
5 Principles for regulation of the retail tenancy market

Despite more than two decades of extensive legislative activity affecting retail tenancies (chapter 3) and the development of dispute resolution systems (chapter 4), imbalances in bargaining power between small retailers and large landlords continues to be raised as an issue of concern. What this suggests is that specific retail tenancy legislation, introduced to redress concerns about bargaining power, has not been entirely successful in delivering the results expected by some. Whether this is a result of inadequacies in regulation or unrealistic expectations is an important question.

While good regulation can contribute significantly to preventing or counteracting market deficiencies, unnecessary or poorly designed and implemented regulation can impose excessive costs on business, restrict competition and distort the allocation of resources in the economy — as well as failing to meet its intended objective.

This chapter seeks to identify relevant ‘design principles’ for the assessment of retail tenancy legislation and for evaluating proposed regulatory changes.

Section 5.1 outlines participants’ views on the effectiveness of the legislation. Section 5.2 places the development of design principles for tenancy regulation in the broader context of regulatory improvement while section 5.3 looks at aspects of retail tenancy bearing on design principles focused on that market. The next section sets out design principles for assessing regulation of retail tenancies. Section 5.5 sums up the chapter.

5.1 Views on effectiveness of retail tenancy regulation

State and Territory retail tenancy legislation prescribes many aspects of the retail landlord-tenant relationship. However, many of the issues raised by participants of this inquiry are the same as those that gave rise to the original retail tenancy legislation. They are also the issues that led to the numerous State-based reviews of the legislation and other inquiries relating to retail tenancy — such as the Reid

Committee inquiry (SCISR 1997) and the 2003 Senate Inquiry into the Effectiveness of the *Trade Practices Act 1974* (TPA).

As one participant said:

Despite the legislative improvements of the past 10 years (Reid Report 1997, Trade Practices Act amendments of 1997 and 2004, etc plus the many amendments made at State level) there remains a massive imbalance of bargaining power between lessor and tenants in retail lease negotiations. (confidential submission)

The Franchise Council of Australia added:

The problems in retail tenancy have been well documented since the 1990s, however despite numerous calls for action, including the comprehensive 1997 Reid Report, there has been no effective government action or the implementation of a national code for retail tenancy, as recommended. Inconsistent and ineffective prohibitions on unconscionable conduct have had a very limited effect on addressing the failures of the market identified more than a decade ago. (submission no. 117, p. 3)

A number of participants also considered that fundamental concerns continue to affect the retail tenancy market (box 5.1).

Box 5.1 Some negative comments relating to the operation of the market for retail tenancies

Council of Small Business of Australia (COSBOA) — ‘the market for retail leases is a continual state of failure. As a result of that failure, COSBOA and its members have seen, first hand and at close quarter small business retailers suffer, mainly at the hands of large businesses. COSBOA asserts that the failure of the retail leasing market is geographically widespread and culturally systemic within large businesses operating in the retail leasing market as lessors — mainly large scale shopping centre owners and managers’ (submission no. 94, p. 1).

Southern Sydney Retailers Association — ‘The long term damage to the Australian economy and the threat to the nation’s future prosperity from the distortion of the broken market for retail leases cannot be overemphasized’ (submission no. 131, p. 10).

Western Australian Retailers Association — ‘Since the Reid Report in 1997, real progress in the retail tenancy arena has been notable by its absence. In essence, it has been a very one-sided bloodbath with great wealth conferred upon a few chosen ones and enormous suffering inflicted on those whose blood, sweat and tears has then seen their Castles and their capital effectively transferred to those chosen few’ (submission no. 118, p. 4).

This suggests that the legislation has not ‘fixed’ many of the ‘problems’ that it was designed to address. The Reid Committee report described the situation in the late 1990s as a ‘war’ going on in shopping centres around Australia:

The idea that there is a ‘war’ going on in shopping centres around Australia, between retail tenants and property owners and managers, conveys accurately the tenor of evidence given to the Fair Trading inquiry on retail tenancy issues. (SCISR 1997, p. 15)

In the Commission’s assessment, the term ‘war’ is not representative of the balance of evidence provided in this inquiry — a few skirmishes, some lingering resentment, hard bargaining and some disappointments, but not ‘war’. This is not to say, however, that the market is working perfectly. Indeed, the Commission heard evidence of difficult commercial negotiations and cases involving significant personal loss. Despite this, it appears that some positive improvements have been made to the overall market since the 1997 Reid Committee report.

