



# COMPETITION & REGULATION TIMES

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# THE LARGE COMPANY DILEMMA

**T**he policy issue of how to accommodate internationally competitive scale of operations for corporate players with global aspirations within the New Zealand market place will become an increasingly pressing one for New Zealand governments and domestic consumers.

In today's world New Zealand must develop a policy framework that acknowledges that in some industries international competitiveness will imply large size and scale in order to achieve both marketing clout and low unit costs. In turn, this may imply the need for domestic mergers leading to large apparently dominant local firms. The policy trick is how to achieve this with an appropriate balance between large scale/low cost operations on the one hand and sufficient competition within the domestic market on the other hand. Domestic producers and consumers need to be assured that they have alternatives other than selling to and buying from a dominant monopolistic domestic producer.

While it is tempting to turn to regulation to resolve this type of dilemma, New Zealand's extensive regulatory experience gives little confidence that economically efficient solutions will emerge from bureaucratic and political oversight of commercial operations with which neither government officials nor politicians have any particular familiarity or commercial skill.

If mergers are in some cases to proceed based principally on the need for international competitiveness, particularly in cases where much of a company's output is likely to be marketed offshore, then the best protection for consumers and other domestic producers will come from the resultant large company having no domestic protection whatsoever. Domestic consumers will retain freedom of choice when other parties are free to enter the market, based either abroad or within New Zealand. In an analogous way, domestic producers should not in any way be bound to utilise a single large domestic corporate buyer. In other words, any mergers that provide domestic dominance should be accompanied by total deregulation of the accompanying market place.

This is not to suggest that the normal legal framework provided by the Commerce Act and the operation of the Commerce Commission should be bypassed. Rather it indicates that if there are special considerations required by the need for international comparative advantage, and where the international market's scale is much more important than the domestic market component, then the

## GUEST EDITORIAL



RODERICK DEANE

government should consider issuing a policy statement under the Commerce Act to provide guidance to the Commerce Commission and to ensure there is an appropriate economic framework that underpins cases of this kind. They certainly should not be treated on an ad hoc regulatory basis, which only guarantees increasingly distortionary interventions by the official sector in economic activities that need full exposure to the rigours of the domestic and international market places. Any policy statement needs to achieve tolerable even-handedness across various industries and resist overtures from particular industry lobbyists.

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Where a company such as Global Dairy Company produces the bulk of its output for overseas markets rather than the domestic market, then domestic regulations should not inhibit its ability to compete internationally, but there may be a need for appropriate safeguards for domestic producers and consumers. The first port of call with respect to the interests of the latter parties should be as much immediate deregulation of the industry as possible, including total deregulation at the producer end. Indeed, given the scale of the new company, it is hard to see why it should not face total and immediate deregulation in the domestic market place.

It is not so many years ago that it was widely thought that some industries, such as electricity, telecommunications and postal services, could not be deregulated because of their supposed monopoly characteristics. New Zealand and other countries have proven this to be abundantly flawed logic. The same point applies to Global Dairy Company. It is a great idea, particularly as it faces all comers in domestic processing and marketing. If Global Dairy Company is as good as it tells us it is going to be, it should have no fear of total openness of this type.

Markets may not be perfect, but they do a hugely better job than bureaucrats, as we have proven over and over again. How often do we have to repeat the lesson?

Roderick Deane is Chairman of Telecom New Zealand Limited, Fletcher Building Limited, Te Papa Tongarewa (Museum of New Zealand), ANZ Banking Group (New Zealand) Limited, and holds a number of directorships. He is a Professor of Economics at Victoria University of Wellington.



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- The Discipline of Open Entry and Exit
- What Does Open Entry to and Exit from Global Dairy Mean?
- Capital Structure and Co-operative Ownership
- A Market is Born
- Regulating Global Dairy
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# A MARKET IS BORN!

**O**n the New York Mercantile Exchange milk is traded in massive volumes. George Crosby<sup>1</sup> explains why Global Dairy Company has a strong incentive to create a wholesale market for milk in New Zealand.

A wholesale milk market consists of contracts for the sale and purchase of raw milk. It may include standard contracts that are instantaneous, as in a spot market for the sale of milk today, or long term, as in a futures market, for delivery of milk at some future date. It also includes non-standard contracts (that is, particular arrangements) between buyers and sellers, such as the contracts that Global Dairy has with its suppliers.

The price of milk will differ depending on the contract. Generally the longer term contract price for milk will be higher than the spot price because the contract provides certainty over the quantity that will be delivered to the purchaser, though it may be lower if there is low supply in the spot market period, as would result from unusually unfavourable climatic conditions. Any systematic influences, such as different seasonal cost factors, will be reflected in differences between future and spot prices.

To date, the development of a wholesale market has been inhibited by vertical integration of the dairy industry and single-desk exporting. The newly formed Global Dairy will have an incentive to offer wholesale market services - such as the prices at which it will buy and sell milk - to demonstrate that it is not exploiting its dominant market position in violation of the Commerce Act. In addition, a wholesale market would provide Global Dairy with more information about factors that influence the milk price and thus assist in setting its unbundled milk price to suppliers. A wholesale market would discipline Global Dairy because if it publishes buy and sell wholesale prices that are not reflective of supply, capacity and demand there will be opportunities for arbitrage that could be very costly for the company.

Potential participants in a wholesale milk market might include small specific-purpose processors and fresh milk product producers

who, perhaps in conjunction with supermarkets, could use the wholesale market to sell their own product labels. Established processors who have their own suppliers, such as Tatua and Westland, could use the spot market to balance surpluses and shortfalls (unders and overs) in supply that may arise from climatic or seasonal conditions. A futures market in milk would also attract traders - 'scalpers' - who take positions in the market based on their views of supply and demand in the market. Although they never actually settle with the physical supply of milk their activities enable a range of views and expectations about the state of the milk market to coalesce in a market price.

