

REVIEW OF THE FRANCHISING CODE OF CONDUCT

Submission from the Lottery Agents' Association of Victoria

February 2013

The Lottery Agents' Association of Victoria represents lottery agents throughout the State who sell Tatts lottery products. Many members also provide instant scratch-it and terminal games supplied by Intralot, although this typically represents a small share of members' businesses. Most also retail unrelated ancillary products such as magazines, gifts, cards and lollies. While the dependence of members on Tatts products varies widely (some sell only Tatts products and some sell lottery tickets as part of a larger business such as a newsagency), there is also wide variation in where they are located (from kiosks in major shopping centres to small retail strips in suburbs and regional towns).

Irrespective of the nature of their business or its location, Tatts Group is the primary franchisor for all of our members. As a result, the Association liaises extensively with Tatts on behalf of members in relation to a wide variety of issues.

Unfortunately the relationship with Tatts has become increasingly fractured. For example, in 2012 an increase in gross commission from 9% to 9.3% was granted, but was grossly inadequate given trends in franchisees' costs and retail sales. It was the first increase in five years and was accompanied by a rise in fees which eroded some of the increased commission. Tatts attitude during these discussions was heavy handed and disrespectful, reminding everyone involved of the highly unequal nature of the franchise relationship.

It unfortunately remains a constant struggle to work with Tatts to improve the franchisee network via better local marketing, training, timing of merchandising material deliveries, etc. In recent years this has been compounded by their move to Queensland, which involved relocating their head office structure to Brisbane and leaving only limited field support services in Melbourne who now perform primarily a policing rather than advisory role. Their increasing emphasis on selling lottery products over the internet has also adversely affected their retail franchises.

The remainder of this document describes our concerns in greater detail and suggests ways the Franchise Code could be strengthened to give **greater recourse** to franchisees in their dealings with Tatts. Ultimately our desire is for the playing field to be levelled by requiring Tatts to act more in the interests of their franchisees, and for there to be meaningful consequences if they act to the detriment of their franchisees.

Our concerns

As a franchisor, Tatts is bound to abide by the Franchising Code of Conduct. However, our experience highlights the weakness of the current Code, as it provides little practical recourse for franchisees against a monopolistic franchisor and only minor consequences for them if they are found to have breached the Code. For example, none of the following concerns of Tatts franchisees can be addressed under the existing Code.

Online sales – franchisees are forced to promote this channel that is not available to agents but which cannibalises their retail sales.

Tatts online sales increased 28.4% in 2011/12 and now account for 6.6% of all their lottery sales (up from 5.7% in 2010/11). Franchisees are required to advertise the online channel through instore signage, advertising and merchandising aids, but receive no compensation in return and are excluded from participating in the online channel in any way. The Tatts franchise agreement absolutely prohibits online lottery sales by franchisees. Some franchisees have been issued with Franchise Breach Notices because of their efforts to compete with Tatts online sales and have had to bow to this competitive restriction. Referral commissions initially promised by Tatts were never introduced, and Tatts has recently and unilaterally removed the online commission received by franchisees in Queensland. Ultimately franchisees are being forced to advertise a competitive distribution channel. The appointment late in 2012 of Robbie Cook from wotif.com as the new Tatts CEO signals a drive towards even greater online growth and is therefore particularly worrying for Tatts franchisees.

The inability of the Association or any individual franchisees to take legal action against Tatts reveals the unfairness of this unequal relationship. It is simply not possible to compete against an organisation the size of Tatts, particularly in legal matters. Most unfortunately, the impact of online sales growth on business valuations has already been significant. Our efforts to enable franchisees to participate in the online space are consistently met with flat refusals by Tatts.

We are not aware of any other franchise chain where the franchisor forces their retail franchisees to promote their online channel and proactively promotes it to the detriment and exclusion of their retail franchisees to anywhere near the extent Tatts does.

We have raised these matters with the Victorian Small Business Commissioner, but he is unable to assist unless Tatts agree to participate in mediation or if a dispute is raised. Tatts will never agree to a mediated outcome. We have also explained the situation to the ACCC in Melbourne, but they also acknowledge the difficulty and uncertainty associated with any potential action due to the nature of the franchise agreement and the vagueness of the Code.

Franchisees have been aware for many years that online sales represent a threat, but even they have been surprised by the vigour with which Tatts has promoted this channel at the expense of their retail franchisees. Tatts' response is that becoming and remaining a Tatts franchisee is voluntary. Ultimately this is true. However, it ignores the reality of the situation. That is, if an existing franchise does not renew their agreement then the goodwill of their business will be lost. As a result, they are bound to renew. Tatts is not approachable with regard to negotiating any substantive changes to their franchise agreements, and have increasingly been using their unilateral right to change their Operations Manual to the detriment of franchisees.

