New South Wales

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Our Ref: S19243

Mr Paul Gretton
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The Market for Retail Tenancy Leases in Australia Inquiry
Productivity Commission
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21 SEP 2007

Dear Mr Gretton

I refer to the Productivity Commission's recent invitation for submissions to its *Inquiry into the Market for Retail Tenancy Leases in Australia*.

The *Retail Leases Act 1994,* under my administration, is the main governing legislation for retail leasing in New South Wales. The Act sets minimum standards for the leasing of retail space and provides a mechanism for the cost-effective and timely resolution of disputes between landlords and tenants. From an operational perspective, the Act is administered by the Retail Tenancy Unit of the NSW Department of State and Regional Development. The Retail Tenancy Unit provides information and assistance to retail landlords and tenants on retail leasing matters, and helps to facilitate timely and cost-effective resolution of disputes through mediation.

A submission prepared by the NSW Department of State and Regional Development, on behalf of the NSW Government, is attached for your consideration. The submission notes that, 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.

While recognising the benefits of greater harmonisation of minimum leasing standards across retail tenancy laws, the NSW Government considers that a strong case remains for state-based regulation of the retail leasing market. State-based regulation allows for greater regulatory flexibility which enables jurisdictions to respond promptly and efficiently to emerging problems in their retail leasing markets. It also provides significant opportunity for jurisdictions to learn from experiences in other States and Territories. This ensures that the legislation continues to evolve and remain relevant, and is likely to lead to the adoption, over time, of best-practice efficient laws across all jurisdictions.

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If your officers require further clarification in relation to this submission, you may contact Mr Alok Ralhan, Director, Industry Policy on (02) 9338 6666 or by email at alok.ralhan@business.nsw.gov.au.

Yours sincerely

Joe Tripodi
Minister for Small Business and Regulatory Reform

PRODUCTIVITY COMMISSION INQUIRY INTO THE MARKET FOR RETAIL TENANCY LEASES IN AUSTRALIA

NSW DEPARTMENT OF STATE AND REGIONAL DEVELOPMENT SUBMISSION

1. Introduction

The NSW Government introduced retail tenancy legislation in 1994. The Retail Leases Act 1994 established a legislative framework for regulating the relationship between landlords and tenants in retail premises, introducing minimum standards for the leasing of retail space, and creating a mechanism for the cost-effective and timely resolution of disputes between landlords and tenants.

For many years, concerns had been raised as to the inequality in bargaining power between landlords and small-to-medium sized tenants and the general lack of fair dealing in the retail industry. These concerns culminated in the introduction, by all States and Territories, of legislation to regulate the relationship between landlords and smaller tenants in retail premises, with the exception of Tasmania which adopted a mandatory code of practice[1].
In NSW, retail tenancy legislation was introduced to:

> "...foster good leasing practices in the retail industry...[by ensuring] that retail leasing arrangements are explicit as to the requirement of both parties, and that they are entered into from a position of reasonably equal negotiating strength." [2]

The NSW *Retail Leases Act 1994* ('the Act') is "...primarily aimed at behaviour change, establishing an acceptable framework within which leasing transactions can occur, and changing the culture from one of confrontation and disputation to one of communication and commercially advantageous cooperation."[3] The intent of the legislation is not to interfere with the cut and thrust of commercial dealings and negotiations, or impose an excessive red tape burden on businesses. As a result, the NSW retail tenancy legislation seeks to regulate the retail leasing market only to the extent that the market fails to deliver efficient and equitable outcomes.[4]

The 2004 NCP Review of the Retail Leases Act received 44 written submissions, including detailed comment from a number of industry associations, legal firms, tenants, retailers and valuers. The views expressed by these groups overwhelmingly supported retention of the Retail Leases Act. The submission by the Shopping Centre Council of Australia stated:

> "... the Retail Leases Act NSW meets its objective of protecting small retail tenants while also adequately balancing the rights and responsibilities of both lessors and

1 See findings of the House of Representatives Standing Committee on Industry, Science and Resources May 1997, *Finding a Balance - Towards Fair Trading in Australia*; and the Joint Parliamentary Committee's 1999 report on the retailing sector, *Fair Market or Market Failure – A review of Australia's Retailing Sector*
2 *Retail Leases Bill 1994*, Second Reading Speech, the Hon Ray Chappell, MP, Minister for Small Business, 20 April 1994.
3 *Retail Leases (Amendment) Bill 1998*, Second Reading Speech, Ms Sandra Nori, 28 October 1998.
4 *Retail Leases Bill 1994*, Second Reading Speech, the Hon Ray Chappell, MP, Minister for Small Business, 20 April 1994.

lessees. As the Review will be aware it has served as a model for the other jurisdictions in recent years."[5]

The 2005 amendments to the Act were aimed at further supporting competition in the retail industry for the ultimate benefit of consumers in New South Wales. These reforms were developed "...so that landlords and small retailers can focus on day-to-day business, secure in the knowledge that the Retail Leases Act clearly sets out their legal rights and financial responsibilities as parties to a shop lease."[6] The legislation aims to achieve competitive tension in the retail leasing industry so that commercial decisions taken in this part of the retail chain work to the ultimate benefit of the consumer while at the same time minimising rent seeking conduct based on market inefficiencies by any participant in the market.

2. The case for retail tenancy legislation

The case for Government regulation of the market for retail leasing has been well established on efficiency and equity principles.[7] While it is generally accepted that market forces are the basis for commercial transactions, as they generally provide beneficial outcomes to the parties to a transaction and the broader community[8], there are certain grounds on which markets may fail to deliver an efficient allocation of resources in the economy.

