



Pubs Code  
Adjudicator

# Market Rent Only (MRO) Verification Exercise

## Report on Evidence and Initial Analysis

August 2017

## 1. Introduction

During the first year of the Pubs Code, the Pubs Code Adjudicator has seen some evidence and heard discussions questioning whether tied pub tenants are getting access to all of the rights and options that Parliament has given them through the Code. In particular, there have been allegations that pub-owning businesses may be operating the Code in a way that is making it hard for tied pub tenants to access their MRO rights.

The PCA therefore commissioned an independent report to verify stakeholders' concerns about how MRO is working. The focus of this verification exercise was to gather detailed evidence from tied pub tenants and their advisers about their experiences of pursuing the MRO option under the Code. Its findings are presented in this report.

## 2. Terms of Reference

2.1 The terms of reference of the exercise were:

- To investigate, using an evidence-based approach, whether any Pub-Ownning Businesses (POBs) in scope of the Pubs Code have policies and/or behaviours that are inhibiting the ability of their Tied Pub Tenants (TPTs) to access their Market Rent Only (MRO) options; and to analyse and report to the PCA on these policies and behaviours.
- To obtain benchmarking data from each of the POBs on the extent and nature of their formal MRO interactions with their TPTs.

2.2 Findings are set out under the following headings:

- a) interpretation by POBs of their Code MRO obligations
- b) the nature of MRO offers made by POBs
- c) communications by POBs with their TPTs on MRO
- d) the role of POB Business Development Managers (BDMs) in relation to MRO
- e) the impact of POBs' approach to MRO on the time taken to complete the MRO process

## 3. Sources of Evidence

### Stakeholder Evidence

3.1 Evidence was sought from a selected range of tenant interests. These comprised:

- Tenant representative bodies; tenant campaign groups and consumer organisations;
- Professional advisers (Lawyers and Surveyors) and MRO Independent Assessors;
- Individual Tied Tenants and Multiple Operators.

### PCA Data

3.2 This consisted of:

- information from arbitration cases
- an analysis of calls to the PCA
- an analysis of correspondence to the PCA
- media reports on the functioning of the Pubs Code.

## POB Benchmarking Data

3.3 Each POB in scope of the Code was asked to provide data about MRO relating to their Tied Pub Tenants. Their responses are summarised in the table below.

Table 1: Summary of POB MRO Data (21<sup>st</sup> July 2016 to 30<sup>th</sup> April 2017)

	<b>Total</b>	<b>Admiral Taverns</b>	<b>Ei Group</b>	<b>Greene King</b>	<b>Marston's</b>	<b>Punch Taverns</b>	<b>Star Pubs &amp; Bars</b>
MRO Notices Served by TPT	497	6	247	90	27	88	39
MRO Notices Accepted by POB	341	6	171	63	16	53	32
MRO Notices Rejected by POB	153	-	75	27	11	35	5
MRO Notices Withdrawn by TPT	7	3	1	1	-	-	2
MRO Tenancies Agreed	11	1	4	3	0	3	0
Referrals to PCA about Terms of MRO Tenancy	90	0	58	15	2	12	3
Referrals to PCA about Independent Assessment of MRO Rent	44	0	17	13	0	12	2

## Analysis

3.4 There is insufficient data from this exercise alone to confirm whether these numbers reflect a complete picture of the level of demand for MRO across the TPT community. However, data from the PCA Enquiry Line indicating that the most common calls in the first months of the Code were from TPTs seeking advice on their MRO rights and options may suggest an early lack of awareness about the Code that could potentially have suppressed demand for MRO in this period.

3.5 The data does demonstrate a very low conversion rate (of about 2 percent or roughly one per month) of 497 MRO Notices into 11 agreed MRO tenancies. It also shows that bilateral negotiation and agreement between the POB and the TPT is the exception; and that some form of third party involvement to progress MRO is more usual – eight times as many cases were referred to the PCA for arbitration than were settled between the parties; four times as many cases went to Independent Assessment.

