'SINGLE SELLER' MARKETING - ANY MARKET POWER?

Dairy Board's claim

For many years, the NZ dairy industry, particularly the Dairy Board, has claimed that:

- NZ's 'single exporter' creates 'market power' for the Dairy Board in overseas markets[1], and
- This market power enables the Dairy Board to achieve higher prices than its competitors.

The Dairy Board has made various claims about the value of its market power from NZ's single exporter system:

- In 1998, the Board claimed it was worth $160-276 million pa ($2 billion on a capitalised basis);
- In 1999, the Board's economic advisers, NZIER, asserted to the Commerce Commission it was worth $20 million pa;
- In 2001, the Board claimed it was worth $110 million pa.

This Appendix summarises the arguments and analysis for and against these claims.

Executive summary

- The consensus among experts is that NZ's single desk system may give the Dairy Board some limited market power in a couple of product markets, but the value of the premiums is likely to be very small – not more than $20 million per year – 0.022% of the NZ industry's total revenues.
- In the long term, Global Co is unlikely to have significant market power. If the merger does not proceed, and NZ adopts a competing exporter model without export licensing restraints, it is unlikely that New Zealand's terms of trade would deteriorate. In other words, it will not matter whether there are one or two major dairy exporters[2]. However, there may be some advantage to the NZ dairy industry from Kiwi and NZDG forming two competing Australasian companies.[3]
- Even the industry's 1998 McKinsey study found that two competing, vertically-integrated NZ dairy companies would be better than a single company – better by $300 million per year.
- Interestingly, even the Dairy Board no longer runs the old arguments about preserving single desk market power. Nor do its consultants. Even more importantly, many dairy industry officials admit privately that the Dairy Board has no material market power from the 'single desk'. [4]

[1] That is non-quota markets.
[2] Promar International Report at page 42, para 9.3.4. See also the balance of section 9.3, pp38-42.
[3] Promar International Report at page 51.
[4] ACIL 1999 at pp.17+18.

- However, the costs of retaining a single exporter for NZ are high – for dairy farmers and the wider NZ economy. The Commerce Commission estimated the cost to be up to $527 million per year.[5]

- Farmers' deep traditional faith in the benefits of single desk selling still has a powerful influence on shaping NZ's dairy future, in particular the politics driving Global Co ahead of .

Meaning of 'market power'

In competitive markets, a firm normally achieve higher prices than its competitors by meetings customer needs better than its competitors – for example, by:

- Providing a better quality product;
- Providing better service; and/or
- Building a stronger brand.

In a few markets, a firm may have 'pure market power' for a period – enabling it to raise its prices, without improving service or product quality or brand, and not loose sales to its competitors. Monopolies like Telecom's local line network or Trans Power's national grid have this potential power.

Firms may have market power to varying degrees:

- Market power can be very high, as in the case of Microsoft or Coca-Cola; but

- It can also be extremely low, as it is in commodity markets where a firm can only minimise its costs[6].

Key question

Does NZ's single exporter system give the Dairy Board market power?

In November 1998, the Industry asserted: *"…an objective review of the evidence drawn from published academic studies supports the conclusion that the Dairy Board does enjoy market power by virtue of its single seller status"*.[7]

Let's look at the arguments and analysis to date in an objective manner.

Dairy Board *has* valuable market power

Arguments made in support of the Dairy Board's claims of market power are as follows:

- There is no single, homogenous, international dairy market, but rather a large range of national and regional markets.

- Among all the dairy-exporting nations, only NZ – by virtue of the legislated single seller – has the ability to co-ordinate the placement of product across alternative markets in a revenue maximising way.

- These markets are segmented or differentiated by various factors – including product differentiation, brand (including country-of-origin), demand differences, government regulations and single buyer structures.

[5] Draft Determination 1999, p.131 Table 15
[6] From Promar International, May 2001 at par 9.3, page 38.
[7] "New Zealand Dairy Industry Scoping Plan", November 1998

- These differences provide opportunities for a single NZ seller to gain price premiums (over its competitors) in its sales of certain products into some non-quota markets.

