



# Summary: Analysis & Evidence

# Policy Option 2

Description: A statutory code and adjudicator (Preferred option)

## FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: - 230.20	High: -7.46	Best Estimate: -40.47

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.5	0.9	8.2
High	0.5	27.9	231.0
Best Estimate	0.5	4.9	41.2

### Description and scale of key monetised costs by 'main affected groups'

The adjudicator is estimated to cost £540k to set up and then £1.75m a year to run. The annual costs are made up of the cost of arbitration £400k, investigations £300k, staff for other functions £470k, appeals £400k and other costs of £180k. These costs will be paid by a levy on business. The cost of carrying out free of tie rent assessments is estimated at £1.6m per year to pub companies and £0.3m to tenants. Our best estimate is that eventually the policy will indirectly cause 52 pub closures resulting in an indirect cost to business of £2.2m per year.

### Other key non-monetised costs by 'main affected groups'

There will be a cost to pub companies of treating tenants more fairly. The exact scale of this transfer to tenants depends on the level of unfairness currently in the sector. Based on all tenants currently being treated unfairly, we estimate the upper bound of this transfer to be £140m. This cost is offset by a benefit to tenants of the same size.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0.0	0.1	0.8
High	0.0	0.1	0.8
Best Estimate	0.0	0.1	0.8

### Description and scale of key monetised benefits by 'main affected groups'

The only monetised benefit is a £0.1m saving from no longer funding voluntary regulatory bodies.

### Other key non-monetised benefits by 'main affected groups'

The key non-monetised benefit is ensuring the fair treatment of tied tenants. Fairness in this context is characterised by treatment in line with the principle that the tied tenant should be no worse off than a free of tie tenant. This benefit will involve a transfer to tenants from pub owning companies where they are currently treated unfairly.

### Key assumptions/sensitivities/risks

Discount rate (%) 3.5

The level of unfairness is uncertain and thus the resultant transfer from pub owning companies to tenants is uncertain.

There is a risk that this policy results in a major disruption to the industry with unintended consequences, such as a pub owning company getting into financial difficulty or selling, closing or taking on direct management of more pubs.

## BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 2.8	Benefits: 0.1	Net: -2.7	Yes	IN

# Background

## Background to the pub industry

1. The pub industry faces a range of pressures including the current economic climate, the impact of the smoking ban, competition from supermarkets, improving home entertainment, increases in duty, social and demographic changes and a trend towards drinking alcohol at home.<sup>1</sup> Respondents to the online questionnaire during our consultation rated the beer tie, supermarket pricing and taxation as the three biggest challenges.<sup>2</sup> Beer sales are also declining.<sup>3</sup> There has been a big contraction in the industry over the last three decades: from almost 70,000 pubs in 1982 to around 50,000 today.<sup>4</sup> Between April 2013 and December 2013 28 (net) pubs closed a week.<sup>5</sup>
2. Despite falling pub numbers there is still competition in the market. In 2010, the OFT found that “At a national, regional and local level, the evidence indicates that there is a large number of competing pub outlets owned by different operators and that there is competition and a choice between different pubs.”<sup>6</sup> Importantly they also said “Given that we have found that consumers are benefiting from a significant degree of competition and choice between pubs, we do not consider that issues relating to the negotiation process between pub companies and lessees can generally be expected to result in consumer detriment.”<sup>7</sup>

## Types of pub

3. For this impact assessment, the main relevant features of pubs are their ownership, management and who they can buy beer from.

**Table 1: Key differences between pubs**

Type of pub	Ownership	Management	Buy beer from	Proportion of pubs in the UK <sup>8</sup>
Managed pubs	Pub Company	Pub company	Pub company	17%
Free house	Freeholder	Freeholder	Anyone	36%
Leased/tenanted pubs – Free of tie	Pub Company	Tenant	Anyone	
Leased/tenanted pubs – Tied	Pub Company	Tenant	Pub company	48%

4. Obviously the relationship between pub owner and tenant<sup>9</sup> is not a problem for free houses or managed pubs as there is no tenant. Despite the potential for problems between owner and tenant, when a fair balance of risk and reward is achieved leased or tenanted pubs offer a relatively low cost entry to the industry. Pub owning companies offer a variety of tied agreements although most broadly fall into two types, either:

- short-term tenancies – are typically for three to five years, normally with an opportunity to renew the agreement, where the pub owning company will generally carry out repairs (or structural

<sup>1</sup> OFT, CAMRA super-complaint - OFT final decision, October 2010

<sup>2</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/265477/Survey\\_Monkey\\_online\\_pubs\\_responses\\_to\\_the\\_consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/265477/Survey_Monkey_online_pubs_responses_to_the_consultation.pdf)

<sup>3</sup> <http://www.beerandpub.com/statistics>

<sup>4</sup> <http://www.beerandpub.com/statistics>

<sup>5</sup> [http://www.camra.org.uk/article.php?group\\_id=12876](http://www.camra.org.uk/article.php?group_id=12876)

<sup>6</sup> OFT, CAMRA super-complaint - OFT final decision, October 2010

<sup>7</sup> OFT, CAMRA super-complaint - OFT final decision, October 2010

<sup>8</sup> Figures from CGA - no distinction is made between free of tie and free house pubs

<sup>9</sup> Tenant is used in this document to refer to the person who has a tenancy or lease for a pub.

repairs at least) and the tenancy will not be assignable but can be easily exited, or;

- longer-term lease agreements – are typically for a duration of 10 to 25 years, during which a lease holder would be required to carry out full repairs and decoration of the premises and the lease would generally be assignable. A lease agreement will therefore allow a lease holder to build up goodwill in a property. This provides a different exit route for a lessee, who is able to assign (sell) the lease. It also allows a lessee to borrow against the lease.

5. There are other tied agreements. Tenancy At Will is a short term agreement that can be terminated by either party with little notice. It is often used as a stop-gap agreement while a longer term agreement is reached. There is also an increasing trend in the provision of franchise type arrangements including some accredited by the British Franchise Association and others which share some but not all the features of a franchise.
6. A further distinction is between industry and non-industry leases. For industry leases pub rents and valuations are assessed with regard to their trading potential as a pub. For non-industry leases (or traditional commercial leases) valuations and rents are usually based on location and size of the property. Tied pubs usually have industry leases whereas the majority of free-of-tie pubs have commercial leases.

### The beer tie<sup>10</sup>

7. The beer tie refers to a condition in a lease which requires a tenant to buy beer through the pub owning company, rather than on the open market. Traditionally these agreements include a discounted property rent, the 'dry rent', and above market prices for the beer, the 'wet rent'. The pub owning company is also likely to provide other services, known as special commercial or financial advantage (SCORFA) such as business development advice, branding or free Sky TV. The provision of these benefits is one of the means by which a tied tenant can be said to be 'no worse off' than a free of tie tenant.<sup>11</sup>

### Benefits of the tie

8. For the pub owning company, having tied pubs provides a guaranteed market for their beer. This gives them economies of scale. The impact of economies of scale is seen in the greater discounts brewers give to larger purchasers such as pub companies and wholesalers.<sup>12</sup> For brewing pub owners this provides them with the minimum scale for their brewing operations. For some of the family brewers having a 'safe market' of a few hundred pubs is seen as critical to establishing and maintaining their brand and beer sales. For non-brewing companies the guaranteed large order volumes gives them economies of scale within purchasing and distribution allowing them to negotiate discounts from brewers. There are also economies of scale in the other benefits pub companies offer such as a website, marketing or free Sky TV.
9. The tie is also a profit and risk-sharing mechanism. If the tenant does well (sells more beer) they will pay more 'wet rent' and, conversely, in hard times they will pay less. For the tenant this means running a pub costs less up front<sup>13</sup> and has less downside risk. The pub owning company is also an experienced partner with an incentive to help increase sales. The two parties have a shared incentive to invest in the pub. For the pub owning company the risk sharing element of the tie makes getting tenants easier by reducing their upfront cost while not necessarily reducing their overall rent. The cost of tenants failing also gives the pub owning company an extra incentive to help the tenant succeed.

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<sup>10</sup> There are other ties in operation but beer accounts for the vast majority of sales

<sup>11</sup> Trade and Industry Committee, Second Report, 2004-05, vol 1 p41

<sup>12</sup> OFT, CAMRA super-complaint - OFT final decision, October 2010

<sup>13</sup> . According to Fleurets (December 2013 Survey of Pub Prices) the average sale price of a leasehold pub was £41k compared to £580k for a freehold.

## Drawbacks of the beer tie

10. The tie adds an extra layer of complexity to the landlord-tenant relationship compared to a fixed rent and separate beer supply agreement. It complicates the relationship between pub owning company and tenant making it tougher for tenants to know if they are getting a good deal. Many complain that they pay above market rates for beer and while this is a deliberate part of the beer tie it is hard for tenants to judge the fairness of the prices they are charged. This complexity also gives greater potential for abuse; for example without the tie there would not be concerns over the use of flow monitoring equipment as a means to enforce the tie.
11. The inability to change supplier also reduces tenants' ability to drive the pub owning company to provide a good service. Although pub companies have a strong incentive to provide a good service in order to get high sales and thus a high wet rent, there are still complaints, for example about deliveries. Complaints about deliveries include deliveries out of the declared time slot, refusal to take all the 'empties' and the crew changes week by week resulting in calls asking for directions, explanation of the position of the drop, and needing "baby-sitting in order to do their job".<sup>14</sup> While there may be problems with deliveries for free of tie pubs, tied pubs are unable to change supplier. Another potential problem arises if the pub owning company wants to sell the pub to a developer. There have been allegations that pub owning companies have deliberately offered a poor service in some cases in order to try to force the tenant out and sell to a developer.
12. Tied tenants have less choice and flexibility with regard to how they run their pub. This can vary from a limit on which beers they stock<sup>15</sup> to restrictions on décor and branding (usually for shorter term tenancies). This is obviously a real downside for the individual publican but doesn't necessarily reduce choice in the market place (see paragraph 24).
13. Profits for tenants from tied products are lower than they would be giving tenants less incentive to sell them. This may be socially inefficient as tenants will not consider the profit that the pub owning company makes.
14. Pub companies lose out if the pub does badly, through reduced wet rent, but may have limited control over how the pub is run. Ensuring they have more control is one reason suggested for having the most profitable pubs as managed pubs.

## The beer tie and pub numbers

15. Overall pub numbers have been in steady decline since at least 1980. Neither the Beer Orders in 1989 (which established the current non-brewing pub company beer tie system) nor pub owning company consolidation in the early '90s have seen a major change in the rate of declines. Closures did accelerate somewhat during the recession but have since returned to the previous steady decline.
16. The decline is widely recognised to be due to a range of factors, including changing cultural habits, increased taxation, the rise of low-cost selling at supermarkets and the smoking ban.
17. Some campaigners argue the tie plays a factor, but there does not seem to be strong evidence to support this. The available figures for pub numbers do not clearly distinguish between tied and free of tie pubs. Instead the figures split pubs by ownership rather than the business model. The non managed category is the closest to a tied category but includes all leased pubs whether subject to purchasing obligations or free of tie.
18. If one does use the available figures, for example a CGA Study commissioned by CAMRA,<sup>16</sup> they show that between March 2010 and September 2012 the closure rate was very slightly lower in 'non managed' pubs, 4.3%, than in 'free' pubs, 4.5% (see table below). The 'net closure' is the more

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<sup>14</sup> Business and Enterprise Committee, Seventh Report, 2008-09, vol 1, p34

<sup>15</sup> Some pub companies do offer their tied licensees hundreds of beers, but some offer a far more limited range. And of course the open market offers even more.

