NERA
ECONOMIC CONSULTING

Public Version

Review of Draft Determination in respect of NZTGA authorisation application

MinterEllisonRuddWatts

20 May 2022

Project team

James Mellsop

Asahi Koizumi

Contents

1. Introduction ... 3

2. More efficient contracts ... 3

3. Allocative efficiency detriments ... 4
3.1. Paragraphs 166.1 and 166.4 ... 4
3.2. Paragraph 166.2 ... 6

4. Productive and dynamic efficiency detriments ... 7
4.1. Dynamic efficiency ... 7
4.2. Productive efficiency ... 8

5. Bargaining power ... 8

6. Transaction costs ... 9

Appendix A. Recent judgments relevant to passthrough of fixed cost changes ... 10

Appendix B. Tegel's views of transaction costs ... 12

1. Introduction

1. On 13 April 2022, the New Zealand Commerce Commission (**"the NZCC"**) issued its draft determination in respect of the New Zealand Tegel Growers Association's (**"the TGA"**) application for authorisation of collective bargaining with Tegel Foods Limited (**"Tegel"**) (**"the Draft Determination"**). Counsel to Tegel, MinterEllisonRuddWatts, has asked us to review certain aspects of the Draft Determination.

2. Confidential information in this report is identified in square brackets and shading as follows:

   A. Green shading is information able to be seen by Tegel and the TGA, but not the public; and

   B. Red shading is information confidential to counsel and experts.

2. More efficient contracts

3. At [135] of the Draft Determination, the NZCC states:

   The Commission considers that collective bargaining is more likely than not to lead to more sophisticated and more efficient contracts, particularly over the long term.

4. The NZCC provides little in the way of economic justification for this statement. The NZCC does give an example of collective bargaining leading to more efficient contract terms (the [ ] discussed at [137]). We agree this seems like a pertinent example of the benefits of collating information from multiple growers, which is an aspect of collective bargaining.

5. However, the other examples given at [136] and [138] are not persuasive, because no comparison of outcomes under the relevant counterfactual is given. For example, at [138] the NZCC states:

   [ ]

6. The difficulty with this example is that the NZCC does not refer to any evidence that less [ ] would have occurred under individual bargaining (i.e., under the counterfactual).

7. The only economic logic the NZCC gives for its view that "collective bargaining is more likely than not to lead to more sophisticated and more efficient contracts" is at [140.1], where the NZCC states:

   the efficiencies are somewhat less likely (that is, closer to a real chance than a certainty) to arise without a collective agreement because the growers have less ability to negotiate or obtain expert advice, and less bargaining power with Tegel to resist requirements [ ]

8. As already noted, an ability to collate information as per the [ ] example could lead to efficiencies, as could the sharing of fixed costs of expert advice (effectively an economy of scale).

9. Somewhat inconsistently, the NZCC then states at [141]:

   Furthermore, it is unclear whether existing contractual mechanisms which allow Tegel to [ ] *are sufficiently sophisticated.* [ ]

10. Given the "existing contractual mechanisms" were collectively bargained, this statement appears to undermine the NZCC's finding that "collective bargaining is more likely than not to lead to more sophisticated and more efficient contracts".

11. In our 5 November 2021 memo, we quoted a passage from King (2013),[1] and then stated:

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

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.

12. Along similar lines, we note the following paragraph from the Australian Competition Tribunal's recent *Port Newcastle* decision ([221]):[2]

    Collective bargaining is more likely to achieve an improved economic outcome in circumstances where a common position in the interests of all buyers can reasonably be expected to be agreed. Conversely, collective bargaining is less likely to achieve an improved economic outcome, and may produce a less efficient outcome, where the requirements and preferences of the bargaining group are heterogeneous. In such a case, collective bargaining may create pressure for individual members of the bargaining group to forgo preferences in favour of a uniform approach and may reduce the incentives for innovation by individual buyers and thereby decrease economic efficiency. The risk of such economic harm is reduced where participation in the bargaining group is voluntary and members are free to pursue individual negotiations to satisfy their individual requirements and preferences.

13. The NZCC's discussion of "more efficient contracts" (particularly at [135-145] of the Draft Determination) does not pick up this homogeneity/heterogeneity distinction, possibly because of the lack of analysis of economic logic and factual evidence already described. (While the *Port Newcastle* case related to collective bargaining by buyers, the same principles would apply to collective bargaining by suppliers, as in the present case).

