

Responses
Re: Commerce Commission Draft Determination (Restricted Version)

Rodney Fort
March 31, 2006

The following are my comments on relevant portions of the Commerce Commission's Draft Determination.

How Hard is the Cap/Expected Effectiveness. The Commission wonders about the effectiveness of the cap and questions just how "hard" it will be; paragraphs 332-333, 497-507, and Question 17.

1. Paragraphs 332-333: The Commission seems worried that only a few unions will be constrained by the cap. But it is important to remember that it isn't *the number of unions affected*, but the *effects of the cap* that matter—more equalized spending by unions, more equal outcomes on the field, and growth in fan demand over time.
2. The Commission comments at paragraph 502: "... there may be certain fixed team performance bonuses and special payments for promotional appearances or speaking engagements..." It seems perhaps I was unclear in my original statement—I was not referring to performance bonuses in my original statement concerning early loopholes in North American caps. I was referring to signing bonuses and signing bonuses are all covered under the NZRU/RPC agreement. In North American leagues, all compensation related to league participation is covered by the cap language, including promotional appearances on behalf of the team, and I read the NZRU/RPC agreement to cover this type of compensation as well. So promotional bonuses will be closely monitored along with all other compensation. Performance bonuses I understood to mean bonuses tied to the success of the union. For example, in North American leagues, players typically earn set bonuses when their team makes the playoffs and for subsequent success in the playoffs on up to the final championship. Even though playoff outcomes in the NBA and NFL are imbalanced, player bonuses tied to team success have never even been mentioned as possible avenues for cap abuse. This is because these success bonuses are determined through collective bargaining and apply equally to all teams. I am unaware of a single case of prosecuted cap abuse through this type of bonus. I don't see this type of bonus abuse as either very likely or very significant.
3. In paragraph 503, the Commission cites "... investment in coaching, medical specialists, facilities and the like..." as examples where larger-revenue unions may subvert the cap with non-pecuniary player benefits. It should be the case that larger-revenue unions already have this advantage. And players migrate to larger-revenue unions for higher pay and to get better coaching and treatment. But since this is true even before the cap, why would larger-revenue clubs spend even more than they currently do to the same end of drawing the same talent? Furthermore, the link between coaching and winning is not dollar for dollar. It seems unlikely that this type

of “in kind” payment is very valuable from the union perspective. [Note: Just as a point of clarification for the Commission, Rottenberg wasn’t writing about “in kind” payments of this variety. He meant more direct non-salary economic benefits going to players—cars and such—that would need to be carefully monitored.]

4. The issues raised in the Question 17 are similar to ones raised in my original statement. But the NZRU/RPC cap language and the language of the Draft Determination make it clear to me that the lessons of the North American cap experience have been learned and that the NZRU is well-aware that the price of the cap’s success is eternal vigilance.

The Uncertainty of Outcome Hypothesis. The Commission takes exception to the idea that the uncertainty of outcome hypothesis (henceforth, UOH) is operative in New Zealand rugby; paragraphs 116-120, 616-630, and Question 28.

5. In paragraphs 116-120, and 622, the Commission concludes that the general evidence on the UOH is mixed. This leads the Commission to state that they will treat estimates of benefits claimed due to the UOH conservatively. I refer the Commission to my assessment of this same literature in Fort (2006), referenced in my original statement. Let me restate my findings as an aid to the Commission’s deliberations in the interests of providing a more complete picture of what the literature says concerning the UOH. The Szymanski paper and the Downward and Dawson chapter cited by the Commission only tally up the combined verdict of works done in the past. Instead, I *assess* all of these works for the validity of any findings on the UOH. I detail how all of the tests to date have been only partially executed and less than a handful have successfully navigated other important estimation hurdles. In my assessment, much of this literature produces erroneous assessments of the role of the UOH. The work that I think passes muster suggests that various aspects of the UOH *are* important in the determination of fan satisfaction.
6. In paragraphs 623-626, the Commission recounts the Owen and Weatherston (henceforth, O-W) findings on New Zealand rugby. I have written a lengthy review of the O-W work for the Commission’s perusal and understand that the Commission did not have time to include it in their Draft Determination, but will do so before preparing its Final Determination. My conclusions are (in summary) that the O-W results a) don’t really even bear on the case at hand of a new Premier Division and b) are problematic in myriad other ways. This is in my view important in helping the Commission decide about the expected role of the UOH in the new form of New Zealand rugby. My considered view, based on the research and analysis I have undertaken, and taking into account the O-W material, remains that the UOH is an important and highly relevant factor when assessing the likely impact of the salary cap.
7. In paragraphs 627 and 628 (and the related Appendix 2), the Commission notes a shortcoming in the O-W work and sets out to remedy it. As I also point out in my review of O-W, the Commission notes that the O-W work is only partially specified;

the O-W work includes game day uncertainty, but nothing about inter-seasonal uncertainty. A complete specification would have both aspects of the UOH included in the estimation approach. This omission by O-W has the potential to render incorrect their conclusion that the UOH doesn't hold for New Zealand rugby. This shortcoming in the O-W work suggests that the Commission should reconsider their conclusion based on that work that the UOH doesn't matter for the new Premier Division.