The State Governments generally considered that the legislation was effective in forming a basis for sound lease practices, with the New South Wales Government commenting:

... since its introduction, the NSW *Retail Leases Act 1994*, has been strongly supported by landlords and tenants associations as forming the basis for good leasing practice in the retail sector. (submission no. 136, p. 1)

The Victorian Government also said:

Overall, the retail tenancy market appears to be functioning relatively well. The existence of enquiries and mediated disputes between landlords and tenants is evidence of a robust regulatory system where parties are able to access the information and advice they need, and can seek low-cost mediation assistance when required. (submission no. 111, p. 10)

It added:

The retail leasing commercial relationship requires some government intervention to ensure fair, competitive outcomes for market participants.

At this point in time there does not appear to be fundamental problems with the retail tenancy market in Victoria that require a substantial change in the regulation of the market. The Victorian Government considers that its approach helps to balance the retail tenancy relationship by dealing with information imbalances and imperfect competition arising from varying degrees of bargaining power between players. (submission no. 111, p. 11)

A number of participants also commented that the current retail tenancy framework and market have a number of positive features and that the market is working reasonably well (box 5.2).

Other participants commented that retail tenancies have become over regulated adding to costs. Westfield, for example, while believing the Australian retail tenancy market to be the most efficient in the world, commented that duplicated legislation creates compliance costs:

... there is, uniquely within Australia, excessive regulation of the retail tenancy lease market through the operation of State and Territory retail tenancy laws which are, in the main, designed to protect retail tenants as a class. Those laws regulate all aspects of the landlord and tenant relationship. In addition, they are supplemented by Commonwealth law principally in the form of the TPA ... State and Territory Retail Tenancy and associated legislation, such as Fair Trading Laws, also provide remedies for unconscionable conduct and misleading and deceptive conduct. It is apparent that the existence of this regulatory framework embeds a significant level of cost within the market for retail tenancies. This cost includes not only the cost of compliance, principally borne by landlords, but also the cost to the taxpayer of the bureaucracy and administrative infrastructure required to oversee and administer these laws. (submission no. 85, p. 16)

Box 5.2 Suggested positive features of the current retail tenancy regulatory framework and market

Law Institute of Victoria (LIV) — ‘Generally the LIV is satisfied with the current regulation in respect of disclosure of relevant information to tenants before and during the course of the lease term’ (submission no. 27, p. 11).

Subway Systems — ‘In view of our considerable footprint on the Australian retail leasing scene over several years we have generally developed a good working relationship with most major lessors’ (submission no. 28, p. 1).

The Royal Institution of Chartered Surveyors (RICS) Oceania — ‘The general RICS view is that the current structure and function of the Australian retail tenancy market has many POSITIVE aspects’. It referred to the disclosure of information, the dispute resolution/mediation process and the operation of registrars/commissioners (submission no. 39, pp. 2-3).

Shopping Centre Council of Australia (SCCA) — ‘The market for retail tenancy leases in Australia is competitive. As a result it works efficiently and there is no evidence of significant market failure that requires correction. ... Only a very small number of retail tenancy disputes (both in numerical terms and as a proportion of retail leases) occur each year and these are usually successfully resolved by low-cost, easily-accessible dispute resolution mechanisms’ (submission no. 83, p. 2).

Real Estate Institute of Australia (REIA) – ‘Notwithstanding localised shortages of retail premises, trends in consumer shopping preferences and regulatory differences between jurisdictions, the retail tenancy market appears to be operating relatively efficiently across Australia. The REIA is not aware of any major fundamental flaw in the market that systematically disadvantages either landlords or tenants (submission no. 112, p. 1).