A wholesale market in milk is now a real possibility for New Zealand, and milk never looks better than when it's traded New York style!

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<sup>1</sup> George Crosby is a student of Law and Economics and a research assistant at ISCR.



# CAN A LARGE, SINGLE, PRODUCER CO-OPERATIVE BE EFFICIENT?

**A** cceptance of the Global Dairy proposal reaffirms dairy farmers' commitment to the co-operative form of business organisation. Professor Lewis Evans<sup>1</sup> assesses whether a large single co-operative can be efficient in the public interest.

In the proposed co-operative structure suppliers will invest capital in and have ownership of the processing operations of the co-operative in proportion to the input that they expect to supply.

Processor co-operatives were principally established by farmers to avoid being at the mercy of a monopoly purchaser they could not control. If suppliers do not control the monopoly processor they will be paid just the minimum to ensure supply and they miss out on the surplus profit - rent - resulting from the monopoly's restriction of output. Co-operative processors solve this problem because the suppliers are the co-operative's shareholders. Thus, if there are any surplus profits they are returned to suppliers in proportion to the input that they have contributed.

A monopoly co-operative processor may produce inefficient levels of output by restricting supplier entry to the co-operative in situations where there is no threat of competition from other processing companies. Suppliers in the co-operative enjoy monopoly profits at the expense of those that are excluded. Open entry to the co-operative, however, will generally result in a level of production that is approximately economically efficient. This is because under open entry, suppliers will enter the co-operative until the costs of the last supplier - in the case of dairying, the cost of the sheds, fences, irrigation and cows, and the cost of the capital required by the co-op - will equal the benefit to the farmer from entry. In short, the cost of the last kg of milk to enter the co-operative will equal the price derived from the output it produces. This equality of cost and price is the efficient level of milk throughput.

As long as there are no diseconomies of scale in processing this argument applies no matter what the co-operative's market share is. If processors emerge that have lower cost structures, or dairy product prices fall so that other farm

## **OPEN ENTRY:**

A supplier's entry decision is purely based on the price to be received and its cost of supply.

## **OPEN EXIT:**

Exit is a cost-benefit decision by the supplier that is not impeded by non-commercial barriers constructed by the co-operative.

activities are more profitable, it will be efficient for suppliers to exit the co-operative and take up alternative activities that produce more profit, or value added. Thus both open entry and exit are required for the co-operative to perform efficiently. If supplier entry or exit is inhibited the co-operative may produce an inefficient level of output, and/or produce at a cost that is higher than the efficient level.

The performance of a dairy co-operative is complicated by the practice of bundling. Co-operative suppliers do not receive a return on their capital invested in the processor separately from the payment for milk.<sup>2</sup> Both are bundled in one payment to farmers. However bundling need not preclude economic efficiency, because the amount of share capital required is tied to the volume of milk supplied and farmers will consider both their supply cost of raw milk and the capital requirements as their (marginal) cost of entry. If there are constant returns to scale the outcome will approximate the efficient level of output. There is no requirement for products

to be sold in competitive commodity markets for this result to hold. It remains valid providing that the co-operative is earning a competitive return in processing, marketing and investment in product differentiation, and there is open entry and exit.<sup>3</sup>

In the past, dairy co-operatives in New Zealand had the power to decline applications for membership and to inhibit exit by retaining the value of the exiting farmer's processing capital in the co-operative for up to five years. If dairy farmers had a choice of co-operatives then the return to farmers and any restrictions on entry and exit would be competitively determined and there would be no economic efficiency issues raised by any co-operative's institutional or pricing policies.

The situation with respect to the newly formed Global Dairy is different because in its initial market position it will approximate a monopoly purchaser. Global Dairy could use this dominant position to restrict the entry and exit of suppliers and may produce a level of output that is not in the public interest. This level of market dominance suggests that regulation should be designed to ensure that entry and exit are not impeded.

Under the co-operative form of organisation, Global Dairy suppliers will hold shares in proportion to the milk they supply. In this way the co-operative form of organisation has the advantage of aligning the interests of suppliers and owners. In addition, the homogeneous quality of milk measured by milk solids means that all suppliers can be treated in the same way.<sup>4</sup> This lowers transaction costs for the co-operative and lessens the potential sources of disputes between the co-operative and suppliers. There are also disadvantages. Holding shares in proportion to the input supplied has implications for the effective supervision and monitoring of management in the co-operative organisation when compared to companies with tradeable shares.

Company performance is greatly enhanced by active monitoring of management by share-



holders and debt-holders. But monitoring requires both resources and incentives. For companies with traded shares these requirements are normally satisfied by having shareholders with relatively large concentrated shareholdings who can allocate resources to monitoring and who have an ability to affect strategy through positions on the Board. Small shareholders normally have access to fewer resources and weaker incentives to monitor and affect management. This is because each has an incentive to 'free ride' on the monitoring of other shareholders.<sup>5</sup>

As share ownership is restricted by the amount of milk supplied in large dairy co-operatives, there is not the same concentrated shareholding interest and thus the same intensity of managerial and strategic oversight as found in companies where shares are traded.<sup>6</sup> We could therefore expect to observe poorer performance from large co-operatives compared to companies whose shares are traded.<sup>7</sup>

Companies raise capital through debt or equity. When a company's organisational structure provides less intense internal monitoring, it affects the firm's ability to raise debt. Any potential lender will want to be assured that there are strong incentives for shareholders to monitor the performance of the company. Also, because share allocations are tied to milk supplied, equity capital can only be raised from the suppliers, either through retained earnings or share issues. This limits the source of capital for co-operatives relative to companies with tradeable shares. This is an important issue where profitable opportunities for expansion exist.