Three grounds, which are particularly relevant to retail tenancies, occur where:

- there is an *information asymmetry* between parties to a transaction[9], which restricts the ability of a party to make informed decisions;
- the market is characterised by *imperfect competition*, due to differences in bargaining power between parties to a transaction; and
- there are high *transaction costs*.

In such circumstances, Government regulation can improve public welfare, provided that regulation is the most effective way of addressing the identified market failure and results in net public benefits to society.

Information asymmetry

Information asymmetry exists where parties to a transaction do not have equal information available to them when making a business decision. Where information imbalances cannot be overcome by professional advice, or the parties to a transaction do not have the same financial resources to overcome the imbalance, the party with the superior information will be at a competitive advantage in any contractual negotiations.

In the case of retail tenancies, detail on the characteristics of premises, the tenancy mix (in the case of a shopping centre), and future planned changes to the centre etc, is critical information

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5 Shopping Centre Council of Australia and Property Council of Australia, joint submission to the NCP Review of the NSW Retail Leases Act 1994, July 2003.

6 Retail Leases Amendment Bill 2005, Second Reading Speech, the Hon David Campbell MP, Minister for Small Business, 19 October 2005.

7 *Final Report of the National Competition Policy Review of the NSW Retail Leases Act 1994*, p.12-31.

8 The market mechanism generally promotes an efficient allocation of resources, which results in greater choice and lower prices for consumers.

9 'Information asymmetry' is characterised by an imbalance in the information available to the parties to a business transaction. This does not necessarily imply that one party has 'withheld' information that the other party needs to make informed decisions. It may result from the complexity of the transactions involved and the expertise required to understand all aspects of such transactions.

that prospective tenants should know in order to make informed decisions on whether to enter into a lease, as it may impact on the success of their business. The landlord is likely to be in possession of such knowledge and therefore is at an unfair advantage in lease negotiations. In some cases, this information asymmetry can be overcome by a prospective tenant engaging professional advisers (eg lawyers). This often involves significant expense, with larger tenants more likely than smaller tenants to be able to afford the costs associated with overcoming this information imbalance.

To address information asymmetries, and ensure smaller tenants are able to make an informed decision, retail tenancy legislation generally requires landlords to make certain minimum disclosures to tenants prior to the signing of the lease, during the lease term and prior to lease end. It should be noted that the costs to landlords of disclosing such information are minimal, as such information is collected and compiled as part of the landlord's normal business practice.

Imperfect competition

Another case of market failure arises where an industry is comprised of parties with different degrees of bargaining power. A party to a transaction may have a superior negotiating position due to its market power, which may affect the ability of the weaker party to negotiate favourable contractual terms.

In the case of retail tenancies, the strong consumer preference to shop at major shopping centres, coupled with the limited number of centres across metropolitan and regional NSW, gives rise to a significant imbalance in bargaining power between landlords and small-to-medium sized tenants, particularly in shopping centres. With significant competition among retailers to locate in shopping centres to take advantage of increased retail trade[10], landlords are in a stronger negotiating position when setting the terms of a lease. In some cases, it could be argued that landlords have a degree of 'localised' market power, with retailers of certain products (eg fashion clothing) reporting that they have little choice but to locate in major shopping centres, in line with consumer expectations. Similarly, in some smaller regional areas, the presence of only one major shopping centre places the landlord at a significant advantage in lease negotiations.

In contrast, smaller retailers are not in a position to significantly influence the terms and conditions of leases offered by shopping centre landlords, with tenants often complaining that they are faced with 'take it or leave it' options when they try to negotiate lease terms. This imbalance in the landlord-tenant relationship, arising from the limited availability of retail shopping centre space, is reflected in the fact that a significant proportion of callers to the NSW Retail Tenancy Unit hotline decide not to complain or seek redress for fear of being disadvantaged at a later point of time in their dealings with their landlord.

To ensure that landlords with superior negotiating strength do not misuse their market power to economically exploit tenants by imposing unreasonable lease terms and conditions, retail tenancy legislation generally specifies minimum standards for lease tenure, a rent assessment process where there is an option to renew the lease, and prohibits unconscionable conduct in business dealings.

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10 Retail shopping centres are increasingly popular locations for retail businesses, as they generally generate higher trade (income) and generally derive higher turnover per square metre than shopping strips. Based on figures prepared by the Shopping Centre Council of Australia in June 2007, although retail shopping centres only comprise 30 percent of the total retail space in Australia, they account for around 40 percent of all retail trade income.

High transaction costs

Transaction costs refer to the costs of engaging in a business transaction, including the cost of searching for relevant information and the costs of obtaining redress in the event of a dispute. Where such costs are high, and there is a significant difference in the financial position of parties to a transaction, the party in the weaker financial position may be at a significant disadvantage, particularly in the event of a dispute.

In the case of retail tenancies, the high cost of obtaining specialised legal advice and pursuing an action through the Courts, means that smaller tenants are at a disadvantage, relative to larger landlords. In the absence of more cost-effective methods of redress, this disadvantage is likely to manifest itself in reluctance by small and medium sized businesses to pursue redress in the event of dispute. Additionally, the 'cost' to smaller tenants of time and resources spent in dispute is relatively higher, as smaller tenants tend to be actively involved in all aspects of their business. To ensure that small-to-medium sized tenants are not at a disadvantage in obtaining justice in the event of dispute, most retail tenancy legislation provides for a cost-effective and timely dispute resolution mechanism.

