Comments on the Commission's Revised Draft Determination

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I have reviewed the Commission's Revised Draft Determination on the proposed merger of Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited. This report summarizes my views on two particular aspects of the Commission's analysis of the public benefits and detriments of the merger: its interviews with wool merchants and its treatment of foreign ownership. That fact that I have not specifically addressed other aspects of the Revised Draft Determination should not be interpreted as me agreeing with the Commission's treatment of those other aspects. My thoughts on those issues can be found in my earlier reports prepared on behalf of Godfrey Hirst New Zealand Limited.

1. Interpreting the results of merchant interviews

In order to calculate the detriments caused by losses of allocative efficiency, the Commission has to calculate the likely increase in scouring prices that will occur if the merger proceeds. There are three potential constraints on the merged firm's ability to raise scouring prices: a rival scour operator might enter the market; merchants might switch to exporting greasy wool for scouring overseas; and individual merchants might have long-term scouring contracts in place that restrict price rises.

The Commission has largely retained its entry model from the original Draft Determination. However, the Commission has radically changed its approach to the threat posed by greasy-wool exports. Its new approach uses information extracted from interviews with merchants to calculate the maximum price increase that can occur without prompting merchants to switch from exporting scoured wool to exporting greasy wool instead.

This issue is covered in paragraphs 247-274 of the Revised Draft Determination in a section entitled *"What price increase would cause merchants to switch to more greasy exports?"* This is a very specific question and, as I explain below, merchants' answers to this question have the potential to provide the Commission with useful information. Paragraph 255 describes what the Commission claims to have done:

> *"The Commission sought feedback from a range of merchants regarding the likelihood that they would switch to greasy exports if scouring prices were to increase, and what magnitude price increase would cause them to switch."*

In these interviews, merchants were asked a series of questions, including variants of the following two questions.

- How big would a price increase have to be to induce you to switch to exporting greasy wool?
- How far do you think a merged firm would increase prices?

The reason for asking merchants the first question is that merchants alone know how they will react to a price increase. They know their cost structures, their revenue opportunities, and their business plans. None of this information is known to the Commission, so asking merchants the first question above will reveal information not already available to the Commission.

In contrast, the second question asks merchants to predict the behaviour of the merged scouring operation. Merchants do not know the merged firm's cost structure, its revenue opportunities, or its business plans. In fact, thanks to the confidential information it has acquired from Cavalier Wool Holdings and NZWSI during the authorisation process, the Commission probably has more information about these things than merchants. As a result, merchants' answers to the second question above are of much less use to the Commission than their answers to the first question. I believe that their answers to the second question are actually of very little (if any) use to the Commission.

My review of the interview file notes provided by the Commission (13 days after the Revised Draft Determination was released and two days before the submission deadline) indicates that the Commission asked merchants the key question above. However, the Commission has chosen not to report their answers in the Revised Draft Determination. Inspection of the interview notes reveals many instances where the merchants reported information that is quite different from the summaries presented by the Commission in the Revised Draft Determination.[1]

What the Commission has done instead is to report merchants' answers to the second question, which asks them to predict the pricing decisions that the merged firm would make. The Commission has done this in a section entitled *"What price increase would cause merchants to switch to more greasy exports?"* The Commission does not explain why it decided to exclude what appears to be the most useful and relevant part of merchants' interview responses.

When I consider the file notes alongside the Revised Draft Determination, as I describe in an appendix to this report, I find that:

[1] My review has also uncovered one case where the Revised Draft Determination misreports a merchant's response. Specifically, the Revised Draft Determination states that [

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[ ] The Commission records its view of the information revealed by these interviews in paragraph 271:

> *"Based on the feedback provided by merchants, the Commission considers that if CWH were to increase prices by 15% in relation to wool destined for export, larger merchants would respond by switching a significant proportion of clean wool exports to greasy exports. Although a real possibility, the Commission is less certain whether price increases lower than this level would cause sufficient switching so as to discipline CWH."*

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The simplest solution, and the one I recommend the Commission adopts, is to return to a single market that does not distinguish between wool destined for export and wool to be processed domestically, and to assume that price rises of 25% are possible without triggering either entry or switches to greasy-wool exports. Unlike the Commission's current approach, this would be consistent with the information the Commission received from merchants.