Dedicated area restrictions – this remains a major competitive restriction on franchisees.

Franchisees are required to sell Tatts lottery products from what is called the 'dedicated area'. No other products can be sold from within that area, which means complementary Intralot lottery products are forced into poor instore locations. This impacts franchisees' lottery sales quite significantly. It also prevents franchisees from using prime merchandising space to sell other higher margin non-lottery ancillary products.

Unfortunately Tatts are increasingly enforcing the dedicated area restrictions, and the restrictions themselves are becoming increasingly stringent (eg. now including the floorspace in front of the counter and the air space above). These changes are made through unilateral amendments to the Operations Manual. One of the consequences is Intralot sales continue to suffer due to the forced poor positioning of their terminals and scratchie displays. Anecdotal evidence suggests placing Intralot scratchies in the Tatts dedicated area increases their sales immediately by 20-25%. The State Government currently suffers as a result through lower duties on lower Intralot sales. The last two relevant State Government Ministers have been sympathetic but unable to fix the situation since the dedicated area is not well defined in Tatts lottery licence. The current Minister has reluctantly not been able to fulfill his policy to fix this issue as he promised when in Opposition.

Shopfits – existing and new franchisees are being forced to make uneconomic investments.

Tatts remain determined to relocate many counters to the front of outlets with little regard for potential sales losses in ancillary businesses, customer queuing congestion or security considerations. The cost of the shopfits also remains in our opinion exorbitant (typically \$30,000 to \$100,000 depending on the size of the outlet) and their designs remain in some cases inappropriately grand. Purchasers of existing franchise businesses are particularly vulnerable because Tatts often only approves their applications if they agree to upgrade their shopfits. In these cases it is the vendor who suffers because the purchaser will take into account the immediate cost of a new fitout. It is also particularly frustrating that Tatts have never provided any evidence that the new shopfit designs they impose on franchisees actually increase sales.

Tatts restrict franchisees to using a limited range of shop fitters they approve, thereby effectively enabling them to operate as an oligopoly. Tatts do not provide any guarantees or support to franchisees if any of these approved shop fitters go into liquidation or do not complete a project adequately. The terms of their quotes are normally highly inappropriate (eg. deposit levels, payment schedules, etc.), but the franchisees are restricted in their ability to 'shop around' and Tatts does not assist them negotiate better terms.

Tatts are also disregarding the limited time franchisees have to recoup their investment in new shop fits, as their Victorian lotteries licence expires on 30 June 2018. They are still requiring franchisees to upgrade and make what are often uneconomic decisions in the face of threats to the continuity of their franchise. This means franchisees are often forced to undertake expensive upgrades that they will not receive an acceptable return on or face the possibility of their franchise being terminated by not meeting a shop fit upgrade requirement imposed by the franchisor.

Tatts heavy-handedness is also sometimes seen when they refuse to approve a relocation to an alternative retail site that is acceptable to both the franchisee and the landlord. There have also been cases where Tatts have forced a relocation on the basis that they will approve another franchisee to operate their preferred location unless the incumbent franchisee agrees to relocate.

Cost shift to franchisees – a GST-related cost Tatts passes on to its franchisees

When the GST was introduced it was agreed between Treasury and Tattersalls to reduce the lottery duty rate so that the introduction of the GST was neutral for gambling operators in Victoria.

Over the years commission rates increased slightly, most notably to a flat rate. However, the duty rate was not adjusted accordingly and neutrality was not maintained. The State Treasury argued there was no requirement to adjust the duty to achieve neutrality beyond the introduction of the GST.

The issue is a continuing concern for lottery franchisees because the reduction of Tatts margin caused by the lottery duty rate not being adjusted when retail commissions changed has been passed on by Tatts to their franchisees, something which we believe the State Government would not have anticipated or been aware of when asked by Tatts to approve changes in commission. Once the Government was made aware their response was that this was a matter between Tatts and their franchisees.

Last year the LAAV reluctantly agreed with Tatts on a small increase in the flat rate commission, but Tatts have again refused our attempts to build in compensation for the margin reduction caused by the fixed duty rate. Tatts continues to shift this imposition to franchisees. In other words, Tatts are again passing on to franchisees a cost they have refused to compensate for, and have not taken this into account when agreeing an increase in commission. Tatts refused to take the opportunity to remove this imposition on franchisees even though a slightly higher commission, ultimately paid by players through price increases, could have compensated for it. As a result, franchisees feel unnecessarily disadvantaged and aggrieved towards Tatts. The amounts involved run to thousands of dollars per franchisee. In our opinion it remains an unjust burden on small business operators, but as with the dedicated area concern, Tatts is not willing to change their position and legal action by franchisees is not practical or affordable.