<sup>16</sup> The Campaign for Real Ale

appropriate statistic to use as it takes into account ‘churn’, where pubs close for a short period then reopen.<sup>17</sup> However, if one uses gross closure figures then proportionately even more ‘free’ pubs are closing, 3.4% versus 5%.

**Table 2: Relative changes in tied and untied pub numbers**

	Free	Non-managed
Number at March 2010	21601	28404
Number at Sept. 2012	20516	27448
Net closures	-975	-1215
Transfers in	-110	259
Overall change	-1085	-956
Net closure rate	-4.50%	-4.30%
Percentage change	-5.00%	-3.40%

19. In 2008 and 2009 large numbers of pubs transferred out of the non managed sector into the free sector. This led the overall number of non managed pubs to fall by over 3000 and the number of free pubs to remain roughly constant. Even if one interprets the non managed sector to be tied and the free sector to be free of tie (see paragraph 17), this does not show that the tie is causing pubs to fail, just as the more recent smaller number of transfers the other way does not show that being a free house is causing pubs to close. The two business models have different benefits and movement between them reflects this.
20. More generally closure figures don’t show whether the tie (or lack thereof) is having an impact. Tied and non-tied pubs differ in other ways that may be impacting these closure figures. For example the OFT “found that [a] higher proportion of free of tie than tied pubs are located in rural areas”. As such, even if free of tie pubs are closing faster this may be nothing to do with their lack of tie.

#### The beer tie and competition in the market

21. In its 2010 response to a super-complaint from CAMRA, the OFT found no evidence that the beer tie results in competition issues that cause harm to consumers. The OFT reasoned “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.” If pub companies tried to limit choice of beer or raise prices, then consumers would go elsewhere.
22. Consumers have a wide choice of pubs with most pubs operating in areas that include a high number of rival operators. The OFT looked at the number of different rival operators that pubs competed with in narrow geographic areas. Their analysis considered a one mile radius in urban areas and a five mile radius for rural areas. They found that:<sup>18</sup>
  - 99.2 per cent of all UK pubs compete in areas that include two or more pubs owned by different operators
  - 97.3 per cent are in areas that include three or more pub operators
  - 87.4 per cent are in areas with six or more pub operators, and
  - 65.4 per cent are in areas with 12 or more pub operators.
23. The OFT did not support CAMRA’s claim that the actions of pub companies lead to higher retail prices in tied pubs. While the OFT did find beer prices to be higher in tied pubs, it considered other factors likely to contribute to this, such as higher rental costs due to more urban locations. Furthermore they found “Large pub companies’ gross profit margins have decreased between 2005

<sup>17</sup> This is appropriate as our interest here is in the number of pub closures rather than business failures, which a short term closure of the pub may be the result of.

<sup>18</sup> CAMRA super-complaint - OFT final decision, October 2010 paragraph 5.33

and 2010 and consistent with this, prices charged to lessees have increased at a lower rate than the prices charged to pub companies by brewers, suggesting that pub companies have not passed on the full extent of price increases at the brewing level of the supply chain". Across the wider pub market, the OFT found "in the last 10 years, beer prices in pubs have not increased at a faster rate than service sector inflation". Service sector inflation is the appropriate comparator as it includes pub costs such as wages.

24. The OFT did not consider "that tied lease agreements prevent pubs offering a wide choice to consumers". The report states that the "evidence demonstrates that large pub companies which supply beer to their tied pubs are generally sourcing from a considerable range of suppliers and there appear to be significant opportunities for access by brewers to pubs and other on-trade outlets." The OFT found that large pub companies which own tied pubs purchase a considerable volume of beer from micro and regional brewers.<sup>19</sup>

#### Legal position of the beer tie<sup>20</sup>

25. The beer tie is considered lawful practice. The practice has been found not to be anti-competitive where pub companies buy drinks from a number of sources and are not large enough to contribute to a cumulative foreclosure effect. However, the tie has been found to hinder market access where a significant number of pubs were tied to companies which acquired their beer largely from one source. In these cases the tie benefited from an exemption to competition law as it was found to lead to an improvement in the distribution of beer and provided countervailing benefits for tied lessees.

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<sup>19</sup> Direct selling to free of tie pubs is the most common route to market, see [http://siba.co.uk/wp-content/uploads/2011/02/industry\\_report\\_20111.pdf](http://siba.co.uk/wp-content/uploads/2011/02/industry_report_20111.pdf)

<sup>20</sup> See CAMRA super-complaint - OFT final decision, October 2010 sections 2.31-2.33 for further detail.

## Problem under consideration and rationale for intervention

26. The consultation made clear the Government's belief that there is a problem in the relationship between pub owning companies and their tenants and stated the Government's intention to intervene. The purpose of the consultation was to obtain views about our proposals to address the problems in that relationship.

### Evidence of a problem

27. The scale of the problem has been demonstrated by evidence presented to four Select Committee investigations over the last decade (2004, 2009, 2010 and 2011) into the relationship between pub owning companies and their tenants, and whether the tied model is at the root of unfairness in this relationship. In addition to the evidence heard by the BIS Select Committee over the last decade from tenants and their representatives, the Government has received a steady and continuous stream of correspondence from tenants about problems in their relationship with their pub owning company, as well as from many MPs writing on behalf of their constituents.
28. This cumulative evidence has clearly established that in too many cases tenants are unable to secure a fair share of risk and reward in their agreements. The April 2009 Business and Enterprise Select Committee for example said:
- Increasing a pub's turnover will benefit the pubco as it increases the sale of tied products. To our surprise it does not seem to benefit the lessee to nearly the same extent. Over 50% of the lessees whose pubs had turnover of more than £500,000 a year earned less than £15,000. The pubcos may share the risks with their lessees but they do not share the benefits equitably.<sup>21</sup>
29. The same Select Committee also found that the notion that tenants were receiving countervailing benefits that compensated for higher tied beer prices was also questionable:
- There is no evidence demonstrating that a tied lessee receives benefits not available to free of tie tenants or freeholders. Nor are we in a position to say with confidence that rents for tied pubs are invariably lower than rents for equivalent free of tie premises. We have been given examples where free of tie premises cost more to rent than tied ones and examples where they cost less.<sup>22</sup>
30. Specific evidence submitted to the committee by publicans cited a number of issues in the way they were treated by their pub owning company including repeated reports of delay in opening rent review negotiations, lack of transparency in such negotiations, failure to carry out repairs agreed when a tenancy began, verbal agreements being ignored, and of harassment of lessees when they were vulnerable through bereavement.<sup>23</sup>
31. The evidence of a problem from tenants can be grouped in the following categories:
- Lack of Transparency
- A failure to provide evidence to support the pub owning company rent assessment assumptions e.g. on likely trade, which later proved to be overestimated. Also a failure to ensure incoming tenants are aware of the true extent of their financial liability e.g. for rates and/or a lack of clarity on the extent of other liabilities e.g. for repairs. There also seems to be confusion about how the tie works; in a telephone survey conducted on behalf of the Federation for Small Businesses 28% of tenants said that when they signed their agreement they thought that under the tie they would be paying the same or less for beer than on the free market.

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<sup>21</sup> Business and Enterprise Committee, Seventh Report, 2008-09, vol 1, pp 50-51

<sup>22</sup> Business and Enterprise Committee, Seventh Report, 2008-09, vol 1, p69

<sup>23</sup> Business and Enterprise Committee, Seventh Report, 2008-09, vol 1, p45

- The Cost of Tied Products

A lack of transparency in the pricing of beer may suggest that the benefits of pubcos buying at scale is not being shared with tenants, also high charges for other tied services e.g. insurance, and/or gaming machines which might be cheaper on the open market.

- Compliance with Agreements

A range of reported practices which suggest the pub owning company is abusing the relationship e.g. in failure to meet deadlines leading to delays in rent negotiations; failure to comply with the contractual processes for termination of tenancies e.g. by not putting grounds of termination in writing ; failure to deliver promised benefits of the tie e.g. in marketing the pub and/or providing training; reliance on flow monitoring equipment to support enforcement action for going outside the tie when other evidence was contradictory; failing to honour commitments in terms of property maintenance e.g. delays to checks and repairs which affected trade; and failure to deliver stock therefore forcing the tenant to either lose trade or buy out of the tie.

- Levels of 'Dry' Rent

Tenants also complained that rent increases took into account increases in trade following improvements they themselves had made to the business. One lessee told the Select Committee that having turned around his pub, after a year, his rent was increased by 50% and his pubco told him that "the rent had been set too low for the previous tenant" although there had been no mention of this when he had taken on the pub.<sup>24</sup>

- Other Issues of Fairness

Other reported practices that question the fairness of dealing by pub companies include: the use of upward only rent review clauses that do not take account of wider circumstances affecting trade<sup>25</sup>; the sale of a pub freehold to another company with no notice so the tenant is faced with a new landlord and new tied arrangements and cases of infrequent and inconsistent communications from the pub company's business development manager.

32. Even in this consultation, which was focussed on what to do rather than gathering evidence of a problem, we received around 90 responses from individual pub tenants outlining concerns about their pub owning company's unfair treatment, including prices and rent levels that they pay to their pub landlord, and/or with the rent assessment process more generally. Of the 714 tied tenants who responded to the online questionnaire that was part of the consultation, 89% supported a statutory code and adjudicator. 56% of the tied tenant respondents thought a compulsory free of tie option was the best way to ensure tied tenants are no worse off than a free of tie tenant. When the Federation of Small Business surveyed 500 tied tenants<sup>26</sup> 87% said they would be better off if they were free of tie paying a fair rent. Tenants have reported a number of actions by pub companies which they consider an abuse of their commercial relationship leading to an unfair share of risk and reward.
33. Tied tenants are also more likely to face serious hardship - 57% of tenants tied to large pub companies reported earning less than £10,000 a year, compared to just 25% for tenants who are free of tie.<sup>27</sup>
34. The tie is not universally bad (see paragraphs 8-9) and the latest independent annual survey – conducted by CGA strategy – showed 7 out of 10 tenants would sign up again with their pub owning company.<sup>28</sup> Nevertheless, ensuring the fair working of the beer tie is particularly important because of the hardship many publicans face including the possibility of losing their home (which is the pub<sup>29</sup>).

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<sup>24</sup> Business and Enterprise Committee, Seventh Report, 2008-09, vol 1, p27

<sup>25</sup> Although this is now prohibited under the voluntary code

<sup>26</sup> All of whom are non-FSB members

<sup>27</sup> CAMRA survey, June 2013. When FSB surveyed their members they found 59% earned less than £10k (see FSB consultation response)

<sup>28</sup> Although the FSB found that 86% of their members would not renew on the same terms.

