prospective tenants to do so, quite the reverse.

That this intervention in a well-functioning market is inappropriate is also apparent from the cost-benefit analysis in the Impact Assessment, where the no-intervention is cost neutral, while the intervention involves a net cost.

Fraudulent behaviour should naturally be pursued but it is not clear that the proposed intervention makes this more likely.

*Q2. Do you agree that the Code should be binding on all companies that own more than 500 pubs? If you think this is not the correct threshold, please suggest an alternative, with supporting evidence.*

There should not be a code in the first place. If there were, it should cover all. Why is it possible for a very large pub companies to hide the fact that it treats tenants badly but not a small one? This seems illogical. Surely the harm to the tenant does not depend on the size of the pub estate? Moreover, as argued above, one could reasonable expect pub companies with large estates to have more to lose from a poor reputation.

*Q.3 Do you agree that, for companies on which the Code is binding, all of that company's non-managed pubs should be covered by the Code?*

*Q.4 How do you consider that franchises should be treated under the Code?*

The potential for unintended consequences is large and much more serious analysis should be conducted before including franchises in the Code. This could have repercussions on how other sectors are organised internally.

*Q.5 What is your assessment of the likely costs and benefits of these proposals on pubs and the pubs sector? Please include supporting evidence.*

This is too narrow a question. If the code imposes further costs on the industry, then the marginal pubs are likely to be closed and prices likely to increase. What are the likely costs to consumers? Finally, to the extent that this sort of intervention could be introduced in other sectors, the proposed industrial policy has effects beyond pubs.

*Q.6 What are your views on the future of self-regulation within the industry?*

Self-regulation is most likely to work when it is in the interest of the majority of [honest] traders. But this depends critically on those, for whom the regulation is framed, doing their part. As long as tenants flock to the supposedly bad pub companies, self-regulation does not work because it does not punish the wicked.

*Q.7 Do you agree that the Code should be based on the following two core and overarching principles? (i) Principle of Fair and Lawful Dealing and (ii) Principle that the Tied Tenant Should be No Worse Off than the Free-of-tie Tenant*

Part (i) is motherhood and apple pie, so long as we are sure that we know what is meant by “fair” and that we all mean the same thing. Part (ii) is hard to assess without some sort of argument why. However, part (ii) is not obvious as a principle and as argued above, it may very well be a bad principle.

*Q.8 Do you agree that the Government should include the following provisions in the Statutory Code? (i) Provide the tenant the right to request an open market rent review if they have not had one in five years, if the pub company significantly increases drink prices or if an event occurs outside the tenant’s control. (ii) Increase transparency, in particular by requiring the pub company to produce parallel ‘tied’ and ‘free-of-tie’ rent assessments so that a tenant can ensure that they are no worse off. (iii) Abolish the gaming machine tie and mandate that no products other than drinks may be tied. (iv) Provide a ‘guest beer’ option in all tied pubs. (v) Provide that flow monitoring equipment may not be used to determine whether a tenant is complying with purchasing obligations, or as evidence in enforcing such obligations*

On 8.iii, what if the establishment is a gaming place with a bar? Is this level of intervention warranted?

On 8.iv, What is the empirical evidence in favour or re-introducing the guest beer rule?

On 8.v, the argument offered in paragraphs 5.19-5.21 seems very odd. To see this just run the same argument with water metering [we have managed without since before the 18<sup>th</sup> century, so ...]. Moreover paragraph 5.21 appears very anti-innovation.

*Q.9 Are there any areas where you consider the draft Statutory Code (at Annex A) should be altered?*

*Q.10 Do you agree that the Statutory Code should be periodically reviewed and, if appropriate amended, if there was evidence that showed that such amendments would deliver more effectively the two overarching principles?*

Yes if we have to have it – but this could become very costly. Has anyone totalled up the resources spent on the lobbying and responses to it so far?

*Q.11. Should the Government include a mandatory free of tie option in the Statutory Code?*

No.

*Q.12 Other than (a) a mandatory free-of-tie option or (b) mandating that higher beer prices must be compensated for by lower rents, do you have any other suggestions as to how the Government could ensure that tied tenants were no worse off than free-of-tie tenants?*

On part (b), let the market decide.

*Q.13 Should the Government appoint an independent Adjudicator to enforce the new Statutory Code?*

No. I agree with the one member in the CC supermarket enquiry who thought that an Adjudicator was a bad idea. Moreover, it is not clear from the document what the relationship between the investigative power of the Adjudicator and the new CMA is supposed to be.

*Q.14 Do you agree that the Adjudicator should be able to: (i) Arbitrate individual disputes? (ii) Carry out investigations into widespread breaches of the Code?*

By all means identify an arbitrator, but there are other contract arbitrators out there, so why a new body? The second part creates huge costs - who will pay these costs? How will you ensure that this is not passed on to the consumer in terms of higher prices either directly or due to reduced competition following further pub closure?

*Q.15 Do you agree that the Adjudicator should be able to impose a range of sanctions on pub companies that have breached the Code, including: (i) Recommendations? (ii) Requirements to publish information ('name and shame') (iii) Financial penalties?*

There is no point in having a toothless regulator, so if we are to have one, let them have the power. But keep in mind that enforcement is not also costly in terms of appeals.

*Q.16 Do you consider the Government's proposals for reporting and review of the Adjudicator are satisfactory?*

*Q.17 Do you agree that the Adjudicator should be funded by an industry levy, with companies who breach the Code more paying a proportionately greater share of the levy? What, in your view, would be the impact of the levy on pub companies, pub tenants, consumers and the overall industry?*

It would be cleaner to have a solution where those who breach the code pay through fines rather than through some more or less unclear levies. That way it is clear to all that the money foregone was due to a breach of a code.

On funding, given the cost of a CC inquiry the estimate sounds way too low, particularly in light of question 14.ii. [Why use the OFT as a guideline for costs as done in the Impact Assessment?]

The Government appears to forget that there are not such things as a free pint. If the market really is competitive as claimed, then increasing the fixed costs of the industry will lead to exit until the price has increased to cover these additional costs. The impact of these extra costs on investment, especially in a climate of little bank lending where such investments are largely made from retained earnings, has not been adequately assessed

The net impact will be fewer pubs and higher prices for people who go to the pub.