Relationship to the market for commercial tenancies

While there are clear competition grounds for regulating the market for retail tenancies, a similarly strong case cannot be made for commercial tenancies. Consequently, in contrast to retail leasing arrangements, commercial leasing arrangements are currently not regulated by Australian States and Territories, with the exception of the Australian Capital Territory.[11]

The difference in treatment between retail and commercial tenancies has often led to an erroneous argument that government regulation of the retail leasing market places owners of retail shops and retail shopping centres at a competitive disadvantage relative to owners of office and industrial space. By regulating the retail leasing market, it is argued that the Government effectively places one class of property owner at a relative disadvantage to other landlords. In support of this argument, it is often noted that other retail tenancy markets – including those in New Zealand and the United States – are not regulated.

However, competition policy does not imply that landlords of different classes of premises should be treated equally. Rather, competition policy seeks to ensure that markets for various types of premises operate efficiently, effectively and equitably. Regulation of a market is only justified where a clear case of market failure can be established. On this basis, there are sound policy reasons for the different treatment of the retail leasing market, as compared to commercial and office leasing markets. The need to regulate a particular market is solely dependent on the particular characteristics of that market.

As stated, one of the most significant reasons for regulating the retail leasing market is to address the imbalance in negotiating power that exists between landlords and smaller tenants of retail premises. 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 businesses and are therefore in a weaker bargaining position in lease negotiations.

11 The ACT's retail tenancy legislation, the *Leases (Commercial and Retail) Act 2001*, also provides certain minimum protections to tenants who lease small commercial premises.

A key reason that customers choose to shop at a particular store is because of its location. Customers value the convenience of a particular location because of its ease of accessibility, visibility and the characteristics of neighbouring shops. Shopping centres are particularly popular as they provide a multi-purpose shopping destination. As the goodwill of a retailer's business is often tied to a particular location, the impact on a retailer's business of having to move out of the shopping centre could be significant, particularly if the tenant's business is replaced by a shop of similar usage. In addition to the loss of custom, the retailer may have also invested in a substantial fit-out of the premises, whose value would be written-off if the retailer moved location. As a result, faced with increase in rent costs in excess of the market level, a retailer may still decide to accept a new lease, having regard to the viability of his business and the costs of moving premises.

These characteristics of the retail tenancy market places retail tenants at a particular disadvantage in leasing negotiations relative to tenants in office and industrial accommodation, where the success of a tenant's business is not as dependent on location. 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. The fact that similar imbalances in negotiating power do not arise between landlords and tenants of office or industrial premises, explains why the State and Territory Governments, generally, have not considered it necessary to introduce specific legislation to regulate these other types of leasing.[12]

3. The case for state-based retail tenancy legislation

A strong case exists for ongoing state-based regulation of the retail tenancy market on several grounds.

Firstly, the division of powers between the Commonwealth and the States means that matters relating to contract law, property law and land use planning are State responsibilities.

It is well recognised that differences in land management and planning policies between jurisdictions can have a significant impact on the availability and concentration of retail leasing space, particularly for shopping centres. This, in turn, can alter the market for retail leasing space and the relative market power between landlords and tenants for such space.[13] Given that the aim of retail tenancy legislation is to address significant imbalances in information and negotiating power between landlords and tenants, and given that differences in land use laws between jurisdictions can affect the nature of this relationship, a strong case exists for ongoing regulation of the market at the state level. In addition, differences in retail ownership concentration between jurisdictions may also imply a different 'optimal' level of regulation across jurisdictions.

Secondly, reliance on a state-based system of regulation also allows for greater regulatory flexibility and the ability for State and Territory based regulators to respond more promptly to jurisdiction-specific issues than arise in the retail leasing market. For instance, in the NSW *Retail Leases Amendment Act 2005*, the NSW Government introduced provisions prohibiting

12 Contracts negotiated between tenants and landlords for office or industrial space are largely governed by contract law and the Commonwealth *Trade Practices Act 1974*.
13 Millington, A.F., Retail Property in Australia: A review of the Retail Property Market in Australia, 1995, p.87

a price discriminatory 'end of lease' tendering practice which had emerged in retail leasing.[14] While similar market practices had not emerged in other States and Territories, landlord and tenant associations agreed that such a practice should be prohibited.

Similarly, in the 2005 amendments, the NSW Government improved the market rent determination provisions of the Act to address the reluctance among valuers in NSW to undertake market rent valuations that threatened to make the rent determination provisions inoperable[15]. To address this matter, the NSW Government found that the least-cost and most effective solution was to involve the Administrative Decisions Tribunal in the market rent determination process. At the time, the key industry stakeholders noted that similar problems were not raised in reviews in other jurisdictions.

This example indicates that a state-based system is not only able to be more flexible in dealing with state-specific leasing issues, but it is likely to be more efficient than a national system. The resolution of the problem in NSW would be more difficult to justify if national legislation was in place. The two possible outcomes would have been: a breakdown in the effectiveness of the legislation in NSW, or an unnecessary regulation imposed in other jurisdictions to correct a problem in NSW.

The NSW Government favours state-based regulation of retail tenancies as it:

- provides States greater flexibility to adjust retail tenancy laws in response to market problems. Failure to respond to emerging problems promptly may result in market inefficiencies and unfair practices;
- takes account of the fact that retail tenancy problems may vary between States due to the different concentration of retail ownership in different jurisdictions and differences in land use and planning policies and legislation; and
- acknowledges that a common level of regulation may not be 'optimal' or justified on net benefit grounds, especially where some emerging problems in the market may be state-based and not nation-wide.