2. Implications of foreign ownership

In my report dated April 21, 2015, I explained why the Commission should exclude benefits that flow to overseas-based owners of the merging firms.

The Commission discusses its approach to the role of foreign ownership in paragraphs 371-395 of its Revised Draft Determination. The Commission correctly rejects NERA's "resource-based" approach and includes two examples, which, in addition to the examples in my previous report, illustrate the flaws in NERA's approach. The Commission has accepted the validity of my "residency-based" approach (paragraph 380), stating that it "may provide an accurate estimate of the immediate, direct benefits that arise within the market of interest". Further, the Commission states that departing from its current approach "may be justified if there would be little, or no, feedback effects from improving returns to foreigners [sic] owners of New Zealand businesses" (footnote 239). However, the Commission goes on to describe five claimed "feedback effects", which it uses to justify its decision to continue to count benefits flowing to overseas investors as a benefit to New Zealand.

I now explain why all five of the Commission's claimed "feedback effects" are invalid.

Cost pass-through (paragraphs 384, 388-390): The Commission claims that competitive pressure from offshore scours could lead to "some proportion" of cost savings being passed onto merchants in the form of lower scouring prices, and then onto farmers in the form of higher farm-gate prices. The Commission claims that, as sheep farms are predominantly owned by New Zealand residents, the benefit of this proportion of the cost savings ultimately flows to New Zealanders.

Even if this were the case, it has already been accounted for in the calculation of the loss of allocative efficiency. In the absence of competitive pressure from offshore scours, the Commission's estimate that scouring prices will rise by 15% would presumably have been higher. Thus, if the Commission were to use the possibility of cost pass-through to justify counting benefits that flow to foreign investors then it would be double counting these benefits.

Allowing for past transactions (paragraph 394): The Commission suggests that Lempriere's shareholders paid for their share of the merger benefits when they bought NZWSI from its New Zealand owners in 2013: "it is possible that some proportion of these cost savings would have already been capitalised into the sale price and captured by the previous New Zealand shareholders."

The Commission's suggestion violates the principles it sets out in its own merger guidelines document. Even if these cost savings had been capitalised into the purchase price (and I explain below why this is unlikely), the New Zealand owners of NZWSI received these benefits regardless of whether or not the current merger is authorized. As the Commission states on p. 13 of its Guidelines:

> *"[I]n identifying public benefits, it is a "with" and "without" comparison which must be made, not a "before" and "after" comparison. It follows that public benefits cannot be ascribed to a particular business acquisition or restrictive trade practice if they are expected to occur even in the absence of the acquisition or practice."*

The transaction the Commission refers to has already happened. The purchase price has already been paid. Any benefits have already been transferred. These benefits therefore occur with or without the merger going ahead. The Commission's own Guidelines imply that they should not be counted as benefits.

There is a further obstacle to the Commission's proposal, and that is Lempriere's application to the Overseas Investment Office, in which it stated that

> *"[Lempriere Australia] is currently aware of Cavalier Wool Holdings Limited's interest in the wool scouring assets of the NZWSI business. [Lempriere Australia] has no intention to dispose of those assets."*

If Lempriere was reporting its intentions truthfully to the Overseas Investment Office (and I am not suggesting otherwise) then the Commission's approach implicitly assumes that Lempriere paid for benefits that it had no intention of receiving. That assumption is obviously implausible.

Market values underestimate net benefits (paragraph 393): The Commission raises the possibility that resources released for use in New Zealand might generate benefits with a present value that is "over and above the cost of these resources". The Commission raises the specific example of land sales and the land generating an "additional (net) surplus for the new owner from being put to alternative use."

The possibility raised by the Commission has nothing to do with the issue of foreign ownership. That is, the existence of any difference between the market value of a resource and the present value of the net benefits that resource generates in an alternative use has absolutely nothing to do with the nationality of its prior owner. Any assessment of the merits of the Commission's claim must therefore be made independently of whether or not the resource is currently owned by a foreigner.

