Notes from Professor Neil Quigley

The Post-Merger Constraints Provided by Scouring in China and Malaysia

1. NERA have not indicated that they have obtained any information on the ability of scouring in China to provide any effective constrain on the exercise of monopoly power by the merged entity. NERA do not appear to have considered whether:

   (i) The cost of shipping coarse greasy wool to China, having it scoured, and shipping it back to New Zealand for use in manufacture, provides a realistic constraint on a monopoly supplier of wool scour services in New Zealand.

   (ii) Wool scours in China and Malaysia have the capacity to process coarse (as opposed to fine) wool, and are prepared to do so on a contract basis for New Zealand users of clean wool.

   NERA have also not considered the cost of the capital tied up in the wool while it is shipped to China and back. This cost of capital can in effect be added to the transport costs in calculating the extent to which Chinese scouring could constrain the exercise of monopoly power in New Zealand.

The Post-Merger Constraints Provided by Potential Entry

2. NERA does not consider the impact of the proposed restrictive covenants on the sites that are being divested on the cost of entry. NERA should have considered that an entrant would need to obtain a consent under the Resource Management Act before commencing operations. This would have two costs that should be considered:

   (i) The costs of obtaining the consent (which should make allowance for the incumbent to oppose the issue of a consent and thus raise the costs of an entrant).

   (ii) The costs of delay in beginning production after purchasing a proposed site.

   It is unlikely that production could commence until the beginning of the third year, and this delay would have a large impact on the expected returns of an entrant.

3. NERA's model of entry does not consider the potential for the merged entity to respond to the threat of entry by reducing prices so as to undermine the expected profitability of the entrant. The Commission will need to consider the potential for the merged entity to reduce prices to the level of avoidable costs to deter entry. This strategy can be more effective in a situation where an entrant would require time to develop a "green fields" scouring plant.

4. NERA does not consider the potential for the merged entity to exercise monopoly power in both the North and the South Islands. If it costs 30c/kg to move wool between the North and South Island for scouring, then back to the North Island for spinning, then below that 30c / kg threshold there are separate markets for scouring wool in the North and South Islands as the Commission has previously recognised. This means that NERA should have assessed the feasibility of entry in both the North and South Islands to support is national approach to pricing, and it should have considered the implications of the "winner take all" competition for wool scouring in both markets that would be created by this entry (given that one scouring plant in each Island can meet all of the demand for wool scouring).

5. NERA do not consider the investment decision of a potential entrant. In particular, NERA do not consider the fact that entry destroys the "real option" of the entrant to delay entry, and will therefore only occur at high expected rates of return. NERA uses a discount rate that is much too low to capture the returns that a potential entrant would require before investing in entry.

6. Given the separation of the markets for wool scouring in the North and the South Island, NERA should have either have:

    a. Considered the risk faced by an entrant establishing plants in both the North and the South Island, and adjusted the required rate of return for the risk associated with a "winner take all" competition with the incumbent, or

    b. Considered a situation where entry occurs in one Island, but monopoly power can freely be exercised (within the bounds defined by inter-island transport costs) in the other island.

7. The above points about the limitations on the ability of entry to constrain the exercise of monopoly power mean that NERA should have considered a scenario where no entry occurs and where the exercise of monopoly power is constrained only by the cost of scouring wool in China or Malaysia. Even if entry is possible there is some probability that under the market conditions described in the application entry will not occur.

Vertical Foreclosure Following Merger

8. With no ongoing supply contracts to protect Godfrey Hirst, NERA should have considered the potential for the vertically-integrated merged entity to use non-price mechanisms to foreclose GH from the market for clean wool. This could take the form of delays in supply at certain times of the year, prioritisation of other customers (including the merged-entities' own upstream carpet manufacturers) as well as full foreclosure. The potential for such foreclosure of GH would increase allocative efficiency detriments of the merger.

Dynamic Efficiency

9. Dynamic efficiency refers to the efficiency of the framework for decision-making over time. Dynamically efficient industries are those in which the incentives for decision-making work to maximise the present value of social welfare, subject to the overall resource constraints of the economy. A dynamically efficient economy is one in which the incentives for decision-making by the owners and managers of firms are such as to maximise long-run social welfare by providing the optimal level of new investment in assets and technologies that will maximise economic growth.

10. NERA refer to dynamic efficiency only in relation to the incentive to invest in innovation, but this is only one element of dynamic efficiency, and in an industry like wool scouring it may not be the most important. On the information available to me, it seems like that investment and divestment decisions (relating to plant location and scale) are more important sources of dynamic efficiency.

11. Decision-making by the monopolist will be less efficient when the threat of competition is absent, and firm strategies that are inefficient will persist because there will be an absence of competitors implementing alternative (more efficient) investment strategies. If the monopoly provider of wool scours can survive with productive and allocative efficiency loses at the level calculated by NERA, then it will also be able to survive with investment and divestment strategies that are inefficient, and that will substantially increase future allocative and productive efficiency losses over time.

12. The absence of competitive decision making and a competitor within New Zealand will in the extreme mean that poor decision-making at a monopoly operator of a wool scour could lead to the failure of the NZ wool scour industry – the most extreme level of cost arising from dynamic inefficiency. It is inappropriate to assume that the interests of the shareholders of the monopolist will eliminate this risk: if the shareholders of a monopoly agree to the wrong strategy then there are not competitors to continue to supply the market.

13. NERA should have considered a broader view of dynamic efficiency than that associated with its "propensity to innovate" approach. A greater focus on the dynamic efficiency losses arising where monopoly power removes the constraints of competitive decision-making on investment and divestment decisions is consistent with the views of the High Court para 221 about the importance of the incentives to invest in new technology for dynamic efficiency.

Summary

14. NERA have produced an analysis based closely on their analysis of an earlier merger proposal. There appear to be three main problems with the NERA analysis;

a. The merger currently being proposed is not similar to the earlier merger proposal because the contracts that protected Godrey Hirst at the time of the earlier proposal are expiring, and because the proposal includes covenants preventing entry at the sites that are being closed.
b. The importance of the covenants on the sites being closed is increase by the fact that the market for wool scouring in the North Island is separate from the market for wool scouring in the South Island. Entry in both markets would be required to limit the exercise of monopoly power by the merged entity. The likelihood of simultaneous entry in both the North and the South Island must be lower than the likelihood of entry through the establishment of one plant in either the North or the South Island, and the expected level of profitability required by a prospective entrant entering the North and the South Island simultaneously would be much higher than NERA assume. The productive and allocative efficiency losses from the merger will be much larger than NERA estimate.
c. Given the productive and allocative efficiency losses arising from the merger calculated by NERA, the dynamic efficiency losses that they calculate are implausibly small. While innovation in the wool scouring industry is not likely to be important, a much wider class of dynamic efficiency losses should have been considered by NERA.

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