

# Comments on submissions on the Commerce Commission's Draft Determination

Prepared for the New Zealand Tegel Growers Association

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1. The New Zealand Tegel Growers Association (NZTGA) has asked me to comment on NERA's "Review of Draft Determination in respect of NZTGA authorisation application," submissions made by individual chicken growers, the view taken by the Commission on wealth transfers in its Draft Determination on NZTGA's authorisation application, and the implications for the assessment of public benefits and detriments of the counterfactual described by the Commission in the Draft Determination.
2. I consider the relevant counterfactual in section 1, address NERA's comments and the submissions by individual chicken growers in sections 2 to 7, and comment on the Commission's approach to wealth transfers in section 8.

## 1. The counterfactual

3. In the Draft Determination, the Commission stated (paragraph 74) that:

*Without the Proposed Arrangement the growers and Tegel would, in our assessment, have little choice but to negotiate individually. By adhering to the FMAs without authorisation the parties would continue to give effect to provisions that may fix the price of chicken growing services to Tegel.*

4. This statement seems to suggest that the existing Farm Management Agreements (FMAs) would not be valid in the counterfactual, and all growers that have an FMA (whether or not they are currently NZTGA members) would need to individually negotiate a new agreement with Tegel. In the remainder of this note, I refer to this counterfactual as Counterfactual 1.
5. The Castalia Report<sup>1</sup> and NZTGA authorisation application assumed that in the counterfactual the existing FMAs would continue to be valid but that over time the FMAs

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<sup>1</sup> Castalia (2 September 2021) "Public benefits and detriments of collective bargaining by Tegel's chicken growers" Prepared for the New Zealand Tegel Growers Association by Emma Ihaia

would not be sustainable without collective bargaining and so a simpler, [REDACTED] contract that is individually negotiated would be more likely to prevail.<sup>2</sup> In the remainder of this note, I refer to this counterfactual as Counterfactual 2. The FMA was negotiated in a context where growers could engage collectively with Tegel to address ongoing implementation of the contract or any required amendments. [REDACTED]

6. The analysis in the Castalia Report of the public benefits and detriments, including the quantitative estimates, was based on Counterfactual 2. In the remainder of this note (particularly when assessing transaction costs) I consider both Counterfactual 1 and Counterfactual 2.

## 2. More efficient contracts

7. NERA (para 4) states that, [REDACTED], the Commission provides little economic justification for the view stated at para 135 of the Draft Determination that “collective bargaining is more likely than not to lead to more sophisticated and more efficient contracts, particularly over the long term.”

8. [REDACTED]

9. [REDACTED]<sup>3</sup> [REDACTED]<sup>4</sup> [REDACTED]

10. [REDACTED]

11. [REDACTED] [REDACTED] [REDACTED] [REDACTED]

12. NERA (para 6) states that NZCC does not refer to any evidence that less shed investment would have occurred under individual bargaining. [REDACTED]

13. At paras 9-10, NERA points out what it views as an inconsistency in reasoning where the Commission says on the one hand that collective bargaining is likely to lead to more sophisticated and efficient contracts, but also suggests that it is not clear that the existing agreement is sophisticated enough. Rather than being inconsistent, this simply suggests that the existing collective negotiation may require some amendments to improve it. These amendments are more likely to occur with collective bargaining than individual bargaining [REDACTED] It is not unusual for contracts to be refined and varied over time, and it is often only when a possible (unexpected) outcome occurs that clauses are tested, and then amended to clarify or improve the clause. [REDACTED]

14. NERA (para 11) refers to its previous memo in which it stated that a one-size-fits-all chicken grower contract may be inefficient. However, the FMA doesn't seem to try to be a one-size-fits-all contract. [REDACTED] – if a grower knew that if its costs were higher, then it would be paid more, it would have less incentive to keep costs down. In any case, a small-scale chicken

<sup>2</sup> See section 3.3 of the Castalia Report.