Scope for harmonisation of legislation

While a strong case exists for state-based legislation as opposed to national legislation, differences in regulations across States and Territories have led to calls, particularly from landlord associations, for greater harmonisation of retail tenancy legislation. Despite the degree of consistency in retail tenancy standards across jurisdictions, and the way the retail tenancy laws have been modified[16], landlord associations argue that managing retail tenancies is made more complex over time, as state governments modify their legislation. Differences in legislation across jurisdictions may impose additional compliance costs on landlords and on retailers who operate nationally. It is argued that such costs could be minimised through greater harmonisation of the key aspects of retail tenancy laws.

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[14] The practice involved landlords tendering retail premises, at the end of the lease, while they were still negotiating with the 'sitting tenant'. The amendment to the legislation allows a 'sitting tenant' to negotiate with a landlord before the lease is made available to the market.

15 The reluctance by valuers to undertake valuations arose as an increasing number of valuers in NSW were being sued for negligence, simply because a party to the lease considered the rent determination to be unfavourable. Where a complaint was made against the valuer, a valuer's professional liability premiums would immediately rise, even if the complaint did not lead to legal action.

16 In December 1997, all State and Territory Governments agreed to adopt certain minimum standards into their retail tenancy legislation to address market failures in the retail leasing market.

The NSW Government recognises that harmonisation of key aspects of retail tenancy laws may have benefits. This is true for areas where equity considerations are clearest, that is, in relation to disclosures by both parties at the pre-lease stage, end of lease rights and responsibilities, and access to low-cost mediation and dispute resolution services.

However, harmonisation may also impose economic costs. This may occur where the 'optimal' form of regulation is dependent upon the particular size, concentration, characteristics and operation of the market for retail tenancies in that jurisdiction, as well as institutional variations and differences in planning laws and land management practices across jurisdictions. Harmonisation may also reduce the ability for jurisdictions to respond quickly to changing market conditions.

In assessing the net benefits of harmonisation, the NSW Government proposes that a comprehensive cost-benefit analysis should be adopted as the policy test in assessing whether regulatory harmonisation is justified. This analysis should be undertaken on a disaggregated (provision by provision) basis with the requirement that the harmonised standard:

- provides net benefits to all jurisdictions; and
- produces an efficient and equitable retail leasing environment and fosters more equitable and efficient retail tenancy.

The NSW Government notes that a general case for harmonisation of legislation based on a cost-benefit analysis would need to be made. However, where harmonisation of certain legislative provisions is found to generate net public benefits, the NSW Government proposes the adoption of common minimum standards or regulatory principles upon which independent State and Territory laws would operate.

Form and degree of harmonisation

While a case for harmonisation of retail tenancy legislation still needs to be made, the NSW Government would be concerned with any harmonisation of retail tenancy laws which significantly diminishes the existing rights and protections available to small tenants - particularly if harmonisation results in the adoption of the 'lowest common level' of protection for small tenants.

For instance, retail tenancy legislation in all States and Territories provides parties to a lease with *access to low-cost dispute resolution by mediation.* However, the way this requirement is adopted across jurisdictions varies significantly. The NSW legislation specifically requires all retail tenancy disputes to be mediated in the first instance. Disputes may only proceed to the Tribunal for resolution where the Registrar of the Retail Tenancy Unit certifies that mediation between the two parties had failed.

The introduction of this mandatory mediation requirement has proved to be extremely successful in NSW, with currently more than 80 percent of disputes being resolved at mediation. The dispute resolution mechanism have also been well-supported by the retail leasing industry because it provides a lower cost of redress for tenants and landlords and ensures that disputes are resolved quickly and efficiently, enabling tenants and landlords to return to their day-to-day business promptly.

Given the success of the NSW dispute resolution model, the Victorian Government introduced a similar dispute resolution mechanism in its 2003 amendments to its legislation.

By contrast, the Queensland legislation provides landlords and tenants with a right to 'voluntary mediation', but does not require that all disputes be mediated before proceeding to the retail tenancy tribunal or further litigation. The South Australian legislation also provides for voluntary mediation.

While the Commonwealth has indicated that it will be assessing the extent and adequacy of dispute resolution mechanisms between States and Territories as part of this review, the NSW Government would be concerned with any proposed harmonisation of redress mechanisms that alters significantly the dispute resolution processes that are currently available to small tenants under the NSW legislation.

The NSW Government considers that a move away from mandatory mediation towards voluntary mediation would impose greater costs on tenants and landlords and reduce the net public benefits associated with the existing provisions, without any benefits to the parties to a lease, investors, or consumers.[17] It is noted that the dispute resolution mechanisms under the NSW legislation are highly regarded by both landlord and tenant associations as being extremely effective in resolving disputes between landlords and tenants.

