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Restricting competition: land agreements at shopping centres and airports

Competition is good; monopoly is bad. Does this received wisdom hold for retail outlets at shopping centres and airports? The unique circumstances of these shopping venues mean that agreements that lessen competition—such as restrictive covenants in some land agreements—might nevertheless be economically beneficial, and should not necessarily be considered anti-competitive

According to economic theory, competition is beneficial for consumers because it leads to lower prices, better quality and higher levels of innovation.

This received wisdom that competition is good and monopoly is bad does not always hold, however. One example of this is in competition between retailers in a particular set of circumstances. For example, where retail space is limited—such as in shopping centres and at airports—measures that reduce competition (whether intentionally or not) might nevertheless be associated with economic benefits by improving customer choice. Further benefits might stem from such measures where they increase the likelihood of a retail venue being commercially viable. In both cases, the benefits from measures that have the effect of reducing competition may or may not outweigh the adverse effects.

Retail competition at shopping centres and airports

Both shopping centres and airports have certain features that distinguish them from other shopping venues such as high streets. Airports, for example, tend to be located outside established commercial areas. More importantly, airports and shopping centres have a limited amount of retail space available. These features do not negate the traditional benefits of competition, but do mean that measures that lessen the degree of competition might nevertheless be economically beneficial.

In 2008, the New Zealand Commerce Commission (NZCC) examined the degree of competition among duty-free retailers at the country's largest international airport, Auckland. At the time, the duty-free retailer, DFS Group, was planning to acquire its rival, The Nuance Group.[1] Both companies operated duty-free outlets at Auckland airport. In its analysis of the degree of competition between the two retailers, the NZCC found that the retailers' customers were price-sensitive, compared prices and readily switched between the two retailers. The regulator also found that price changes and promotional activities tended to coincide between DFS and Nuance.

In addition, the NZCC considered whether duty-free retailers at other airports with direct flight connections to and from Auckland posed a significant competitive constraint, which included looking at average annual price differences between identical duty-free products sold at different airports. This analysis found substantial price differences—both positive and negative—between duty-free retailers at Auckland airport and Sydney airport (which is the most frequent destination and origin for international flights to and from New Zealand), suggesting a limited competitive constraint between the two.

DFS and Nuance argued that, despite the reduction in the number of duty-free retailers at Auckland airport from two to one, competition would not be substantially lessened since the airport operator, Auckland International Airport Limited (Auckland Airport), had the incentive and ability to ensure that the combined entity's offerings were competitive.

In terms of incentives, the retailers argued that a competitive retail environment was in the operator's interest since it made the airport more attractive to travellers. Indeed, Auckland Airport confirmed that it would obtain prices of various high-selling, duty-free products on a regular basis for comparison purposes. In terms of Auckland Airport's ability to ensure competitive prices, DFS and Nuance submitted that

their licensing agreements included clauses requiring them to ensure that prices were 'competitive' and to provide price comparisons to the airport operator on an ongoing basis. However, the NZCC concluded that Auckland Airport would have limited incentives for ensuring that the combined entity's duty-free prices were constrained to the level likely to be seen in the case of both retailers operating independently, since rents were directly proportionate to retailers' revenues.[2] By its chosen rent structure, Auckland Airport incentivised retailers to charge higher prices than would otherwise be observed. The regulator supported its conclusion by referring to the observed price differences across duty-free retailers at different airports.

Ultimately, the NZCC rejected the proposed acquisition of Nuance by DFS, concluding that it could not be satisfied that competition would not be significantly lessened as a result. The regulator argued that the competitive constraints from duty-free retailers located at other international airports would fall far short of those between the two retailers operating at Auckland airport. Furthermore, the airport operator would have limited incentives to ensure that the combined entity's duty-free prices were constrained to the level likely to be seen if both retailers were operating independently.

Competition authorities—including the NZCC—generally acknowledge that some measures that have the effect of limiting or reducing competition might nevertheless result in efficiencies, and that these efficiencies can outweigh the adverse effects from a loss of competition. Although DFS, Nuance and Auckland Airport referred to efficiency gains in their submissions, these gains do not appear to have materially affected the regulator's decision-making process.

The economic benefits of measures that limit competition

There might be benefits in a more efficient retail distribution system that reduces duplication in product ranges and results in the availability of a greater variety of products for consumers. This is an important factor to the extent that consumers value variety, especially where retail space is limited, as it is at airports and shopping centres. To potential customers, the attractiveness of a shopping centre partly depends on the variety of products it offers. In this sense, a shopping destination with a greater variety of products better meets customers' demands, and is therefore more efficient. The variety of product ranges is of particular concern for smaller shopping centres.[3]

An additional benefit of measures that have the effect of limiting the degree of competition is the very existence of a retail venue. The creation of a new shopping centre is associated with significant costs and financial uncertainties, and the commercial success of such centres depends on the landlord's ability to attract tenants. Protection from competition may sometimes be the only way of achieving a rental agreement, and exclusivity may thereby help to ensure the economic viability of the shopping centre as a whole. Failing to offer exclusive sales arrangements could mean that a shopping centre does not attract the necessary tenants, and is therefore not commercially viable.