The Commission is making a bold claim: *that the market value of a resource underestimates the present value of the benefits that resource can generate and that the estimation error is material.* Even if the first part of the Commission's claim were correct, the effect would be so small as to be immaterial. That is probably why the Commission has consistently used the expected sales price of a resource as its estimate of the present value of the public benefits that will be generated by that resource once it becomes available for alternative uses. It is the approach adopted in the rest of the Revised Draft Determination. As discussed in NERA's report of October 22, 2014, it is also the approach the Commission used in its Ruapehu authorisation (Decision 410, November 14, 2000), where it explicitly used the expected sales price of a maintenance base to estimate the value of the benefits from releasing this land for alternative use. If the Commission persists with the view expressed in paragraph 393, then it is effectively saying that its entire approach to valuing the benefits of releasing resources for alternative uses has been incorrect for at least the last 15 years.

Lastly, from Table 7 of the Revised Draft Determination, [ ] of the claimed benefits come from reduced "production and administration costs". If the Commission's point were valid in principle, and if it was to have a material effect on the final net benefit result, it would have to apply to production and administration costs. However, any suggestion that the prices of inputs such as gas and electricity materially underestimate the value to New Zealand of the benefits that they generate is not credible Neither is it credible to suggest that spending on maintenance and repair costs, general office expenses, etc., underestimates the value to New Zealand of releasing these resources for alternative uses.

Incentivizing efficient investment (paragraphs 382-383 and 392): The Commission points out that increased profits to overseas shareholders can be a consequence of "owner or managerial insight and expertise, effort, and/or risk." The Commission correctly points out that such increased profits are "required to incentivize efficient investment". However, it then mistakenly claims that "accounting for productivity gains regardless of the residency of shareholders ensures that a merger will be appropriately evaluated when we assess net public benefits."

I have pointed out the mistake in the Commission's claim before, in my report dated April 21, 2015, and during the first conference. However, my explanation of the Commission's mistakes has been ignored by the Commission in its Revised Draft Determination. Here I make one more attempt to help the Commission understand why its argument is incorrect.

I use a simple example that captures the underlying economic issues and is flexible enough to include a variety of scenarios that the Commission appears to have in mind.[2] In this example, an overseas-owned firm is considering undertaking merger activity in New Zealand.

The foreign firm will incur some costs if the merger goes ahead, but will also earn higher profits. I use NB_F to denote the net benefits to the owners of the foreign firm. If NB_F is positive then the foreign firm's owners will want the merger to proceed; if NB_F is negative then they will not want it to proceed.

[2] I present a second, more complicated, example in an appendix to this report. Like the simple example in the main text, it shows that the Commission's approach does not change foreign firms' investment incentives in ways that benefit New Zealand.

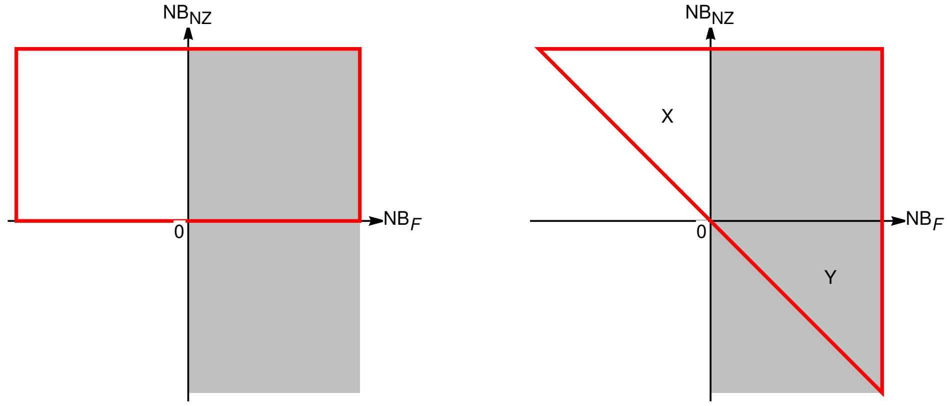
New Zealand producers and consumers will also potentially incur some costs and receive some benefits if the merger goes ahead. I use NB_{NZ} to denote the net benefits to New Zealand producers and consumers. If NB_{NZ} is positive then New Zealand benefits if the merger goes ahead; if NB_{NZ} is negative then New Zealand is worse off if the merger goes ahead.