The GPT Group submitted that:

Certainly additional legislation is not required in what we believe is already an area of business that is over regulated. Rather a simplification and uniformity of legislation will lead to benefits for both retailers and landlords. (submission no. 34, p. 2)

Colonial First State Property Management (CFSPM) considered that some of the regulation was redundant:

... with the large amount of regulation comes some uncertainty, inconsistency, and significant compliance costs affecting both owners and tenants. CFSPM has been involved in several reviews of retail legislation over the past 5 years and has noticed that in some cases at least, regulation was introduced which served no material benefit to either owners or tenants, yet resulted in additional compliance costs. In other cases, regulation was introduced as a result of only a small number (supported by empirical evidence) of isolated incidents in the retail leasing market, although again, it had a material and significant impact on the vast majority of participants in the retail leasing industry. (submission no. 78, p. 7)

Others commented on the extent of regulation covering the retail tenancy market in Australia compared with that in other countries. For example, the Australian National Retailers Association said that its members:

... who have a presence in both countries (NZ & Aus) believe the system in Australia is over-regulated and inconsistent with multi-layered legislation. (submission no. 92, p. 6)

The SCCA added:

It is difficult to think of another area of business-to-business relationships where governments have intervened so substantially in order to protect small businesses or where they spend so much taxpayers' money on providing advice and support.

As a result of this intervention the market for retail tenancy leases in Australia is now heavily regulated. We are unaware of any other country in the world with such a highly regulated retail tenancy market. (submission no. 83, p. 7)

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Many of the concerns raised in this inquiry are the same as those that gave rise to the original retail tenancy regulation. This suggests that the regulation has not fixed the concerns that it was intended to address. Some participants, however, suggested that regulation has gone too far.

Detailed comments and a range of suggestions for possible changes to the regulatory environment for retail tenancy reflecting these various perspectives were presented to the Commission. Many of the suggestions focus on more heavily regulating the relationship between contracting parties, particularly leases in large shopping centres. Suggestions covered concerns in the areas of:

- security of tenure — including 'end of lease' issues;
- occupancy costs — including rent setting and outgoings, turnover rents and fit-outs;

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- market information, transparency and disclosure — including reporting turnover data, lease transparency and understanding, model leases and disclosure statements, and lease registration; and
 - business conduct — including clarifying unconscionable conduct provisions and extending these to regulate for greater ‘fairness’ in the market.

There were also suggestions for a less regulated approach and for greater national consistency.

In order to assess participants’ (sometimes conflicting) concerns and possible options for regulatory change (which is taken up in the following chapters), a framework for assessing the regulation of retail tenancy leases is required.

5.2 Designing good regulation

While markets are the most efficient way of allocating resources, there are occasions when markets can work in such a way as to result in perverse economic and social outcomes. Good regulation can contribute significantly to preventing or counteracting such outcomes. But inappropriate or poorly designed and implemented regulation can act as a handicap by imposing excessive costs on businesses, limiting competition, stifling efficient investment and changing business behaviour. It can also add to the administration costs incurred by government. Ultimately, the costs of poor regulation are borne by taxpayers and consumers.

Effective regulation can correct market failures and help achieve economic efficiency, while avoiding the imposition of unnecessary burdens on businesses or the community (see box 5.3 and PC 2006a). In other words, well considered regulations or actions by governments have the potential to generate benefits to society that exceed their costs.

Box 5.3 Notions of economic efficiency and effectiveness

Notions of effectiveness and efficiency are often used by economists to evaluate market outcomes and the effects of regulation. An economically efficient outcome is one where no other outcome has a higher net benefit to society as a whole.

Effectiveness relates to how well a stated (or given) objective is achieved. The effectiveness of regulations, for example, is measured by how well the outcomes of the regulation achieve their stated or desired outcomes.

Determining whether regulation meets the dual goals of ‘effectiveness’ and ‘efficiency’ requires a structured approach to policy development that

systematically evaluates costs and benefits of policy. According to the Regulation Taskforce (2006), good process for developing and administering regulation requires the application of six key principles:

- Governments should not act to address ‘problems’ until a case for action has been clearly established.
 - This should include establishing the nature of the problem and why actions additional to existing measures are needed, recognising that not all ‘problems’ will justify (additional) government action.
- A range of feasible options — including self-regulatory and co-regulatory approaches — need to be identified and their benefits and costs, including compliance costs, assessed within an appropriate framework.
- Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted.
- Effective guidance should be provided to relevant regulators and regulated parties in order to ensure that the policy intent of the regulation is clear, as well as the expected compliance requirements.
- Mechanisms are needed to ensure that regulation remains relevant and effective over time.
- There needs to be effective consultation with regulated parties at all stages of the regulatory cycle.

