NERA
ECONOMIC CONSULTING

James Mellsop
Managing Director
NERA Economic Consulting
Level 11
15 Customs Street West
Auckland 1010
New Zealand
+64 (9) 928 3290
james.mellsop@nera.com

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MEMO

TO:	Dr Ross Patterson, Minter Ellison Rudd Watts
DATE:	5 November 2021
FROM:	James Mellsop and Barbara Kaleff
SUBJECT:	**NZTGA authorisation application**

1. Introduction

1. We have been asked to review the 2 September 2021 Castalia report titled, "Public benefits and detriments of collective bargaining by Tegel's chicken growers". We refer to this as **"Castalia Report 1"**, as there is also a later Castalia report accompanying the provisional authorisation application by the New Zealand Tegel Growers Association (**"the NZTGA"**), which we responded to in our 11 October 2021 memo alongside Tegel's response to the NZTGA's provisional application.

2. Counterfactual

2. Castalia Report 1 finds that, without authorisation, the counterfactual is that the existing farm management agreement between Tegel and each of its growers (**"the FMA"**) would unlikely persist in its current form and would be replaced by a simpler agreement that is individually negotiated but based on a standard form agreement.[1] Castalia Report 1 bases this counterfactual on the proposition that the costs and delay of "amending, maintaining and applying" the existing FMA through individual negotiation is unlikely to be workable.[2]

3. In our view, there is a jump in logic here. If there are difficulties in "amending, maintaining and applying contract [the existing FMA]"[3], then the most obvious outcome under the counterfactual is that the FMA would continue as it is (i.e., unamended). The FMA has up to 20 years left to run, depending on shed age (as discussed below). On the Castalia reports' own arguments about the benefits of collective bargaining, the FMA is efficient.[4] It should therefore be assumed to last for its formal life.

4. Castalia Report 1 makes another argument for a counterfactual of individual agreements rather than continuation of the FMA. **[ ]** The report suggests that Tegel may have a reduced incentive to retain the FMA without authorisation as it may be able to achieve lower pricing through individual bargaining, and that Tegel would have an incentive to force renegotiation by making the contract unstable.[5]

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[1] Castalia Report 1, p 16.

[2] Castalia Report 1, p 16.

[3] Castalia Report 1, p 16.

[4] Castalia Report 1, p 24.

[5] Castalia Report 1, p 17 & 22.

5. This argument implies that Tegel [ ] to strategically shift growers to individual contracts, rather than just when Tegel has overcapacity or a need to reduce costs. However, this would be a costly strategy for Tegel.
6. Tegel has a material sunk investment in its processing plants and accordingly is dependent on growers investing in their own sunk assets. If Tegel develops a reputation [ ] or more generally dealing unfairly with growers, growers will be reticent to make any further investments in their farms (and new growers may be deterred). Accordingly, Tegel's reputation for "fair dealing" is important to Tegel's ongoing business.
7. Furthermore, there would be a risk that if [ ], that grower would instead choose to do something else with her land (e.g., supply another processor or use the land for another purpose). We acknowledge that growers have specific investments on their land. However, it is still plausible that if Tegel attempted to reduce price, a grower's best option would be to reject Tegel's offered contract and do something else. Tegel would therefore be exposing itself to insufficient capacity.
8. We conclude that the appropriate counterfactual is individual renegotiation of the FMA (to the extent that any renegotiation is required).
9. We also note the factual set out by Castalia for the purposes of calculating transaction cost savings is that the FMA would continue, amended, for all NZTGA growers for 10 years, using an average cost per grower annually. However, we understand this does not align with the actual terms of the FMA.
10. As described in the Tegel submission at [4.2], the FMA is structured [ ].
11. Nonetheless, we analyse the factual as set out by Castalia Report 1.