Global Dairy intends to issue notes that can be traded in financial markets. The performance of these notes will reflect the financial market's assessment of both Global Dairy's past performance and its future prospects and thereby provide a signal about a wider set of views than those of Global Dairy's management and board, or even of suppliers more generally. Valuation of the notes will provide some incentive for analysts to study and monitor the co-operative.

It is also proposed that Global Dairy will have a 'Shareholders' Council' elected by the suppliers under a different process from that used to elect the board of directors. The council will have a limited oversight role. The creation of a Shareholders' Council seems to suggest that

Global Dairy's designers are aware that the governance of large co-operatives has limited scope for intensive effective managerial monitoring. However the Shareholders' Council cannot substitute for a 'concentrated interest' of shareholders, and indeed provides no additional incentive for Global Dairy to perform well as an organisation.<sup>8</sup>

A proposal allowing share-milker share ownership also raises some issues relating to the structure of shareholding. If milk from a farm is supplied partly by the farmer and partly by the share-milker the number of shareholders will increase and thus the incentive to monitor Global Dairy's performance will be even weaker. As about 45% of milk is currently being produced by share-milkers there could be a very significant increase in the number of shareholders.

However, if ownership of milk itself becomes the entire basis of Global Dairy's shareholding, it would provide a means by which concentrated shareholding can occur. If farmers and share-milkers could transfer their milk to a broker who then supplied it to Global Dairy, the broker - who could even be a farmer or share-milker - could acquire sufficient ownership rights in milk to create a large shareholding which would strengthen shareholder monitoring, to the benefit of the company.

1 Lewis Evans is Executive Director of ISCR.

2 This is because there is no competitive market price for raw milk, which means that the farmers' return, based on the milk they supply, is also partly a return on capital from processing.

3 A second form of bundling occurs when excess returns are persistently obtained from milk products

*sold in high value markets - eg quota rents - and these are bundled in the payout to farmers. This will encourage inefficient over-production as farmers respond to the excessive bundled payout. Under open entry the co-operative will want to ensure that the excess returns are separated out and any right to them purchased by entering suppliers at a valuation of their expected future return. Not to do this would make existing suppliers worse off by the entry of new suppliers. As long as persistent excess returns are valued and purchased upon entry, efficient production levels can be approximated under a co-operative structure.*

4 If Global Dairy were required to accept any supplier at the posted wholesale price of milk, it would potentially face increased costs if farmers in very remote locations took advantage of the cross subsidy on transportation inherent in the uniform price. Potential entrants in remote areas will have the option of paying to transport milk to the nearest point where milk is already being collected. Thus transport costs should not be an impediment to a successful open entry and exit regime.

5 This is not to say that farmers do not have an incentive to monitor the co-operative. The shareholding in a co-operative is likely to be a major investment for any individual farmer.

6 Even the potential that one party might acquire a concentrated shareholding may be sufficient to promote efficiency in companies with traded shares.

7 This is not necessarily the case for smaller co-operatives, because the smaller the co-operative the larger the influence of any given shareholder. Small co-operatives also face lower transaction costs that may outweigh the costs that result from the need to maintain greater oversight of management and thus make them relatively more efficient. But as co-operatives get larger, their relative performance can be expected to deteriorate, placing the weight of advantage on companies with tradeable shares.

8 Although the Shareholders' Council oversees the valuation of the milk price, it is the open entry and exit regime that provides the incentive for Global Dairy to set the milk price at the optimal level. See 'Regulating Global Dairy', this issue.



# REGULATING GLOBAL DAIRY

**I** SCR's Executive Director Lewis Evans explains the principles that should guide the design of a regulatory framework for New Zealand's dairy industry.

The formation of Global Dairy has only been possible through the deregulation of one of New Zealand's oldest and most heavily regulated industries.

The merger proposal included provision for a regulatory framework that allows anyone to export dairy produce, provides incentives for Global Dairy to price efficiently and limits the potential for Global Dairy to use its market power in the domestic market.

Global Dairy's market power lies in its virtual monopsony position as the purchaser of raw milk. There is no benefit to be gained from imposing regulations on other companies. The last vestiges of heavy-handed regulation of the dairy industry have thus been swept away by the merger.

The regulatory framework for Global Dairy should:

- be process rather than outcome oriented
- ensure there are no barriers to entry and exit
- encourage third party monitoring for cost-effective oversight
- resolve disputes and sanction breaches of the regulations
- ensure that the regulator is not subject to 'capture' by any party

A good regulatory regime monitors process rather than specifies defined outcomes because defined outcomes require anticipating any events that might arise. Regulating for outcomes, eg by defining the calculation of the price of milk, requires very heavy regulation, which would adversely affect the performance of Global Dairy to the detriment of the whole industry.<sup>1</sup>