The Commission seems to be concerned about the possibility that New Zealand will miss out on the benefit NB_{NZ} if the Commission does not allow somehow for NB_F. I show that the concern is unfounded.

The Commission mistakenly assumes that it is able to alter the foreign firm's investment incentives. As I explained above, the foreign firm decides whether or not to attempt the merger based on the net benefits that it would actually receive if the merger goes ahead. What the Commission includes in its own net benefits *calculation* has absolutely no effect on the net benefits that the foreign firm *actually receives*. In terms of the notation introduced above, the foreign firm will initiate the merger if NB_F is positive and will not initiate the merger if NB_F is negative. The Commission cannot do anything to change this. It cannot force the foreign firm to initiate the merger process if its owners do not want to do so; it cannot stop them from initiating the merger process if they want to do so.

All that the Commission can do is allow or disallow mergers that the foreign firm chooses to initiate. The correct approach is for the Commission to allow a merger if NB_{NZ} is positive and to disallow a merger if NB_{NZ} is negative. The Commission's (incorrect) approach in the Revised Draft Determination is to allow a merger if $NB_{NZ} + NB_F$ is positive and to disallow a merger if $NB_{NZ} + NB_F$ is negative.

The following two graphs show what happens. Each potential merger sits somewhere in each graph. If the net benefits to the foreign firm are relatively high then the merger will appear somewhere towards the right-hand side of each graph. If the net benefits to New Zealand are relatively high then the merger will appear somewhere towards the top of each graph. The left-hand graph represents the correct approach and the right-hand graph represents the Commission's approach in the Revised Draft Determination.



If the merger sits in the shaded region then the net benefits to the foreign firm are positive. These are the only situations where the foreign firm will initiate the merger process. Any merger in the unshaded region will not be initiated by the foreign firm because the firm's owners would be worse off if the merger occurred than if it did not occur. Thus, the only merger applications that the Commission will ever have to consider correspond to mergers in the shaded region of each graph.

If the Commission adopts the correct approach, it will approve any merger inside the red rectangle in the left-hand graph. If the Commission adopts this approach, the only mergers that are approved by the Commission are good for New Zealand. These correspond to mergers in the shaded region inside the red rectangle. The only mergers that are prevented by the Commission are bad for New Zealand. These correspond to mergers in the shaded region outside the red rectangle.

In contrast, if the Commission continues to follow the approach in the Revised Draft Determination, it will approve any merger inside the red triangle in the right-hand graph. If the Commission continues to use this approach, it will approve all the mergers that would be approved using the correct rule, but it will also approve some mergers that would not be approved by the correct rule. This latter category corresponds to shaded region Y in the right-hand graph. These mergers are bad for New Zealand because NB_{NZ} is negative.

The Commission appears to have adopted the incorrect rule in the hope of approving mergers that sit in the unshaded region X in the right-hand graph. Such mergers would of course be good for New Zealand because NB_{NZ} is positive. However, because they are bad for the foreign firm (that is, they are in the unshaded region), the foreign firm will never actually initiate such a merger. All that the Commission's approach achieves is to allow mergers in region Y. That is, compared to the correct approach, the Commission's approach results in more bad mergers occurring and does not result in any additional good mergers occurring. The Commission's approach in the Revised Draft Determination is unambiguously bad for New Zealand.

In summary, the Commission's approach is not giving foreign firms an *incentive* to undertake mergers that are *good* for New Zealand. Rather, the Commission is giving foreign firms the *ability* to undertake mergers that are *bad* for New Zealand.

There is, however, one incentive that the Commission's proposed approach does create—and it is an unwelcome one. One implication of the approach in the Revised Draft Determination is that if a foreign firm invests in a New Zealand business and that investment under-performs, the foreign firm will believe that the Commission may bail it out at the expense of the New Zealand public. If the Commission persists with its approach, it will create such a moral hazard problem.

International competitiveness (paragraphs 381 and 391): The final "feedback effect" claimed by the Commission relates to the possibility that the merger increases the international competitiveness of New Zealand's scouring operations: "This may improve the likelihood that the domestic scouring sector would continue to operate profitably over the longer term and so produce greater public benefits to New Zealand than may otherwise be the case if denying the merger would prevent the sector from undertaking necessary cost rationalisation."

