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RE: SUBMISSION TO FRANCHISE INQUIRY

Dear Sir or Madam,

The Franchise Advisory Centre has been providing advice and education about franchising to franchisees and franchisors since 2004.

It has provided submissions into federal government reviews in 2006, 2008 and 2013, as well as additional state government reviews in 2008 and 2010.

Franchise Advisory Centre founder Jason Gehrke is an experienced franchising professional with more than 25 years experience in the sector at franchisee, franchisor and advisor level. He is currently a director on the board of two franchise networks with a combined population of around 180 franchisees across Australia and New Zealand, and the publisher of **Franchise News**, Australia's leading franchise sector email news service.

More than half of the franchise brands in Australia and New Zealand have been represented at one or more franchise education event organised and presented by the Franchise Advisory Centre.

Responses to Terms of Reference

The Franchise Advisory Centre's responses to the Terms of Reference of the inquiry are shown indented below each term of reference (which are shown in bold italics). Recommendations for the inquiry committee to consider are underlined in bold.

(a) the operation and effectiveness of the Franchising Code of Conduct, including the disclosure document and information statement, and the Oil Code of Conduct, in ensuring full disclosure to potential franchisees of all information necessary to make a fully-informed decision when assessing whether to enter a franchise agreement, including information on:

(i) likely financial performance of a franchise and worse-case scenarios,

Franchisors rarely provide detailed information about the likely financial performance of a franchise as this could be construed as a representation and create a future basis for litigation. Common practise is to provide as little financial information as possible to limit legal liability.

The Franchise Advisory Centre estimates that less than half of franchisors require their franchisees to put a business plan together as a condition of granting the franchise. Franchisees are often left to their own devices to make assumptions about

relative costs and likely sales, which may or may not be reviewed by the franchisor prior to admission to the franchise.

Common sense suggests that business plans should be required for all new small business intenders (franchised or otherwise), yet it may be an overreach for the Code to legislate for such common sense.

However, what the Code could require is for franchisors to disclose actual average data for costs and revenues, as well as ranges achieved within the network, while at the same time providing protection for franchisors from claims of financial misrepresentation on this data.

The commercial-in-confidence nature of this level of disclosure is significant, as such information could compromise a franchise network's competitive advantage if it finds its way into the hands of a rival group.

(ii) the contractual rights and obligations of all parties, including termination rights and geographical exclusivity,

We have no specific comment on this item not otherwise covered by the existing Code;

(iii) the leasing arrangements and any limitations of the franchisee's ability to enforce tenants' rights, and

Sub-leasing (or otherwise granting a franchisee a license to occupy a location) is common in many retail networks, particularly those located in shopping centres.

Franchisors prefer to control the site in this manner in order to keep competitors from gaining the location. Franchisors may also negotiate the initial lease (and any renewal), as well as any requirements around fitout (including landlord contributions to the cost of a fitout) for the site, however do this in their own right and not as agent for the franchisee, which means that they do not necessarily have the franchisee's best interests at heart during the negotiation.

This can result in franchisees paying higher than necessary rents or outgoings, failing to receive the flow-on benefit of a landlord contribution to fitout costs, or being located in a sub-optimal location as a concession to the landlord if the franchisor is negotiating on multiple locations simultaneously.

Holding head leases on sites remains a perfectly valid property strategy for franchisors, **however an amendment to the Code to recognise the interests of the franchisee in some way (concurrently with those of the franchisor) where head leases are held would alleviate some of the problems currently experienced by site-dependent franchisees.**

(iv) the expected running costs, including cost of goods required to be purchased through prescribed suppliers;

The cost of goods supplied to franchisees through prescribed suppliers is an ongoing challenge in the franchise relationship. To create a uniform customer experience across a brand, a franchisor must be able to prescribe that inputs of a certain standard are required, usually from one endorsed supplier.

Recent media coverage has highlighted examples where franchisees are forced to buy identical products under group supply arrangements at prices often greater than in the open market.

This suggests that either franchisors are really bad at negotiating good prices on group supply arrangements (which is generally unlikely as the leverage of a group's

buying power should logically result in the reduction of prices), or that the franchisor is receiving a rebate from the supplier, which after being factored into the price, results in an inflated cost of goods to franchisees.

Where franchisees are forced into third party supply arrangements that put them at a long term commercial disadvantage compared to the open market, then a problem exists. Note the use of “long term commercial disadvantage” as this will be necessary to filter out instances where suppliers do one-off deals or dump aging stock, but where the ongoing (not one-off) supply is a necessary input for the brand (eg. coffee beans in coffee franchise).

Recent amendments to consumer law now make it easier for franchisors to enter exclusive supply arrangements, however the test to assess whether these are anti-competitive is often more focussed on the end user (ie. the consumer), rather than purchasers under such arrangements (ie. the franchisees).

In networks where the franchisor charges the franchisee a royalty based on gross turnover, and then enters supply arrangements with third party providers who pay rebates, the franchisee is effectively being charged twice – once on their turnover and again on their purchases.

In circumstances where franchisors charge royalties on turnover, their rebate income can result in the franchisee paying more for exactly the same item than a franchisee can achieve in the open market on an ongoing like-for-like basis. Ideally, this should not occur, and any supply arrangement entered by the franchisor should add value to a franchisee's business, not erode value. The problem here is determining like-for-like as the franchisor will always likely have a much more prescriptive view (ie. identical coffee bean blend) versus a broader, more self-interested interpretation that franchisees may take (eg. Pepsi instead of Coke because they are both cola-based beverages). The latter interpretation by franchisees must inevitably cause franchisors to be ever-vigilant for the best deals they can achieve.