3. Claimed transaction cost benefits

12. The Castalia Report 1 claimed transaction cost benefits for a 10-year NPV of $1.4m to $3.1m are partly a function of the claimed gap between the factual and the counterfactual. For the reasons discussed in section 2 above, Castalia Report 1 materially overstates that gap, if there is indeed a gap. Rather, the only difference between the factual and counterfactual would be collective bargaining over any amendments to the FMA versus individual bargaining over any amendments to the FMA. In our view, any transaction cost and efficiency benefits of collective bargaining are overstated due to this difference in counterfactuals.
13. Furthermore, it is not at all clear that collective bargaining by Tegel growers would lead to lower transaction costs under whatever the counterfactual is versus the factual. This is because there is a high degree of heterogeneity among Tegel growers.
14. [ ]:
    A. [ ].
    B. [ ].
    C. [ ].
15. These farms are located in and around Christchurch, New Plymouth and Auckland. Auckland has consistently higher median farm sales prices per hectare than the other two regions.[6] Moreover,

[6] REINZ, Rural Press Releases for March, June, and Sepetmber 2021. Available at, for example, https://www.reinz.co.nz/reinz-rural-press-release-june-2021.

the condition of the farm (e.g., shed quality), the land it is on (e.g., property development potential) and the time remaining on the growing contract affect the value of the farm.

16. Indeed, Castalia Report 1 acknowledges this when discussing its counterfactual, stating that growers "have varying circumstances, which may lead to individual growers accepting a variety of different price terms".[7]

17. This heterogeneity among growers means that the transaction costs of reaching agreement with Tegel would be shifted by collective bargaining, rather than avoided. Internal NZTGA negotiations must occur that do not exist when Tegel and growers are making individual negotiations. Within these internal negotiations, a collective position must be reached which at one end may be relatively simple, but if growers have differing needs or expectations these may be time consuming and costly. At the far end of the spectrum, transaction costs may even increase in comparison to individual negotiation if there are severe internal conflicts within the NZTGA.

18. As noted by King (2013):[8]

> *A bargaining group may reduce the per-business cost of external negotiations with a counterparty. However, the ability of the group to exploit economies of scale in bargaining costs depends on the group's own ability to agree on relevant contractual parameters. As such, the bargaining group substitutes internal costs of coordination for external bargaining costs.*
>
> *The internal costs of coordination will depend on the nature of the members of the bargaining group. The 'more alike' the members, the lower the internal costs of coordination. In contrast, if the members of the bargaining group are very different, so that desirable contracts for each member of the group differ considerably, then coordination costs are likely to be high.*

19. Relatedly, a "one size fits all" contract may be quite inefficient. For example, a single fee across all growers will benefit growers' differently. Farms located in areas with more expensive land prices, all else equal, will make less profit under a single fee than farms in a less expensive area. Larger farms which benefit from economies of scale and, therefore, have a lower average cost per chicken will profit more than smaller farms with higher average costs per chicken.

20. Moreover, Castalia Report 1 also states that the FMA is an example of a sophisticated and efficient contractual arrangement because it is [ ].[9] Although [ ] contracts do reduce the risk faced by growers, as Castalia points out, these terms are not necessarily only achievable through collective negotiation.

21. As Castalia Report 1 discusses, [ ], which assumed a renegotiation would happen every three years through individual negotiations.[10]

22. More generally, the Castalia Report 1 claims that collective bargaining leads to more efficient contracts is undermined by:

    A. The fact the NZTGA is now seeking the Commerce Commission's authorisation to effectively override provisions of that ostensibly efficient contract; and

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[7] Castalia Report 1, p 18.

[8] Stephen P. King (2013), "Collective Bargaining by Business: Economic and Legal Implications", *UNSW Law Journal*, 36(1), p 131.

[9] Castalia Report 1, p 24.

[10] Castalia Report 1, p 23.

B. The Castalia Report 1 arguments that the FMA will effectively fall away under the counterfactual.

4. Claimed transfer benefit

23. Castalia Report 1 suggests that new individually negotiated contracts in its counterfactual are likely to have terms that reduce payments to growers by up to **[ ]**.[11] However, we have already pointed out that the Castalia Report 1 counterfactual is speculative, and the more realistic counterfactual is a continuation of the FMA. Accordingly, there is unlikely to be any transfer.

24. Even if there would be a transfer under the counterfactual, avoidance of it would not be a public benefit of authorisation, which is what the Castalia report claims. Rather, any such transfer should be treated as neutral.