<sup>3</sup> Tegel Foods Limited (20 May 2022), “Submission in Response to Statement of Preliminary Issues Dated 8 October 2021”, Appendix 1

<sup>4</sup> [REDACTED] submission on NZTGA Authorisation Application, [REDACTED].

farm may achieve economies of scope (instead of scale) by being located on a farm which raises other types of animals.

15. NERA (para 12) further discusses the issue of homogeneity by referring to a paragraph from the Australian Competition Tribunal's decision on Port of Newcastle. I note that the Tribunal's reasons for not finding any material transactions cost savings did not include a lack of homogeneity between coal producers (see paras 347 to 350 of the Tribunal decision) and found that the coal producers did have a common interest. Instead, the reasoning behind the Tribunal's decision is primarily that many, if not all, of the nine coal producers would want to be represented at meetings with the Port, would want to consider the contractual terms within their own management teams and potentially take their own advice, and that the Port would likely continue to meet individually with the coal producers even in the presence of collective bargaining. The Tribunal therefore considered that there would not be substantial transaction costs savings from collective negotiation.
16. In the case of collective bargaining by NZTGA, there is a large number of chicken growers who have a common interest in negotiating an agreement with Tegel, and the FMA reflects that the nature of the relationship between Tegel and growers is the same across all growers. Tegel requires a high degree of homogeneity in the products that are produced, including the way they are produced (for example, Tegel provides the chicks, feed, and all other inputs and has very specific shedding requirements). As noted above, differences in shedding types (and effectively age) are reflected in the collective agreement. [REDACTED] [REDACTED].

### 3. Allocative efficiency detriments

17. Key factors relevant to determining allocative efficiency detriments are that: (1) grower prices are a relatively small proportion of retail prices; (2) Tegel will still have strong buyer power if the authorisation is granted so the difference in price between collective bargaining and the counterfactual is likely to be small, (3) the price elasticity of chicken meat is low, and (4) Tegel is unlikely to reduce the wholesale price of chicken if the authorisation is not granted.
18. For the following reasons, my view is that these factors all point to very limited allocative efficiency losses of the authorisation. In particular:
  - a. [REDACTED]<sup>5</sup> As a result, even if fully passed through, a significant change to grower costs would have a reasonably small effect on wholesale prices and even less of an impact on retail prices.
  - b. The authorisation application does not include a boycott and, as a result, has only some effect in counterbalancing the strong bargaining power of Tegel. Therefore, the difference between the grower charges in the counterfactual and the factual are likely to be low.
  - c. On the topic of elasticities, NERA expresses the view that the price elasticity would be lower over a 10-year period. However it is not clear that this reasoning applies

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<sup>5</sup> Commerce Commission Draft Determination, footnote 174. [REDACTED]

particularly well to chicken consumption. Demand for a good or service is more likely to be more elastic over the long term where it is difficult for consumers to change their demand in the short term. A classic example is that in the short-term consumers who are reliant on cars for transport may not respond strongly to an increase in the price of fuel, but when viewed over a longer period consumers may respond by purchasing more fuel-efficient vehicles. However, in the case of chicken meat purchase (either at the retail or wholesale levels) it is less clear that there are factors that would significantly increase the elasticity of demand over a 10-year period as compared with a shorter period.

- d. Given Tegel's financial position and its announcement that wholesale prices would increase (as noted in the Commission's Draft Determination), it seems unlikely that Tegel would passthrough any reduction in grower fees in the form of lower wholesale prices.