8. More on paragraphs 627 and 628. In the estimation of inter-seasonal effects, the Commission's model holds constant population, income, ticket price, union quality (reaching the semi's in previous seasons), marketing expenditure, and unobserved other characteristics (the constant term) and the analysis focuses on two variables that measure inter-seasonal outcome uncertainty. Either variable seems a sensible description. I offer four suggestions that should improve the Commission's investigation of this important point (my comments pertain only to versions 1 and 2 in Appendix 2 since only those specifications include the most complete specification used by the Commission that also is suggested by theory). First, the Commission's estimates concern the old First and Second Division form of NZRU. The Commission might wish to consider that the results of their estimation are thus suggestive at best for the new Premier Division/Division One structure. Second, the Commission will find that a simultaneous equations approach to the estimation improves the precision of their model estimates. It appears the Commission used ordinary least squares, a technique that accounts only poorly for the fact that both fan and union decisions simultaneously determine attendance outcomes. Third, the Commission's approach includes inter-seasonal outcome uncertainty but no other aspects of the UOH, for example, a measure of closeness of matches for each team in each season. This type of specification omission renders other estimates in their model less precise than they could be. Finally, the two variables used to capture inter-seasonal uncertainty appear to me inversely related and it will be quite difficult to discern independent effects of either variable. The Commission's effort to learn more about the UOH will be more precise and, possibly, more insightful if these suggestions are included in the revision of their determination.

9. Turning to Question 28, very little is known about the demand for TV viewing and the role of the UOH. But there are two pieces of intuition that might prove useful. First, even if the gains from enhanced balance were small per viewer, millions of viewing opportunities lead to very large total increased satisfaction from close games. But, again, there has been no work on this to my knowledge because the data on viewing are very expensive. Second, many fans will not have a clear identification with a local Premier union. Instead, their viewing satisfaction will be determined in part by the general level of play across the entire Division, as well as the excitement of the various matches at that level. Basic economic intuition suggests that more of these fans will be happier in their viewing when the level of play is high and the games are close; casual fans without a particular union to root for can be rabid fans of the sport in general.

The Absence of Revenue Sharing. The Commission wonders if adding revenue sharing would change the rate at which the cap becomes effective; paragraph 521.

10. At Paragraph 521: "... talent diffusion would be expected to occur more quickly if measures to equalize revenues were also implemented." There are some additional complexities that the Commission may wish to consider on this issue. First, in my original statement I did not hazard a guess at how long a cap *alone* will take to equalize talent across teams. As the Commission points out, all models of caps are static and the historical look at caps doesn't find that those in North American sports actually helped much at all. Second, there is very little support for the view that revenue sharing *alone* has actually reduced talent inequality in North American leagues. The NFL case suggests it *may* have, but we have no "before and after" experiment in this case since NFL owners have always shared the vast majority of all of their revenues. It could instead simply be that willingness to pay among NFL fans in different locations is more equal in the first place. MLB is a case in point where two different local revenue sharing approaches have been tried. But the standard deviation measure of dispersion shows that only in a small way did these approaches reduce imbalance, and then only in the National League for the first version of sharing in 1995. Third, from the strictly theoretical standpoint, the salary cap is sufficient to do the job alone. If the cap is used and it equalizes talent, then the additional imposition of revenue sharing may actually result in a combined approach that overshoots the mark. Adding revenue sharing (disproportionately from larger-revenue unions to smaller) would further reduce the value of talent to larger-revenue unions and even more equality on the field would result than initially planned. But even if the combined approach is carefully managed in this regard, there is very little history and no forecast models have ever been employed to address the question of how long it will take to get the result of enhanced balance. It is safe to say that it will happen "gradually" but I find no basis for quantifying how long it will take.

Revenue Disparity and Cap Effectiveness. The Commission wonders whether existing and growing revenue inequality will undo the cap; paragraphs 519-521 and Question 19.

11. The Commission comments here seem centered on whether or not existing revenue inequality and possibly growing revenue inequality will undo a cap. I take the intent of the comments to say again that revenue sharing should be added with the cap. The response in my paragraph 11, above, should be repeated here. Further, the point of a cap is to "grow the game" so that all revenues rise and, relatively speaking, more for currently smaller-revenue unions than for larger-revenue unions. So, in my opinion, growth in revenues will not necessarily result in greater revenue inequality.

Estimates of Player Migration. The Commission wonders if player migration will be a larger problem than I think it will be; Paragraph 569.

12. The Commission estimates the impacts of player migration on benefits and detriments. While I was not asked to address this by the NZRU, I suggest that the impacts of migration be assessed through sensitivity analysis. What happens to the

estimated impacts if fewer players migrate than in the Commission's model? If more migrate? And what if the time horizon is shorter or longer than the Commission's model uses at present? Indeed, if there is time, the migration function could be estimated directly with relative salaries, domestic and foreign, as one of the determinants. It simply is the case that not many players are leaving now. Further, star player salaries in New Zealand aren't likely to be affected much relative to star salaries elsewhere since New Zealand is the world's rugby hotbed and should remain competitive for the best players. Indeed, if the cap is successful, so that the game grows and grows more balanced, perhaps fewer players will migrate and talent *immigration* may become a future issue. And a model of migration would prove instructive in that event as well.

Assessment of Benefits and Detriments

13. I was not asked by the NZRU to comment on the assessment of benefits and detriments, which was underway before I was asked for my contribution regarding the North American experience with salary caps. But I do have one suggestion, echoing my idea in paragraph 12, above. I would suggest using sensitivity analysis to investigate how the Commission's estimates change for more and less conservative assumptions on both costs and benefits. This should enable more helpful comparisons to be drawn, as compared with the discounting approach used by the Commission.