25. The evidence is that **[ ]**.[12] Tegel has suffered operating losses the past two years.[13]

26. Accordingly, there can be no claim that any transfer would be of "functionless economic rents", being the phrase used at [85] the NZCC's 2020 *Authorisation Guidelines* to identify when an overseas transfer might be treated as being other than neutral. The NZTGA application also refers to the *Godfrey Hirst v Commerce Commission* High Court decision to support its discussion of "functionless monopoly rents", which clearly defines these as "supranormal profits that arise neither from cost savings nor from innovation".[14] "Supranormal profits" are profits above a "normal" (competitive) rate of return. In contrast, the "rents" to Tegel would have social value, in that they would contribute to the financial sustainability of Tegel. Given Tegel's current financial situation, a decrease in costs as set out in the Castalia Report 1 counterfactual would not cause Tegel to attain supranormal profits.

27. Therefore, any transfer should be treated as being neutral.

28. Indeed, Castalia Report 1 acknowledges that growers have an incentive to ensure that Tegel is financially sustainable to ensure certainty of supply.[15]

29. Additionally, the NZCC's *Authorisation Guidelines* state that effects on non-New Zealanders that may ultimately feed back or pass through to New Zealanders must also be considered; for example, benefits of import competition or foreign investment within New Zealand.[16]

30. If Tegel did negotiate lower grower fees under the counterfactual, the increase in surplus to Tegel would be used to fund Tegel's costs, as already noted. To treat such a transfer as a public detriment just because Tegel is foreign-owned would send a poor signal to potential foreign investors in New Zealand.

31. We also understand that when growers **[ ]**

32. As a final comment, the **[ ]** Castalia applies to determine the public benefit from the wealth transfer is very likely to be an overstatement between even Castalia Report 1's counterfactual and the factual.

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[11] Castalia Report 1, p 19.

[12] Tegel 12 October 2021 submission, para 2.11 and 4.1

[13] Tegel 12 October 2021 submission, para 2.13.

[14] Lane Neave, *Application for Authorisation of a Restrictive Trade Practice*, 15 September 2021, para 8.13.

[15] Castalia Report 1, p 19.

[16] NZCC, *Authorisation Guidelines*, para 86.

33. The [ ] reduction per square meter assumed by Castalia Report 1 is in relation to the existing terms of the FMA; however, Castalia Report 1 notes in both its factual scenarios that [ ]

34. Additionally, there is further evidence that a change in [ ] in the counterfactual from individual negotiations would be a smaller reduction than [ ].

35. [ ]

36. [ ]

37. Any reduction in [ ] assumed in the counterfactual should account for these facts, such that any reduction in the counterfactual may be less than [ ].

38. This combined with evidence that the [ ] in the factual may be reduced demonstrates that the [ ] per annum wealth transfer presented by Castalia is likely to be highly overestimated.

5. Detriments of collective bargaining

39. The Castalia report has overlooked some important detriments of collective bargaining by Tegel growers.

40. The very nature of collectivism is likely to stifle individual innovation (or effort more generally) because there would be no individual reward for innovation (effort) under a collective agreement (or at least it would be more limited than could occur under individual contracts).

41. For example, a grower may be able to offer some valuable service to Tegel that is not accounted for in the collective contract and is either not able to or not incentivised because of the common contract and compensation.

42. This will in turn limit Tegel's innovativeness and competitiveness.

43. The other important detriment would be the overriding of the terms of a freely negotiated contract, as we described in our 11 October 2021 memo. This would have negative implications for dynamic efficiency (e.g., investment incentives). We understand that NZTGA disputes that there would be an overriding in its cross submission.[17] However, we also note Tegel's view that NZTGA's purpose in obtaining authorisation is inconsistent with the existing FMA provisions.[18] This appears to be a legal issue – we simply note that if the effect of authorisation would be an overriding, then our dynamic efficiency detriment point stands.

44. Finally, Castalia Report 1 briefly discusses whether there would be allocative efficiency losses (section 3.5.4) from an authorisation, appearing to reach the view there would not be. However, if the counterfactual would reduce the losses being made by Tegel, then the factual (authorisation) would likely be less allocatively efficient.

[17] Lane Neave, *NZTGA Provisional Authorisation Application – Cross-Submission*, 26 October 2021, para 43.

[18] Tegel, Submission in response to statement of preliminary issues dated 8 October 2021, 5 November 2021, para 11.1.