Breaking Barriers: Investigating the Effect of Restrictive Covenants on Entry Deterrence in Retail

Lear Competition Festival - Research Proposal

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Introduction

The geographic location of a firm plays an important role when consumers have to travel to consume a product. Therefore, location becomes an important source of product differentiation. To stake out an attractive location, retailers can engage in exclusivity contracts or in various forms of restrictive clauses to deter the entry of competitors (Ater, 2015). This becomes a more severe issue considering the substantial land use regulations that already exist within the retail trade sector across many countries (Suzuki, 2013).

A restrictive clause, also known as a restrictive covenant, is a broad term used to describe any specific clause or condition included in an agreement that imposes certain limitations or restrictions on the tenant's and the owner's use of the property, serving the interests of the party issuing it. Restrictive clauses can vary depending on the specific terms negotiated in the agreement, but they typically include limitations on specific activities. In the current project, we are specifically interested in the use of restrictions and non-compete agreements issued by firms intended to deter the entry of competitors.

To illustrate the functioning of a restrictive covenant, consider a situation where a firm owns multiple stores within a neighborhood and decides to close one of them, subsequently leasing or selling the premises. In such cases, the firm may include a clause in the lease or sale agreement prohibiting any business competing with its existing stores.

Restrictive clauses in the grocery industry have faced legal scrutiny, triggering numerous anti-competitive lawsuits worldwide. Since the 1950s, US grocery chains have been employing restrictive clauses, raising concerns about their compliance with antitrust laws.[1] In the UK, the Office of Fair Trade has received a

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[1] https://thecounter.org/supermarket-chains-poor-communities-lease-agreements-food-insecurity/

number of complaints about usage restrictions as terms in a sales contract with the intention to restrict the entry of other retailers. In 2010 the CMA conducted a thorough study of the UK grocery market and concluded that at least 90 of restrictive covenants were established as entry barriers.[2] Subsequently, it was proposed to introduce a ban on the creation of such restrictions.[3] The Australian Competition and Consumer Commission obligated two major players to cease restrictive leases.[4] However, anti-competitive effects have attracted little attention from economists, and their quantitative importance is not well understood. The goal of this project is to fill the gap by assessing the role of such restrictive clauses and their consequences for the dynamics of the grocery industry and the intensity of local competition. Understanding this topic will lead to a better decision basis for the assessment of cases when a firm creates barriers strategically, which is related to the abuse of dominant position regulation.[5]

The anti-competitive impacts of land use regulation are pertinent across various industries where firms engage in local competition. Retail sectors like supermarkets, gas stations, and hotels are typical examples. In this study, our focus centers specifically on the grocery industry in Norway.

Several facts draw attention to the anti-competitive effects of restrictive lease clauses in the grocery industry. First, the location appears to be the major determinant of demand, and hence it plays a crucial part in the entry decisions of stores. Second, restrictive covenants can constitute an entry barrier for new players who want to establish themselves in the grocery market. Finally, retailers can use restrictive covenants as a strategic tool to stake out attractive locations and limit competition in a local market. These factors collectively draw attention to the impact and implications of restrictive lease clauses on competition within the grocery industry.

The Norwegian context, which is the focus of this study, presents additional interest as there is currently an open investigation regarding the prohibition of negative covenants and exclusive clauses in the grocery market in Norway.[6] Lately The Norwegian competition authority (NCA) has stepped up its efforts in the food market after discussions about high concentration and high prices compared to other Scandinavian and European countries. Over the last several years, market concentration in the grocery sector has increased. Competition is further threatened by the fact that it is difficult for new players to enter an already concentrated market. Restrictive covenants as an entry barrier can lead

[2] Appendix to the CMA Report: https://webarchive.nationalarchives.gov.uk/ukgwa/20140402235553mp_/http:/www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/538_7_3.pdf

[3] Explanatory note to accompany market investigation (controlled land) order 2010: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/904492/controlled_land_order_explanatory_note_300710_PDF_A.pdf

[4] https://www.smh.com.au/business/supermarkets-abandon-restrictive-lease-terms-20090918-fvb2.html

[5] Abuse of dominant position is regulated by section 11 of the Norwegian Competition Act and TFEU article 101 in EU competition law.