Increased international competitiveness is, in principle, a benefit from a merger. That value of that benefit can be thought of as the product of two numbers:

- The present value of the net benefits that flow to New Zealand producers and consumers due to the existence of scouring operators in New Zealand; and
- The increase in the probability that the industry survives in New Zealand (that is, the probability that the industry survives if the merger is authorised minus the probability that the industry survives if the merger is denied).

However, the Commission is effectively proposing to measure the value of increased international competitiveness by the present value of the increased profits that flow to the overseas owners of Lempriere as a result of the merger. There is absolutely no reason why the present value of the increased profits flowing to Lempriere's shareholders as a result of this merger are equal to (or even have the same order of magnitude as) the benefits to New Zealand of making the survival of a domestic scouring industry more likely. I cannot make this point strongly enough: the two quantities have nothing in common other than that they are objects that can be measured in dollars and that they are positive. The Commission's proposal to effectively equate the two quantities has absolutely no merit.

In case the flaws in the Commission's proposal are still unclear, consider the following.

The calculations in the Revised Draft Determination assume that 45% of the merged scouring operation will be owned by overseas investors. The Commission is implicitly arguing that the increased profits flowing to Lempriere's shareholders as a result of this merger are equal to the product of (1) the total producer and consumer surplus flowing to the New Zealand public and (2) the increase in the probability of the industry surviving.

Suppose that, instead, 60% of the merged scouring operation was to be owned by overseas investors. Clearly this would increase the increased profits flowing to Lempriere's shareholders as a result of this merger. However, it would decrease the total producer and consumer surplus flowing to the New Zealand public (because a bigger percentage would be diverted overseas). Thus, even if by some coincidence the increased profits flowing to Lempriere's shareholders equal the value to the New Zealand public of increased international competitiveness of the scouring industry in the special case where Lempriere owns 45% of the merged firm, the two quantities would not be equal when it owned 60% of the merged firm.

If the Commission's approach is to be correct, then we have to believe that Lempriere's 45% ownership stake is the magic number that makes these two quantities equal. But that means that if Lempriere owned 60% instead, the Commission would not have been able to use its approach, because if the two quantities are equal if the ownership stake is 45% then they cannot be equal if it is 60%, and vice versa. Of course, if Lempriere owned 30% instead, the Commission would also not have been able to use its approach, because if the two quantities are equal if the ownership stake is 45% then they cannot be equal if it is 30%, and vice versa. It is simply not credible to suggest—which is what the Commission is implicitly doing—that by some miraculous coincidence, Lempriere's 45% ownership stake is the "magic number" that makes the two quantities equal.

3. What has the Commission actually done here?

The Commission accepts that my approach "may provide an accurate estimate of the immediate, direct benefits that arise within the market of interest". When I apply the approach described in my report dated April 21, 2015 to the Commission's numbers in the Revised Draft Determination, I find that the present value of the "quantified benefits" in Table 7 falls by \$10.31-\$11.02 million. It follows that, once the flow of profits to overseas investors is removed, the benefits to the New Zealand public are equal to \$18.18-\$19.66 million.

That is, using the Commission's own numbers, the value of "quantified detriments" that "arise in the market of interest" equal \$6.84-\$23.98 million, whereas the "quantified benefits" equal \$18.18-\$19.66 million.

If the Commission had left things there, which it should have done, then it would not have been able to authorize the merger. However, instead the Commission has, at the last minute and under the cover of two paragraphs in a 111-page report, simply added in \$10.31-\$11.02 million of additional benefits to get the merger across the line.

I have already explained why the Commission's justifications in terms of cost pass-through (double counting), past transactions (inconsistent with the Guidelines regarding with-versus-without benefits; a reliance on Lempriere behaving either irrationally or dishonestly), market values underestimating benefits (inconsistency with what the Commission has done for at least the last 15 years; immateriality), and investment incentives (faulty economic reasoning) are wrong. That leaves just the value of increased international competitiveness as a possible justification for the Commission's last-minute introduction of \$11 million of additional benefits.