14. While there might be some issues in the present case in respect of which there is a degree of homogeneity in the interests of growers, there are also likely to be other issues where there is heterogeneity. For example, we understand that shed upgrade requirements vary widely across growers because of significant variation is shed size, number, age and condition.

15. In summary, the effect of collective bargaining on contract efficiency is likely to depend on the contractual issue being negotiated and how that relates to the underlying homogeneity or heterogeneity of grower interests. However, the NZCC is assuming that collective bargaining will *generally* result in increased contract efficiency, and is proposing to provide a blanket authorisation, for 10 years (we return to the issue of the 10-year period in section 5 of this report).

3. Allocative efficiency detriments

16. At [166] of the Draft Determination, the NZCC states its view "that any potential allocative efficiency detriments that would result from grower fees being higher with authorisation are likely to be relatively small". The NZCC provides four reasons for this view ([166.1 to 166.4]), three of which we disagree with.[3]

3.1. Paragraphs 166.1 and 166.4

17. The first reason the NZCC gives is that a "[ ]" and are therefore "[ ]" ([166.1]).

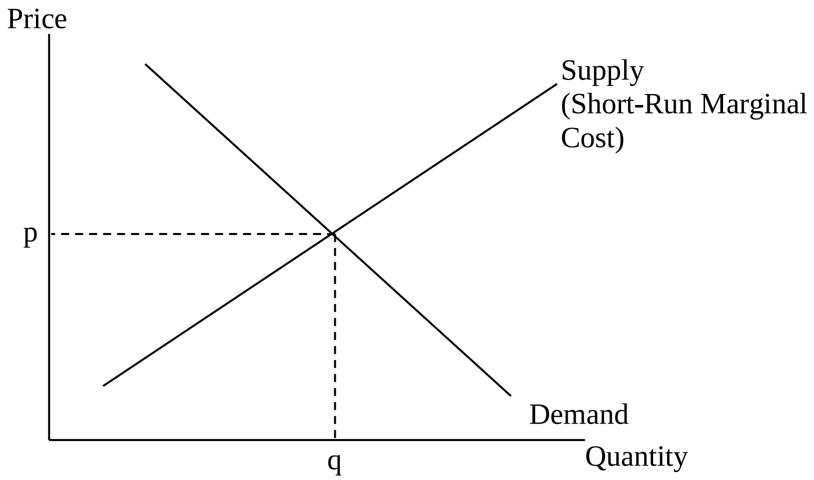
18. This statement is consistent with simple economic models finding that price is a function of marginal cost and demand, and nothing else. Figure 1 sets out a simple (short-run) representation of a market. The supply curve represents the marginal costs of suppliers, which to an

[2] Australian Competition Tribunal, Application by Port of Newcastle Operations Pty Limited (No 2) [2022] ACompT 1.

[3] This does not necessarily mean we agree with the fourth reason, being that "grower fees comprise a relatively small portion of Tegel's total costs and revenues" ([166.3]). Rather, this seems to us to be a factual issue. We also agree with the point Tegel makes in its submission on the Draft Determination that the increase in grower fees is just one aspect of the potential effect of collective bargaining on Tegel – these broader potential effects could all affect the competitiveness of the downstream markets that Tegel operates in.

approximation is the same as variable cost. In a competitive market, price is set at the intersection of the market demand and supply curves. The firm that produces at the intersection of market demand and supply is the "marginal firm", so price in this model equals the marginal cost of the marginal firm. In this type of standard economic model, fixed costs do not affect price.

Figure 1: Short-Run Supply and Demand in a Market



19. However, there are two problems with this narrow approach.

20. The first is that the NZCC is proposing to authorise collective bargaining for a 10-year period. Many costs that would be fixed in the short-term might become variable over the long-term. Relatedly, the retail demand for chicken products will become more elastic over this 10-year timeframe, raising questions about the NZCC's [166.4] reasoning.

21. The second is that the simple economic model described above is not realistic and fixed cost increases will in fact be passed through, whether it be in price increases, quality decreases or some combination. Indeed, three recent Australasian court judgments have found that fixed cost savings can affect competitive outcomes, either through lower prices or higher quality (via increased investments). We briefly summarise these judgments in Appendix A to this report.[4]

22. Of course, in the present case the issue is the effect of higher fixed costs on Tegel, not reduced fixed costs. But the principles are the same – these court judgments imply that higher fixed costs to Tegel would be passed through in either higher prices or reduced investment (which would in turn negatively affect quality and competition).