## 4. Report

*Note – references to ‘tenants’ includes multiple operators, tenant representatives and campaigning bodies and consumer organisations.*

### a) Interpretation by POBs of their MRO Obligations

#### POB Attitudes to the Pubs Code

4.1 Almost without exception, tenants and tenant advisers reported that while the POBs are abiding by the letter of the Pubs Code, to varying degrees they are not acting within the spirit of the Code; and that some are taking a legalistic approach to the Code. Data to the end of April 2017 from the PCA Enquiry Line supports this – showing that the second-highest number of calls from TPTs related to the behaviour of their POB.

4.2 While not direct evidence, there were a number of descriptions given by respondents about the behaviour of POBs. These included ‘intimidatory’, ‘bullying’, ‘antagonistic’, ‘delaying’ and ‘frustrating’. Another said that their POB was actively ‘playing the system’ by exploiting the loopholes in the Code. A number of tenants and tenant advisers stated that it was in the interests of POBs to be unhelpful throughout the MRO process as delays were to their financial advantage (and simultaneously detrimental to the finances of the TPT).

4.3 PCA data on referrals for arbitration is strongly supportive of assertions by many tenants that POBs are not open to discussion of the terms of their opening MRO proposals; and that the statutory MRO Negotiation Period is not being used in a meaningful way to seek to negotiate individual MRO deals. More than one respondent characterised the approach of the POBs to their MRO offers as ‘take it or leave it – or go to the PCA’. Another respondent said that POBs are waiting for the Negotiation Period to end to see if the TPT is inclined to take their MRO rent offer to Independent Assessment.

4.4 Two respondents highlighted attempts by POBs during the Independent Assessment stage to influence them to stay tied by questioning the outcome of the assessment and offering to re-open negotiations in return for the TPT withdrawing their MRO case.

4.5 A number of respondents were very concerned about the practice of issuing Calderbank Offer letters to TPTs who had commenced the MRO process. They understood that the intention was to thwart the MRO process and to force the TPT into a new tied deal in its place. These concerns have also been reported in correspondence to the PCA. Other respondents were concerned that POBs would respond to TPTs’ MRO Notices at renewal by commencing Landlord and Tenant Act (LTA) proceedings to take the pubs back into their managed estates.

4.6 Two tenants highlighted the timing by POBs of the issuing of Code Rent Assessment Proposals (RAPs). The Code requires RAPs to be sent to the TPT no later than six months before the date of the scheduled tied rent review date in the tenancy agreement; and receipt by the TPT opens a 21-day window for the request of an MRO Offer. The respondents reported that in some cases POBs had issued RAPs significantly in advance of the six-month deadline, and claimed that the intention was to frustrate MRO by ‘gaming’ the timetable.

#### Restrictive Interpretation of Code Provisions

4.7 A number of respondents were concerned that POBs are not fully complying with Schedule 2 of the Pubs Code – specifically by not consistently providing comparable

evidence to support assumptions in their forecast profit and loss statements. Several respondents reported that POBs have claimed that they are prevented from providing this information by non-disclosure agreements with other TPTs. The same concerns have also been raised in correspondence to the PCA, in calls to the PCA Enquiry Line, and in referrals for arbitration.

### Costs of the MRO Process

4.8 Many respondents reported that TPTs were facing significant costs to pursue MRO. This is supported by similar concerns in correspondence to the PCA. A number of respondents said that high costs were acting as a deterrent to MRO; and that they were aware of a number of TPTs who had withdrawn their referrals to the PCA because of mounting costs.

### MRO Rents

4.9 Many respondents reported that the rents in POBs' MRO offers are higher than they had expected. One Independent Assessor described them as 'extremely bullish'.

### **b) Nature of MRO Offers**

4.10 The consensus amongst respondents was that POBs' MRO offers are routinely including terms that have not been commonly found in either tied tenancies or in pre- and non-Code free-of-tie agreements. This is strongly supported by evidence from referrals to the PCA for arbitration – the majority of which have been on the POB's MRO full response or the nature of their MRO offer.

4.11 Respondents stated that these terms are designed to make MRO appear as unattractive as possible. Many respondents noted that the practical effect of these terms is to require significant up-front payments by the TPT before they can agree an MRO tenancy. They said that their cumulative effect is to deter TPTs from pursuing MRO because they would find it commercially disadvantageous or difficult to raise the required funding.