The application of this policy development process should ensure that the benefits to the community of any regulation outweigh the costs and provide some assurance that the option chosen yields the greatest net benefits.

5.3 Considerations for intervening in retail tenancies

To assess whether aspects of the retail tenancy market provide a case for government intervention, a set of more detailed principles, consistent with the above broad policy process, are needed. The detailed principles should focus on maintaining the efficient operation of the tenancy market and provide a basis for avoiding regulatory pitfalls. To develop these principles, this section considers:

- aspects of the retail tenancy market that have provided a case for government intervention;
- issues associated with the application of specific retail tenancy regulation; and
- considerations associated with efficient rents and other tenancy conditions for retail space.

Aspects of retail tenancies leading to government intervention

Australia is unique in its regulation of retail tenancies (box 5.4). The case underpinning regulation of this market, as discussed in the two previous chapters, was based on perceived impediments to its efficient operation, including:

- information imbalances between large landlords and small to medium sized tenants;
- the potential for landlords to misuse negotiating power; and
- the need for low-cost resolution of disputes.

Box 5.4 Approaches to retail tenancy governance in other countries

Australia's approach to retail tenancy governance is different to that taken in comparable OECD countries.

Retail tenancies are overseen by a broader commercial tenancy voluntary code of practice in the United Kingdom (applying to England and Wales only) along with the Landlord and Tenants Act which covers both residential and commercial tenancy matters. The code of practice is 'intended to promote best practice in commercial lease negotiations' and provide 'greater choice and flexibility in the market and for businesses to take professional advice on their property issues' (BPF 2007, p. 1). The code covers lease negotiation, conduct during a lease, and landlord and tenant rights and responsibilities. It is a principles based code.

In New Zealand, Canada and the United States, no specific retail tenancy legislation, or codes of conduct exist. These markets operate under broader commercial laws such as the Fair Trading Act 1986 in New Zealand. In Canada, Industry Canada provides a series of information reports, such as *Winning Retail* (Industry Canada 2003), which seek to provide guidance to retail tenants when choosing and negotiating a lease. This document also sets out what are considered affordable occupancy costs as a percentage of sales amongst other things, which Industry Canada suggest (potential) tenants should not exceed when signing a lease (that is, walk away from the deal if the occupancy cost is too high).

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Australia is unique in its specific regulation of retail tenancies.

Regulations were developed based on the notion that failures arose in the retail tenancy market due to imbalances in negotiating power between landlords and tenants, particularly in shopping centres.

Regulators considered that information asymmetries were one aspect of the market that contributed to differences in negotiating power. Differences in information,

exploited by a party to a negotiation, could lead to inefficient business investment and operating decisions. It was also considered that significant transaction costs existed in accessing traditional dispute resolution processes (such as, through the courts), limiting the available recourse for small, less resourced market participants.

The information required by prospective tenants in the retail market (particularly those operating in a shopping centre) is market specific and extensive (and therefore difficult to obtain). Notwithstanding strong commercial incentives to acquire relevant information, some prospective tenants could be disadvantaged in lease negotiations. As the New South Wales Government put it:

In some cases, this information asymmetry can be overcome by a prospective tenant engaging professional advisors (eg lawyers). This often involves significant expense, with large tenants more likely than smaller tenants to be able to afford the costs associated with overcoming this information imbalance. (submission no. 136, p. 3)

However, in assessing the need for government regulation to fill information gaps, a balance needs to be struck between the potential benefits of new information and the likely compliance and administrative costs that would be incurred in order to fill known gaps.

It has also been argued that retailers' greater dependence on location, compared with other commercial tenants, has contributed to imbalances in negotiating power. As stated by the New South Wales Government:

This imbalance arises largely because, unlike businesses which lease office and industrial space, retailers are arguably more dependent on 'location' for the success of their business and are therefore in a weaker bargaining position in lease negotiations.

... Tenants who lease office or industrial space can generally relocate to new premises with minimal impact on their business, if they are offered lease terms for existing premises that they consider unfavourable. (submission no. 136, pp. 5-6)

Negotiations for location-dependent tenants were believed to occur predominately with larger landlords, exacerbating imbalances. However, retailers are not the only business tenants that may negotiate with larger landlords, or be location dependent. The Australian Capital Territory legislation recognises this possibility by including all small commercial tenants in its coverage (those who rent a space of less than 300 square metres).