Another area of regulatory difference between jurisdictions relates to the *minimum disclosures* that landlords are required to provide to tenants prior to the signing of the lease. While there is broad consistency regarding the level of disclosure to be provided by landlords to tenants prior to the signing of a lease, differences exist between the States and Territories. For example, the 2005 amendments to the NSW legislation resulted in an agreement by landlord and tenant associations to increase the disclosures to be provided by shopping centre landlords to tenants prior to the signing of the lease. These additional disclosures require landlords to provide tenants with:

- notification as to whether the landlord is subject to, or aware of, any legal proceedings being brought against himself/herself; and
- an indication, in the disclosure statement, as to whether the tenant is, or is not, being offered an exclusive right to trade in particular goods in the shopping centre.[18]

The need for these additional disclosures arose due to specific problems, which had been raised on a consistent basis with the NSW Retail Tenancy Unit. In relation to the issue of exclusive rights, tenants had often raised complaints with the Retail Tenancy Unit that they had been given verbal commitments regarding 'exclusive use' by centre managers, even though such commitments were not reflected in their lease document.

In assessing alternative ways to address this problem, the NSW Government concluded that the requirement for landlords to include in the disclosure statement whether an 'exclusive right' was being provided to the tenant or not, represented the least cost way of addressing this problem, with significant net public benefits. While these disclosures are additional to those required by most other States and Territories, the NSW Government would oppose harmonisation of legislation which resulted in a reduction in the existing level of disclosure required to be provided by landlords to tenants in NSW.[19]

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17 For a full analysis of the net public benefit case for the NSW dispute resolution mechanisms, see *the Final Report of the National Competition Policy Review of the NSW Retail Leases Act 1994*, p.78-86.

18 Similar provisions were introduced by the Queensland government in 2002 to address specific problems that were emerging with tenants alleging that landlords/centre managers had verbally offered them exclusive rights to trade. However, these rights never appeared in the lease documentation.

19 In its 2004 National Competition Policy review of the legislation, the NSW Government found a benefit case for the existing level of disclosures in the NSW legislation.

The *coverage of the legislation* also varies across States and Territories and may be another area of concern in regards to proposed retail tenancy harmonisation. While the aim of the legislation is to provide protections to small and medium sized tenants, a notable exception exists between jurisdictions in relation to the treatment of publicly listed companies. The Western Australian, Victorian and Queensland legislation specifically excludes publicly listed companies. The basis for their exclusion is the argument that such companies are generally in a stronger financial and bargaining position than small-to-medium sized businesses, and are therefore able to negotiate fair lease deals with large shopping centre landlords, without the need of the protections available under retail tenancy legislation.

Notwithstanding this argument, the NSW Government considers that the exclusion of publicly listed companies from the coverage of the Act is likely to result in anti-competitive leasing practices, which disadvantages the small-to-medium sized tenants that the legislation seeks to protect. In the National Competition Policy (NCP) review of the Act, the NSW Government found that the exclusion of publicly listed companies from the coverage of the legislation would exacerbate competitive disadvantage suffered by smaller tenants in competing for retail space against publicly listed company tenants.

NSW is therefore concerned with any harmonisation of legislation which alters the existing rights of tenants and which alters the competitive nature of the retail leasing environment in favour of one type of tenant over another. It should be noted that while Queensland and Victoria have examined competition issues, as part of the recent amendments to their legislation, NSW is the only State to have conducted an NCP review of all the provisions of its legislation. With the exception of two minor provisions, the NCP review found a net benefit case for the retention of the NSW legislation.

Industry advisers regularly report that NSW has the most progressive retail tenancy legislation. During the 2004 NCP Review, both the landlord and tenant associations noted that the NSW legislation is considered to be the benchmark against which other states have modelled their own retail leasing legislation in recent years, and the basis for the implementation of harmonised retail tenancy legislation across Australia.

4. Operation of NSW legislation

The NSW Government introduced retail tenancy legislation in 1994, in response to significant pressure from the retail leasing industry for measures to ensure fair retail leasing practices.[20] Although a Voluntary Code of Practice ('the Code') had been endorsed and adopted by the industry in January 1992, significant non-compliance with the Code by landlords had made it essentially ineffective.[21]

Following extensive consultation with key industry groups, the NSW Government developed the *Retail Leases Act 1994* ('the Act'). The Act established a legislative framework for regulating the relationship between landlords and tenants in retail premises, introducing minimum standards for the leasing of retail space, and creating a mechanism for the cost-effective and timely resolution of disputes between landlords and tenants.

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20 Similar concerns prompted other Australian States and Territories to introduce retail tenancy legislation. The first Australian State to introduce retail tenancy legislation was Queensland, with the enactment of *the Retail Shop Leases Act 1984*. This was closely followed by similar legislation in three other States - Victoria, South Australia and Western Australia.

21 An industry review of the operation of the Voluntary Code of Conduct in early 1993, found that there was significant non-compliance with the Code which had made it unworkable. In addition, the review found that the procedures set up to deal with disputes under the Code had failed to deal with them.

Since its introduction, several major changes have been made to the Act to improve its operation. In particular, following extensive discussions with industry stakeholders, significant amendments were made to the Act in 1998 to strengthen the existing disclosure requirements under the Act, to clarify the process for market rent reviews, and to provide retailers and landlords with access to the unconscionable conduct protections available under section 51AC of the Commonwealth *Trade Practices Act 1974*.

Further amendments were also made in 2002, to allow GST to be collected by landlords on rent paid by a tenant, and to exclude certain premises at Kingsford Smith Airport from the operation of the Act and exempt landlords of these premises from certain legislative requirements.

More recently, in 2005, significant amendments were made to the Act, based on issues of concern raised by the industry during the course of the 2004 National Competition Review of the legislation.