<b>Issue 1: Form of the MRO Tenancy</b>
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4.12 Without exception, tenant respondents cited the insistence by POBs that an MRO tenancy must be effected through a brand new tenancy agreement (which is corroborated by the POBs' own benchmarking data) and not by way of a Deed of Variation (DoV) to the existing tied tenancy. This was seen as the most significant barrier to TPTs successfully exercising their MRO option.

4.13 The same points have been made in a number of items of correspondence to the PCA. Two respondents reported that some POBs had told TPTs that the law prohibits them from doing anything but issuing a new agreement.

4.14 A large number of respondents reported that POBs have historically given effect to both full and partial freeing from the tie by way of a DoV – and in some cases are continuing to do so when freeing from the tie outside the MRO process. A number of respondents pointed out that across the industry existing tied tenancies generally include a term that permits the POB unilaterally to sever the tie and to adjust the rent accordingly; and that those tenancy agreements are drafted so that the tie can be removed by a DoV leaving the other terms intact.

## Effect on the Tenancy

4.15 Regulation 30(2) of the Pubs Code states that a tenancy will only be MRO-compliant if it is *'for a period that is at least as long as the remaining term of the existing tenancy'*. Many respondents reported that this provision will have a significant material impact on TPTs who are contracted-in under the Landlord and Tenant Act (LTA) if MRO is given effect through a new tenancy agreement, when it will limit the period for which the LTA court may grant a renewal to the shorter, remaining term of the old tied tenancy. If MRO were achieved through a DoV, the legal starting point for the LTA court would be the full term of the tied tenancy (up to the LTA cap of 15 years).

## Effect on costs

4.16 A number of respondents said that there were significant additional legal costs associated with agreeing new tenancy agreements compared to the relatively straightforward and short DoVs that have been used to sever the tie in non-Code cases. Other respondents said that a consequence of POBs insisting on a new tenancy agreement as the vehicle for MRO was to 'open the door' to a number of terms and requirements that have not historically been common in free-of-tie tenancies, but that impose substantial additional upfront costs on TPTs before they can go MRO.

4.17 Two respondents noted the effect that a new MRO tenancy would have on their Stamp Duty obligations – which is payable on the full amount; but would only apply to the change in the rent if MRO were achieved by way of a DoV.

## **Issue 2: Deposits and Rent in Advance**

4.18 Many respondents highlighted that TPTs who wish to go MRO are being required by their POB to pay a sum equal to 6 months' MRO rent (made up of 3 months' rent in advance plus a deposit equivalent to a further 3 months' rent) before the POB will conclude the MRO tenancy.

4.19 One respondent stated that they knew of multiple MRO requests that had not been progressed by TPTs because of the level of advance payments required. Tenants quoted figures for advance payments in the range of £30,000 to £100,000 – with an average of around £60,000 per pub.

4.20 A number of respondents stated that advance payments of this size were particularly disproportionate when taken with the shorter term of the tenancy as a consequence of a new agreement. One respondent said that finding these amounts would put tenants under cashflow pressures. Another noted that POBs have not required advance payments of this order in pre- and non-Code free-of-tie agreements

4.21 A minority of respondents took a more relaxed view. One felt that rent in advance was reasonable, but not the deposit. Another thought that the deposit was acceptable, but that rent in advance should be for only one month. A third did not see either requirement as a block on MRO.

## **Other Terms that are 'Not Common'**

4.22 Respondents highlighted a range of terms that are frequently appearing in POBs' MRO tenancies that they believe do not pass the reasonableness test in section 43 of the Small Business, Enterprise and Employment Act 2015 because they are not common within the meaning of Regulation 31(2) of the Pubs Code.

4.23 Many respondents mentioned the requirement – not currently found in either tied or free-of-tie tenancies – for the tenant to make annual payments into a Compliance Fund to cover dilapidations obligations. It was suggested that this was inconsistent with the full-repairing responsibility placed on the tenant elsewhere in the lease. One respondent suggested that such funds are normally only found in leases in multi-occupation premises. A similar number of respondents queried the requirement – also not present in existing tenancies – for the tenant to make yearly payments of similar amounts into a fund to cover their legal obligations under the tenancy.