While legislation has been instituted to reduce negotiating power imbalances, regulating to eliminate differences is not likely to be possible in all cases and could lower incentives to develop negotiating skills commensurate with the market. Also, because such regulations tend to advantage a certain class of business, they are likely to restrict the entry of new businesses in response to technological change and changes in consumer taste.

Regulators also assessed that imbalances in negotiating powers had the potential to lead to leases and business negotiations that were inherently ‘unfair’. In response, a range of fairness provisions prohibiting unconscionable conduct were introduced. While there is an economic justification for regulating for fairness or against unconscionable behaviour — such situations are not unique to the market for retail tenancies. Also, clauses to prevent unfairness can be fraught with problems. Not least of these is the distinction between what constitutes unfair or unconscionable behaviour as opposed to a hard bargain. If levels of fairness are overly prescribed, provisions may also create disincentives for parties to enter into contracts that are mutually beneficial and undertake efficient investment. Further, overly defined provisions could become inflexible, becoming unresponsive to changing views on acceptable conduct.

High transaction costs to settle grievances through court-based judicial processes are a further reason put forward for government intervention into the retail tenancy market. To ameliorate these costs, governments have established low cost dispute settlement processes that deal with retailer and landlord issues. For small business, such processes can be particularly important as the cost of legal action through the judicial system can be significant relative to potential gains, and could present a barrier to proceeding with substantive complaints. Access to low cost dispute settlement procedures can, therefore, be important in improving efficient and fair outcomes in the retail tenancy market. While it may be cost effective to establish dispute resolution processes for retail tenancies, it is, nevertheless, likely that the processes established could apply more widely to other business disputes.

Recognising many of these issues, the Victorian Government (2001,) in seeking to regulate to the minimum extent necessary to address impediments to the efficient operation of the market, adopted a set of policy guidelines:

- ... 1: Government regulation of retail tenancies should focus on addressing information imbalances and the misuse of market power.
- ... 2: Retail tenancies legislation should only protect small and medium sized retail businesses.
- ... 3: Government involvement in retail tenancies matters should aim at ensuring that prospective tenants have sufficient knowledge to make an informed business decision.
- ... 4: While a landlord has a fundamental right of control over the use of its property, this right does not extend to engaging in unfair business practices.
- ... 5: Landlords and tenants should be able to access a low-cost informal dispute resolution forum prior to any grievances proceeding to formal litigation. (Victorian Government 2001, p. 5)

Such an approach involves creating incentives/opportunities for efficient decision making and penalties for the misuse of market power and unfair business practices,

rather than through legislated intrusions into contract terms (limiting the right of control over property). Many legislative provisions, however, do target contract terms (such as minimum lease terms) violating the stated principles of intervention.

Issues associated with the application of specific retail tenancy regulation

For various reasons, the judicial and legislative mechanisms that cover standard business contracts (such as common law and the TPA) have been deemed insufficient to deal with retail leases. This has led to State-specific regulations which, in some instances, overlap or are inconsistent with current judicial and legislative mechanisms.

Concerns about imbalances in bargaining power and information asymmetries in the context of shopping centre leases, led regulators to limit the coverage of retail tenancy legislation by definitions of what constitutes a ‘retail tenancy’ (see chapter 3). Definitions range from business types (listed companies versus partnerships and sole traders), to floor space occupied, to lease value or a combination of all aspects. These somewhat arbitrary definitions add to the complexity of operating retail (and sometimes commercial) businesses, particularly those operating in multiple jurisdictions. Arbitrary lines of distinction can also create market inefficiencies if they alter landlords’ choice of tenants — for example, landlords preferring certain types of businesses because they face fewer tenancy regulations in dealing with them, or tenants selecting certain business formats for similar reasons.