- The Dairy Board argues it is not a 'price-taker' in those markets.

- Examples given by the Dairy Board of where it is not a 'price-taker' include:

  - Milk powder in Peru;
  - Processed cheese in Taiwan;
  - Skim-milk powder and butter in Japan; and
  - European Union markets where importers bid for licences and NZ has 'most favoured nation' status.

- The Dairy Board and NZIER also argue that the Board derives market power from its perceived official association and status with the NZ Government.[8]

Dairy Board does *not* have valuable market power:

Arguments made to rebut the Dairy Board's claims of market power are as follows:

- Most dairy products consumed in a country are produced in that country – very little is imported or exported. In other words, most countries are self-sufficient[9].

- A firm's market share is commonly used as a indicator of market power. However, even if the Dairy Board had a high market share, it does not follow that it could consistently exercise market power – it also depends critically on how competitors respond, barriers to entry and how easily consumers can find substitutes. In dairy commodity and ingredient markets, there is a huge surplus of supply and a high level of competition among suppliers. Customers can readily find substitutes.

- World trade of dairy products is a fraction of total world dairy production.

- While NZ has 30% of traded dairy markets, only 8% is traded.

- New Zealand accounts for a mere 2% of total world dairy production.

- Prices for most of NZ's dairy exports to non-quota markets are determined by supply and demand, which is well beyond the control of the Dairy Board.

- Prices are established when supply equals demand. And supply is not determined by the number of sellers bidding the price down, but by the total volume of supply.

- The overseas markets in which NZ mainly operates are awash with high volumes of dairy commodities and ingredients.

- It makes no difference whether the competition comes from. Other competing exporters from NZ would have no impact on commodity and ingredient prices.

[8] NZIER particularly emphasises this factor as providing 'added market power' resulting in premiums.

[9] NZ is an unusual exception, exporting 95% of our dairy production. Japan and Singapore are also unusual in importing most of their dairy products.

- In addition, the Dairy Board is obliged to buy *all* dairy products made in NZ for export, which means the Board is *not* able easily to control the flow NZ products to particular markets. It's main driver is simply to sell them. (The Board's ability to place product in a variety of markets mitigates some of the 'production drive' from NZ, but it is still difficult).

Overview of expert analysis

Several studies have been carried out over the years. Quantification of the claimed premiums from market power has been controversial.

A summary of the key studies is set out in **Annex 1**. Bear in mind that the terms of reference of each study were *not* necessarily the same. Also, when comparing claimed values of the claimed market power of the Dairy Board, keep in mind that NZ dairy sales are about $9,000 million per year. The consensus estimate of the Dairy Board's market power is around $20 million per year (or 0.022% of NZ exports).

That is the value - $20 million – that the industry has been seeking to protect so vehemently.

Claimed consequences of deregulation

Anti-deregulation view

The Dairy Board and many other in the NZ dairy industry have argued doggedly for many years that the consequences of removing the single desk system would be dire, in particular:

- The Board's ability to extract price premiums due to its market power would be lost. According to the Dairy Board, the cost to the NZ dairy industry could be in the magnitude of $160-276 million per year. [10] That has now been revised down to $110 million per year.

- Deregulation would result in cherry picking and, over time, bidding away of current premiums by competing NZ exporters.[11]

- There would be 'intra-brand competition, reduced incentives to spend on developing and sustaining the (NZ) brand, and the risk of free-riding by one participants eroding the value of the brand. [12]

- Therefore, if deregulation is to happen, as far as possible make sure NZ still has only one main exporter. This is a driving force behind Global Co and it's fundamentally flawed – causing the industry to choose a flawed structure in Global Co.

Pro-deregulation view

- Two major NZ dairy exporters would not cause any material loss of market power for the NZ dairy industry.[13] Nothing material would be lost by removing the single exporter system.