## 4. Dynamic efficiency

19. Dynamic efficiency benefits of the authorisation include:

- a. a more efficient grower contract with Tegel that provides a payment structure and term that is more likely to support grower investment than in the counterfactual where collective bargaining is not permitted (as discussed above in paragraphs 11 and 12), and
- b. the ability for the growers to collaborate through the NZTGA on innovative growing techniques. In addition to having the capability to negotiate with Tegel, the NZTGA also provides a means for coordinating and supporting innovation by growers. For example, the NZTGA has informed me that in 2017 and 2018, NZTGA members jointly ran trials to use sawdust instead of wood-shavings in sheds, and also trialed mixes of the two materials. The goal of the trials was to address pad-burn. If the authorisation is not granted, the NZTGA is unlikely to continue to provide the same forum for efficiency-enhancing collaboration as it would if the authorisation is granted. In other words, if the NZTGA is not permitted to collectively bargain with Tegel on behalf of its members, the association is less likely to continue in its current form with the same in-house capability and resourcing that it currently has, both because (1) without the ability to collectively bargain there is less commercial imperative to maintain the current resourcing of the association, and (2) given the consequence of breaching cartel restrictions, growers would be more wary of actively collaborating when an authorisation application had been denied by the Commerce Commission.

20. NERA (at para 34) repeats the view from its earlier memo that "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)." NERA provides the example of situation where "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.” However, growers still have the option to negotiate an individual agreement with Tegel. Under the example given by NERA, a grower can separately negotiate an agreement (or variation) to provide the new innovative service and be compensated for that innovation. [REDACTED].

21. At paragraph 37 NERA highlights that if collective bargaining results in higher costs to Tegel then there may be a negative impact on Tegel’s innovation and investment [REDACTED].

## 5. Productive efficiency

22. NERA takes that view that the Commission has overstated the productive efficiency benefits of collective bargaining, and says that the Commission should assume that Tegel makes rational decisions rather than assuming Tegel behaves in an automated way in the counterfactual by [REDACTED]<sup>6</sup> [REDACTED].

## 6. Bargaining power

23. NERA takes the view that the relationship between Tegel growers is one of mutual independence with precise bargaining power varying over time as the demand for chicken meat varies. NERA suggests that because the future is uncertain, and the relative bargaining power of the parties may change, 10 years is too long for an authorisation. However, NERA’s reasoning does not recognise that individual growers are *entirely* dependent on Tegel for recovering the significant shedding investments that are specific to raising broiler chickens, but Tegel is not entirely dependent on any individual grower. This leads to a fundamental imbalance in bargaining power that would persist over the 10-year period of the proposed authorisation. [REDACTED].

## 7. Transaction costs

24. NERA states that Tegel has a different view of the transaction costs of collective and individual bargaining than those provided in the Castalia Report. Tegel bases its view of the costs of individual bargaining on the time taken to negotiate recent contracts with individual growers. However, the experience of recent negotiations cannot be used to provide approximation of the resources and cost required to negotiate individual contracts in the counterfactual. Neither can the costs of recent collective negotiations be used as an approximation of collective bargaining costs under the factual, as I explain below.

25. [REDACTED]; [REDACTED]

26. Under Counterfactual 1, the FMA would no longer be able to be used and new contracts would need to be negotiated. Therefore, growers would not have the security of the FMA as a fallback option. Given the imbalance in bargaining power between Tegel and the growers, Tegel would have the incentive to seek a significantly different agreement under Counterfactual 1 than under individual bargaining either in the factual (after full authorisation is granted) or than in recent times (that is in 2021 or in 2022 before the

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<sup>6</sup> NERA, para 41.

Commission's final decision on authorisation). In particular, individually negotiated agreements in the counterfactual are likely to provide terms that are significantly less attractive to growers than the existing FMA (such as lower grower fees and/or a structure and term that places greater risk on growers) [REDACTED]. Therefore, the context and nature of the negotiations, and the time and costs required to negotiate the contracts are likely to be significantly different in the counterfactual – in particular, the negotiations in the counterfactual would likely take longer and would be more costly. This is because Tegel's stronger bargaining power in the counterfactual would likely mean that negotiation would be difficult for the growers, and they would likely require additional support (such as financial and legal advice) because the contract terms would be less attractive than those that currently apply in the FMA.