23. There are three ways to reconcile these court judgments with the simple economic models that the NZCC's [166.1] reasoning is based on:

    A. Competition occurs on more dimensions than just price;

    B. The basic economic models are short-term—over the longer-term, all costs are variable and relevant to price; and/or

    C. In the "real world", firms may not follow the narrow short-term economic theory exactly.

[4] James Mellsop gave evidence in two of these cases and was involved in the pre-litigation process of the other.

24. Regarding the first point, if investments are important to the output competition between chicken processors, then higher fixed costs will make these investments more difficult to fund.

25. Regarding the second point, as already noted, the distinction between variable and fixed costs is only a matter of timeframe; in the long-run, all costs are variable. As mentioned previously, price in many models of competitive markets equals the marginal cost of the marginal firm. Of course, that marginal firm will also seek to recover its fixed costs. Consider the investment decision that the marginal firm made when it entered the market; the marginal firm would have entered only at the point when its expected revenues from entry equalled or exceeded its expected entry costs, both capital and operating.

26. Consider the long-term effect of a fixed cost increase applying to all market participants (a characterisation we think is applicable to the current case – see section 3.2 below), including potential entrants. If this results in losses, then assets would not be replaced and capacity would eventually leave the market, until the point when price covers replacement cost.

27. Rubinovitz (2008) discusses increasing evidence that fixed cost savings can improve consumer welfare, but that it occurs over a longer time horizon than the effects from marginal cost savings.[5] His study extends traditional models to include the effects of a decrease in fixed cost and shows that this improves consumer welfare and, therefore, should be given weight in antitrust analysis of mergers (page 235):

> *When a decrease in the fixed cost of producing a given level of quality is introduced into this type of model, either because of some exogenous change or a merger, it is shown that consumer welfare increases, as quality-adjusted prices generally decrease. The clear implication of this model is that fixed cost savings should be given weight in the analysis of the potential effects of a merger on consumer welfare.*

28. Regarding the third point, the realities of marginal cost pricing have been debated by economists for a long time, with survey evidence suggesting that firms take fixed costs as well as variable costs into account when setting prices. Pittman (2009, 4) summarises:[6]

> *In their classic and often cited paper, Hall and Hitch (1939)—writing on behalf of a "group of economists in Oxford studying problems connected with the trade cycle"—reported survey results that "cast[] doubt on the general applicability of the conventional analysis of price and output policy in terms of marginal cost and marginal revenue", suggesting rather a common reliance by businesses on "the 'full cost' principle" of price setting.*
>
> > *[T]he procedure can be not unfairly generalized as follows: prime (or "direct") cost per unit is taken as the base, a percentage addition is made to cover overheads, and a further conventional addition is made for profit. (p. 19)*
>
> *Subsequent survey results over the years have been in general agreement with this finding (Govindarajan and Anthony, 1983; Shim and Sudit, 1995; Greenslade and Parker, 2008), and a number of marketing textbooks present this "mark up pricing" strategy as at least a default model to be followed (Lilien, et al., 1992; Thompson and Strickland, 1999; Czinkota and Kotabe, 2001).*

3.2. Paragraph 166.2

29. The second reason the NZCC gives is ([166.2], emphasis added):

[5] Robert Rubinovitz, "The Role of Fixed Cost Savings in Merger Analysis", *Journal of Competition Law and Economics*, Vol. 5, no. 2, June 2009, 233-248.

[6] Russell Pittman, "Who Are You Calling Irrational? Marginal Costs, Variable Costs, and the Pricing Practices of Firms", *Economic Analysis Group Discussion Paper* 09-3, 2009, p. 4.

Tegel faces competition in wholesale markets from other poultry processors who are likely to have some ability to expand to constrain Tegel should it seek to pass on cost increases ***that are not also incurred by its rivals****.*

30. It is true that Tegel faces competition in its output markets ([166.2]). But if the NZCC authorises Tegel's growers to collectively bargain, then the same should be assumed to apply to Tegel's rivals. Indeed, the NZCC has already authorised collective bargaining by Inghams' growers.[7] It should be assumed that growers for other processors will also now seek to have collective bargaining authorised, given the precedent being set by the NZCC.

