NERA
ECONOMIC CONSULTING

NERA Economic Consulting
Level 18, 151 Queen Street
Auckland 1010
New Zealand
Tel: +64 9 928 3290 Fax: +64 9 928 3289
Mobile: +64 21 549 905
James.Mellsop@nera.com
www.nera.com

MEMO

TO:	Phil Taylor, Torrin Crowther and Emma Harris, Bell Gully
DATE:	21 October 2015
FROM:	James Mellsop, Wil Taylor and Bronwyn McDonald
SUBJECT:	CWH/NZWSI - review of responses to Second Draft Determination

1. Introduction

You have asked us to review and comment on two aspects of the Chapman Tripp and Graeme Guthrie responses (both dated 15 October 2015) to the Second Draft Determination:

- Foreign ownership; and
- Productive and dynamic efficiency detriments.

2. Foreign ownership

The Commission provides a variety of rationales for its finding that (partial) foreign ownership of the merged entity is not relevant for the benefits assessment. However, on our reading the Commission's primary justification is best captured by the following words from paragraph 382 of the Second Draft Determination:

> *Therefore, accounting for productivity gains regardless of the residency of shareholders ensures that a merger will be appropriately evaluated when we assess net public benefits. This approach recognises that making existing resources more productive can improve domestic economic performance.*

We agree with this reasoning, and note that it accords with the following points we made in our review of Professor Guthrie's 21 April 2015 report:[1]

> *At the extreme, Professor Guthrie's suggested approach implies that there would be no benefit to the New Zealand economy by a rationalisation that frees up New Zealand resources for higher value use in New Zealand if the rationalising parties and their customers were foreign-owned.*
>
> *Put another way, the test proposed would be likely to preclude the restructuring of inefficient sectors of the economy in situations with substantial foreign ownership.*

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[1] NERA note, undated, but filed as an attachment to the 29 April 2015 Bell Gully memo.

Professor Guthrie's main critique of the Commission's justification appears to be the one utilising the diagrams at the bottom of page 7 of his 15 October 2015 report. However, we are not sure these diagrams really help much – at the end of the day, Professor Guthrie's argument is that the release of surplus resources in New Zealand leading to a profit increase to foreigners should not be regarded as a benefit – hence he asserts that the Commission ends up in area Y (positive net benefits to foreigners and negative net benefits to New Zealanders). Whereas the Commission would say that it is in the top right corner (positive net benefits to foreigners and positive net benefits to New Zealanders), because the freeing up of resources enhances New Zealand's "domestic economic performance", regardless of ownership.

Indeed, we think it is important to reiterate the following words from the paragraph 382 quote above: *"This approach recognises that making existing resources more productive can improve domestic economic performance."* The focus here is on what is happening to resources in the New Zealand economy, and this is what is being measured by the Commission's public benefit quantification.

A complementary way to arrive at the same conclusion is the characterisation we articulated in response to Professor Guthrie's 21 April 2015 report, and further described at the 10 June 2015 conference, which the Commission has labelled the "resource-based approach" on page 64 of the Second Draft Determination. At paragraphs 374-375, the Commission rejects this approach for two reasons, which we now comment on.

At paragraph 374, the Commission argues that the "resource-based" approach would ignore the "net gain to New Zealand in the form of the funds received by the New Zealand shareholders from the foreign buyer" in the Commission's hypothetical example. However, this is not correct, as we now explain.

Under the "resource-based" approach, the public benefit occurs because a resource is used for an activity that adds greater value to the New Zealand economy. The proposed CWH/NZWSI merger would enable this in respect of resources currently allocated to wool scouring. If a specific asset adds more value to an overseas economy than it does to New Zealand's, then New Zealand benefits if that asset is sold overseas and the resulting freed-up capital can then be re-invested in the New Zealand economy. The financial transfer is not the benefit – rather, the benefit is that a redundant asset has been converted into capital available for investment, adding greater value to the New Zealand economy than the redundant asset did.[2]

[2] We have had time to reflect on this issue more carefully since the hypothetical question was put to James Mellsop during a 2 July 2015 discussion between James Mellsop, Reuben Irvine, Harshal Chitale, Torrin Crowther and Penny Pasley – we acknowledge that our view has changed with further time for analysis.

This approach is actually very orthodox, being based on the premise that New Zealand is best off by ensuring its resources are allocated to the highest value uses.