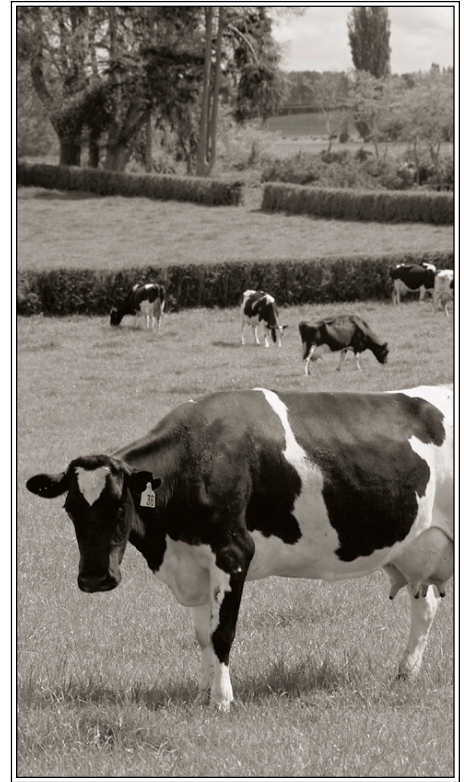
The regulatory environment should ensure open entry and exit by farmers as shareholders and potential shareholders of Global Dairy to promote efficiency in the market for raw milk. In co-operatives, farmers receive a 'bundled' payout representing their return on the milk supplied and a return on capital.<sup>2</sup> Open entry and exit of farmers, provides strong incentives to set the correct valuation of processing capital and the associated efficient price for raw milk. If capital was over-valued relative to the

price of milk there will be exit by suppliers when their supply would be profitable to Global Dairy. If it sets the capital value too low there will be a demand for entry beyond that which would be profitable. Because open entry and exit provide Global Dairy with the incentive to price both the capital return and price of raw milk at the efficient level and because a regulator has neither the incentive nor the information that Global Dairy has, the regulator should ensure open entry and exit rather than attempt to regulate the price of milk. Furthermore this approach places the strategic decision of the milk price on those who have responsibility for working in the interests of Global Dairy. If the milk price were to be regulated, this responsibility would be shared between the regulator and Global Dairy and reduce management's accountability for performance.

A cost effective regulatory framework is more likely to be achieved when there are strong incentives for interested parties to monitor and report alleged breaches to a regulatory body. In this way the regulator is much less likely to be 'captured' by the monitored party. Further, the regulator is required only to resolve disputes and impose sanctions.

Under the proposed dairy industry structure, potential and existing Global Dairy shareholders will be transacting commercially with Global Dairy so they will have every incentive to report disputes to the regulatory body for resolution. Similarly, parties to actual and potential contracts with Global Dairy in the wholesale spot and contract market in milk will have an incentive to report disputes. Thus enforcement can be reactive to complaints, rather than proactive in initiating investigations.

However, Global Dairy will have access to financial resources and information exceeding that of almost all potential claimants. This raises the potential for complaints to be resolved in Global Dairy's favour due simply to the disparity of resourcing. This needs to be considered in determining the mechanism by which disputes are resolved. For example, it is unlikely that dis-



putes can be resolved satisfactorily when regulatory enforcement is in the hands of the courts, because this mechanism relies on claimants' own recognisance and resources to take up alleged breaches.

Other enforcement mechanisms, apart from the courts, might be considered. These include a Milk Commissioner appointed by the Global Dairy Shareholders' Council, and an independent Milk Market Enforcement Panel, perhaps as part of the Commerce Commission<sup>3</sup>, and the Commerce Commission itself.

A Milk Commissioner appointed by the Shareholders' Council is not a satisfactory option because the position will be a creature of existing suppliers, not potential suppliers or processors, and therefore it cannot be credibly capture free. However, a Milk Commissioner may help settle contractual disputes involving Global Dairy *before* disputes reach the enforcement body.

Other options include a specialist Milk Market Enforcement Panel or the Commerce Commission as final arbiters of contract disputes.

There are a number of issues that would need to be addressed if the Commission were appointed as the regulator.<sup>4</sup> Importantly, the Commission would be the obvious body to assess when the market share threshold for removal of specific regulation of Global Dairy has been reached. But if the Commission is also the regulator it arguably has an incentive to retain regu-

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# VERTICAL RESTRAINTS, FREE RIDERS & CANNIBALISATION

Victor P. Goldberg

## GUEST ARTICLE

There was a time when vertical restraints in distribution systems were viewed with hostility and suspicion. Any interference with free markets, it was thought, must have some anti-competitive motive or effect. *GTE Sylvania*<sup>1</sup> changed all that by introducing the free-rider concept. If a retailer provides services such as advice and demonstrations to consumers, a consumer could make use of that service and then buy the product from a no-frills retailer. If the manufacturer cannot control the free-riding proclivities of other retailers, no retailer would find it in his interest to provide the services. By imposing vertical restrictions on its retailers, the manufacturer can make the provision of those services profitable, thereby increasing his sales.

The argument has, perhaps, been too successful. Defense lawyers have treated the free rider rationale as a safe harbour and have tried to force the facts into a free-rider story. Plaintiff lawyers have tried to limit the feasible explanations to the consumer services rationale and then argued that the services in a particular market were insufficient to justify the restraints. As a result, there has been little effort to search for a broader range of benign explanations for vertical restraints. I do not mean to overstate my case. Courts and commentators have recognised that retailers do provide services to manufacturers and that other retailers might attempt to free-ride on these services. This is particularly true of local efforts to cultivate customers. But they are more clearly in their comfort zone if they could find services provided directly to consumers.

I want to reverse the emphasis. Yes, retailers provide services, but the services provided to consumers are of secondary importance. The significant services are those provided to manu-

facturers. The services range from the hands-on product demonstrations featured in the standard free-rider story to carrying a full line of products, holding inventory, or simply putting goods on shelves where potential purchasers will be exposed to them. For many products over half the final price will be distribution costs. Manufacturers have a strong incentive to economise on these just as they do with physical production costs. The manufacturer does not pay directly for these services. It does not say to a retailer I will pay you \$2,000 for so many units

“ YES, RETAILERS  
PROVIDE SERVICES,  
BUT THE SERVICES  
PROVIDED TO CONSUMERS  
ARE OF SECONDARY  
IMPORTANCE. THE  
SIGNIFICANT SERVICES  
ARE THOSE PROVIDED TO  
MANUFACTURERS. ”

of retailing effort this month. Rather, it pays indirectly; the payment is contingent on the actual sale of the goods and the fee is the difference between the wholesale and retail price, the gross margin.