31. In other words, all chicken processors will face similar cost increases, and there will be complete pass-through, particularly over the long timeframe for authorisation proposed by the NZCC (10 years).

4. Productive and dynamic efficiency detriments

32. The Draft Determination is equivocal regarding the impact of collective bargaining on productive and dynamic efficiency. After discussing various ways in which these efficiencies might be enhanced or undermined by collective bargaining, the NZCC concludes ([178]):

Consequently, on balance our view is that any productive and dynamic efficiency impacts are more likely to either be relatively small detriments or benefits than to be substantial detriments.

4.1. Dynamic efficiency

33. We think the NZCC has understated the dynamic efficiency detriment of collective bargaining, at least in the present case. To repeat part of the Australian Competition Tribunal quote again (this time with emphasis added):

Conversely, collective bargaining is less likely to achieve an improved economic outcome, and may produce a less efficient outcome, where the requirements and preferences of the bargaining group are heterogeneous. In such a case, collective bargaining may create pressure for individual members of the bargaining group to forgo preferences in favour of a uniform approach ***and may reduce the incentives for innovation by individual buyers and thereby decrease economic efficiency****.*

34. As we noted in our 5 November 2021 memo, 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).

35. 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.

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

37. At [168], the NZCC refers to the TGA claim that "growers are less likely to innovate and make new investment if they are being paid less in the counterfactual". But the obvious mirror image of this argument is not acknowledged, i.e., the effect on Tegel's innovation and investment if collective bargaining results in higher costs to Tegel. We have already discussed the implications of higher fixed costs for investment (in section 3.1 above). The issues are even starker given that [redacted].[8]

[7] Waikato-Bay of Plenty Chicken Growers Association Incorporated [2017] NZCC [37].

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

38. Furthermore, the NZCC does not appear to dispute Tegel's submission that growers [ ] (see, e.g., [161] of the Draft Determination).

4.2. Productive efficiency

39. We also think the NZCC overstates the productive efficiency benefits of collective bargaining.

40. At [174], the NZCC states:

In contrast, authorisation could improve productive efficiency if it led to the [ ].

41. This paragraph implies that Tegel would behave as some sort of automaton in the counterfactual and [ ]. Instead, the NZCC should assume that Tegel would make rational decisions and that the outcome under the counterfactual would be retention of the most efficient growers.

42. At [175], the NZCC states (footnote omitted):

[ ]

43. We are not familiar enough with [ ] to be able to judge the reasonableness of this statement. But even if the statement is correct, it does not justify a 10-year, open-ended authorisation – something much more time-constrained and narrow would appear to address the issue.

5. Bargaining power

44. An underlying theme of the Draft Determination is that growers are at a bargaining power disadvantage to Tegel, because growers:

    A. Invest in specialised assets; and

    B. Generally have just one buyer (Tegel).

45. In contrast the Draft Determination states ([156, emphasis added]):

In isolation, individual growers are likely to have little bargaining power in relation to Tegel as they have no effective alternative demand for their growing services; ***whereas Tegel has a large network of substitutable growers****.*

46. It may be correct that at times of excess growing capacity Tegel does have "substitutable growers". However, at other times it is likely that Tegel would not have "substitutable growers". Precisely because chicken growing requires specialised investment and, we understand:

    A. Suitable land within the appropriate distance of a feedmill and processing facility; and

    B. Resource consent;

    it would take some time for Tegel to obtain new growers (we are advised by Tegel that the typical timeframe would be 2-3 years).

47. This timeframe would provide the growers with bargaining power (particularly, of course, if they are permitted to act collectively).

48. Furthermore, Tegel also has specialised assets.

49. Accordingly, it is fairer to characterise the relationship between Tegel and growers as one of mutual dependence, with the precise bargaining power varying over time as demand for chicken meat varies.

50. This variability of bargaining power over time also raises the issue of the appropriateness of a 10-year authorisation, as opposed to something shorter. More generally, there is a lot of uncertainty about how the world will pan out over 10 years. [ ]

6. Transaction costs

51. At [117] of the Draft Determination, the NZCC states:

> *In particular we consider that TGA's long-term transaction costs savings estimate of between $1 million to $3 million appears to be a reasonable estimate of the likely upper bound of these potential benefits and we have placed weight on this figure.*

52. Based on its recent experience negotiating with the TGA and growers, Tegel has a different view about the transaction costs of collective versus individual bargaining. Tegel has provided us with its views, which we set out in Appendix B to this report.