Our response

In response to the types of unbending behavior described above the Association firmly believes Tatts is an example of a franchisor who needs to be **held more accountable** for the performance of their franchisees and who needs to take into account implications for franchisees' businesses when imposing requirements to a much greater degree than is the case currently.

Options for recourse, legal or otherwise, should therefore in our opinion be improved for franchisees to address the **traditionally unequal relationship** between franchisees and franchisors. The playing field needs to be leveled and the **consequences for franchisors** breaching the Code need to be more significant.

Ultimately any franchisee will need to decide if taking some form of action against their franchisor is practical and expedient. The difficulty currently is that the bar is set too high in favour of the franchisor. The Association's experience with Tatts exemplifies this position. Well intentioned franchisors would not be affected by strengthening the Code.

In our opinion, the main way more even balance can be achieved is through the formal incorporation into the Code of a 'duty of care' or 'good faith' provision. A burden of proof would remain, and the provision could be carefully defined.

The Association therefore strongly supports the second option described on page 34 of the detailed briefing paper attached to this submission that was prepared by Giles Consulting International for the National Independent Retailers Association. Supporting legal advice is also attached.

Waiting for common law to evolve will take too long, and promoting separate action at State level is better than nothing but not ideal.

Other suggestions

In addition to the adoption of a good faith provision, the Association would like to suggest other ways in which the current Code can be improved. These are as follows:

Introduce penalties

Penalties for breaches of the current Code are clearly lacking. While the original voluntary Code was rightly criticized for having 'no teeth', making the Code mandatory was a step in the right direction but not far enough. After all, the implications for a franchisor breaching the Code are insignificant, even if some dispute resolution or legal action is prompted by a franchisee. The Association is not aware of any significant penalties being imposed on franchisors as a result of Code breaches, but we are aware of many issues not being pursued by franchisees for obvious reasons – either they do not want to 'get on the wrong side of their franchisor' and are therefore prepared to tolerate a lot or ignore their concerns, or they simply cannot afford to take action. What good is a Code if there are not consequences for breaching it?

Agreement renewals

Uncertainty around whether or not a franchisee will have their franchise agreement renewed is one of the factors limiting their willingness to risk upsetting their franchisor, as they have significant emotional and financial investments in their franchises. Franchisees would be much more secure if they had an automatic right to renew their franchise agreement, much like a retail lease with options. From the franchisor's perspective certain performance expectations would need to be met (inc. the need for the franchisee to retain tenure on their location), but franchisees would be able to maintain the value of their businesses. Currently the value of a franchise business deteriorates significantly as the end of a franchise agreement approaches, which is exactly the opposite of what should happen assuming the business is running acceptably.

Unilateral changes

Tatts is an example of a franchisor that has often made unilateral changes to their franchise agreement to the detriment of franchisees who have to accept the changes because, if they don't, they risk losing their franchise and hence the investment in their business. Increasingly Tatts is also imposing additional restrictions through unilateral changes to their Operations Manual, which their franchise agreement requires franchisees to abide by but which Tatts can change when ever and how ever they want. For example, Tatts requirements in relation to dedicated area restrictions and shop fit requirements have become significantly more onerous in recent years through changes to their manual.

A solution is to require changes to Operations Manuals proposed by a franchisor to be approved by a representative group of franchisees such as an industry association. The onus could also be placed on franchisors to provide a commercial business case justifying increased costs they want to impose on franchisees.

Time periods

Currently franchisors have up to 42 days to approve the purchaser of a franchise business before the approval becomes automatic. This is far too long, as it simply caters for process inefficiency or inadequate resource allocation. For the vendor it can cause significant frustration, and for the purchaser it can lead to significant uncertainty. It causes difficulty in relation to when the purchaser can leave any existing job, and lengthens the handover period which in Tatts case cannot commence until approval is granted. With Tatts there have been cases where they have inadvertently allowed the 42 days to elapse. The time period should at least be halved, which would still give franchisors more than adequate time to evaluate prospective purchasers.

Threats

The unfortunate reality is that Tatts often threaten their franchisees in various ways in an attempt to get their own way. For example, franchisees are often threatened they will be breached if they do not do certain things, some of which are extremely minor. Even worse, sometimes they are threatened that if they do not do something then Tatts will approve a new outlet nearby or not renew their franchise agreement. In such circumstances franchisees have little power to react.

Franchisees need the quite reasonable protection of a 'Duty of Care' obligation imposed on Franchisors to enable them to respond to such threats.

The Association looks forward to providing clarification of any of the matters raised in this submission or the attached briefing paper, and eagerly awaits the outcome of the Code review.