The price paid per unit sold is not the same as the fee per unit of retailing service purchased (which is unobservable). This difference matters a lot. Suppose that the retailer is selling a particular brand of men's underwear at a 50% markup and the turnover in that outlet is such that the retailer is receiving \$5 per foot of shelf space for this product while for others it is receiving only \$2. The manufacturer is being overcharged for the input. It could deal with this



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Professor Goldberg visited New Zealand early in 2001 to present two-day programmes on economics and competition policy for antitrust lawyers and judges in Auckland and Wellington, arranged by the Institute for the Study of Competition and Regulation.

Topics presented by Professor Goldberg were *Basic Economics of Monopoly Vs Competition, Predation and Dumping, Essential Facilities* and *Vertical Restraints and Retailing*.

Co-Presenters Professors Lewis Evans (Executive Director, ISCR) and Neil Quigley (Pro Vice-Chancellor (Commerce and International), Victoria University) and Dr Michael Pickford (Chief Economist, Commerce Commission) covered *Economics of Scale, Scope and Networks, Oligopoly, Mergers, Concentration and Unilateral Effects* and *Public Benefits and the Williamson Trade-Off Model*.

Sponsors of the *Economics for Competition Lawyers and Judges* programmes were Bell Gully, Buddle Findlay, Chapman Tripp and Rudd Watts & Stone.



directly by raising the wholesale price or capping the retail price, but since the price of shelf space will vary across outlets this would be very difficult. Alternatively, it could attempt to extract side payments in-kind. It could establish sales quotas that exceed the retailer's profit-maximising quantity. Faced with an all-or-nothing choice, the retailer might be induced to provide more selling effort, in effect lowering its implicit price. Various forms of bundling that have aroused antitrust concerns (for example, tie-ins or full-line forcing) are manifestations of this indirect haggling over price.

The free-rider story is based on a simple externality. The selling efforts of retailer X decrease the selling costs of retailer Y. If X is not adequately compensated, he will cease to provide the service. Since the manufacturer contracts with all the retailers, it can internalise that externality. It could subsidise X (for example, with co-operative advertising) or control Y (for example, arrange for Y to compensate X, restrict its behaviour, or require that Y provide the same package of services as a condition of carrying its goods).

There is, however, a second externality, the antithesis of the first. X's activity might raise Y's selling costs. The more homes X visits in a particular neighborhood, the lower the probability that any customer will buy from Y. X has no incentive to take into account this adverse effect on Y. The costs per sale of both X and Y can increase as a result of this cannibalisation. If the manufacturer could limit the competition between its retailers, it could reduce the net costs of the retail services it is purchasing. The manufacturer has to balance the gains from increased exposure of its goods against the costs of cannibalisation when determining the structure of its retail network.

If the retailers were employees of the manufacturer, we wouldn't think twice about the manufacturer dividing its sales force on regional or product lines. One employee could be responsible for all sales to Auckland. If another employee sold in his territory, the manufacturer might require that the invader compensate the first; or the invader might be disciplined or even fired. No antitrust issue would be raised. Analytically, this is no different from the case in which a retailer sells in another territory. The purpose is the same and the legal result should be the same.

Shielding the retailer from competition in any dimension always imposes some costs on the manufacturer, so it has strong incentives to make the vertical restraints no more onerous than necessary. The manufacturer must choose the dimensions in which it will restrict dealer competition (price, territory, classes of customers) and the extent. Thus, rather than promise an exclusive territory, the manufacturer might promise only that the number of retailers carrying a particular brand will be limited. Sitting retailers might be upset when the manufacturer

adds another retailer in its neighbourhood. Indeed, it was GTE Sylvania's addition of a retailer into Continental's territory that precipitated that litigation. The manufacturer is in a better position than courts or legislatures to determine the extent of intrabrand competition. The better we understand the underlying economics, the more inclined we should be to giving them free rein to structure their distribution network.

*1 Continental TV Inc v GTE Sylvania Inc, 433 US 36, 55 (1977).*

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lations in its own interest. This suggests that the Commission should not be the regulator if it is to adjudicate on the 'bright line' test.<sup>5</sup>

An independent Milk Market Enforcement Panel, modelled after the electricity market equivalent, could provide expertise and the judgement required in a developing market for raw milk. It would also be cost effective as it would only meet to determine disputes and, being part-time without a monitoring role, would not be unduly subject to capture.

While there is still much to be worked through, the regulatory framework should be based on principles that encourage efficiency on the part of both the regulated and the regulator.

*1 Of course monitoring for process rather than for breaches of specific outcomes requires judgement in enforcement, which means that the regulatory body should have the required expertise to undertake this role.*

*2 This analysis ignores quota rents (see ISCR's monograph Watershed for New Zealand Dairy Industry). Note that the return on capital, the return on milk and other returns from, for example, quota rents all must add up to Global Dairy's total return.*

*3 The Telecommunications Commissioner is in a similar position. It is not strictly part of the Commerce Commission because it will have an independent stance on telecommunications matters.*

*4 For a full discussion of these issues see ISCR's monograph Watershed for New Zealand Dairy Industry.*

*5 Although the test is 'bright line' there may well be judgement to be made at the margin - judgement on which substantial financial decisions may hinge.*

## Business ethics – an oxymoron?

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# SHOULD RATES BE LEVIED ON THE VALUE OF UTILITY COMPANY DISTRIBUTION NETWORKS?