This is a hugely significant increase in the claimed merger benefits. In fact, based on the Commission's own numbers, this last-minute addition has increased the merger benefits by more than [ ]. Moreover, this addition has been made on the basis of no quantitative analysis whatsoever. I think it is worth noting the discussion in Section 9 ("Quantification of benefits and detriments") of the Commission's Guidelines document:

> *"Turning to public benefits, the Act places the onus upon the applicant to satisfy the Commission that the claimed public benefits will accrue. … Claims of benefits need to be supported by detailed analysis and, where possible, by quantification to carry weight with the Commission."*

The applicant has made no attempt to quantify the benefits of increased international competitiveness of the scouring industry: the Commission has initiated this aspect itself. Further, the Commission has not provided any analysis, detailed or otherwise, to support its claims. Indeed, the Commission is holding itself to a standard that falls spectacularly below the standard it holds outside parties to.

Lastly, the Commission's approach of incorporating these benefits in the way that is has introduces entirely spurious precision. At the very least, there should be a plausible range included for the $11 million of last-minute benefits.

Appendix 1: Assessing the Commission's merchant interviews

This appendix reviews the merchant interviews the Commission discusses in paragraphs 255-270 of the Revised Draft Determination (RDD), in the order in which they appear there.

[ ]

- As summarized in the RDD: The Commission does not report [ ] views on how [ ] firm would respond to a price increase. [ ] did not speculate on the magnitude of a likely price change, but speculated that any price rise would occur in a series of steps.
- As summarized in the Commission's file notes: [
    - [ ]
    - [ ]
    - [ ]

  [ ]

[ ] (paragraph 262, [ ]

- As summarized in the RDD: The Commission does not report [ ] views on how [ ] firm would respond to a price increase. [ ] "considered that a price increase of 15% would be unlikely because merchants would likely switch to more greasy exports. [ ] believed that any increase in scouring charges would be [ ]
- [ ]

[ ] (paragraphs 263-264)

- As summarized in the RDD: [ ] "would not necessarily sell more wool greasy for delivery directly to overseas customers".
- As summarized in the Commission's file note: Unavailable at present.

[ ](paragraphs [ ], [ ])

- The Commission's summary: The Commission does not report the merchants' views on how their firm would respond to a price increase. The merchants provided no information about price increases.
- As summarized in the Commission's file note: [ ]

[ ] (paragraph 267, [ ]

- As summarized in the RDD: The Commission does not report [ ] views on how [ ] firm would respond to a price increase. However, it reports [ ] as saying that "…if scouring prices were to increase, any such increase would be limited to around 10% at the highest."
- As summarized in the Commission's file note: [ ]

[ ] (paragraph 268)

- As summarized in the RDD: [ ] "would begin to consider" switching to exporting greasy wool if the scouring price increased by 10%. I note that

"beginning to consider" is not the same thing as actually carrying out the switch to greasy-wool exports.
- As summarized in the Commission's file note: Unavailable at present.

[ ](paragraph 269)

- As summarized in the RDD (emphasis added): "**<u>if scouring prices were increased by 20% only a small proportion of scouring would be lost</u>**."
- As summarized in the Commission's file note: Unavailable at present.

[ ] (paragraph 270, [ ]

- The Commission's summary (emphasis added): "**<u>it would probably deal with 25% increases</u>** before it would be [sic] start to reduce its reliance on domestic scouring."
- As summarized in the Commission's file note: [ ]

Appendix 2: Investment incentives and foreign ownership

This appendix extends the example in the main text by supposing that the foreign firm potentially makes two investments. First, it invests in New Zealand in a way that does not require Commission approval. Second, it initiates a merger that does require Commission approval. The rule adopted by the Commission for the purposes of evaluating the second-stage merger potentially affects the foreign firm's initial investment decision.

Four different net benefit measures are relevant in this situation.

- The foreign firm will incur some costs when making its original investment, but will also earn higher profits. I use NBI_F to denote the net benefits to the owners of the foreign firm from the original investment.

- New Zealand producers and consumers will potentially incur some costs and receive some benefits associated with the foreign firm's original investment. I use NBI_{NZ} to denote the net benefits to New Zealand producers and consumers from the foreign firm's original investment.