27. Under Counterfactual 2, as described in the Castalia Report, the FMA is likely to become unstable over time as collective bargaining is no longer available to support the ongoing implementation of the agreement. Given that I do not expect the FMA to endure under Counterfactual 2, I would also expect that the time and cost of individual negotiations to be greater in Counterfactual 2 than in recent negotiations for the same reasons discussed above. That is, that Tegel's stronger bargaining position would make the negotiations more difficult for chicken growers, with the result that they would require more support (such as legal and financial advice).

28. [REDACTED].

29. In summary, given that the negotiating context in the counterfactual would be different to the context of recent negotiations, I do not consider the costs of agreements that have been negotiated in 2021 and 2022 to be relevant to estimating the costs of individual negotiation in the counterfactual. Other reasons why I do not believe the costs of recent agreements to provide a good indication of individual contract negotiation costs in the counterfactual are:

- a. while some recent individual negotiations have concluded, others have not – Tegel and NERA only appear to have used the costs, resourcing and time requirements of individual negotiations that have concluded, and not those that did not conclude [REDACTED]. As a result, the cost and time estimates used by Tegel do not necessarily provide an accurate picture of the true cost and time requirements of the negotiations.
- b. Tegel had a very strong incentive to provide examples to the Commerce Commission of individual negotiations that were concluded quickly and at a low cost to influence the Commission's decision on whether to grant an authorisation. [REDACTED] [REDACTED]

30. [REDACTED].

31. Given the discussion above, I do not agree with NERA's estimates of the transactions costs with and without collective bargaining. I am of the view that the range I provided in the Castalia Report of \$1.4 million to \$3.1 million remains a reasonable estimate of the transactions costs savings of collective bargaining.

32. In the Castalia Report, the lower end of the range estimated the transaction cost savings if the existing agreement remains in place in the counterfactual for a period of 5 years and individual contracts are then negotiated. The upper end of the range estimated the cost savings where the existing agreement is replaced upfront with individually negotiated

contracts that have a term of three years. If Counterfactual 1 is the relevant counterfactual, then the transactions costs savings would likely be at the upper end of the range because Counterfactual 1 would require all growers to individually negotiate new agreements with Tegel following a decision to decline authorisation.

33. As NERA points out, estimating transaction costs 10 years into the future is difficult. However, it stands to reason that the economies of scale in negotiating with one party rather than in the range of 70 individuals means that there are significant transactions costs savings, particularly as most growers are unlikely to want to be heavily involved in the collective negotiations or seek their own advice (in contrast to the situation considered by the Australian Competition Tribunal in its decision on the Port of Newcastle collective bargaining authorisation).

## 8. Wealth transfers

34. In the Draft Determination, the Commission takes the view that Tegel's recent performance is not consistent with earning supranormal profits, though it acknowledges the contributing causes of the COVID-19 pandemic and IBD outbreaks.
35. The authorisation application is for a period of 10 years, and therefore the analysis of public benefits, including welfare transfers, should be a forward-looking analysis based on the likely conditions over that 10-year period, rather than giving undue weight to an extremely unusual temporary downturn in demand. Trading conditions are improving through: (1) the easing of domestic COVID restrictions and international borders opening, and (2) the 2019 IBD outbreak having been resolved and no longer restricting exports. As a result, the period in which Tegel made losses is unlikely to be reflective of the next 10 years. [REDACTED].
36. Given that the Commission found in its determination on the Waikato-Bay of Plenty Chicken Growers Association's authorisation that wealth transfers may represent a positive public benefit, it is unclear as to why that conclusion would not equally apply to NZTGA's authorisation application. In the case of the NZTGA authorisation application, the Commission finds (para 141.1 of the Draft Determination) that Tegel is likely to have more bargaining power in the counterfactual. Therefore, it stands to reason that under usual trading conditions an authorisation would result in a public benefit from a wealth transfer.