**M**any Local Authorities in New Zealand are currently planning to introduce new rates on the value of the distribution networks that utility companies operate within their jurisdiction. In this article Neil Quigley draws on research undertaken with Lewis Evans<sup>1</sup> to argue that rates based on the value of utility company distribution networks reduce economic efficiency and are inconsistent with a range of government policy objectives.

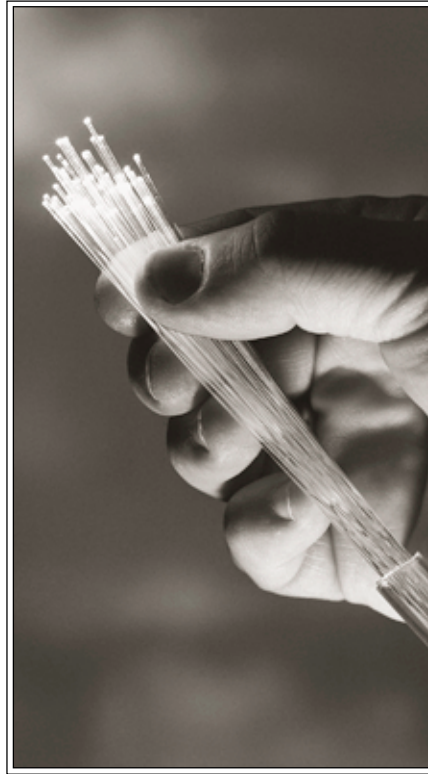
Utility companies, including those running data, telecommunications, gas and electricity distribution networks, generally have statutory rights to place cables and wires below the ground or on poles above the ground in the public road bed. The Rating Powers Act 1988 deems all land to be rateable property.<sup>2</sup> The occupier of any rateable property is primarily liable for the rates upon it (s 121) and the occupier is defined (s 2) as the owner except where there is a tenancy for 12 months or more.

In *Telecom Auckland Ltd v Auckland City Council* the Court of Appeal found that telephone lines above or below the ground constituted an interest in land under these sections of the Rating Powers Act. In doing so the Court followed earlier findings that had made electricity and gas distribution networks subject to rates, and affirmed the applicability of those judgements to telecommunications lines.

At present only the Auckland City Council actually levies rates on this basis,<sup>3</sup> but as a result of the Court decision the Valuer General is now requiring that the value of distribution networks be included on all valuation rolls. This has stimulated widespread interest among local bodies in extending their rating base to the distribution networks of utility companies.

Utilities are required to pay the cost of any work on their network, including the costs of permits to undertake work on the road bed and the cost of repairing the road surface to its original condition. Given this, there is no obvious economic rationale for local bodies to charge utilities simply for access to the unobstructed right of way that is provided by the road bed: the marginal (extra) cost of providing this service is zero, and user charges should be determined by marginal cost and marginal benefit.

Even where utilities receive marginal benefits or increase the marginal costs of local bodies, it may not be economically efficient to levy rates on the value of those networks. Eco-



“ THE CENTRAL QUESTION IS WHETHER, WHEN VIEWED IN THE CONTEXT OF THE FULL RANGE OF TAXATION OPTIONS OPEN TO GOVERNMENT AND THE LOCAL BODIES, RATING THE DISTRIBUTION NETWORK OF UTILITY COMPANIES IS PART OF AN OPTIMALLY-DESIGNED GENERAL TAX SYSTEM. ”

nommic efficiency will depend on transaction costs, the incidence of the tax, and the relative efficiency of the other tax options available. The central question is whether, when viewed in the context of the full range of taxation options open to government and the local bodies, rating the distribution network of utility companies is part of an optimally-designed general tax system.

Taxes change the incentives of individuals in society. In responding to those incentives individuals will behave in ways that minimise the impact of the tax on them, and typically in ways that are inconsistent with the purpose and intentions of the tax. The social costs of these adjustments in behaviour and the additional compliance costs are called the deadweight loss of the tax.<sup>4</sup> The best tax policy is that which minimises the deadweight loss of raising a given amount of taxation revenue and the adverse incentives for future actions that will yield future deadweight losses.

When local bodies levy rates on the value of the distribution network of utility companies, it is equivalent to a tax on a specific sort of capital. As a capital tax it differs from corporate tax in that it may not be related to current income from the asset as will typically be the case with cost-based valuation methods. Thus, for example, a fibre-optic cable will have the same (cost-based) value whether it is laid in downtown Auckland or in the main street of a small town, but the current period profits generated by the two cables may be quite different. Similarly, the tax will be higher on cables buried underground than it is on cables on poles because the cost of laying underground cables (and therefore their value) is much higher even though the revenue generated is the same.

The social cost of any tax will depend upon the nature of the goods or activities being taxed, and upon the form of the taxation - that is, the extent to which the marginal rate changes and