- The foreign firm will incur some costs if the merger goes ahead, but will also earn higher profits. I use NBM_F to denote the net benefits to the owners of the foreign firm. If NBM_F is positive then the foreign firm's owners will want the merger to proceed; if NBM_F is negative then they will not want it to proceed.

- New Zealand producers and consumers will potentially incur some costs and receive some benefits if the merger goes ahead. I use NBM_{NZ} to denote the net benefits to the New Zealand producers and consumers. If NBM_{NZ} is positive then New Zealand benefits if the merger goes ahead; if NBM_{NZ} is negative then New Zealand is worse off if the merger goes ahead.

There are two cases to consider, which differ according to whether or not the foreign firm needs the merger to be approved in order for the original investment to be beneficial.

In the first case, the foreign firm's net benefit from the original investment is positive ($NBI_F > 0$). In this case, the foreign firm will make the original investment regardless of the rule the Commission uses to evaluate a subsequent merger, because it benefits from the original investment regardless of the merger rule adopted by the Commission and it decides whether it initiates the subsequent merger. Therefore, the Commission's problem when evaluating a subsequent merger proposal is identical to the problem considered in the main text, and the results found there still apply. The correct approach is to authorise the merger if NBM_{NZ} is positive and to not authorise it if NBM_{NZ} is negative.

In the second case, the foreign firm's net payoff from the original investment is negative ($NBI_F < 0$) but if the merger is authorised then its total net benefit is positive ($NBI_F + NBM_F > 0$).[3] That is, the subsequent merger is essential to the original investment being in the best interests of the foreign firm. The firm will invest in New Zealand if it believes the Commission will authorise the merger. However, the firm will not invest in New Zealand if it believes the Commission will not authorise the merger. It follows that the New Zealand public receives a total net benefit of $NBI_{NZ} + NBM_{NZ}$ if the Commission authorises the merger and 0 if the Commission declines it.

In the second case, the best approach for New Zealand ex post is for the Commission to authorise the merger if NBM_{NZ} is positive and to not authorise it if NBM_{NZ} is negative. However, the best approach for New Zealand ex ante is for the Commission to authorise the merger if $NBI_{NZ} + NBM_{NZ}$ is positive and to not authorise it if $NBI_{NZ} + NBM_{NZ}$ is negative.

NBI_{NZ}, the benefit to the New Zealand public of Lempriere's *original investment* in wool scouring, is likely to be negligible. From p. 15 of the Guidelines,

> *"[I]nflows of overseas capital themselves are not benefits to New Zealand, since they are made in return for the subsequent outflow of dividends, interest, and capital repayments. Only if things such as technology transfer, access to additional overseas market, etc., are associated with capital inflows would public benefits be likely to arise from them."*

I am not aware of any such factors that might generate a public benefit. If, as seems reasonable, the benefits are negligible, then the merger benefits in the second case above are approximately equal to NBM_{NZ}. Thus, in both cases it is appropriate for the Commission to calculate the public benefits of the merger as

[3] Note that we do not need to consider the remaining case, where $NBI_F < 0$ and $NBI_F + NBM_F < 0$, because in this case the foreign firm will not make the original investment regardless of the Commission's approach to evaluating the merger.

NBM_{NZ}. That is, the net benefits to New Zealand resulting from the proposed merger are the only net benefits that should be included in the overall calculation. Including the net benefits to the foreign firm, as in the Revised Draft Determination, does not give foreign firms an *incentive* to undertake mergers that are *good* for New Zealand. All it does is give foreign firms the *ability* to undertake mergers that are *bad* for New Zealand.

The only circumstances in which the Commission's current approach of calculating the net benefits of the merger as NBM_{NZ} + NBM_F might be good for New Zealand would be if NBI_{NZ} were approximately equal to NBM_F, because then the Commission would be basing its authorisation decision on the benefits to the New Zealand public of the original investment plus the merger. However, there is absolutely no reason to believe that the two quantities are approximately equal. The net benefits of the merger to the foreign firm are completely unrelated to the net benefits to the New Zealand public of the foreign firm's original investment.