[6] Article in E24 newspaper: https://e24.no/naeringsliv/i/OK9Mgg/konkurransetilsynet-dagligvarekjedene-kan-ha-utestengt-konkurrenter-paa-200300-eiendommer

to a poorer choice in terms of prices, quality, and service for a consumer, while incumbent grocery chains could earn additional profits due to impeded market entry. The investigation was initiated as NCA has uncovered a practice where grocery retailers through the use of restrictive covenants prevent existing and potential competitors from running grocery businesses on properties that they sell or rent out. Figure 1 illustrates the prevalence of covenants in the center of Bergen.

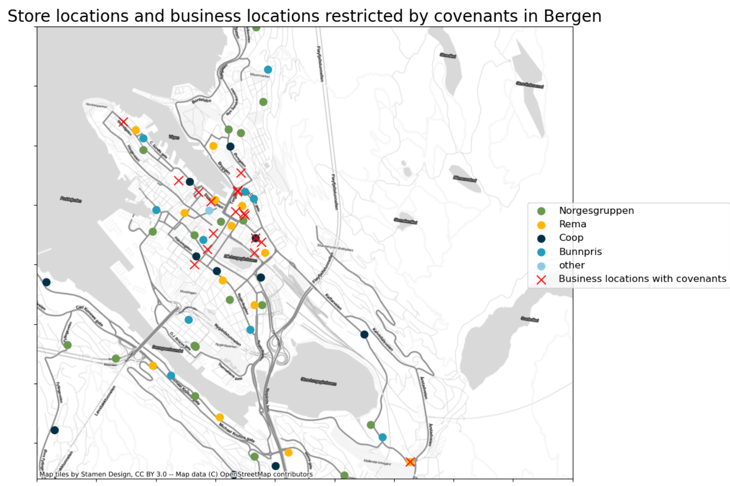

Figure 1: Store locations and locations restricted by covenants in Bergen

This project is aimed to investigate the impact of endogenously created entry barriers on market outcomes in the grocery sector in Norway. Specifically, we will quantify the effect for consumers on different local markets. Subsequently, we want to show what role entry deterrence plays in shaping food inequality which can be considered as the absence of grocery stores in the local market, stores of a given format (for example, discount stores), and the assortment in the local market.

Data

We focus on the retail grocery market in Norway. The research questions mentioned above require combining data from multiple sources. First, we use a store-level panel provided by Geodata, the Norwegian spatial data provider. Geodata's database contains yearly information on store-level turnover and profit for 2010-2021. Additionally, it provides information on location, date of store opening, store size, and the number of employees. Geodata's database covers the whole grocery market in Norway and allows us to track store entry history. Second, we will use data on restrictive covenants provided by the Norwegian Competition Authority. This data contains information on a property, a company that issued the covenant, the date of issue, the property's current owner, and the exact wording of the ban on trade activity as it appears in the contract. Third, we have extensive demographic characteristics provided by Statistics Norway and Geodata, which will allow us to account for differences in local market conditions, such as the income of people.

Approach

Reduced form analysis will give us insights into the impact of entry barriers on a degree of market competition and industry dynamics and help to form hypotheses and develop a structural dynamic entry model. Since the decision to issue restrictive covenants and open new stores is strategically made by firms, we will establish and estimate a structural model that incorporates the endogeneity of these decisions. Additionally, the model will account for short-term pricing decisions. The structural model will allow us to run a counterfactual analysis without entry barriers and quantify the impact on firms and consumers. The model will also allow us to simulate the effects of various regulation scenarios.

Contribution

This project will contribute to the literature on empirical models of entry (Bresnahan and Reiss, 1991; Davis, 2006; Maican and Orth, 2017, 2021). It is further relevant to the literature on firms' strategic behavior that impedes the entry of new firms (Zheng, 2016; Pozzi et al., 2018; Igami and Yang, 2016). To our knowledge, there are only descriptive studies that analyze strategic entry barriers, most of which analyze them from a legal perspective. This project is intended to be one of the first empirical studies in which we will quantify the impact of strategic entry barriers on market outcomes. The project is aimed to provide regulators and practitioners with insights on how to improve market competition. A comprehensive economic model will help to develop policy tools to improve retail efficiency and make market entry more accessible.

To summarise, this project raises new research questions that, together with unique data, will provide valuable insights for policymakers and has a scientific novelty that gives it the potential to be published in a leading journal.

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