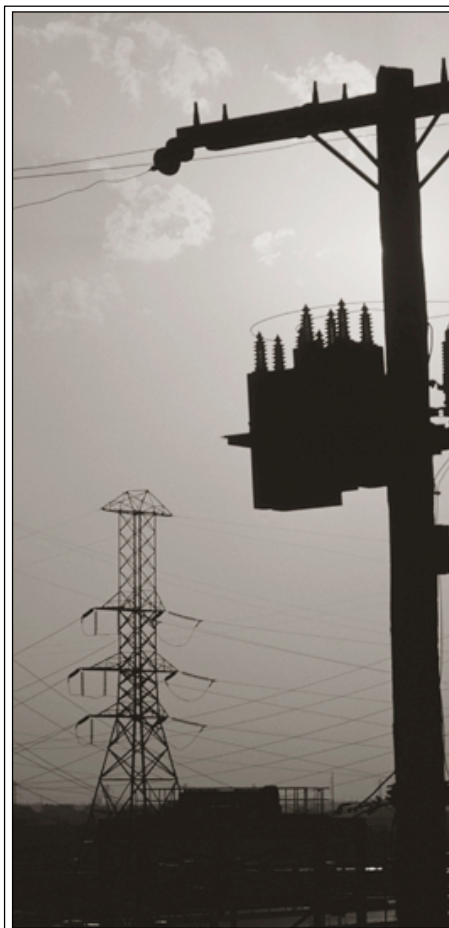
the extent to which it is a specific tax on investment. It is likely that a specific tax on equipment, plant and infrastructure would carry a higher social cost than that of standard taxation because the specific tax is essentially being levied on investment and hence economic growth - as opposed to income or consumption. Although a specific tax on investment may be particularly injurious for new investment, at the margin it may also lead to less investment in maintenance and service of existing plant and equipment and result in declining quantities and qualities of network services.

The levy of rates on the distribution networks of utility companies is a specific tax on a capital asset, which at one percent of value would, under assumptions, be equivalent to a significant ten percent tax on their profits. Since new investment is required to provide consumers with higher levels of service and new products, the impact of the tax will be particularly marked in these cases. Outside the main urban centres rating utility assets may have the effect of reducing demand below the level that provides the company the surplus (profits) required to justify their fixed cost of entry.

The core products of network utilities are necessities that have demand that is unresponsive to price. This means that utility companies will rationally pass a large part of the tax on to consumers, and the response of consumers will be to consume less of other goods rather than less of the basic products of the utility companies. As a result, a specific tax on network infrastructure will fall largely on consumers of basic utility services. Further, since the consumption of basic utility services forms a relatively high proportion of the budgets of low income households, these households are likely to bear a disproportionately large share of the burden of these rates.

The short-term efficiency losses from such taxes are large, and there is no evidence that there are offsetting benefits for these welfare losses. The transparency of taxation will be reduced by the difference between the legal incidence and the economic incidence of the tax: that is, those who actually pay are not those on whom the tax is levied. Tax collection costs are increased (because rates are levied on more entities) but no more revenue may be raised.

In contrast to basic products, the newer and more innovative products of utility companies



are much more price sensitive, at least at the time of introduction. Thus the profitability of introducing these products may be materially reduced by any tax that raises the price that must be charged to consumers. This and the fact that the tax is specific to a particular capital item may significantly impact on dynamic efficiency and economic growth.

Dynamic efficiency refers to the welfare of consumers in the short and long term resulting from the allocation of resources, production technologies of firms and investment in new knowledge. Recent research in economics has emphasised the importance of new goods and the potentially significant consumer gains that arise from such goods. But it is only recently that much empirical and theoretical work has been directed at quantifying the dynamic efficiency implications of taxation and other public policies affecting the uptake of new goods and services and the rate of new investment in the technologies required to provide them.

Goolsbee<sup>5</sup> recognises that the standard approach to estimating the social cost of taxation utilises information about products actually in markets but ignores markets where new products are available but do not enter. The consumer outcomes of this market-exclusion effect are legitimately a social cost of taxation regimes.

This cost is substantial because, although the same costs are not incurred without market development, both producers' benefits and all consumers' benefits are lost if entry does not occur. These losses can be substantial if entry is delayed. In his study of differing uptakes of broadband, the welfare loss of all markets combined - ie both markets with and without broadband - was approximately five times the taxation revenue raised.<sup>6</sup>

A specific tax on network utility investments will discourage rather than encourage investment in the infrastructure required for the knowledge economy. A tax of this type will also make it more expensive for utility companies to expand their networks into the provincial centres of New Zealand, and thus work against the government's economic development policies. Finally, this analysis suggests that the burden of any rates levied on utility networks will fall disproportionately on low income households, which again is inconsistent with the social policy of current and recent New Zealand governments.

Given these disadvantages, there is an arguable case for incorporating into upcoming amendments to the Rating Powers Act a prohibition of local bodies rating on the value of utility distribution networks. As a minimum, existing provisions (such as s 122 (f) of the Local Government Act) should be strengthened to encourage the courts to impose a more stringent and exhaustive efficiency test to any plans to impose rates on this basis.

1 See Neil Quigley and Lewis Evans, (2001), *Local Body Rating of Utility Distribution Networks*. <http://www.iscr.org.nz/research>

2 Where 'land' means 'all land, tenements, and hereditaments, whether corporeal or incorporeal, and all chattel or other interests therein, and all trees growing or standing thereon'.

3 Part IV of the Rating Powers Act 1988, and in particular s 80, authorises a local body to make and levy rates differentially. This means in practice that local bodies may choose which rateable assets they actually levy rates on, and within individual asset categories, can use differential rates (greater than or equal to zero).

4 Deadweight losses result from actions taken to avoid the tax and the resources expended on avoiding a tax.

5 (2000) *The Value of Broadband and the Deadweight Loss of Taxing New Technology*, mimeo, University of Chicago and NBER.

6 Notice that no revenue is raised in markets where entry does not occur.

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# GROWING OUR NEXT GENERATION OF BUSINESS LEADERS

**“New Zealand business needs informed leaders who are prepared to make the hard decisions and then deliver on them”, said Roderick Deane, Professor of Economics in Victoria University’s Graduate School of Business and Government Management at a recent ISCR function to celebrate the achievements of top MBA students.**

The challenge facing business schools today is how to take talented aspiring executives and educate them to become the confident, informed and experienced managers that Professor Deane identifies are so necessary for the future of New Zealand businesses.