Similarly, the landlord of an existing shopping centre needs to ensure that a sufficient variety of product ranges is offered in order to attract the necessary shoppers to keep the centre economically sustainable. One way of ensuring an appropriate level of choice for customers is through exclusive agreements.[4]

Granting exclusivity through land agreements

One way of determining the use of retail space is through 'restrictive covenants' in the form of land agreements. Such agreements might contain provisions that affect or limit the way in which land may be used, or how a right over the land can be exercised. In other words, a land agreement might guarantee a retailer exclusivity over a certain product or product range, such as at an airport or shopping centre.

Land agreements can be termed positively or negatively. An example of the former is one whereby a landlord rents out retail space for an assigned use only, such as selling duty-free products. The same effect can be achieved by using a series of negative covenants that prevent individual tenants from selling particular products or product ranges.

Land agreements that offer exclusivity to retailers effectively protect them from competition. It is this kind of agreement that is most likely to breach competition law, which prohibits contracts or arrangements that prevent, restrict or distort competition.[5]

Land agreements and competition law

Legal systems interpret restrictive covenants differently. In the Netherlands, for example, an exemption covers exclusive establishment agreements for retailers in shopping centres.[6] In the USA, by contrast, the Federal Trade Commission successfully challenged a number of restrictive covenants in shopping centre leases in the 1980s. This created the view that such covenants were illegal per se, although this view has changed, and the relevant 'rule of reason' in terms of whether a covenant breaches competition

rules now depends on a number of factors including the size of the shopping centre. Restrictive covenants in smaller shopping centres are unlikely to be considered unlawful. In contrast, covenants in larger centres require a more detailed review.[7]

In the UK, restrictive covenants in leases are currently excluded from the prohibition of anti-competitive practices, but this will come to an end on April 6th 2011.[8] Thereafter, most contracts, arrangements or understandings will be in conflict with UK and/or EU competition law if they prevent, restrict or distort competition and do not benefit from an individual or block exemption.[9] Contracts or arrangements that restrict or distort competition are generally void, and each party is liable for a financial penalty. In addition, third parties that consider that they have suffered a loss as a result of any unlawful agreement may claim compensation for damages.

The restrictive covenants in this case will not be illegal per se, however. The question of whether a contract or arrangement restricts or distorts competition requires a 'with and without' (or 'factual versus counterfactual') comparison. Would the level of competition with the agreement be lower than the level without the agreement? Even if the agreement reduced competition, would there be efficiencies that could offset this loss?

While the existence of efficiencies is the key argument for a land agreement to be exempt from competition law, there are three further cumulative conditions that must be fulfilled.

- It must be shown that the consumer will receive a fair share of the benefit.
- The imposed restrictions must not go beyond those indispensable to achieving the restriction's objectives.
- The restriction must not afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question.

In the case of duty-free retailing at Auckland airport, the airport operator's intention was to reduce the number of duty-free retailers from two to one, regardless of the proposed acquisition of Nuance by DFS. The plan was to create one retailer that would occupy a greater area than the two retailers individually, but a smaller area than the two retailers combined. The airport operator argued that a sole duty-free retailer would make better use of the available space by avoiding duplication—Auckland Airport expected the sole operator to carry a greater product range while occupying a smaller area than the two existing retailers combined.

In response to this plan, the NZCC issued a warning letter to Auckland Airport stating that it risked breaching competition law. The regulator was concerned that the move from two duty-free retailers to one would mean that consumers no longer had a choice between retailers, and could not access the price benefits gained from competition. Auckland Airport subsequently entered into undertakings with the regulator to drop plans to reduce the number of duty-free retailers at the airport.

In the DFS/Nuance example, the factual/counterfactual comparison was between a situation with a single duty-free retailer and a situation with two retailers. Requiring the airport to maintain two duty-free retailers would not stop the airport operating, although it might become less profitable. Potential efficiency gains would have resulted from better use of the limited retail space since duplication in the product range would be reduced. Although there is no public domain information on the extent to which the NZCC explicitly took into account the benefits of reducing the number of competitors, its rejection of the proposed acquisition and the commitment from Auckland Airport not to reduce the number of duty-free outlets is consistent with the loss of competition outweighing the efficiency gain.