Also, because of concerns that retail tenancies differed materially from other commercial tenancies, a range of regulations prescribing deviations from commercial law (for example, minimum lease terms) were enacted. However, attempts to regulate behaviour of market participants through prescriptive limits on what they can and cannot do are often unsuccessful (Lattimore et al. 1998). With such limits, it is often possible to exploit gaps within legislation, reducing its effectiveness. In these instances, prescriptive legislation can result in unwarranted compliance costs on businesses and other mechanisms to influence conduct may work better. Prescriptive regulation can also:

- lead to instances where small tenants come to rely on government to reduce the negative consequences of their own bad decisions, and thus become more likely to make such decisions — known as ‘moral hazard’; and
- restrict the ability of two parties to engage in trade and commerce, and thereby inhibit economic activity that is beneficial overall.

What level of government is best to govern retail tenancies?

Currently, matters relating to retail tenancy are the responsibility of State and Territory governments. The Subsidiarity Principle proposes one answer to the question of what level of government is best to govern retail tenancies (PC 2005). Under this principle, responsibility for a particular function should, where practicable, reside with the lowest level of government competent to deliver it (CEPR 1993; Kasper 1995 and 1996). However, even when applying this principle in determining governance arrangements that can most efficiently resolve retail tenancy issues, the relevant benefits and costs of governance at any level need to be considered.

The characteristics of retail tenancies have an impact on the suitability of different levels of government for dealing with retail landlord-tenant relationships. At a local government level, for example, there will be advantages in that regulators will have a greater understanding of the community in which landlords and retailers operate, but they will not necessarily give weight to broader issues of competition or the costs of cross-border commerce. Conversely, at the Commonwealth level, regulators may be too distant from communities to understand the manner in which the markets are functioning when making decisions. Despite this, a national approach to regulation would be beneficial to firms operating across State and Territory boundaries.

One potential benefit that has arisen by each State and Territory maintaining jurisdiction over regulation in the retail tenancy market is that jurisdictions have conducted, in effect, policy experiments in order to devise a better regulatory approach. With numerous legislative revisions increasing prescriptions of the landlord-tenant relationship, however, these gains are likely to have been exhausted and even eroded.

Considerations for efficient rents for retail space

Market interactions between retailers and landlords that occur within retail concentrations, such as shopping centres, have unique characteristics that need to be considered in deriving principles for the efficient regulation of retail tenancy agreements. In particular, regulations should not predetermine pricing behaviour in different retail formats or impinge on the ability of market participants to negotiate.

In shopping centres, individual retailers do not act in isolation from other retailers. Rather, the sales generated by one retailer have an effect on the sales of others. Where there is a single landlord and many retailers in the retail concentration, as in shopping centres, the overall success of the centre is largely the responsibility of the

centre landlord. In less concentrated retail spaces, these interactions are not as significant, with leases between individual landlords and tenants formed via negotiation, as for any business contract, where neither the landlord nor tenant has a controlling influence on the surroundings.

The clustering of retailers is brought about to capitalise on consumers' preference for 'one stop' shopping (Ghosh 1986; Brown 1989; Oppewal and Holyoake 2004; and Smith and Hay 2005). Retailers within these concentrations are able to exploit the passing trade that is created by consumers visiting multiple stores, at very little additional cost per visit. This has been termed the 'inter-store externality', and means that the returns earned by each store are, in part, dependent on how many customers other stores attract and on the foot traffic generated overall.

Leasing retail space within retail concentrations provides the opportunity for individual retailers to capture the benefits of passing trade created within a retail concentration. In the case of shopping centres, the landlord supplies a common space for retailers and an opportunity for different retailers to aggregate in the one location (Miceli and Sirmans 1995). Landlords, through using larger well known 'anchor tenants' as draw cards, attempt to generate customer traffic within their centres (Arakawa 2006). For shopping centre landlords, the success of a centre, in terms of its ability to generate rental returns on the invested capital, is dependent on the centre's ability to attract and establish leases with a sufficiently diverse mix of retailers to generate the maximum amount of passing trade and for the stores therein to take advantage of this.

These two characteristics of retail shopping centres — that each store's turnover depends on other stores and that landlords need to maximise the passing-trade effects to maximise the overall return to the shopping centre — have several implications for the setting of rents in centres.