These amendments include:

- *Increased disclosures to be provided by landlords to tenants prior to the start of a lease*, so that tenants have an indication of how the centre is trading and costs that will be associated with entering a lease;
- *Increased coverage of the Act*, to provide coverage for new and emerging retail businesses;
- *Prohibition of certain end-of-lease tendering practices*, such as landlords tendering premises at the end of a lease, while they are still negotiating a new lease with the sitting tenant. This amendment enables a 'sitting tenant' to negotiate a new lease with a willing landlord before the lease is made available to the market;
- *Improvements in the mechanism to determine current market rent where a lease contains an option to renew*. The revised mechanism addresses operational problems that existed with the previous market rent determination provisions. This has led to a reduction in the cost of rent valuations and enables parties to a lease to have access to a cost-effective dispute resolution mechanism;
- *Provisions for a more cost-effective method for the hearing of misleading and deceptive conduct claims* by the Administrative Decisions Tribunal, without need for the matter to be referred to the Court System; and
- *New regime for the safekeeping of security bonds,* with provision for bonds to be lodged with the Director General of the Department of State and Regional Development.

From an operational perspective, the NSW legislation has been strongly supported by both landlord and tenant industry bodies as providing a basis for good leasing practices in the NSW retail leasing industry.

The effectiveness of the legislation is reflected in the fact that, since its introduction in September 1994:

- the NSW Retail Tenancy Unit has handled over 60,000 inquiries from tenants and landlords.
- conducted in excess of 2,700 formal mediations. Based on current figures, approximately 80 percent of these formal mediations are successful in resolving matters in dispute.
- resolved the bulk of inquiries through informal mediation. This involves staff of the Retail Tenancy Unit providing advice to landlords and tenants to enable them to develop their own solutions to the dispute. Staff of the Retail Tenancy Unit may also contact the

other party to the dispute, with the permission of the party approaching the Unit, with a view to assisting the parties to reach a solution.[22]

In terms of the effectiveness of the provisions, it should be noted that all the provisions in the *Retail Leases Act 1994,* including those contained in the 2005 amendments, are considered to be justified on net public benefit grounds. The National Competition Policy Review of the Act, which was completed in 2004, found that the Act generates public benefits by minimising differences in information available to each party in a lease agreement. These public benefits were considered to far outweigh any public costs, including costs of compliance.

In addition, the 2005 amendments to the Act which commenced on 1 January 2006 appear to be well received by the retail leasing industry and working well. Based on initial statistics compiled by the Retail Tenancy Unit, the new disclosure and market rent valuation provisions have been effective in reducing disputes.

Nonetheless, despite strong industry support for the legislation, the NSW Government is mindful that the mandatory disclosure requirements need to be complemented with education aimed at informing tenants of the implications of signing a lease. Prospective tenants should be made aware of the risks and rewards of operating businesses and the relative costs and benefits of operating a business in a shopping centres or a shopping strip, in terms of likely costs of fit-out and the likelihood of lease renewal at end of lease.

Such education campaigns have ensured that State legislation provides the maximum benefit to market participants. Education of small retailers, especially with regards to evaluating a lease and understanding their rights and obligations under the lease, remains an area of continuing challenge that could be usefully boosted by national resourcing from the Commonwealth Government.

5. Continuing issues in the retail tenancy market

The NSW Government considers that information asymmetries and the emergence of harsh leasing practices continue to validate the need for ongoing improvement to both Commonwealth and State legislation regulating the market for retail leasing. Specific areas of ongoing concern in the retail leasing relationship are discussed below.

5.1 Disclosure of turnover data enshrined in lease contracts

A key objective of the retail tenancy legislation is to address the information asymmetry that exists between landlords and small-to-medium sized tenants. The NSW *Retail Leases Act 1994* recognises that a lease has profound implications for the success of a tenant's business and that access to relevant information is vital to successful commercial relationships. However, a significant area of information asymmetry continues to exist between tenants and landlords in shopping centres at end of lease.

Most shopping centre leases require tenants to provide landlords with turnover figures, as a condition of the lease. This requirement arises as most leases for shops in shopping centres provide for a minimum rent to be paid, plus an percentage of turnover (or gross sales), when turnover exceeds an agreed turnover threshold. Despite the fact that the turnover rarely

22 Informal mediation is provided for under section 67 of the *Retail Leases Act 1994*.

exceeds the threshold level at which additional rent becomes payable, this rental arrangement provides landlords with a basis for collecting turnover figures from tenants.

Tenant associations argue that the ability of landlords to include such provisions in leases means that tenants are without suitable protections from the ability of landlords to seek unreasonable rents at the time of lease renewal negotiations. Some tenants reported to the Australian Retailers Association that they were aware that the landlord's knowledge of their turnover information was being used to set the rent for a new lease for the premises they were currently occupying.

Landlord associations argue that the collection of turnover figures provides useful information to assist them to manage shopping centres – particularly in determining a centre's overall financial performance, and the strengths and weaknesses of the centre's existing retail offer in various retail categories. Turnover information, it is argued, is important for ensuring the effectiveness of the existing tenancy mix strategy and for determining shopping centre marketing and promotional strategies. Landlords also argue that turnover information can be used to improve a tenant's business when landlords identify under-performing tenants and provide assistance in marketing their businesses.

However, the requirement for tenants to disclose turnover information enables the landlord to build up a substantial profile of the trading performance of the tenant. This places the landlord at a competitive advantage in 'end of lease' negotiations for the renewal of a lease with the 'sitting tenant', as the landlord is aware of the tenant's capacity to pay and can approach the rental negotiations on this basis. Tenants have no such similar information about a landlord's costs in setting the rent. This information asymmetry could be reduced if tenants had access to information on the actual market rent being paid by other tenants for premises of similar retail usage, as this would enable the tenant to determine whether the landlord's initial rental offer was reasonable.