- On the contrary, the NZ dairy industry and the wider NZ economy would be significantly better off with competitive exporting: NZ exporting would become be demand (not production) driven; innovation would be allowed to flourish; and resources would be used more efficiently in the economy. And the transition costs are very small compared to the longer term gains.

- Even if the single desk created some small degree of pure market power for the Dairy Board, it is extremely small (insignificant, in fact) when compared with the industry's total turnover (equal to a microscopic 0.022%).

- However, the costs of retaining a single exporter for NZ are high – for dairy farmers and the wider NZ economy. The Commerce Commission estimated the cost to be up to $527 million per year.[14]

- Ending the 'single desk' system would put a stop to those huge costs on the industry and the NZ economy.

[10] Industry's Scoping Plan 1998 at p 41.
[11] Industry's Scoping Plan 1998 at p.40
[12] See Board's argument to the Commerce Commission in its 1999 Draft Determination at para 608.
[13] Promar International Report at page 42, para 9.3.4. See also the balance of section 9.3, pp38-42.
[14] Draft Determination 1999, p.131 Table 15

Consensus view

"It will not matter whether there are one or two major dairy exporters[15].....[however] there may be some advantage to the NZ dairy industry from [Kiwi and NZDG forming two Australasian companies]."[16]

Interestingly, even the Dairy Board now no longer runs its normal arguments about preserving market power. Nor do Dairy Board consultants.

Even more importantly, many dairy industry officials admit privately that the Dairy Board has no material market power from the 'single desk'. [17]

Even the industry's 1998 McKinsey study found that two competing, vertically-integrated NZ dairy companies would be better than a single company – better by $300 million per year.

So why a 'single company' now ?

In short, the industry still has a strong attachment to the tradition and sense of familiarity of a farmer-owned 'single exporter', despite the Board's unspoken (private) acceptance that its long-serving 'single desk, market power' arguments are not valid.

It is the only system the NZ industry has known for 85 years (see Appendix [ ]).

And it fits with farmers' strong desire to keep out non-farmers, retain a pure cooperative and hold on to what seems to have worked.

For many senior managers, a single company is favoured as it will continue to give them extremely high levels of control – significantly more than the directors.

[15] Promar International Report at page 42, para 9.3.4. See also the balance of section 9.3, pp38-42.
[16] Promar International Report at page 51.
[17] ACIL 1999 at pp.17+18.

ANNEX 1:
SUMMARY OF STUDIES OF WHETHER THE SINGLE DESK GIVES THE DAIRY BOARD MARKET POWER

	ESTIMATED VALUE OF MARKET POWER
1991, Commerce Commission	**Nil**

- **1991, Commerce Commission** — **Nil**

  The Commission concluded that, given the large surpluses of supply and the multitude of players, "*The Dairy Board is effectively a price-taker…the Dairy Board sells its goods at the best prices which it is offered*".[18]

- **1992, ACIL** — **Under $20 million per year**

  Concluded that the Dairy Board has some degree of market power in some markets, but degree of power and the gain are likely to be small.

- **1993 , Two academic studies** — **Not specified**

  W. Cartwright of Auckland University and AC Zwart of Lincoln University have each argued that there is a gain from market power, but neither put a value on it[19]

- **1997, Thurman study** — **$37-69 million per year**

  Estimated gains from single desk selling to be in the range of $37-69 million pa. This study has never been made public. The Commerce Commission referred to Thurman finding a value of $20m pa.[20]

[18] Commerce Commission 1991, p.52
[19] NZAES 1993 – W Cartwright, University of Auckland. NZAES 1993, AC Zwart, Lincoln University.
[20] See Draft Determination 1999 at para 609.

ESTIMATED VALUE OF MARKET POWER

- **1998, Findlayson, Lattimore & Ward** **Very low**

  Found that if NZ reduced its supply of butter and cheese by 10%, traded prices of would rise by less than 0.5%. In other words, a single NZ dairy exporter has *very little* market power.