First, rents should vary by store to be efficient (this does not constitute monopoly power — see box 5.5). For example, to account for the larger volume of customers attracted by anchor tenants, the unit rent of these tenants should be lower. Those smaller tenants who benefit (in terms of customer sales for their own business) from the passing trade created by anchor tenants should pay higher unit rents (Brueckner 1993 and Wheaton 2000). In this sense, price regimes between tenants that allow larger anchor tenants to pay less rent per unit of space occupied, while smaller tenants pay more per unit, are more likely to be efficient (Brueckner 1993 and Arakawa 2006).

Second, centre managers require flexibility to alter the tenant mix and location within centres. By having the flexibility to change the tenant mix, centre managers can remove underperforming tenants or tenants offering services poorly aligned

with a centre's market and replace such tenants with better performing or suited tenants. This, in turn, can benefit all other tenants to the extent that new, better performing tenants attract an increased number of potential customers to the centre. Such flexibility is particularly important in the face of changing consumer preferences and product technology. To do this, landlords require the ability to not renew leases of those stores whose sales performance or range of goods/services are not compatible with the objective of maximising the returns for the shopping centres as a whole, in the judgement of the centre manager (Miceli and Sirmans 1995).

Box 5.5 Price discrimination does not mean monopoly pricing

Landlords, in particular those who own larger shopping centres, do not operate in a perfectly competitive market for the provision of retail space. Due to zoning restrictions, high set-up costs and geographic factors (such as the population size that is required to support large retail concentrations), owners of retail concentrations such as shopping centres compete in an oligopolistic fashion with other landlords. This type of competition suggests that some positive economic rents are extracted from consumers as the overall supply of retail space has been restricted. This restriction leads to a net loss in economic surplus, which can also be viewed as a market failure.

However, this *does not* mean that landlords act as monopolists to retail tenants. A monopolist will restrict the supply of a good or service in order to extract a higher price than what otherwise would be paid if there were competition in the market. In dealing with tenants, landlords have no incentive to restrict access to retail space for potential tenants within existing developments. Indeed, landlords have an incentive to lease all available space to tenants who can, in aggregate, achieve the greatest return. Thus, there is no loss in economic surplus within this more narrowly defined market.

But landlords will actively, and should, price discriminate between tenants (that is, charge different rents to different tenants) to maximise the return on their investment. This price discrimination is evidenced by rents to individual tenants that are based on the number of customers drawn to a centre or turnover achieved. The practice of setting different rents for similar spaces cannot be taken as *prima facie* evidence that the market is inefficient (or inequitable). Indeed, price discrimination can be a feature of well-functioning markets — such as the pricing of aeronautical services at airports (PC 2006b). Price discrimination has also been established as a principle to enhance the efficient operation of the telecommunications market (PC 2001) and it should not be ruled out as a pricing approach in the retail tenancy market.

Third, lease conditions need to be such as to align the incentives of tenants and landlords. Leases should be designed so the rent paid reflects the benefits *created* by differing levels of passing trade, and so that landlords do not under-provide services (such as marketing which helps to draw consumers to a centre) that are

beneficial to all stores or operate in an opportunistic manner (Miceli and Sirmans 1995 and Wheaton 2000). Leases should also be designed to:

- reflect a need for landlords to share some of the retail market risk of tenants so that landlords are responsive to changes in the retail market; and
- provide a disincentive for landlords to act in a predatory fashion, particularly in ‘end of lease’ situations.

Finally, rents should reflect different demands placed on, and services provided by, landlords (such as security, marketing and utilities).

While these considerations are relevant to establishing regimes for efficient rent setting and lease conditions, there is debate over the implications of how they should be realised in leasing conditions. For example, Miceli and Sirmans (1995) suggest that percentage rents provide retailers with an incentive to under-report their turnover or reduce their selling ‘effort’ to *reduce* the rent paid. On the other hand, Wheaton (2000), argues that under certain conditions percentage rents provide an incentive for landlords to avoid acting in an predatory fashion or against existing tenants when reletting space.¹ Further, it was argued that percentage rents were an efficient means to ensure the sharing of market risks.

5.4 Proposed principles

The preceding discussion indicated that there are many potential pitfalls in the regulation of the retail tenancy market, as with any market. There are also different views concerning the most efficient leasing conditions in particular circumstances. Accordingly, regulation of landlord-tenant relations needs to proceed with caution and with consideration of the current rules and laws that govern standard business contracts. Principles for regulation in this market need to rest on facilitating commercial transactions and maintaining the efficient operation of markets so that the net gains to society are maximised while maintaining conscionability in business transactions. With this in mind, some general principles for the regulation of retail tenancies are presented in box 5.6.