<sup>29</sup> This, of course, is no different from much of the rest of the pub trade

## Rationale for intervention

35. The Government considers that these poor outcomes for tenants are driven by features of the market and exacerbated by the nature of the tie between pub companies and tenants. In particular the market is characterised by:

- Asymmetric information

There is asymmetric information in the pubs sector with pub companies having better information than tenants. Key areas of asymmetry include access to a wider set of pubs to compare with - pub companies will deal with hundreds of pubs - and large pub companies will presumably have a better idea of what is particular to a pub and what is a market wide phenomenon. There was also evidence presented to the select committees that pub companies are likely to better understand particular lease arrangements; 34% of tenants “did not feel sufficiently prepared by information and advice from their pubco before signing their lease”<sup>30</sup> and 23% of tenants “did not understand the options being presented to them”<sup>31</sup>

- Imbalance of bargaining power

One of the causes of problems highlighted by BISCOM is the inequality of bargaining power between the two parties. In 2004 when the select committee first identified the imbalance they noted that:

The pubcos have argued that if tenants do not agree with their rent assessment, they should not have entered into the lease or accepted the rent review. We do not share this view. In the relationship between pubco and tenant, the tenant is in the weaker bargaining position. Pubcos should recognise that they have a responsibility to ensure they do not exploit their position of economic strength.<sup>32</sup>

The imbalance identified by the select committee may be a result of pub companies having access to more information and resources; they can better afford legal and surveying costs. Pub companies may have less to lose from not reaching an agreement with a tenant; they may be better able than tenants to afford to go to court (or an arbitration service).

- Behavioural biases

Tenants are likely to suffer from behavioural biases, including being over optimistic about a pub’s potential and struggling to deal with complexity. The problem may be exacerbated by tenants who go into the pub sector as a ‘lifestyle choice’ rather than as a commercial business decision. Many publicans do not shop around for pubs<sup>33</sup> or invest based on business reasons, rather they choose a pub they like or on the basis of the attached living accommodation. The tie may add to problems as it complicates the relationship between tenant and pub owning company, making it tougher for tenants to know if they are getting a good deal. There also seems to be confusion about how the tie works; in a telephone survey conducted on behalf of the Federation for Small Businesses 28% of tenants said that when they signed their agreement they thought that under the tie they would be paying the same or less for beer than on the free market.

- Lock-in through the tie

As well as contributing to the above problems, the tie means once they have signed a lease tenants cannot change their pub owning company. Being locked in limits tenants’ ability to put pressure on pub companies to provide a good deal. It also makes it difficult to judge whether tied tenants get a good deal or not as they cannot choose.

36. The existing self-regulatory approach seeks to address the first three of these issues - asymmetric information, imbalance of bargaining power and behavioural biases. However experience to date

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<sup>30</sup> Business and Enterprise Committee, Seventh Report, 2008-09, vol 1, p21

<sup>31</sup> Business, Innovation and Skills Committee, Tenth Report, 2010-12, vol 1, p18

<sup>32</sup> Trade and Industry Committee, Second Report 2004-05, vol 1, p46

<sup>33</sup> In one CGA survey 73% of respondents only looked at one pub company

suggests that problems remain (see paragraphs 40-44). The statutory code and adjudicator will go further on these issues. Asymmetric information will be addressed by improving the provision of information to tenants when they sign leases and at rental negotiations. The adjudicator's investigation power might be used to prevent systematic abuses around information provision, for example if the adjudicator has reason to suspect a pub owning company is not correctly providing tenants' information. The imbalance of bargaining power will be addressed by information provision and improved enforcement. The main improvement to bargaining power will be through the provision of parallel rent assessments (discussed in the next paragraph). Behavioural biases are addressed through pre-entry training, which is already included in the voluntary Code but where BISCOP raised as an area where compliance is weak.

37. Including an option for tenants to request parallel rent assessments in the statutory code will greatly improve how these issues are addressed. A free of tie rent assessment will allow tenants to make a more straightforward comparison between the tied and free of tie business model. In setting out the free-of-tie assessment pub owning companies will be required to demonstrate that tenants are likely to be 'no worse off' as tied tenants than they would be if free-of-tie. This reduces the asymmetry of information as pub companies will have to better explain the benefits of the tied model. Having a free of tie comparison will also make the differences in the models more apparent reducing behavioural biases due to complexity. While this doesn't address the problem of lock-in, it will impact the balance of bargaining power. This is a big difference from the self regulatory system which does not address this. Giving tenants the ability to compare tied and free of tie rental assessments will enable them to ensure that any premium paid for tied products is compensated for in lower dry rents or other benefits. This puts them in a stronger bargaining position and pub companies will have to work harder to demonstrate that tenants are not losing out from being tied. The parallel rental assessments will also provide a check that the tied market as a whole is working as it should do with higher tied product prices being offset by other benefits such as lower rent or services from the pub owning company.
38. Given the evidence, particularly from the select committee reports, Ministers believe there is reason to intervene on the basis of fairness to rebalance outcomes.

# Analysis of Options

## Options considered

39. At the consultation stage we considered the following options.
- Option 1 - continue with self-regulation
  - Option 2 - a statutory code and adjudicator
  - Option 3 - a statutory code and adjudicator including a mandatory free of tie option

Options 1 and 3 have now been discarded and option 2 is the preferred option.

## Option 1 - continue with self-regulation

40. A self-regulatory approach has been in operation since at least 1998<sup>34</sup>, but it was found wanting by the Select Committee in 2011. This was confirmed by the responses to a call for evidence made by the Secretary of State in Autumn 2012 about whether self-regulation was working. The Government received 19 responses to the call for evidence from a range of individuals and organisation, which suggested that individual publicans are continuing to face serious hardship and difficulties operating in the industry. The Association of Licensed Multiple Retailers, for instance, noted in their response that 'outstanding fundamental issues remain to be resolved'. The Government had therefore concluded that self-regulation had not been sufficient to increase transparency in the relationship between pub owning company and tenant; or to give tenants better access to all of the information they needed to make informed business choices. There was still evidence of ongoing hardship faced by individual tenants.
41. The Government recognises that there has been progress with self-regulation and that efforts have been made by the pub owning companies, their representatives, and some tenant groups to deliver change. We have seen the creation of the Pubs Independent Conciliation and Arbitration Service (PICAS), the Pubs Independent Rent Review Scheme (PIRRS) rent dispute arbitration service and the introduction of an industry framework code (IFC). Version 6 of the IFC was agreed in January 2013 and the Government understands that individual company codes have since completed the accreditation process. A Pubs Governing Body was created in May 2013 to oversee the IFC, as well as PIRRS and PICAS.
42. However, there are reasons to believe the ability of self regulation to continue making incremental improvements is limited by the acrimony in the industry, the limited scope of self regulation and issues around compliance. There is a high level of acrimony in the industry<sup>35</sup>; many tenants do not regard the self-regulatory process as transparent or independent. While some tenants groups are represented on the Governing Body, we are aware that a number of tenant groups are not willing to be represented because the Board does not share the objective of tied tenants being no worse off than free of tie tenants. While the IFC stipulates that all contracts must be 'fair, reasonable and comply with all legal requirements', it still does not directly address the issue of rebalancing risk and reward.
43. Self regulation will not be able to deliver the improvements required because it does not cover many of the most contentious issues, such as flow monitoring equipment, the gaming machine tie and the principle of tied tenants being no worse off than free of tie tenants, There are also concerns over compliance with BISCOP finding insufficient pre-entry training and significant use of waivers to avoid the training; a third of lessees reported not receiving a copy of their company code; pub companies not seeking proof that tenants were in receipt of professional advice; and trade bodies not ensuring that RICS guidance was adhered to. A voluntary code cannot effect the sort of fundamental rebalancing of risk and reward between pub companies and tenants that the Government has concluded are necessary. This is because the industry has not shown sufficient willingness to address risk and reward in the voluntary industry code.

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<sup>34</sup> Greene King introduced a voluntary code in 1998 - letter from Greene King May 2013

<sup>35</sup> Business, Innovation and Skills Committee, Tenth Report, 2010-12, vol 1, p11 and despite some progress still visible in the consultation responses

44. A statutory code and adjudicator would correct these failures of self regulation – the problems with acrimony, scope and compliance. As agreement will not be necessary for a statutory adjudicator to act the acrimony within the industry will not be a hindrance. Furthermore, the existence of an independent adjudicator will give both sides reassurance that the system is fair and the rules are being followed; this may reduce the level of acrimony in the sector. The scope of the statutory code will be wider including the key issue of risk and reward. Compliance with the code will be improved as the adjudicator has greater powers and can provide stronger enforcement than the existing industry dispute resolution mechanisms. In particular, the adjudicator will have the ability to investigate systemic breaches of the code, to impose financial penalties and to publicise breaches.

### **Option 3 - a statutory code and adjudicator including a mandatory free of tie option**

45. Mandatory Free of Tie arguably represents the simplest and quickest way of delivering the Government's aim of ensuring that no tied tenant is worse off than a free of tie tenant. It also fits with the process of negotiation that is the norm in the industry. However, the Government is very conscious of the impacts of previous legislative changes, for example the unexpected impact of the Beer Orders. A mandatory free of tie option would be more disruptive than the preferred option of providing parallel rent assessments. The preferred option will address the issue of risk and reward while not permitting tenants to oblige a change from a tied to a free of tie agreement. Under a mandatory free of tie provision the uncertainty generated by pub companies not knowing whether pubs will remain tied or not could negatively impact on the operation of the tied model. Pub companies may have less incentive to invest in pubs if they lose their tied revenue stream. Faced with a significant number of their tenants going free of tie pub-owning companies may even take the decision that it makes business sense to abandon the tied market. While as property owners they would still have an incentive to invest in their property, the result may be a more hands off relationship with tenants. Even some of the strongest critics of poor pub owning company practice do not argue they want to diminish the tie as a business model.
46. Furthermore a mandatory free of tie provision in the statutory code is estimated to lead to a greater number of pub closures. This option is estimated to lead to 390 closures (see annex A) compared to 52 for the preferred option (see paragraphs 108-121).

## **Analysis of Preferred Option**

### **Option 2 - a statutory code and adjudicator**

47. Under this option there will be a statutory code enforced by an adjudicator. This would be an improvement on self regulation, which has failed (see paragraphs 40-44), and would address the imbalance of bargaining power between pub owning company and tenant (see paragraphs 36-37). The Code will require pub owning companies to supply, on request, tied and free of tie rent assessments for a specific pub in line with open market principles and in line with RICS guidance. They will focus on the circumstances of the pub in question drawing on relevant market information. In line with the long held industry view, the Government will expect that the parallel assessments to show that the tenant will be no worse off under the tied agreement than if he or she were free of tie. It will therefore directly address the incentives on pub owning companies to ensure they take a fair share of the profits from a tied pub business. A tenant in receipt of fair parallel rent assessment statements, with projected post rent balances, will be able to determine whether they are no worse off in a tied agreement and use the assessments provided to negotiate a better tied deal. If a tenant believes that a tied or free-of-tied assessment breaches the Code they will be able to appeal to the Adjudicator. If the Adjudicator finds in favour of the tenant then the pub owning company will be required to produce a new assessment.