Additionally, it should be recognised that in lieu of charging a royalty on turnover, some franchisors are primarily rewarded by the rebates they receive from group purchasing arrangements. This includes networks that have formed from buying groups or cooperatives, and where in some cases, the franchisor entity is actually owned by the franchisees.

The 2006 Matthews Inquiry into franchising highlighted the issue of rebates being used by franchisors to exploit franchisees, and recommended the disclosure of rebate amounts and suppliers who pay rebates.

This recommendation was not adopted then – nor should it be today – as it risks compromising the competitive advantage of a network if the information falls into the hands of a market rival. Instead, the authorisation and notification process involving franchise networks should return to its former, stricter iteration, and all current and future authorisations include a process of consulting with franchisees and an annual reviewed by the ACCC.

(b) the effectiveness of dispute resolution under the Franchising Code of Conduct and the Oil Code of Conduct;

Dispute resolution under the Franchising Code of Conduct via mediation is understood to result in around three out of four disputes referred to mediation achieving an outcome acceptable to both parties. A lack of awareness, and a lack of sufficiently early referral to mediation potentially reduces the reach of mediation, but it is nonetheless an effective dispute resolution mechanism.

(c) the impact of the Australian consumer law unfair contract provisions on new, renewed and terminated franchise agreements entered into since 12 November 2016, including whether changes to standard franchise agreements have resulted;

The application of Unfair Contract Term provisions on franchise agreements has, to date, had little effect on the franchise sector in my experience (other than initial education and compliance costs). I defer to submissions lodged by legal practitioners, and especially that of franchising legal expert Derek Sutherland, for more meaningful input on this point and others involving technical amendments to the Code.

(d) whether the provisions of other mandatory industry codes of conduct, such as the Oil Code, contain advantages or disadvantages relevant to franchising relationships in comparison with terms of the Franchising Code of Conduct;

The current review represents an obvious opportunity to harmonise the provisions of these two Codes where unnecessary difference currently exist.

(e) the adequacy and operation of termination provisions in the Franchising Code of Conduct and the Oil Code of Conduct;

Some franchisors who have been subject to adverse media coverage arising from the detection of wage fraud in their networks believe that they should be allowed to terminate franchisees without notice for wage fraud, or other breaches of the Protecting Vulnerable Workers bill or Fair Work Act. This would seem to be an attempt to create legislation to make up for a lack of adequate provisions in a franchise agreement itself (and also a narrow interpretation of the fraud provisions for instant termination under the current Franchising Code).

The risk of giving franchisors more powers to terminate franchisees could lead to exploitation or opportunistic terminations.

It is recommended that only where a franchisee has been prosecuted by the Fair Work Ombudsman for a breach of the Fair Work Act that has not been remedied, should a right of termination without notice apply.

(f) the imposition of restraints of trade on former franchisees following the termination of a franchise agreement;

I believe the existing Franchising Code of Conduct adequately canvasses the issue of restraints.

(g) the enforcement of breaches of the Franchising Code of Conduct and the Oil Code of Conduct and other applicable laws, such as the Competition and Consumer Act 2010, and franchisors; and

There is a common perception among the general public that government enforcement agencies are generally too slow to respond where complaints are raised about real or perceived wrongdoing, regardless of the severity of any penalties that might be applied.

Ideally, the ACCC would be sufficiently resourced so that it could consider the merits of complaints in a much quicker timeframe, and that investigations of serious wrongdoing are expedited in such a manner to more closely align with community expectations.

(h) any related matter.

It is unlikely that any amount of legislation will prevent franchisees from going broke, for which there are many external contributing factors (plus the capabilities of the business operator themselves).

Suggestions that franchisees should not be permitted to buy a franchise before obtaining legal, accounting and business advice from appropriately qualified professionals have merit, but could be enacted as a matter of policy responsible franchisors without recourse to legislation.

In 2010 the ACCC funded the development of an online pre-purchase education program hosted by Griffith University which has been undertaken by more than 16,000 people. Research by the university indicates that people who do the program spend an average month longer on their due diligence prior to buying a franchise, compared to those who didn't undertake the program. Likewise, program participants are reported to experience a much higher level of satisfaction with their franchise six months after commencement compared to those who did not undertake the program.

The program itself focuses a potential franchise buyer on the importance of rigorous due diligence (which highlights the need to get legal, accounting and business advice from appropriately-qualified professionals).

The program is free, takes no more than five hours to complete, and includes five self-assessment stages to demonstrate comprehension of key concepts before subsequent stages can be completed.

It is recommended that a few words encouraging people to undertake the program and its URL be required to be displayed at the bottom of each page of a franchise disclosure document, in addition to its very small reference in the Mandatory Risk Statement currently outlined in the Code. Franchisors should also be required to include a link from their websites to the program.

It should also be noted that the pre-entry education program is no longer hosted by Griffith University, but rather on the website of a recently-formed not-for-profit organisation which has little visibility.

It is further recommended that the hosting of the pre-entry education program is moved to a better-known and more highly-visited host website, such as that of the ACCC or the Franchise Council of Australia to increase its reach and visibility.

Should you require any additional information in regards to this submission, please contact me directly.

Regards,

Jason Gehrke
Director
Franchise Advisory Centre

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