Landlord associations argue that the existing information imbalance has already been addressed by a number of States – including NSW, Queensland, the ACT and the Northern Territory – through the practice of leases of more than 3 years duration being registered to protect parties' interest in land. As a result, for a small fee, tenants may view such leases and determine the 'market rent' being paid by other tenants for comparable premises in the centre.

However, a significant shortcoming of the registration process is that the rents disclosed on registered leases rarely reflect the 'net' (or 'effective') rent being paid by tenants. It is well known among retail valuers that the rent recorded on registered leases (the 'face rent') often differs significantly from the 'effective rent' being paid by tenants, due to presence of 'side deals' (eg., rent-free periods, landlord contributions to fit-out etc).[23] As 'side deals' are not disclosed on registered leases, an examination of registered leases does not necessarily provide tenants with useful information about the market rent, and therefore it does not address the existing information imbalance between landlords and tenants at end of lease.[24]

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23 The variation between face rents and effective rents is exacerbated by the fact that landlords have a vested interest in recording higher face rents on registered leases and compensating tenants with 'side deals'. This practice increases the borrowing capacity of landowners against other investments, as the capitalised value of the rent stream, which the banks consider in offering loan amounts, is based on the capitalised value of the 'face rent', not the 'effective rent'.

24 Moreover, the use of side deals has the effect of making the market rent seem higher than is actually the case. Registered leases may therefore provide erroneous information to tenants in their future rental negotiations which may further distort the retail leasing market.

It has been proposed that the information imbalance between landlords and tenants at end of lease could be addressed if tenants take advantage of recent amendments to collective bargaining provisions under the *Trade Practice Act 1974*. Recent amendments to the *Trade Practices Act 1994* enable tenants to seek authorisation from the ACCC to engage in collective bargaining practices with landlords for retail space. However, it is difficult to make a case for collective bargaining in retail leasing.

Collective bargaining is generally effective when the 'product' being traded is largely homogenous. However, retail shop space, particularly in shopping centres, is not homogenous. As a result, the price ('rent') charged for retail space is not a fixed amount per square metre. Rents per square metre vary based on the size of the premises, the frontage of the retail premise and its location within the centre.[25] Rents also vary based on the usage of the premises, as retailers have a different capacity to pay depending on the profits margins that apply to their retail goods category. In addition to these differences, any attempt by tenants to collectively bargain is likely to be difficult, as each tenant's lease has a different expiry date.

Even if all leases for a particular retail category were due to expire within a similar period of time, it is not likely to be in the best interest of tenants in that retail category to bargain collectively with the landlord to determine the rent on renewal. Each tenant will be motivated by a desire to improve their competitive position by trying to negotiate the most favourable lease conditions possible. This competition among retailers for a share of consumer expenditure in the centre means that collective bargaining will be useful in only a small number of circumstances.

It is also noted that due to the stronger bargaining power of shopping centre landlords, retail tenant are unlikely to be able to collectively bargain to contract out of having to disclose turnover figures.

End of lease issues continue to be a major area of ongoing dispute in retail leasing arrangements. Based on figures compiled by the Retail Tenancy Unit, end of lease disputes accounted for around 38 percent of all inquiries made to the Retail Tenancy Unit in 2006-07 and resulted in around 36 percent of all applications for mediation. Of these disputes, 53 percent related to leases for premises in shopping centres, with the remaining 47 percent relating to leases for premises in shopping strips.

A number of other jurisdictions, including Victoria and Western Australia, have also raised concerns during their retail tenancy reviews about the competitive advantage that landlords have in end of lease negotiations, due to their ability to collect information on a tenant's turnover.

To address this matter, in its 2003 amendments to its retail tenancy legislation, the Victorian Government included an additional criterion which the Victorian Civil and Administrative Tribunal can consider in determining whether conduct by landlords is unconscionable. Specifically, sections 77 and 78 of the Victorian *Retail Leases Act 2003* states that conduct by landlords may be considered to be unconscionable, if the landlord unreasonably uses information about the turnover of the tenant, or a previous tenant, in negotiating a business'

25 The location of a retail shop in the shopping centre is an important determinant of the likely traffic flows and therefore the cost of those premises (eg. retailer located closer to major chains and supermarkets are likely to have more traffic flow past their shop).

rent. However, it is not yet clear, by a process of review of the Courts, whether this additional criterion is working effectively.

It is noted that shopping centre landlords in the United Kingdom or the United States of America do not collect this information from tenants and yet are able to successfully manage their centres.

5.2 Greater role for the ACCC in instigating proceedings for breaches under the Trade Practices Act

While the existing dispute resolution mechanisms under the NSW Act provide cost-effective redress for small tenants in their disputes with landlords, the NSW Government considers that the ACCC needs to take a greater role in instigating proceedings for breaches of the *Trade Practices Act 1974*.

The Australian Consumer and Competition Commission (ACCC) has powers to investigate possible breaches of the *Trade Practices Act 1994*, based on complaints from industry, and to instigate necessary actions which are in the public interest to enforce the provisions of the *Trade Practices Act 1974*.[26] The ACCC may also independently initiate investigations into breaches of the Act, whether or not it receives complaints. However, to date, very few retail leasing matters have been brought to Court by the ACCC.