#### **The Statutory Code**

48. The core part of the statutory code would be based on the existing Industry Framework Code (version 6), but would include enhanced provisions, including the provision of parallel rent assessments, that only apply to pub companies with 500 or more tied pubs. The parallel rent

assessments would be done in the same way as is currently done for real free of tie rent assessments. Both tied and free of tie rent assessments should use the guidance from the Royal Institution of Chartered Surveyors.

49. This is a change from the consultation when we proposed that rents in the two offers, tied and free of tie, should be the same as a proportion of the pub's profits. This meant no consideration could be given to any reduction in rent already part of the tied rental agreement. Importantly this would have meant the share of profits paid as rent under free of tie agreements would have been artificially low in most cases. The original proposal was designed to avoid pub companies being able to put tenants off the free of tie option by proposing unjustifiably high rents. However, we now consider that this can be avoided by ensuring rents are set in accordance with RICS guidance. This means the share of profit paid in rent will depend on the demand for the property, as is currently the case in the market for other rental agreements.
50. Other changes from the code proposed in the consultation include -
- Not including the 'guest beer option' i.e. the right to sell one guest beer from any source - this would have benefited tenants in an untargeted way.
  - Not abolishing the gaming tie, rather letting tenants choose whether to be tied or not for gaming machines.
51. The core provisions of the statutory code would apply to all tied pubs, with parallel rent assessments element only applicable to those pub companies with 500 or more tied pubs.<sup>36</sup> Our estimate for the number of pubs covered by the core code is based on the British Beer and Pub Association's (BBPA) estimate that 20,000 UK tied pubs are covered by self regulation. Tied pubs in Scotland and Northern Ireland will not be covered and so need to be excluded, while any tied pubs currently not covered by self regulation (in England and Wales) need to be added in. The number to be excluded almost certainly exceeds the number to be added in; three of the large pubcos operate a tied model in Scotland, with around 800 pubs between them and the BBPA believes almost all tied pubs are covered by the voluntary code. To avoid underestimating the costs to these businesses we assume these adjustments are both 1000, resulting in an estimate of the number of pubs covered as 20,000. Only pub companies with 500 or more tied pubs will be covered by the requirement to offer a parallel rent assessment.

### **Nature of the Adjudicator**

52. The adjudicator will have the power and function to:
- arbitrate disputes between pub companies and their tenants;
  - carry out investigations based on complaints that have been received,
  - have wide-ranging powers to require information from pub companies during an investigation;
  - impose sanctions including, in the case of severe breaches, financial penalties where an investigation finds that a pub owning company has breached the Code;
  - publish guidance on when and how investigations will proceed and how these enforcement powers will be used;
  - advise pub companies and tenants on interpretation of the Code; and
  - recommend changes to the Code.
53. The adjudicator would be funded by an industry levy on those who are covered by the statutory code with, over time, those who breach the code more paying a proportionately higher levy.

### **Summary of benefits and costs**

54. The main benefit of this option is the fair treatment of tenants. The resultant transfer to tenants is discussed in paragraphs 59-63. The other benefit is the saving from not funding self regulation discussed in paragraph 64.

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<sup>36</sup> For more details see government response

55. The following costs are estimated:
- Costs of the adjudicator (paragraphs 65-91)
  - Transfer from pub companies to tenants (paragraphs 92)
  - Costs of compliance for pub companies (paragraphs 93-100)
  - Costs of compliance for tenants (paragraphs 101-105)
  - Closures (paragraphs 106-121)
56. The impact of these costs on consumers and pub companies is considered in paragraphs 122 and 123 respectively. The regulatory burden under one-in two-out rules is summarised in paragraph 124.

## Benefits

57. The main benefit of this option is ensuring fair treatment of tenants in line with the principle that tied tenants should be no worse off than free of tie tenants. This will be achieved by enhancing tenants' bargaining power and ensuring any dispute is resolved in a fair way. Under this option a tied tenant will be able to clearly see whether they are getting the benefits that they should be as part of the tied model. This will equip the lessee with the information required to enter into a genuine commercial negotiation and to assess the fairness and full implications of the deal being offered to him. The independent statutory adjudicator will have much greater powers and provide stronger enforcement than the existing industry dispute resolution mechanisms. In particular, the adjudicator will have the ability to investigate systemic breaches of the code, to impose financial penalties and to publicise breaches.
58. This should only benefit tenants where they are currently treated unfairly. None of the improvements - increased transparency, better enforcement and the ability to get parallel rent assessments - should benefit tenants who are already treated fairly (although it may offer reassurance). This is in line with the goal of the policy to ensure that tenants are treated fairly in accordance with the principle that a tied tenant should be no worse off than a free of tie tenant.

## Transfer to tenants from pub companies

59. This improved treatment will result in a transfer from pub companies to tenants. As the benefit will only be for those who are currently treated unfairly, we expect that there will only be a transfer where tenants are not currently treated fairly and that the transfer will be proportionate to the current level of unfair treatment. Although there is clear evidence of a problem, there is no independent quantification of the current level of unfair treatment. The level of current unfair treatment is subject to strong disagreement. Tenants' groups claim the level of unfairness is high - the GMB union estimate that "average tied lessees are overcharged by pubcos by around £12,000 per annum".<sup>37</sup> Individual tenants claim even greater issues; one tenant stated if free of tie he would be £45-50k better off.<sup>38</sup> Pub companies claim that the current system of self regulation is working and there is no evidence of a risk and reward problem - the British Beer and Pub Association submitted that "there is likely to be little if any transfer of value if proper consideration is given to the SCORFA benefits over the lifetime of an agreement and taking account of risk and reward". Even on the single issue of estimating the value of SCORFA opinions vary from a valuation of zero to estimates over £10k.<sup>39</sup>
60. One way to establish an upper bound for the level of transfer is to assume all tenants are treated unfairly and so will gain a transfer a result of this policy. This is in effect what we did in the consultation stage IA. As discussed in paragraph 49, the consultation proposals did not allow the share of expected profits paid as dry rent to vary between free of tie and tied offers. This meant any discount in rent given to tied tenants could not be taken out of a free of tie deal. This makes sense if these discounts were not given in the first place and tenants are charged a premium on tied products without a reduction in dry rent. Another way wet rent is justified is by the provision of other services, SCORFA, however the OFT estimated this as just £1.5k per pub per year compared to wet rent of

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<sup>37</sup> <http://www.gmb.org.uk/campaigns/gmb-tied-trade-tenants-dispute/about>

<sup>38</sup> Quoted in CAMRA response

<sup>39</sup> CAMRA and eg. BBPA (£6-10k business/legal/property/marketing/training etc. + direct financial support £1-5k +50% premium if bought on open market) responses respectively

£15.5k per pub per year.<sup>40</sup> This makes tied pubs £14k less profitable a year than an equivalent free of tie pub. If dry rent is 50% of expected profits<sup>41</sup>, this will reduce dry rent by £7k, but still leave the tenant £7k worse off.<sup>42</sup>

61. Multiplying this figure by the 20,000 pubs covered by the statutory code gives a high estimate of the transfer of £140m. As explained in the paragraph above, this assumes no tenants are given reductions in the share of expected profits they pay as dry rent as part of the tied deal. As this policy will only benefit tenants who have been treated unfairly, the less unfair treatment there is the smaller the transfer will be. At the other extreme, if all tenants are treated fairly, there will be no transfer. The level of unfairness will only be settled by looking at the individual agreements to establish what the fair rent should be under tied and free of tie leases. This will happen under this policy as tenants will be able to get assessments on both a tied and free of tie basis. We do not have a best estimate for the size of the transfer
62. However, we estimate the net cost/benefit to be zero and so have not monetised this benefit. This is because we believe that the benefit to unfairly treated tenants will be exactly offset by the cost to pub companies. As this option works within the tied model it will not impact the profitability of pubs and so there is a fixed amount of benefit, the profit from the pub, that is merely redistributed between tenants and pub companies.
63. As such, we estimate that the net impact of the transfer will be zero with the tenants' gains being exactly offset by the pub companies' losses.

### **Saving from self regulation**

64. With a statutory code and adjudicator the industry would no longer need a voluntary code and organisations to enforce it. The costs of complying with the code will not be saved as these costs will still be incurred under the statutory system. However the cost of running PICAS and PIRRS will be avoided; these costs have been assessed as around £100k per year by the chair of the PIRRS board.

## **Costs**

### **Costs of the adjudicator**

65. Some of the costs of the pubs adjudicator are based on the costs of the Groceries Code Adjudicator (GCA). This was done in the consultation stage impact assessment because the two bodies would both be BIS established bodies, with similar powers handling complaints about a small group of companies. Recognising that these similarities do not necessarily mean costs will be similar, work has since been done to improve these estimates. Staff and arbitration costs have been estimated afresh without reference to the GCA. Due to the similarity of powers and nature of the task the cost of each investigation and appeal is estimated to cost the same as for the GCA. However, given the high level of disagreement in the sector we estimate there will be a higher number of investigations and appeals. The remaining costs are not related to the function of the body and are based on the GCA's costs as set out in their budget dated September 2013.
66. These costs are unrelated to the function of the body as they represent the support functions required for the operation of the body, for example HR and ICT. Regardless of the function of the body the cost of support functions will be driven by how they are provided, the number of staff and the length of time they are required. We expect the pubs adjudicator's support functions to be provided in a similar way to the GCA's because like the GCA the pubs adjudicator is expected to share accommodation and other functions with an existing government body. The GCA's costs are adjusted for the different expected number of staff and in the set up costs for the longer set up period.

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<sup>40</sup> CAMRA super-complaint - OFT final decision, October 2010 paragraphs 5.154 and 5.147 for SCORFA and wet rent figure respectively

<sup>41</sup> This is the mid point of the 35-65% range referenced in RICS guidance and is often used as a generalisation in the industry

<sup>42</sup> This doesn't take into account other benefits of the tie such as lower entry costs and less risk

## Set up costs

67. The one-off set up costs for the body are estimated to be in the region of £360k (more detail below). However, to take into account that costs are often underestimated, we include an optimism bias of 50%. This leads to a best estimated cost of approximately £540k.
68. The set up costs are estimated in four categories: staff and recruitment; accommodation; services, which include HR, ICT and finance functions; and other costs, such as training, travel and legal advice. The staff costs are based on an internal assessment of the number of staff that the adjudicator will require.
69. Staff and recruitment: This will cover the costs of recruitment of the adjudicator, and pay of staff as the body is being set up, before it is receiving cases. We estimate that the adjudicator and staff with an annual cost of £470k would be in place for up to 6 months before the adjudicator becomes fully operational. The staffing requirement is for six members of staff at a mix of grades including a full time adjudicator. This requirement was estimated by the team in BIS responsible for the pubs adjudicator policy. This is marginally lower than the 6.5 staff in the GCA and so the support costs are reduced accordingly. The staff costs are estimated using BIS equivalent salaries increased to take into account of non wage labour costs. The cost of recruiting the adjudicator is conservatively estimated as £20k based on recent recruitments to the new Competition and Markets Authority, which was a more high profile recruitment. In total, it is estimated that staff and recruitment set up costs would be in the region of £250k (£230K staff costs and £20k recruitment).
70. Accommodation: This is estimated to be £10k<sup>43</sup> based on the GCA's actual annual accommodation costs (£24k) divided by two due to the initial set up period being 6 months and adjusted proportionately to account for the different expected size of the pubs adjudicator. As discussed in paragraphs 65-66, using the GCA's costs is considered reasonable as these costs are not related to the function of the organisation.
71. Services: The costs for HR, ICT, finance, procurement and media functions are based on the GCA's annual costs, which total £45k (£25k for ICT and £5k each for HR, finance and procurement), divided by two due to the initial set up period being 6 months and adjusted proportionately to account for the different expected size of the pubs adjudicator. It is estimated that this would cost £20k.<sup>44</sup> As discussed in paragraphs 65-66, using the GCA's costs is considered reasonable as these costs are not related to the function of the organisation.
72. Other: Other costs including legal advice, events and hospitality, audit fees, bank charges etc. are based on the GCA's annual costs, which total £80k (£40k for legal, £8k for events, £20k audit fees, £7k for bank charges and £5k for other smaller costs) divided by two due to the initial set up period being 6 months and adjusted proportionately to account for the different expected size of the pubs adjudicator. Additional legal costs of £40k are included to account for the additional requirement due to drawing up contracts and issuing guidance. It is estimated that these costs will total £80k.<sup>45</sup> As discussed in paragraphs 65-66, using the GCA's costs is considered reasonable as these costs are not related to the function of the organisation.