53. The effect is that for one negotiation round of the contract, collective bargaining would result in a $1.6m *detriment*.

54. The $1 million to $3 million the NZCC refers to in the above quote is a present value. To calculate 10-year present values, Castalia assumed:[9]

    A. A certain frequency of renegotiations that varied between assumed counterfactuals; and

    B. Material "maintenance costs" in each of the ten years, with those costs being higher under individual than under collective bargaining.

55. For the same type of reasons that Tegel considers the Castalia-assumed transaction costs of collective versus individual bargaining to be wrong, we assume Tegel would consider the relative maintenance costs to also be wrong.

56. However, as also discussed in this report, we are concerned about the length of the proposed authorisation (10 years) and the difficulty of forecasting over this timeframe – we think any forecasts are speculative. If the NZCC accepts the Tegel view of the relative transaction costs, there may be no need to build out a forecast time series of costs, as doing so would simply increase the present value of the detriments. But to illustrate, we assume:

    A. A renegotiation in years 5 and 10; and

    B. No annual "maintenance costs" (or equivalently, equal "maintenance costs" between the factual and the counterfactual.

57. Using the Castalia discount rate of 5%, the result is a present value detriment from collective bargaining of $3.6m. See Table 1.

Table 1: Present value of transaction cost detriment (based on Tegel inputs)

[ ]

[9] Castalia Appendix D, "Public benefits and determents of collective bargaining by Tegel's chicken growers". 3.51.

Appendix A. Recent judgments relevant to passthrough of fixed cost changes

Three recent Australasian court judgments have found that fixed cost savings can affect competitive outcomes, although only one of the cases focused purely on the question of whether there would be a substantial lessening of competition.

The most recent of the three cases is the Federal Court's judgment in *Vodafone Hutchison Australia Pty Limited v Australian Competition and Consumer Commission*, which included the following statement:[10]

> *Some savings can be savings in variable costs, while others are savings in fixed costs. Both forms of cost savings are important from an economic perspective. Savings in variable costs will be passed on to some degree to consumers in the form of lower prices. Reductions in fixed costs are less likely to be passed on in the form of lower prices. However, fixed cost savings result in increased cash flows. Investment is sensitive to cash flows and, more specifically, how much a firm can invest.*

The Court found that investment (e.g., in fifth-generation mobile networks—5G) is an important component of competition in mobile markets.[11] Accordingly, if increased cash flows due to fixed cost savings would result in more investment, that would be a competitive benefit.

The Court rejected the argument that these increased cash flows should be assumed to be paid out to shareholders as dividends or to debtors, finding (emphasis original):[12]

> *There is no evidence that MergeCo would <u>not</u> use its improved financial position to compete more effectively in the retail mobile market.*

The Court found that the:

- Merged Vodafone/TPG would be more competitive than standalone Vodafone and TPG for a variety of reasons, including the ability to fund network investment and roll out 5G faster;[13] and
- The merger would not have the effect, and would not be likely to have the effect, of substantially lessening competition in any market.[14]

The second case is the 2017 Australian Competition Tribunal authorisation of the merger of Tabcorp and Tatts, on the basis it would result in such a benefit to the public that it should be allowed.[15] We recognise that this authorisation test goes beyond just competitive effects. Nevertheless, the Tribunal appeared to find that fixed costs savings could affect competitive outcomes.

---

[10] *Vodafone Hutchison Australia Pty Limited v Australian Competition and Consumer Commission* [2020] FCA 117, at [893]

[11] *Ibid.*, at [854]

[12] *Ibid.*, at [851]

[13] *Ibid.*, at [897-898]

[14] *Ibid.*, at [899]

[15] Applications by Tabcorp Holdings Limited [2017] ACompT 5, at [285]

The claimed cost efficiencies arising out of the proposed merger were a combination of fixed and variable costs.[16] The Tribunal found:[17]

> *The proposed merger is consistent with the trend towards industry consolidation, with the Merged Entity acquiring greater scale in addition to lower costs. The Merged Entity will consequently be a more effective competitor than the Merger Parties would be separately without the merger. As such, there will likely be greater competition than without the merger, particularly in online wagering, something that would add to the public benefits identified by Tabcorp, which would accrue to the racing industry and to consumers.*

Although the Tribunal did not explicitly analyse any distinction in effect between variable and fixed cost savings, we think this paragraph can be read as implying that both are relevant to competitiveness.