While there are still two duty-free retailers operating at Auckland airport, all other international airports in New Zealand have only one retailer. This includes the much smaller Wellington International Airport, which recently switched from having two duty-free retailers to having one. The NZCC's decision not to intervene on the grounds of competition law is consistent with the benefits from efficiency gains (ie, better use of the space available and a greater product range) outweighing the loss in competition.[10]

To return to the hypothetical example of a planned or existing large shopping centre, the commercial viability of the centre relies on the landlord's ability to maintain or attract tenants. Being able to offer exclusive agreements increases this ability. In this case, the factual (ie, a world with exclusive agreements) would see the shopping centre being built or continue to operate. In contrast, the counterfactual (ie, a world with no exclusive agreement) would see the shopping centre not being built or ceasing to operate.

In the hypothetical example, it would be up to the competition authorities or a court to determine the likelihood of the counterfactual occurring and the lost efficiency it would entail for consumers. If the appropriate counterfactual were indeed one without a shopping centre, the restrictive covenant granting exclusivity might, in fact, not be considered anti-competitive.

Conclusion

The principle of retail competition is that suppliers such as retailers try to win rivals' customers. This process generally results in lower prices, higher quality and greater innovation. In some cases, however, measures that have the effect of reducing competition might nevertheless be economically beneficial. In shopping centres and airports, the economic benefits include a more effective distribution system due to lower levels of duplication in product ranges. In this case, consumers benefit from a wider product range and greater choice. An additional benefit is the existence of the shopping venue in the first place, which might not be economically sustainable in the absence of exclusive sales agreements.

Measures that restrict or distort competition are, however, at risk of breaching competition law. Such agreements may be void and parties could be liable to financial penalties and third-party damages claims. In the case of land agreements, a careful factual/counterfactual comparison is necessary on a case-by-case basis. Depending on the outcome of this analysis, it might be that some restrictive covenants are found not to be anti-competitive.

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[1] Commerce Commission (2008), 'Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving DFS Group Limited and The Nuance Group', Decision No. 638.
[2] The details of the case were such that the rental payment was directly proportionate to the retailers' revenues. This rent structure, adopted by the airport operator, incentivised the retailers to charge quite different prices from those that would maximise revenues or profits, because of the effect that the rental arrangement would have on the retailers' cost structures. (Fixed rents do not affect a retailer's marginal costs—ie, the costs of selling one extra item, but proportional payment rents can affect a retailer's marginal costs, since selling one extra item might result in an increase in the level of the rental payment.)
[3] The difficulty, however, is how to measure the benefits of range and variety and compare them against adverse effects such as higher prices. The price benefits can be easily measured—for example, the NZCC found that the loss of competition through the proposed acquisition of Nuance by DFS would have resulted in price increases for duty-free products in the order of 10%. The regulator then converted this figure into a (confidential) estimate of the total monetary loss to consumers. In contrast, range and variety benefits are not directly observable, and are therefore more difficult to measure.
[4] In addition, exclusive agreements might facilitate a logical outlay of a retail venue, for example by allowing the landlord to group together similar retailers.
[5] An example is Article 101 of the Treaty on the Functioning of the European Union (TFEU), and Chapter I of the Competition Act 1998. Retail space in shopping centres and at airports is often let through tender processes whereby the landlord invites interested potential tenants to put forward rental bids. In markets with such bidding features, it is often argued that competition takes place 'for the market', rather than 'in the market'. Following this logic, exclusivity agreements cannot be anti-competitive, since they do not affect competition for the market. In the case of retail, however, competition might occur at one of two stages: the bidding stage and the retailing stage. Exclusive agreements therefore still have the potential to lessen competition, despite possible bidding market features.
[6] Holmes, M. and Murphy, S. (2010), 'Shopping Centre Assessments—Some Tips for the UK from Other Jurisdictions', *Competition Law Insight*, p. 11, July.
[7] Ibid.
[8] The UK Office of Fair Trading published a consultation paper in October 2010: 'Land Agreements—Guidance on the application of competition law following the revocation of the Land Agreements Exclusion Order'.
[9] The provisions prohibiting agreements preventing, restricting or distorting competition are contained in Article 101(1) of the TFEU and Section 2(1) of the Competition Act 1998.
[10] Although the NZCC's Mergers and Acquisitions Guidelines explicitly refer to efficiency gains—and the possibility of these gains outweighing the adverse effects from any loss in competition—the regulator did not explicitly discuss efficiencies in the public version of its decision on the proposed acquisition of Nuance by DFS. See Commerce Commission (2004), 'Mergers and Acquisitions Guidelines', January.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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