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<sup>43</sup> £24k\*0.5\*6/6.5

<sup>44</sup> £34k\*0.5\*6/6.5

<sup>45</sup> £80k\*0.5\*6/6.5 + £40k

**Table 3: Set up costs of the pubs adjudicator**

	Estimated costs	Estimated costs with 50% optimism bias
	£000's to nearest 10k	£000's to nearest 10k
Staff and Recruitment	250	380
Accommodation	10	20
Services	20	30
Other	80	120
Total	360	540 <sup>46</sup>

### Operating costs

73. The adjudicator's ongoing costs are estimated to be £1.75m per annum.
74. These costs are estimated in seven categories: arbitration, investigations, appeals, other staff, accommodation, services, which includes HR, ICT and finance functions, and other costs, such as training, travel and legal advice.
75. Arbitration: These costs will be similar to those of PIRRS and PICAS in the current self regulatory set up. The costs for PIRRS, PICAS and the regulatory board that governs them have been estimated by the Chair of the PIRRS board as "something just under £100,000". These costs are currently funded by those signed up to self regulation.
76. This estimate of £100k is our low estimate as we expect the number of cases to increase, as a result of the adjudicator being more independent and more widely known than the current services, and there is potential for the cost per case to increase. Our high estimate is based on roughly one percent of rent assessments covered by the code going to the adjudicator. This one per cent figure is based on what one large pub company said was the proportion of its assessments that went to any form of arbitration and an estimate from an independent pubs surveyor involved in the RICS response to the consultation. The total number of assessments covered each year is estimated to be about 5,800 based on there being 6,400<sup>47</sup> in leased pubs and just over 90% of leased pubs being tied and therefore covered by the code. This would result in the pubs adjudicator taking just over three and a half times the number of cases as PIRRS does and we assume an equivalent increase in the number of cases that would have been dealt with by PICAS. There is also the potential for cases at the statutory adjudicator to be more expensive than PIRRS cases. This is because of rules to increase transparency for example through more explanation of decisions. The increase in detail envisaged should not double costs and so we use this to calculate the high cost. The resulting high estimate is £700k (about seven times the low estimate due to three and a half times more cases at twice the cost per case). Our best estimate is £400k (the mid point of the low and high estimates).
77. If, as expected, more cases go to the adjudicator rather than more costly non-PICAS arbitration this will represent a saving to both pubcos and tenants. This saving has not been costed.
78. Investigations: The cost per investigation will depend on the complaint and the complexity of investigating it. One potential comparison is with the cost of OFT market studies that were estimated to cost £380k each.<sup>48</sup> A better comparison is with the Groceries Code Adjudicator where investigations will be into breaches of a code of practice; there the expected cost is between £50k and £150k. Alleged breaches of the voluntary pubs code of practice are currently dealt with far more cheaply by PICAS as can be seen from the costs of PIRRS and PICAS above. To be conservative and account for the fact that PICAS is less proactive than the statutory adjudicator will be, we estimate the cost of investigations will be the same as the GCA's costs i.e. £50k-£150k per investigation with a best estimate of £100k. This is reasonable as both adjudicators will be investigating breaches of codes of practice and will have similar powers to require information. These

<sup>46</sup> The figures in the column above don't add to 540 due to rounding

<sup>47</sup> From the Enterprise Inns consultation response "An analysis undertaken by Fleurets indicates that there are approximately 6,400 rent review or lease renewals each year on leased pubs."

<sup>48</sup> See GCA Impact Assessment

investigations will be discretionary and so the adjudicator could reduce the number if, for example, the costs per investigation were higher than expected.

79. The other key variable will be the number of investigations that the pubs adjudicator runs per year. It should be noted that these investigations will be of systemic breaches of the code rather than one off complaints that will be handled as part of the arbitration function. There was much disagreement among stakeholders with regard to the scale of abuse in the pubs sector. This makes estimating the number of investigations difficult. Due to this uncertainty we estimate the number of investigations to be between 1 and 5 a year with a best estimate of 3, a wider range than we previously estimated. Even if there is enough evidence of systemic breaches for more investigations, the adjudicator will have to prioritise its workload to fit its budget. As such the number of investigations cannot increase unless there is an offsetting reduction in the cost per investigation. The Adjudicator will be expected to consult on guidance outlining how investigations will be carried out, including how decisions will be taken to prioritise those that have the highest impact for the resources required.
80. From the figures above, we estimate that investigations will cost between £50k and £750k a year with a best estimate of £300k.
81. Appeals: The adjudicator's decisions will be subject to judicial review at the High Court and any financial penalties imposed by the Adjudicator will be subject to a full right of appeal.
82. It has not been possible to gather accurate data on the likely costs associated with these appeals and the responses to the consultation did not provide further evidence.
83. As the adjudicator's powers will be similar in nature to the GCA's and focussed on a similar task, namely assessing and enforcing compliance with a code of practice, the appeals are likely to be similar. As such we estimate the cost of appeals will be the same as estimated for the GCA - £200k per appeal (including the cost to courts) with a high estimate of £400k.
84. The number of appeals depends on the number of arbitrations and investigations that the adjudicator undertakes. As discussed previously, there is disagreement about the scale of abuse and so the number of decisions and appeals is uncertain. The responses to the consultation did not provide further evidence on this. However, given the disagreement between stakeholders, to be prudent we have expanded our range of potential appeals to 0 to 4 appeals (as opposed to 0 to 2 in the consultation) with a best estimate of 2 appeals per year.
85. From the figures above, we estimate that appeals will cost between zero and £1.6m a year with a central estimate of £400k.
86. Staff: BIS has assessed the number and grade mix of staff required for the adjudicator's functions excluding arbitration and those parts of investigation that will require external assistance. The adjudicator has been assessed to require 6 full time equivalents for day to day operations of the adjudicator (this is in addition to the staff costs implicitly included in the arbitration and investigation costs). This requirement was estimated by the team in BIS responsible for the pubs adjudicator policy, and allowed for legal and administrative support for the adjudicator to carry out arbitrations, investigations and every day functions.<sup>49</sup> This is marginally lower than the 6.5 staff in the GCA and so the support costs are reduced accordingly. The staff costs are estimated using BIS equivalent salaries increased to take into account of non wage labour costs. The grade mix results in annual staff costs, including non wage labour costs, of £470k. The low and high estimates are calculated by estimating the manpower requirement for a respectively lighter and heavier workload.
87. Accommodation: This is estimated to be £20k per year<sup>50</sup> based on the GCA's annual accommodation costs (£24k) adjusted proportionately to account for the different expected size of the pubs adjudicator. Based on requiring 175 square feet per person the best estimate implies a cost of £21 per square foot. One assumption behind this estimate is that the adjudicator will share offices with another government body. The high and low estimates represent the costs for respectively a higher

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<sup>49</sup> The estimated staff complement is made up of: 1 Adjudicator, 1 Head of Office, 1 legal advisor and 3 other support staff.

<sup>50</sup> £24k\*6/6.5

and lower number of staff. As discussed in paragraphs 65-66, using the GCA's costs is considered reasonable as these costs are not related to the function of the organisation.

88. Services: The costs for HR, ICT, finance, procurement and media functions are based on the GCA's annual costs, which total £45k (£25k for ICT and £5k each for HR, finance and procurement), adjusted proportionately to account for the different expected size of the pubs adjudicator. It is estimated that these will cost £40k per year.<sup>51</sup> The high and low estimates represent the costs for respectively a higher and lower number of staff. As discussed in paragraphs 65-66, using the GCA's costs is considered reasonable as these costs are not related to the function of the organisation.
89. Other: Other costs including legal advice, events and hospitality, audit fees, bank charges etc. are based on the GCA's annual costs, which total £80k (£40k for legal, £8k for events, £20k audit fees, £7k for bank charges and £5k for other smaller costs) adjusted proportionately to account for the different expected size of the pubs adjudicator. The ongoing costs also include costs for training and travel and subsistence (T&S) based on the GCA's annual cost (£30k and £24k respectively) adjusted for staff numbers. It is estimated that these costs will total £120k per year<sup>52</sup>. The high and low estimates represent the costs for respectively a higher and lower number of staff. As discussed in paragraphs 65-66, using the GCA's costs is considered reasonable as these costs are not related to the function of the organisation.

**Table 4: Operating costs of the pubs adjudicator**

	Low estimate	High estimate	Best estimate
	£000's	£000's	£000's
Arbitration	100	700	400
Investigations	50	750	300
Appeals	0	1600	400
Staff	320	580	470
Accommodation	20	30	20
Services	30	60	40
Other	90	180	120
Rounded Total	610	3890	1750

90. The adjudicator will be required to report annually on its activity and costs and a post implementation review will seek to establish the actual costs incurred.
91. This gives a best estimate of the costs of the adjudicator of £1.75m with a low of £0.6m and a high of £3.9m. The pubs adjudicator will be funded by a levy on the pub companies covered by the statutory code so these costs are a cost to business.

### Transfer from pub companies to tenants

92. As discussed in paragraph 59, reducing the unfair treatment of tenants is expected to result in a transfer from pub companies to tenants. This transfer may be up to £140m as discussed in paragraphs 60-61, but due to the uncertainty around the current level of unfairness we do not provide a best estimate. We do, however, believe the cost to pub companies will be exactly offset by the benefit to tenants. This is because the profitability of pubs will be unaffected and so the policy just redistributes a fixed amount of profit.