The final judgment is a New Zealand one, and was not specifically a competition case. In 2019, the High Court of New Zealand heard a judicial review relating to the implementation of an Accommodation Provider Targeted Rate (APTR) to help fund Auckland Tourism, Events and Economic Development Limited's activities promoting Auckland as a destination.[18] One of the major issues considered was the ability of the accommodation providers (e.g., hotels) to pass through this rate increase (being a fixed cost) to visitors. The accommodation providers argued the rate was implemented by Auckland Council on the incorrect assumption they could pass on the added cost to customers.

In the decision, Justice Moore stated, "I do not consider that any issue relating to the pass-through of the APTR renders the Council's decision unreasonable", [19] and more specifically on the pass-through of fixed costs:[20]

> *It is far from clear to me that pass-through of the APTR is impossible. The utility of [the accommodation providers' expert economist's] evidence, in my view, is limited. It may be based on sound microeconomic theory. But I agree with Mr Farmer that its applicability to real-world situations is fraught. [The accommodation provider's expert economist's] opinion is based on the core proposition that, as a matter of economic principle, an increase in fixed costs will not affect the price of a supplied service or product. That may be so in an economic vacuum, but there is merit in the Council's submission that in the "real world" firms will adjust price to incorporate both fixed and variable costs. That approach appeals to both common sense and a robust view of commercial reality.*

[16] For example, the judgment refers to cost savings in the categories of the marketing function, corporate, property and field services, call centres, wagering system capital expenditure and improved terms from suppliers. Applications by Tabcorp Holdings Limited [2017] ACompT 5, at [208].

[17] Applications by Tabcorp Holdings Limited [2017] ACompT 5, at [132]

[18] *CP Group Limited and Ors v Auckland Council* [2020], NZHC 89, [5 February 2020]

[19] *Ibid.*, at [194]

[20] *Ibid.*, at [195]

Appendix B. Tegel's views of transaction costs

Notes:

- Tegel hours and legal fees for individual and collective negotiation are based on actual time and cost incurred in the recent individual and collective negotiations.
- It is assumed that: (1) the TGA incurred the same time and costs as Tegel in the collective negotiations; (2) the TGA incurred the same costs again in internal negotiations with the TGA members; and (3) total collective negotiation costs will be duplicated in collective negotiation of outstanding issues ([ ]).

Calculation for hourly rates

[ ]

Actual values from the most recent negotiations, provided by Tegel

[ ]

Cost estimates of individually negotiating based on values provided/estimated by Tegel

[ ]

Cost estimates of collectively negotiating based on values provided/estimated by Tegel

[ ]

Total cost for individual and collective negotiations for 78 farms

[ ]

Qualifications, assumptions, and limiting conditions

This report is for the exclusive use of the NERA Economic Consulting client named herein. This report is not intended for general circulation or publication, nor is it to be reproduced, quoted, or distributed for any purpose without the prior written permission of NERA Economic Consulting. There are no third-party beneficiaries with respect to this report, and NERA Economic Consulting does not accept any liability to any third party.

Information furnished by others, upon which all or portions of this report are based, is believed to be reliable but has not been independently verified, unless otherwise expressly indicated. Public information and industry and statistical data are from sources we deem to be reliable; however, we make no representation as to the accuracy or completeness of such information. The findings contained in this report may contain predictions based on current data and historical trends. Any such predictions are subject to inherent risks and uncertainties. NERA Economic Consulting accepts no responsibility for actual results or future events.

The opinions expressed in this report are valid only for the purpose stated herein and as of the date of this report. No obligation is assumed to revise this report to reflect changes, events, or conditions, which occur subsequent to the date hereof.

All decisions in connection with the implementation or use of advice or recommendations contained in this report are the sole responsibility of the client. This report does not represent investment advice nor does it provide an opinion regarding the fairness of any transaction to any and all parties. In addition, this report does not represent legal, medical, accounting, safety, or other specialized advice. For any such advice, NERA Economic Consulting recommends seeking and obtaining advice from a qualified professional.

NERA Economic Consulting
Level 11
15 Customs Street West
Auckland 1010
New Zealand
www.nera.com