4.24 Some respondents questioned what value there was to the POB in requiring long-standing and successful TPTs to submit a formal business plan before they could take an MRO tenancy. Others objected to the inclusion of upward-only rent reviews; and the prohibition on the re-assignment of the MRO lease within the first two years.

4.25 Other respondents highlighted the absence of a cap on annual rent increases pegged to RPI; the requirement to install pay-as-you-go meters; and having to pay the buildings insurance premium in full and in advance.

### **Issue 3: Assessments of Dilapidations**

4.26 Both in interviews and through correspondence, a significant number of tenants have highlighted expensive assessments of dilapidations that are being made in relation to MRO cases. Some respondents suggested that these might in part be explained by POBs 'catching-up' on dilapidations that had not been fully enforced during the tied tenancy. A number of respondents identified acceptance of these schedules of dilapidations as effectively a pre-condition, and therefore a barrier, to securing MRO.

4.27 Many respondents pointed out that where MRO is being pursued at a mid-tenancy rent review (when they would expect a 'Schedule of Wants of Repair'), the POB is applying full end-of-lease Terminal Schedules of Dilapidations – in line with their own policy that an MRO tenancy should be a wholly new agreement. In at least one case, the POB's terminal schedule was said to be inconsistent with the mid-tenancy schedule recently agreed with the TPT under the same tied tenancy. Other respondents cited inflated cost estimates that adopt a 'new for old', rather than the usual 'put and keep', approach.

4.28 A number of tenants expressed concerns about the inclusion of unexpected or novel items in POBs' assessments of dilapidations – including full redecoration; a new roof; new patios; re-surfacing of car parks; cellar tanking; and fire risk assessments.

#### **c) POB Communications on MRO**

4.29 Up to the end of April 2017, the most common reason for TPTs to call the PCA Enquiry Line was to get information on their MRO rights and advice on the MRO process. This would appear to correlate with the views of many respondents that POBs are generally being unhelpful in terms of advising the TPTs on their MRO options and alerting them to MRO deadlines.

4.30 A number of respondents reported their experience of POBs being reluctant to give TPTs even basic neutral information on the MRO provisions. Some respondents said that they knew of cases of TPTs losing their right to an MRO option because of failures of communication by their POB – for example where documents had been sent to the pub and not to the TPT's registered office meaning the TPT ran out of time to serve a MRO notice.

4.31 A number of respondents provided evidence of communications sent by some POBs to TPTs who had requested MRO, that they believe are likely to deter the TPT from pursuing their MRO option – by talking-up the benefits of the tie; and by stressing the costs and risks of MRO.

**d) Role of POB Business Development Managers (BDMs)**

4.32 Respondents indicated that TPTs are experiencing a more transactional and less collaborative relationship with BDMs since the Code came into force. Almost every respondent stated that BDMs were not working with their TPTs to help them to understand their MRO options. In general, BDMs were described as having been ‘disempowered’ by the POBs in relation to MRO.

4.33 A number of respondents said that it is the policy of some POBs to transfer the relationship with a TPT who has made an MRO request from their BDM to the Estates Team at Head Office – for all matters, and not just for the MRO process. Whether or not this is the intention, TPTs said that the loss of the business-as-usual relationship with their BDM had an isolating effect.

**e) Impact of POBs’ approach to MRO on timescales**

4.34 There was a strong consensus among respondents that the MRO process was taking much longer than they had expected. Most respondents identified the primary cause of delay as the POBs’ unwillingness to engage in meaningful MRO negotiations, and the necessity for TPTs who are unhappy with their MRO offer to refer it to the PCA for arbitration. Several respondents said that some POBs are routinely challenging the determinations of Independent Assessors.

4.35 A number of respondents pointed out that delays have no adverse financial consequences for the POB, but that delays are expensive for TPTs in terms of both professional fees and the costs of remaining on their existing tied terms for the duration of the MRO process.