### Cost of compliance

93. There will be a cost to pub companies of complying with the code. We estimate the cost of complying with the *core provisions* of the statutory code will be the same as complying with the voluntary code. If companies breach their voluntary codes and the dispute can not be resolved by their internal processes the tenant can currently take their case to PICAS, which has the ability to give financial

<sup>51</sup> £45k\*6/6.5

<sup>52</sup> (£80k+£30k+£24k)\*6/6.5

awards to tenants. Compliance with the current code is not the main issue; rather it is the strength of the code itself. As such, the burden of complying with the *core* part of the statutory code is similar to the compliance costs for the current codes of practice. The BBPA estimate that compliance with the voluntary code costs around £40 per pub.<sup>53</sup> This gives a total additional cost for compliance for those not currently covered by the voluntary system of £40k.<sup>54</sup> For companies already following the voluntary code there will be no additional costs of complying with the *core* part of the statutory code. The only strengthening of the code that will involve additional cost is providing free of tie rent assessments.

94. For similar reasons there will not be any additional familiarisation costs associated with the statutory code. While there will be familiarisation costs for the statutory code, they will be similar to those already occurring under self regulation. The statutory code is based on the voluntary code and the main enhancement, parallel rent assessments for companies with 500 or more tied pubs, is based on existing practice. As there have been four versions of the voluntary code since January 2010, it is reasonable to assume that without a statutory code there would have been another version in the near future. This means that the familiarisation costs of the statutory code will not be additional to those of the voluntary codes. The same will be true for tenants who may also need to familiarise themselves with the statutory code.
95. The additional cost of producing a free of tie rent assessment will be similar to the current cost of producing a tied rent assessment. There will be some reduction in cost from having to do the two at the same time as some of the work is the same, for example assessing the trading potential of the pub and some of the work establishing comparable properties. One experienced chartered surveyor estimated that doing a tied and free of tie assessment would cost between 50% and 100% more than just carrying out a tied assessment.
96. The cost of each rental assessment will vary depending on how much work is required and who is hired to do it. At the high end of cost is a full assessment carried out by an externally hired chartered surveyor. From discussion with RICS and one of their experienced members, who was involved in their consultation response and sits on their President's Panel of approved assessors, we estimate that a full assessment would take as long as 14 hours of work. The hourly charge would be between £250 and £350, giving a cost of around £4200 for a single assessment. However, our understanding is that most assessments are carried out in-house. The mean hourly pay for Chartered surveyors in the Annual Survey of Hours and Earnings, 2012 Provisional Results was £18.35. Increasing this by 17.8% for non wage labour costs brings this to a little over £21 per hour. If an assessment takes 14 hours, this results in a cost of about £300 per rental assessment. This is likely to be a conservative estimate as pub companies will know their estates better than external surveyors and so take less than 14 hours per assessment.
97. Rental assessments will be costlier where there is greater dispute around the rental figure proposed. As discussed in paragraph 76, around one percent of cases go to some form of arbitration. Our low estimate is based on these cases having the higher cost of rent assessment and the rest costing the lower amount. This is likely to be an underestimate as some rent assessments that don't go to arbitration will still involve a full and expensive assessment of the rent. One pub owning company in its response stated that 75% of rents were agreed at the rate proposed in their first letter with 25% going on to further negotiation. Our high estimate is based on these 25% of assessments having the higher cost and 75% costing the lower amount. This is likely to be an over estimate as many of these further negotiations will not involve a full assessment by a chartered surveyor. Neither estimate accounts for the fact that the free of tie assessment will only need to be provided if tenants want it. These proportions and the two estimates of the costs of assessments in the previous paragraph give our high and low estimate of the average cost of a rent assessment. Our best estimate of the current cost of rent assessments is £809, which is the average of the high and low estimates.

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<sup>53</sup> This includes costs for compliance, training and other. This excludes the cost of running PICAS and PIRRS; the cost of adjudicating disputes in the statutory system is estimated above as part of the costs of the adjudicator.

<sup>54</sup> Based on 1000 tied pubs not covered by the current system of self regulation see paragraph 51

**Table 5: Calculation of low and high estimates of average rental assessment cost to pub companies**

	Low	High
Proportion at £4200	1%	25%
Proportion at £300	99%	75%
Average cost	£342	£1277

98. The additional cost of parallel rent assessments will depend firstly on how often they are requested. Given the potential cost of parallel rent assessments the government is keen they are only carried out where they are valuable to the tenant. To ensure this, tenants will be charged £200 for a parallel rent assessment (although pub companies may choose to offer a simple version at no cost). This money will go to the adjudicator and reduce its cost to pub companies and so does not affect the net cost to business. The number of tenants who request parallel rent assessments will depend on tenants' weighing up of the benefit of potentially reducing their rent against the £200 cost. The £200 charge is relatively small in the context of a three to five year rent agreement where the average tenant may be £7,000 pa worse off if they are being treated unfairly (see paragraph 60). As such, if a tenant feels they are being treated unfairly the benefit from a parallel rent assessment will almost certainly outweigh the cost. So we have modelled the proportion of tenants requesting parallel rent assessments based on how many tenants report to be happy with the amount of rent they currently pay. We used two surveys of tenants to give us a range of the likely impact. In a survey of just under 1800 tenants in the pub estates of Independent Family Brewers of Britain (IFBB) members 51% of tenants agreed or strongly agreed that the rent was fair for the business they do. This survey possibly overestimates the situation for tenants who can request parallel rent assessments because the family brewers are not covered by the enhanced provisions of the code that include parallel rent assessments. As such, our low estimate of the cost uses the assumption that about half of tenants do not request a parallel rent assessment. Our high estimate of the cost is based on a survey by the Federation of Small Businesses. In this survey 79% of tenants responded that they thought their pub company took too much of their pub's profit, suggesting 21% would not have a parallel rent assessment. Our best estimate uses the mid-point of the proportion used in the high and low estimates.

99. Where parallel rent assessments are requested, the additional cost to pub companies of producing the free of tie assessment will be the 50% -100% additional costs from producing it alongside the tied assessment (see paragraph 95). Applying the 50% additional cost to the low estimate of the average cost, 100% to the high estimate and the mid-point to the best estimate gives low, high and best estimates of the average additional cost from the parallel rent assessment of £84, £1009 and £388 respectively.

**Table 6: Calculation of cost of parallel rent assessment to pub companies**

	Low	High	Best
Average cost	£342	£1277	£809
Proportion without PRAs	51%	21%	36%
Assumption of % extra cost	50%	100%	75%
Additional cost	£84	£1009	£388

100. We estimate there will be 4200 rent assessments per year that could have parallel rent assessments; based on 6,400 assessments per year for leased pubs<sup>55</sup> and 65% of leased pubs being part of pub companies with 500 or more pubs.<sup>56</sup> Despite the downwards trend in pub numbers, we assume a constant number of pubs and assessments; as a result we may be overestimating this cost. This gives a best estimate of the total cost to pub companies of £1.6m with a high of £4.2m and a low of £0.3m.

<sup>55</sup> As in paragraph 76, this is from the Enterprise Inns response "An analysis undertaken by Fleurets indicates that there are approximately 6,400 rent review or lease renewals each year on leased pubs."

<sup>56</sup> Based on BBPA numbers (15,000/23,000)

## Costs of compliance to tenants

101. The cost to tenants of rent assessments may also increase. While the extra requirements to provide information falls on the pub companies, tenants may choose to spend more to challenge the pub owning company's offer or produce a well reasoned counter offer. As discussed above, there will also be a £200 charge for parallel rent assessments. This money will go to the adjudicator and reduce its cost to pub companies and so does not affect the net cost to business.
102. Most tenants don't pay for advice; advice is sometimes available for free or as part of membership of a group such as the FLVA, or some tenants will pay for a full report which will be charged at something like £750 - £1,250.<sup>57</sup> The cost to tenants is estimated in a similar way to the cost to businesses above. Following the reasoning set out in paragraph 96, in the low estimate just 1% of tenants are assumed to get a full report costing £1000 and in the high estimate 25% are assumed to do so. The resulting low estimate of the current average cost per rent assessment of £10 and a high estimate of £250, with the best estimate at the mid point of £130.
103. Following the reasoning set out in paragraphs 96-97, the number of tenants not requesting a parallel rent request is 51% in the low estimate, 21% in the high estimate and 36% in the best estimate. The additional cost to tenants of challenging a free of tie rent assessment is 50% in the low estimate, 100% in the high estimate and the midpoint of 75% in the best estimate where a parallel rent assessment is requested.

**Table 7: Calculation of cost of additional advice about parallel rent assessment to tenants**

	Low	High	Best
Proportion at £1000	1%	25%	
Proportion at £0	99%	75%	
Average cost	£10	£250	£130
Proportion without PRAs	51%	21%	36%
Assumption of % extra cost	50%	100%	75%
Additional cost	£2	£189	£62

104. As in paragraph 100, we estimate there will be 4200 rent assessments per year requiring parallel rent assessments. This gives a best estimate of the total cost to tenants of £260k with a high of £820k and a low of £10k.
105. A free of tie offer will only need to be provided if a tenant requests it. So while this cost will be initially borne by tenants, along with the £200 charge, it will only be spent with the expectation of getting a benefit from pub companies. The final cost is likely to fall on pub companies through reduced rents. Regardless this is a cost to business.

## Closures

106. The costs above are direct impacts of the policy as they are a direct result of setting up an adjudicator and giving tenants a parallel rent assessment.<sup>58</sup> These direct impacts result in an additional cost of up to £210<sup>59</sup> per pub per year. This may directly result in a small number of closures where being run as a pub is only marginally, that is less than £210, preferable to the next best use. However, the number of pubs closing as a direct result of this burden is likely to be small as the burden is small. Also as the cost per pub is already counted above, to add this lost benefit as a cost would be double counting. Furthermore as discussed in paragraph 122 some of the additional cost may be passed through to customers.

<sup>57</sup> Input from Simon Clarke (tenant, surveyor and secretary of the campaign group the Independent Pubs Confederation) and tenants' group FLVA

<sup>58</sup> See Better Regulation Framework Manual p45 - [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf)

<sup>59</sup> This is made up of the cost of the adjudicator (£90 per pub) and the cost of compliance with the enhanced code (£125 per pub) minus the saving from not funding self regulation (£5 per pub). For pub companies not covered by the enhanced provisions of the code, ie those with less than 500 tied pubs, the cost will be £90 per pub or for those not previously covered by self regulation £130 per pub.

107. Another direct impact of the regulation is the transfer from pub companies to tenants. As a result of this direct impact, we estimate that there will be pub closures (see below). As these closures are a subsequent effect that occurs as a result of a direct impact in line with guidance set out in the Better Regulation Framework Manual, we consider that these impacts are indirect. This makes intuitive sense as the closures depend on how pub companies and tenants respond to the direct regulatory change.
108. As part of the consultation, BIS commissioned independent research to better understand the possible impact of the proposed policies on pub closures and employment. Following a competitive tender process, London Economics were chosen to do this research. This research has been published alongside the consultation responses.<sup>60</sup> The BBPA commissioned a report from Compass Lexecon looking at the impact of the mandatory free of tie option.
109. In order to assess impacts on viability, London Economics, using data provided by the pub companies, estimated the current profitability of each pub in their sample. While revenues were available for each pub, costs were only available at an aggregate level and so LE had to apportion these across the pubs.
110. To assess how profitability would change under this option, LE needed to estimate the likely transfer from pub companies to tenants as a result of providing a parallel rent assessment. However since it is hard to predict how tenants will respond and how the rent assessment could thereby shift revenues, LE instead modelled four different assumptions for the size of transfer as a percentage of total pub revenue. The values LE used were 1%, 5%, 10% and 15% reflecting the range of feasible outcomes. LE noted that: “The 15% figure is derived from the highest average profit margin experienced by any of the pubcos in the datasets provided; in short it is an upper bound on what share of the pubco’s revenues the tenant could take”.<sup>61</sup> Obviously the more that is transferred to tenants, the more likely pubs are to become unviable for pub companies. The table below shows LE’s estimates of the number of additional pubs becoming unviable to pub companies and consequently sold in each of their four scenarios.