Management education requires many different inputs: state-of-the-art research into current and changing business practices and their economic outcomes, the wisdom and experience of managers who have ‘trodden the path before’, and the support of businesses prepared to provide the environment for aspiring managers to test their learning. Not least in this menu of inputs is the optimal mix of incentives to ensure that the best suited candidates for this education offer themselves and exert the effort required to gain the necessary skills and experiences.

This combination of inputs is generally beyond the reach of business schools alone. So it is vitally important that business schools form partnerships and alliances that bring these inputs together for the desired outcome to be achieved.

Victoria University’s Graduate School of Business and Government Management was able to facilitate such a partnership in its MBA course: Advanced Corporate Management MMBA579.

Professor Lewis Evans and Bronwyn Howell (ISCR), and Professor Neil Quigley (Victoria

University) joined Professor Deane (MMBA579 course co-ordinator), and business leaders Theresa Gattung (Telecom New Zealand Ltd), Dame Cheryl Sotheran (Te Papa), Dr Murray Horn (ANZ Banking Group), Sir Ronald Trotter, Jane Freeman (e-Venture), Graham Mitchell (Xtra) and Ross George (Direct Capital) to present relevant research and real life experiences to the nineteen students on topics ranging from corporate governance, innovation and competition law, to the similarities and differences between public and private sector management, and the process of privatisation. And to address the need for the students themselves to gain practical experience, each student was required to complete a detailed research work about a corporate management issue in New Zealand business or industry. ISCR corporate members, Telecom New Zealand Ltd and Transpower New Zealand Ltd were among the organisations which assisted students in completing their projects.

The research produced by the students was of a high quality, but four stood out in respect of their timeliness, relevance, and the blending of theory and application. Seth Campbell provided a cogent analysis of the venture capital market in New Zealand and the implications of this for new technology based companies seeking to develop a worldwide presence. Sue Harrop investigated the corporate governance structures



JONAS TÖRNQVIST AND PROFESSOR DEANE

of two of New Zealand’s largest nonprofit health and disability sector providers, IHC and Plunket, and how these organisations continue to address governance issues in order to improve their performance. In a very topical piece, Julia Napier examined the ways in which libraries measure the performance of investment in information assets and how this might provide new insights into information investment practices in other sectors as information becomes an increasingly important corporate asset. The winning piece of research was Jonas Törnqvist’s analysis of the dynamic interaction of board and management of a prominent New Zealand company.<sup>1</sup> What distinguished Jonas’ work from the others was the comprehensive way in which he devised a series of practical recommendations for how this company could redesign its governance processes.

Telecom offered prizes for the best work and these were presented at the ISCR-hosted seminar in April, where the winning students were given the opportunity to present their findings.

ISCR has welcomed this opportunity to ‘walk the talk’, combining the resources of its members and the wider business community to raise the standard of both management education and research output in New Zealand.<sup>2</sup>

*1 Jonas Törnqvist works for the New Zealand Treasury. The co-operation of the company that was the subject of Jonas’ research was contingent upon ongoing confidentiality of both the information provided and the findings.*

*2 ISCR’s involvement has stimulated two students, including prize winner Jonas Törnqvist, to pursue more in-depth research on issues of competition and regulation as part of their MBA studies. These will be supervised by Professor Evans, Executive Director of ISCR.*



SETH CAMPBELL, SUE HARROP, JULIE NAPIER AND JONAS TÖRNQVIST



# SIX O'CLOCK SWILL FILLED BREWERS' TROUGH

**A** law designed to limit alcohol consumption and drunkenness achieved just the opposite and served the interests of hotel owners and trade unions, finds Tim Mulcare in an ISCR study.

Hotel public bars were closed at six o'clock by statute in New Zealand and most Australian states from 1917 to the 1960s. This regulation was ostensibly to lower the consumption of alcohol and the level of drunkenness. However, per capita alcohol consumption in New Zealand increased throughout most of the period of restricted trading hours.

Drunkenness was encouraged by the concentration of demand in the hour after work and before closing. So an alternative hypothesis for the maintenance of six o'clock closing was that it served the interests of hotel owners, trade unions and prohibition organisations.

Hotel owners favoured six o'clock closing because their costs fell but their revenue did not. Costs were lower with restricted hours pri-

marily because the demand for quality fell. There were two main reasons for this. The concentration of custom in a one-hour period (and the restriction on new hotel licenses) restricted the time available for customers to search for hotels. This meant that hoteliers did not have to invest in the amenities or product variety to attract and retain customers. Second, six o'clock closing inhibited demand from those who would seek better quality amenities, mostly working women and some men who finished their working day later than 6pm.

Organised labour gained from six o'clock closing because it shortened the working week of hotel labour. During this period trade unions secured higher real wages through arbitration by negotiating fewer working hours for the same

remuneration. Employers avoided the requirement to pay penalty 'overtime' rates for work in excess of the standard working week, by lowering trading hours to the threshold at which overtime applied.

However, hotel unions were unable to negotiate shorter working hours, because hotel trading hours were set by the Licensing Act, not the Arbitration Court. This implied that the relative wage of hotel labour fell to the point where it implicitly set minimum wages. The statutory reduction of public bar trading hours thus increased real wages for hotel labour and standardised work conditions across trades.

Prohibition and temperance groups saw six o'clock closing as a key manifestation of their political power. Temperance groups favoured it as long as they believed there was a positive correlation between alcohol consumption and the number of bar trading hours. Prohibition groups favoured it because lower quality and higher levels of drunkenness maintained the pressure for even more restrictive regulation of alcoholic beverage markets.

Six o'clock closing ended after the 1967 referendum, as demand changed with expanding suburbs and the beginnings of deregulation of trading hours and the labour market.