- **1998, Boston Consulting Group** **$276 million per year**

  As reported by the Dairy Board, its consultants – Boston Consulting Group – assessed the gain from market power to be in the order of $276m pa. However, the BCG report has never been made public. It is questionable whether BCG would attribute this figure to loss of pure market power from the single desk, or to the difference between single desk and two competing vertically integrated exporters.

- **1998, NZIER** **$40 million per year**

  NZIER estimated the total benefits of the Dairy Board's 'single seller' market power to be NZ$40 million pa. [Note that the Dairy Board reported in the 1998 Scoping Plan that NZIER estimated the value to be $160m pa]

- **1998, Profs Evan and Quigley** **Nil**

  Professors Evans and Quigley of Victoria University reviewed the NZIER report and demonstrated that:

  - The conceptual basis of NZIER's study was implausible, and
  - Both the methodology and conclusions were flawed.

- **1999, Briefing by Boston Consulting Group** **Nil**

  BCG quite openly admitted that the Dairy Board does *not* have pure market power from its position as NZ's single desk exporter.

ESTIMATED VALUE OF MARKET POWER

- **1999, ACIL** **Nil**
  Found that the weight of evidence and logic strongly suggests that the Dairy Board is *"essentially a price-taker on world markets. Somewhat ironically, the board [itself] concedes the point"".*[21]

- **1999, Commerce Commission** **Nil-$20 million per year**
  In considering the 'Mega Merger' proposal of 1999, the Commission reviewed the arguments for and against market power under 'single desk selling' and concluded: *"The Commission remains to be convinced of the sustainability of the argument for premiums in non-quota markets, but is prepared to accept a figure of between zero and $20m as a provisional estimate".*[22]

- **1999, Some Australian dairy companies** **Unspecified**
  Some Australian dairy companies submitted to the Commerce Commission that hey believe competition between Bonlac and Murray Goulburn undermined returns from Australian dairy exports, and that NZ's 'single desk' system is a significant advantage.

- **2001, Prof Neil Quigley** **Nil**
  "There is nothing in the material provided as part of the Global Co proposal to indicate the basis of the claim of single desk premiums of $110m pa". [23]

- **2001, Promar International Report** **Nil**
  Promar reported that while the Dairy Board has a relatively high share of dairy consumption in some markets – like 73% of Mexico's milk powder, 16% of the UK's butter and 29% of Malaysia's cheese – NZ is not in a position to strong influence prices in these markets as the world is awash with those products. Buyers can easily find low cost substitutes, particularly from Russia, Brazil and India.

In summary, Promar International advised that:

❖ In the commodity and ingredients markets *"….currently no one player regardless of scale is likely to be able to influence price".*

❖ There may be a short term advantage for NZ in retaining market power in high fat products, but this market power depends on continuing high levels of foreign market protection (if it declines, any market power will reduce rapidly).

❖ In the consumer foods sector, *"the scale benefits of Global Co in this market are likely to be limited. For example, Danone spent $1.4 billion on advertising and promotion in 2000 to support its brands. While this represents only 5% of its total sales, it would equate to about 12% of Global Co's".*

[21] ACIL, 1999 at p.18
[22] 1999 Draft Determination at para 612
[23] Quigley, Jan 2001 at page 18, para 4.4

Overall, Promar International concluded:

"In the long term, Global Co is unlikely to have significant market power……if the merger does not proceed, and NZ adopts a competing exporter model without export licensing restraint, it is unlikely that New Zealand's terms of trade would deteriorate over. In other words, it will not matter whether there are one or two major dairy exporters[24]…..[however] there may be some advantage to the NZ dairy industry from [Kiwi and NZDG forming two Australasian companies]."[25]

Interestingly, even the Dairy Board no longer runs the old arguments about preserving market power. Nor do its consultants. Even more importantly, many dairy industry officials admit privately that the Dairy Board has no material market power from the single desk. [26]

[24] Promar International Report at page 42, para 9.3.4. See also the balance of section 9.3, pp38-42.
[25] Promar International Report at page 51.
[26] ACIL 1999 at pp.17+18.