**Table 8: Number of pubs sold in LE scenarios**

Reduction in revenue to pub companies	Number of pubs sold
1%	0
5%	100
10%	800
15%	1000

111. In practice we would expect the number of closures to be towards the bottom of this range for two reasons. First, the LE research was based on an across the board transfer from pub companies to tenants. As we do not believe there is unfairness in all pub owning company - tenant relationships, we do not expect an across the board transfer. Second, even where the parallel rent assessment suggests that the tenant should be getting a better deal, there will not be an automatic adjustment in the contract – it will still be subject to a commercial negotiation between the pubco and the tenant. In practice if the pubco indicated that it would have to sell the pub if the tenant were to demand better terms, the tenant may choose to accept the existing terms. Due to these factors, our low estimate is the 1% scenario, our best estimate is the 5% scenario and our high estimate is the 10% scenario.
112. A proportion of the pubs sold off by pubcos might be expected to close entirely. However, this would only be the case where the tenant does not choose to operate as a free house and the pub is not bought by another operator. Based on studies of what has happened recently LE assumed that two thirds of pubs sold would close. Part of the reason for assuming this was to maintain comparability with previous studies; Compass Lexecon use a similar assumption.
113. However, these estimates are based on historic evidence of the impact of past pub sales. As such, it is not clear that they offer a good prediction of the impact of implementing the mandatory free of tie

<sup>60</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/265460/Tied\\_Pubs\\_Final\\_Report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/265460/Tied_Pubs_Final_Report.pdf)

<sup>61</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/265460/Tied\\_Pubs\\_Final\\_Report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/265460/Tied_Pubs_Final_Report.pdf) p19

policy. Past closures would have been those naturally occurring in the market, presumably because a pub was found not to be financially viable at the operating level. In contrast, in the current impact assessment we are estimating the impact of a policy change which might affect the viability of a particular pub business model (pubcos and tied houses) but which should not affect the underlying economics of the pubs market. An analogy is with what would happen if a pub owning company ceased trading and put all its full portfolio of pubs up for sale; one would not expect two thirds to cease being pubs. Therefore, we would expect a significant proportion of any pubs sold off by the pubcos to remain in business – either as free houses or purchased by another operator. As such we use the two thirds closing assumption as our high estimate.

114. Compass Lexecon consider two ways in which pubs sold by pub companies may close; they may be sold outside the pub trade or operate as a pub but then close. Our low estimate is based on the change in reason for disposals not affecting the number of pubs being sold outside the pub trade but pubs that stay in the trade continue trading. Over the past 5 years around 37% of pubs have been sold for use outside the pub trade; this is our low estimate for the proportion of disposals from pub companies that result in pub closures. We use the mid point of our high and low estimates as our best estimate.

115. The table below sets out the resulting estimates of pub closures from this policy. The best estimate for the number of closures is 52 pubs. This is a result of using the best estimates for pubs sold and percentage closing in the table below. An alternative would have been to use the midpoint of the high and low estimates, i.e. 268 pubs, but we instead follow the methodology of the London Economics and Compass Lexecon work, considering first the number of pubs becoming unviable and then what proportion of them close.

**Table 9: Estimates of pub closures**

	Low	High	Best
Pubs sold	0	800	100
Percentage closing	37%	67%	52%
Pub closures	0	536	52

116. The cost to business of these closures will be the lost profit to pubco and the tenant. Figures from the accounts of Enterprise Inns and Punch Taverns, the two largest pub companies, suggest the lost pre tax profit per pub will be £18k (combined 9589 pubs and £170m profit). Tenant incomes are harder to assess. Enterprise estimates its tenants earn £35k while research from CGA found 80% of tenants earned less than £15k. We use these figures for our high and low estimates with the midpoint as our best estimate.

117. This takes no account of the fact that pubs that become unviable to pub companies and are not taken up by alternative operators are likely to be less profitable than the average pub, so is likely to be an underestimate. Closures are unlikely to be as bad for the tenant as our estimates suggest; if a pub is currently being kept open at the expense of the tenant, perhaps using up their life savings, the closure of that pub would be consistent with the objective of ensuring fairer treatment for tenants.

118. The resulting annual cost to business is:

**Table 10: Estimates of cost to business of pub closures**

	Low	High	Best
Closures	0	536	52
Cost to pubcos per closure	£18k	£18k	£18k
Cost to tenants per closure	£15k	£35k	£25k
Total cost per closure	£33k	£53k	£43k
Total cost to business	£0m	£28.3m	£2.2m

119. This will be the annual cost once all pubs have had a rent review. The cost will gradually build to this cost over five years. As discussed in paragraph 107, these costs are an indirect result of the transfer

from pub company to tenant. As they are indirect they are not included in the One-in Two-out cost to business, but are included in the net present value of the policy.

120. There may be wider costs as a result of pub closures. Oxford Economics identified an average of five full-time employees per pub<sup>62</sup> suggesting a potential loss of employment of 1950.<sup>63</sup> Compass Lexecon also estimate the wider economic impact of pub closures using Oxford Economics data.<sup>64</sup> Adjusting their estimates for the lower expected number of closures gives estimated wider economic costs of £13m including lost direct, indirect and induced value added.
121. These additional closures should also be seen in the context of a long term decline in pub numbers with 28 pubs closing a week between April 2013 and December 2013. If this trend was to continue the closures from this policy would make up a negligible 0.7% of closures over the next 5 years. Stakeholders speaking to London Economics said there may be up to 6,000 surplus pubs in the UK. London Economics' report also states that if the policy did result in closures "it would act as a substantial fraction of this long-term trend which is likely to occur unless major changes to tax policy and social norms take place." Furthermore if consumers move to other pubs "it may deliver enough of a boost to other pubs to reduce closure rates in the medium term." However, even if the market were in a steady state, by the methodology LE use, closures would still be expected as a result of the policy.

### Effect on consumers

122. The additional costs of this policy may be passed on to consumers. Low profit margins in the pubs sector may mean there is little room to absorb further costs and so these additional costs are passed through to consumers. However, as the pubs market is very competitive (as discussed in paragraphs 21-22), this may limit the potential for the costs to be passed on to consumers because tied pubs represent only around half of all pubs so passing on the costs would put those pubs at a disadvantage. The Campaign for Real Ale (CAMRA) in their response to the consultation stated that they would expect the cost of the adjudicator to be borne by the pub companies. Even if the costs are passed through to consumers, the costs are very small compared to the total spent in pubs. According to the Q2 2013 BBPA Beer Barometer<sup>65</sup> just under 14m barrels of beer were sold on trade<sup>66</sup> over the last year. Based on there being 288 pints per barrel this represents 4 billion pints of beer. The additional costs to pubs from this policy are £3.6m per year (the ongoing costs of the adjudicator £1.8m, and free of tie rent assessments £1.6m+£0.3m, cost of additional pubs covered £40k and a saving of £0.1m from not funding self regulation) representing 0.09p per pint added to the average price of £3.09<sup>67</sup>. The scale of any pass through does not impact cost to business estimates as these are calculated according to where they are directly imposed. There will be reduction in choice for some consumers if the estimated closures do occur.

### Viability of pub companies

123. It is possible that the policy could have an impact on the viability of pub companies, as opposed to individual pubs. The two largest pub companies, Punch Taverns and Enterprise Inns, announced combined profits before tax of £170m in their latest annual reports.<sup>68</sup> As well as being the biggest pub companies they do not have brewing operations making the impact on the pub owning business clearer. The eventual annual cost of the legislation to these two pub companies (including the costs of the adjudicator at £90 per pub, compliance with the code at £125 per pub and the cost of closures at £150 per pub covered by the enhanced code minus the saving from not funding self regulation, but

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<sup>62</sup> London Economics report p21

<sup>63</sup> This doesn't include potential indirect labour effect or second order effects of the alternative use of the property or spending (London Economics report p21).

<sup>64</sup> Oxford Economics (2010) report on the Local impact of the beer and pub sector, table 3.1

<sup>65</sup> <http://www.beerandpub.com/statistics>

<sup>66</sup> On trade sales include those to restaurants, hotels and clubs so this will overstate the sales to pubs. Working in the other direction is that this is only beer sales and pubs sell other products too.

<sup>67</sup> <http://www.beerandpub.com/statistics>

<sup>68</sup> At the time of writing this was Enterprise Inns 2012 annual report - <http://www.enterpriseinns.com/Investors/AnnouncementAndAlerts/Documents/Annual%20Report%202012.pdf> and Punch Taverns 2013 annual report - <http://www.punchtavernsplc.com/NR/rdonlyres/D6C1285E-4B7E-4AEE-8BBE-67E5C778FEAB/0/2013annualreport.pdf>

excluding the uncertain transfer to tenants) is estimated to be £3.4m reflecting the costs set out above (total no. of pubs in annual reports multiplied by estimated cost per pub). The cost is estimated to gradually increase to this level as pubs go through their rent reviews. While this is a considerable amount of lost profit it does not seem enough to mean that this policy will make pub companies unviable.

### One-in, Two-out (OITO) assessment - summary

124. To reduce the number of new regulations for businesses, the government operates a 'one-in, two-out' rule. When a government department wants to introduce a new regulation the costs to business have to be assessed in accordance with better regulation guidance.<sup>69</sup> The table below sets out our assessment of the costs and benefits to business of the policy including whether they are part of the equivalent annual net cost to business (EANCB).

**Table 11 : Summary of costs and benefits**

Cost/benefit	type of cost	Included in EANCB	Size	Profile of costs	see paragraph
Transfer from pub companies to tenants	Zero net cost	No	£0	n/a	59-63 and 91
Adjudicator set up costs	direct cost to business	Yes	£540k	Just in year 0	67-72
Adjudicator operating costs	direct cost to business	Yes	£1.8m	Annual from year 1	73-91
Cost of compliance for newly covered firms	direct cost to business	Yes	£40k	Annual from year 1	93
FOT Rent Assessments for pubcos	direct cost to business	Yes	£1.6m	Annual from year 1	93-100
FOT Rent Assessments for tenants	direct cost to business	Yes	£260K	Annual from year 1	101-105
Closures	indirect cost to business	No	£2.2m	Gradually building for five years then full from year 6	106-121
Funding voluntary regulatory bodies	direct benefit to business	Yes	£100k	Annual from year 1	64

125. The total EANCB, composed of the costs referenced in the table above, is £2.69m.

### Risks and unintended consequences

126. As this option works within the current tied mode this is a less risky option than a code with a mandatory free of tie option. Of course there is still uncertainty about how tenants respond to having the option to have parallel rent assessments as reflected by the range of potential cost figures.