The cost benefit analysis literature focuses on the use and value of real resources. For example, a well-known author in the cost benefit analysis literature, E J Mishan, notes the following:[3]

> *Idle land provides another familiar example. If the owner has no personal use for it – neither hunting on it, strolling on it, or getting any pleasure at all from merely gazing at it in its unused state – its opportunity cost to him is nil. If a project can now make use of this piece of land in the production of a good x, and (by discriminating exploitation of its demand curve*[4] *for x) could offer at most, $10,000 for its use, the whole of this $10,000 would be the measure of additional social benefit from bringing the land into economic use. Whether, after some bargaining by the landlord, the price he paid is much less, say $2,000, and whether the price is set so that consumers have a surplus of, say, $5,000, the remaining $3,000 going initially to the owners of the business as excess profits, makes no difference to the measure of this additional benefit of $10,000. It affects only the distribution of the $10,000 benefit.*

The New Zealand Treasury's CBA guidelines make a similar same point, stating that "economic CBA reflects real resource use" and that "[a]s a general principle, only real costs and benefits, that is to say changes in real resources should be taken into account: payments to suppliers, while technically financial transfers, are proxies for the consumption of real resources".[5]

Furthermore, the "resource-based" approach appears to be exactly what the High Court in *Godfrey Hirst v Commerce Commission* had in mind at paragraph 281:

> *…The public benefit is that fewer land and building resources are needed for the scouring operations in the factual compared with the counterfactual, thereby releasing land for other productive uses. It is not necessary to inquire into the relative level of productivity of the alternative use.* ***The benefit lies in the release of surplus resources for other economic uses****; and the best evidence of the value of those alternative uses is the price that is likely to be paid for the surplus resources. [Emphasis added.]*

At paragraph 375, the Commission argues that the "resource-based" approach would ignore the (e.g., ongoing repair and maintenance) costs of using a specific asset. However, this is not correct, as these

3 E.J. Mishan (1978), Elements of Cost-Benefit Analysis, George Allen & Unwin Ltd, London, pp.53-54.

4 Mishan's footnote states: "The perfectly discriminating monopolist is, of course, a fictional character who, by discriminating among each of his consumers, and charging each the maximum for successive units, manages to appropriate for himself the whole of the consumers' surplus. The revenue of the discriminating monopolist can be taken as equal to the consumers' surplus of the quantity he sells, if it were all priced at zero."

5 New Zealand Treasury (2015), "Guide to Social Cost Benefit Analysis", July, paragraphs 21 and 24.

costs would be picked up separately to the capital costs – indeed, in the present case, these costs are picked up under “non-capital cost savings”.

To re-emphasise, we agree with the Commission’s conclusion to count all cost savings as public benefits, regardless of ownership of the merged entity. Our point is that there is a complementary way to get to this same answer.

3. Productive and dynamic efficiency

The 15 October 2015 Chapman Tripp memo argues that because the Commission has defined separate customer markets and accordingly calculated separate allocative efficiency detriments, it should therefore do the same when calculating productive and dynamic efficiency detriments (pages 20-24).

Perhaps this argument would have some merit if the merged entity was truly a multi-product firm. However, the merged entity will not be – it will be using the same platform to scour wool for all customers, regardless of those customers’ options. So logically the prospects of much distinction in productive and dynamic efficiency effects across customers markets are small.

More specifically regarding productive efficiency, the Chapman Tripp argument (at paragraphs 128 to 131) is odd, because it is actually about quality, not productive efficiency. Quality deterioration is already picked up by the allocative efficiency detriment calculations, as a quality reduction has a similar effect on welfare as a price increase.[6]

Regarding dynamic efficiency, the Chapman Tripp submission spends two or three pages outlining potential new wool products. The submission then simply asserts that new wool products will “require equally innovative scouring services” (paragraph 146), without any evidence, or indeed any evidence that exporters of wool might not also be interested in such innovations.

In fact, we are advised by Nigel Hales that:

- Because there is a single platform, investments and productivity improvements tend to benefit all customers, regardless of options; and

6 A loss of allocative efficiency includes non-price effects of the transaction such as service quality or number of choices. A reduction in service quality can result in the same switching by consumers to otherwise inferior products or services as does a price increase, which is exactly the deadweight loss captured by allocative efficiency. See Commerce Commission, *Authorisation Guidelines*, July 2013.

- The new wool products outlined by Chapman Tripp would either require no change to the scouring process, or at most the addition of some sort of additive with a *de minimis* (and variable, as opposed to fixed) cost.