¹ Wheaton (2000) suggested that landlords were less likely to act in an opportunistic fashion when percentage rents are adopted as the rent receipts from small tenants would expand to comprise a greater share (and importance) of a landlord’s earnings. Further, when there are fit-out and other fixed costs or when leasing contracts do not fully account for the tenant-landlord relationship (such as the impact of passing trade), Wheaton also suggested that percentage rents would provide the greatest net benefits compared to other rent setting regimes.

Box 5.6 Principles for assessing regulation of retail tenancies

To ensure the efficient and fair operation of the retail tenancy market and facilitate commerce, regulations should:

- not extend or overlap with current laws governing all commercial transactions (including common law and the TPA) unless there is a clear net benefit to the community;
- ensure all lease conditions (rights and responsibilities) are clear and transparent to lessees and lessors and that lease and property rights are clearly defined;
- provide affordable and accessible dispute resolution and judicial processes;
- not unduly restrict the provision or the conditions (and hence availability) of retail tenancy space;
- not restrict commercial decision making including through:
 - arbitrary regulatory distinctions between businesses (whether landlord or tenant) based on the type or level of activity, or geographic location;
 - prescriptive rent setting or mandated rent setting processes; and
 - limitations on the flexibility of landlords and tenants to decide whether or not to re-enter a new lease agreement.
- not provide opportunities for market participants to shift risks associated with letting retail space or undertaking retail business;
- not overly prescribe levels of ‘unconscionable’ behaviour in a manner that would reduce the efficient operation of the market;
- ensure that those significantly involved in the negotiation and management of a lease are subject to unconscionable conduct provisions and legal proceedings;
- not restrict the commercial provision of market information; and
- be the minimum necessary and not unduly add to administrative and compliance costs.

The first principle relates to the pre-existing body of laws and regulations that are in place outside specific retail tenancy legislation. Simply, it suggests that if provisions exist under common law, or in other legislation and/or regulations that have a wider scope of application, such provisions should not be repeated in specific retail tenancy legislation. This ensures that regulatory overlap or inconsistencies, which have the potential to lead to unnecessary compliance and administration costs for businesses and governments, are minimised. Also, if current laws are to be extended or varied, additional regulation should be beneficial (overall) to the community. Moreover, as set out in the final principle, all regulation introduced should be the minimum necessary, to avoid an excessive compliance and administrative cost burden for businesses and governments respectively.

The second principle states that all lease conditions need to be clear and transparent, and lease and property rights need to be clearly defined. Such information is critical if informed decisions about the market are to be made — participants need to be aware of what they are entitled to, the recourse available to them when their rights are impinged upon, and the penalties that apply for breaches to their responsibilities.

The third principle relates to access to dispute resolution processes when breaches of tenancy rights and responsibilities occur. In this regard, it is essential that market participants have access to dispute resolution processes as this can be important in achieving efficient outcomes in the retail tenancy market.

The remaining principles deal with the incentives created by regulation. These principles provide a basis against which regulations that seek to change the behaviour of market participants can be evaluated. In essence, regulations should avoid altering market incentives that provide for efficient trade, and seek to remove those that create inefficiencies. In order to do this, regulations should not seek to prescribe what can and cannot be contracted (once property rights have been established and assigned), but instead should seek to establish an efficient environment in which negotiations take place.

FINDING

Principles are needed to assess alternative views about regulatory requirements and approaches to ensure that the maximum net benefit from government interventions are realised.

5.5 Summing up

The principles presented in this chapter can guide the Commission’s assessment of the current regulatory arrangements and inform recommendations to improve the efficiency and equity of the operation of the retail tenancy market.

The principles are applied in chapters 6 to 9 to assess four broad areas of concern raised by participants:

- security of tenure (chapter 6);
- occupancy costs (chapter 7);
- market information, transparency and disclosure (chapter 8); and
- business conduct and dispute resolution (chapter 9).

They are then used to assess some alternative approaches to regulation in the retail tenancy market (chapter 10) and the Commission’s recommendations (chapter 11).