127. Some specific risks include:

- That pub owning companies find a loop hole in the statutory code that allows them to continue acting as they do currently. To mitigate this risk the rules will be written in terms that are difficult to game. The code, which is likely to be set out in secondary legislation, will be amendable in certain circumstances which will allow it to reflect new developments in the industry and close any loop holes that are found.
- That the costs of the policy to pub owning companies results in a major disruption in the industry. This could be a result of one or more pub owning companies deciding to manage, sell or close

<sup>69</sup> Better Regulation Framework Manual - [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf)

more pubs or getting into financial difficulty - the impact on the viability of pub companies is dealt with in paragraph 123.

- That the policy may make the UK a less attractive place to invest. This wasn't a major concern raised in consultation responses and a statutory code is supported by business trade bodies such as the Federation of Small Businesses and the Forum for Private Business. Neither expressed concern about the broader impact on investment.

128. While unexpected consequences are possible, their impact on the market as a whole may be limited by the existence already of free houses and managed pubs. This competition in the market means that we can expect limited upsides and downsides of this intervention.

### **Small and Micro-Business Assessment**

129. Micro businesses (those with up to 10 employees) will be exempt because they are disproportionately burdened by regulation. This threshold has been set with reference to employees rather than pubs because it is possible for big firms, who are not disproportionately burdened by regulation, to own just a small number of pubs.

130. Small businesses (those with 10-49 employees), presuming they own fewer than 500 pubs, will be exempt from the most burdensome part of the code, the parallel rent assessments. This means they are only required to comply with the core provisions of the code that are similar to the industry framework code, which most small pub companies already comply with.

131. Fully exempting small businesses would leave a number of pubs not covered by any code if the self regulation system is no longer sustainable without the large pub companies funding it. All the current members of the British Beer and Pub Association (BBPA) and Independent Family Brewers of Britain have signed up to the current self regulatory system. Once the statutory code is enacted, it is very likely that the companies covered by it (and paying for it) will stop funding PIRRS and PICAS. This would leave smaller pub owning companies having to fund the voluntary system – which may not be viable for them. If the voluntary system were to fold, over 3,000 tied tenants of family brewers who are currently protected by the voluntary code would not be covered by any code. This is not a problem for the exemption for micro-business because we do not believe any of the companies currently signed up to self regulation are micro-businesses.

132. Available data on the nature of pub owners at the smaller end of the market is very limited. It is generally provided by industry bodies such as the BBPA, so it is even more difficult to accurately assess the number of very small pub owning companies who are not BBPA members and how many tied pubs and employees they have.

133. It should be noted that the beneficiaries of this policy, pub tenants, are largely micro and small businesses. This is why the trade bodies the Federation of Small Business and Forum for Private Business are supportive of government action in this area.

134. The best estimate of the additional cost to the most affected small firms (that is those not currently part of the self regulatory system) is £130 per pub per year. This is made up of the £90 per pub cost of the adjudicator (see paragraphs 73-91) and £40 per pub cost of the current voluntary code (see paragraph 93). There is also a benefit to companies in being covered by the code because being covered by the code and adjudicator should help them attract and retain tenants. For this reason pub companies falling below the 10 employee threshold will be able to opt into the code on a voluntary basis.

### **Competition Assessment**

135. This competition assessment focuses on the impact of the proposed policy on competition in the pubs sector. To assess the impact we will consider four questions with reference to guidance on competition assessments provided by the OFT.<sup>70</sup> Would the proposal -

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<sup>70</sup> [http://www.of.gov.uk/shared\\_of/reports/comp\\_policy/oft876.pdf](http://www.of.gov.uk/shared_of/reports/comp_policy/oft876.pdf)

- a) Directly limit the number or range of suppliers?
- b) Indirectly limit the number or range of suppliers?
- c) Limit the ability of suppliers to compete?
- d) Reduce suppliers' incentives to compete vigorously?

136. The main relevant market that this policy impacts is the market for tenants where pubcos compete to attract tenants.

137. In the market for tenants, the policy involves no direct limits on the number of pub companies (question a) and doesn't reduce incentives to compete (question d). There is the potential for an indirect impact on the number of suppliers (question b) as there is an increase in cost to some existing suppliers compared to others. In this case the relative increase in cost is to pub companies with 500 or more pubs. Were a company to decide to stop competing for tenants, for example by abandoning the tie, this would reduce the competition in the market. However, they would also likely reduce the supply of tenants because there will be more free of tie tenancies or manager positions available. This is likely to mean the overall level of competition will not be significantly affected. Large pub companies' ability to compete with each other (question c) for tenants will be curtailed as they will not be able to offer leases without parallel rent assessments. Alternative approaches to achieve the desired outcome, such as requiring better information have been tried as part of the self regulatory approach. So while this will limit the scope of competition it is felt worthwhile to achieve the objective of better treatment for tenants.

138. There is also the potential for an impact on competition in the downstream consumer market. We estimate there will be an indirect reduction of 52 pubs (suppliers) and this will impact on competition. However, as discussed in paragraph 121, this is negligible in the context of 28 pubs closing a week and many in the industry believing there is a surplus of pubs. The industry is also highly competitive currently (see paragraph 22).

## Annex A - Closures from Mandatory Free of tie

139. In response to the mandatory free of tie offer, individual pubs will choose whether or not to opt out of the tie. Their choice will depend on their expected profitability under a free of tie agreement compared with under a tied agreement.
140. Where a pub chooses to go free of tie, this will have an impact on the pubco's revenues and costs. The pubco will no longer have to provide services to the tenant or arrange for distribution of beer. On the other hand, it will lose revenues through the wet rent because the tenant will subsequently buy beer on the open market. The pubco will also receive a different dry rent from the tenant. Assuming that the tenant would only choose to go free of tie if this increased its expected profits, we might expect that the pubco is likely to lose out when its tenant goes free of tie.
141. There are two main transmission mechanisms by which decisions by tenants to go free of tie might lead to the pubco deciding to sell off pubs.
- a. First, pubs that go free of tie might be sold off by the pubco because as untied tenants they are no longer viable to the pubco. The scale of this effect will depend crucially on the free of tie terms offered to the tenant, and in particular on how the 'fair market' free-of-tie dry rent is estimated. (See below)
  - b. Second, there might be an increase in marginal costs for pubs that remain within the tie. This could be because of:
    - i) increased distribution costs – density of the pubco's distribution network falls as individual pubs choose to go free of tie, leading to higher distribution costs for the remaining tied houses.
    - ii) reduced bargaining power in negotiating beer prices with the large brewersThese effects could make currently marginally profitable pubs unviable for the pubco, leading to further sell offs.
142. While there is likely to be some loss of scale, it isn't clear how great the economies of scale are, how much they are shared with pubs or whether they are also available from brewers directly. Also much of the benefit will still be achievable even at 500 pubs, which is the threshold for the mandatory free of tie option. The size of pub owning company estates vary considerably with Trust Inns for example operating a tied pub owning company model with around 500 pubs compared to around 5000 pubs for Enterprise Inns. Also the existence of a large number of free houses operating competitively in a similar way to tied houses<sup>71</sup> suggests that the benefits of economies of scale are limited. As the impact of reducing economies of scale is not clear and likely to be quite limited, we focus on the first of these two mechanisms. Both London Economics (LE) and Compass Lexecon in reports commissioned by BIS and the BBPA respectively also focussed on this first mechanism.
143. London Economics using data provided by the pub companies estimated the current profitability of each pub. While revenues were available for each pub, only the overall costs were and so LE had to apportion these across the pubs. To model a tenant going free of tie, LE started by removed the wet rent. This would increase the pub's profitability by the amount of the wet rent and in turn the dry rent, which is set as a share of expected profits. The increase in the dry rent depends on what share of expected profits pub companies get. To give an example, if the wet rent was £10k then removing this increases the pub's profit by £10k, if the dry rent is 50% of expected profits the dry rent increases by £5k. The uncertainty around these shares meant LE estimated scenarios with assumptions of 35%, 50% and 65%.
144. Using this approach LE estimated that under the mandatory free of tie option between 1100 and 2000 additional pubs would become unviable for pubcos and consequently be sold. LE's methodology is based on applying the policy change to the current costs and revenues of pubs. This means no counterfactual is assumed with regard to the future trend of closures. If the current trend of

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<sup>71</sup> This is in contrast to other sectors where smaller firms operate in a different way to large competitors and so their existence doesn't suggest the absence of strong economies of scale. In retail smaller firms compete by offering local convenience or in operate in high end niches.

closures continues, the above mechanism would still result in closures. Equally if the number of pubs steadies, the above mechanism would also result in closures. Rather than relying on a prediction of future pub numbers, LE's approach instead estimates the difference the policy would make. This is a sensible approach due to the large uncertainty around the future number of pubs. These figures are based on all tenants going free of tie. The range is a result of different scenarios run by LE with different assumptions. The key assumption is what percentage of the pub's operating profit pubcos take. If this is set at the industry standard 50%, the number of pubs sold is 1500.

145. However, this research was based on the simplifying assumption in the consultation that the free of tie dry rent would be calculated to maintain a constant division of profits between the pubco and the tenant. As discussed in paragraph 49, this would have held down free of tie rents as pubcos couldn't recoup their lost revenues from beer sales. Following the consultation our preferred approach is to let the share of profits paid as rent differ between the tied and free of tie offers as justified by demand for the pub. This means that in the example in paragraph 143 the dry rent could increase by £10k as the share of profits would be allowed to increase from 50%. Correcting this will make free of tie less attractive and so fewer tenants are likely to take the option and when tenants do pubcos will lose less income. As a result of this change the 1500 pubs being sold is our high estimate.

146. Pub companies insist that the traditional bargain of the tie has been stuck to, with a premium for tied products (the wet rent) being offset by a dry rent below the market level and other SCORFA benefits. Under the new proposals the share of expected profits paid as dry rent can increase depending on the demand for the pub (in line with RICS guidance). This means where the traditional bargain has been achieved lost wet rent will be replaced by increased dry rent and savings on SCORFA. Thus pub companies will be no worse off and these pubs won't become unviable. If this is the case across their estates as they claim then there won't be any closures. As such our low estimate is no pubs being sold. Our best estimate is the mid point of our low and high estimate, 750 pubs being sold.

147. Our estimates for what proportion of these pubs will close are the same as for the preferred option (paragraphs 112-114). The table below sets out the resulting estimates of pub closures from this policy. The best estimate for the number of closures is 390 pubs. This is a result of using the best estimates for pubs sold and percentage closing in the table below. An alternative would have been to use the midpoint of the high and low estimates, i.e. 500 pubs, but we instead follow the methodology of the London Economics and Compass Lexecon work, considering first the number of pubs becoming unviable and then what proportion of them close.

**Table 12: Estimates of pub closures**

	Low	High	Best
Pubs sold	0	1500	750
Percentage closing	37%	67%	52%
Pub closures	0	1000	390