The NSW Government believes that the ACCC should consider conducting more investigations and, where appropriate, instigating actions into possible breaches of the unconscionable conduct provisions of the *Trade Practices Act 1974*, in retail leasing arrangements. This will help to build up the case law in this area and provide guidance to lower-cost State and Territory Courts and Tribunals on conduct considered to be unconscionable.

5.3 End of lease negotiations to be conducted in "good faith"

Another particular problem raised by the retail leasing industry relates to the issue of how the duty to "act in good faith" is applied to leasing arrangements and lease negotiations. The NSW Retail Tenancy Unit reports that end of lease disputes accounted for around 38 percent of all inquiries made to the Unit in 2006-07 and resulted in around 36 percent of all applications for mediation.

Tenants regularly claim that landlords are not 'acting in good faith' in end of lease negotiations. It is claimed that when a new lease or lease renewal is offered, landlords often seek sharp increases in rent that are well in excess of the market rent. As the sitting tenant's goodwill is often tied to a location, and landlords, particularly in a shopping centre, are aware of the tenant's capacity to pay, tenants argue that landlords seek monopoly rents. In addition, it is reported that landlords are rarely willing to negotiate the rent on the new lease.

Further, tenants claim that, if they choose not to accept the above market rental offer, the landlord will often lease the premises to another tenant at a rent not dissimilar to the rent the

26 Specifically, section 155 of the *Trade Practices Act 1974* provides the ACCC with powers to obtain information, documents and evidence in the course of investigating possible contraventions of the Act and for use in proceedings under the Act.

sitting tenant was paying at the end of lease, or even lower. Tenants argue that this practice appears to be contrary to a 'good faith' negotiation.

Although the role of good faith in Australian contract law is currently unsettled, common law concerning the implied 'duty of good faith' in both the negotiation and performance of a contract is growing. Despite this, there is still considerable debate as to the precise meaning of 'good faith', with the assumed meaning varying across a spectrum from not much more than honesty (or lack of dishonesty or bad faith), a standard which the courts have always imposed, through to being effectively equated with "reasonableness', which is a higher standard and probably imposes active or positive duties. [27]

Sections 52 and section 51AC of the Trade Practices Act 1974 require parties to a contract not to engage in misleading and deceptive conduct, and unconscionable conduct, respectively. Section 51AC of the *Trade Practices Act 1974* states that, in considering whether conduct is unconscionable or not, the Federal Court may make reference to "...the extent to which the supplier and the business consumer acted in good faith." This has been drawn down in State and Territory legislation as "the extent to which the lessor and the lessee acted in good faith". However, the meaning of acting in 'good faith' in end of lease negotiations has not yet been tested.

The ACCC should undertake more investigations and instigating actions, where considered appropriate, in relation to lease negotiations which it considers may constitute possible breaches of the duty to 'act in good faith', under the unconscionable conduct provisions of the *Trade Practices Act 1974*.

6. Conclusion

Since its introduction, the NSW *Retail Leases Act 1994* has provided a basis for good leasing practices in the retail industry in NSW. The legislation seeks to address key areas of market failure in the retail leasing relationship by minimising information asymmetries, ensuring a more equitable bargaining position between the parties to a lease, and providing for cost-effective and timely resolution where disputes arise.

The NSW Government considers that a strong case remains for state-based regulation of the retail leasing market, as this allows for greater regulatory flexibility and enables jurisdictions to respond promptly to emerging problems in their retail leasing markets. The dynamic nature of the retail leasing market, which constantly adapts to new retail concepts and consumer expectations, means that retail leasing practices and the nature of the landlord-tenant relationship is likely to change significantly over time. Failure to respond to emerging problems promptly may result in market inefficiencies and unfair practices.

State-based regulation also provides a significant opportunity for jurisdictions to learn from experiences in other States and Territories. This ensures that the legislation continues to evolve and remain relevant, and is likely to lead to the adoption, over time, of best-practice efficient laws across all jurisdictions.

As retail tenancy legislation in Australia is still relatively young, it is important that the legislation continues to evolve and that more efficient ways of addressing market failure be

27 D'Angelo, N., The demise of contract the rise of the 'do the right thing' doctrine, Australia Corporate Lawyers Association Conference, March 2004.

considered and incorporated into the retail tenancy laws. Market failure can most efficiently be addressed by regulating the market at the state level.

Despite the fact that retail tenancy legislation has been extremely effective in ensuring good leasing practice in the retail industry and in dealing with areas of market failure, landlords and tenants associations are of the view that certain issues have still not been adequately addressed.

From the landlords' perspective, there is need for greater education of tenants regarding their rights and obligations under the lease to minimise the possibility of disputes. While significant efforts have been made by all jurisdictions in this area, education of small retailers remains an area of ongoing challenge.

From the tenants' perspective, end of lease issues continue to be an area of ongoing concern, particularly for tenants in shopping centres, with calls by tenant associations for measures to address the competitive advantage that landlords have in end of lease negotiations because of their access to a tenant's turnover figures. The disclosure of turnover creates a perception that it enables landlords take unfair advantage of tenants in end of lease negotiations. This is an area that would benefit from harmonisation between States and Territories.

The NSW Government is also of the view that the ACCC should consider investigating a greater number of allegations, as well as initiating investigations, into possible breaches of the unconscionable conduct provisions under the *Trade Practices Act 1974*, which relate to retail leasing arrangements. This will help to build up the case law in this area and provide guidance to State and Territory jurisdictions on conduct considered to be unconscionable, especially in the area of "acting in good faith".

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