Fonterra and monopoly-like costs

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Context

As a highly dominant firm, Fonterra carries with it some of the costs and risks that arise in monopoly-like businesses.

These costs and risks were highlighted in lead up to forming Fonterra back in 2001.

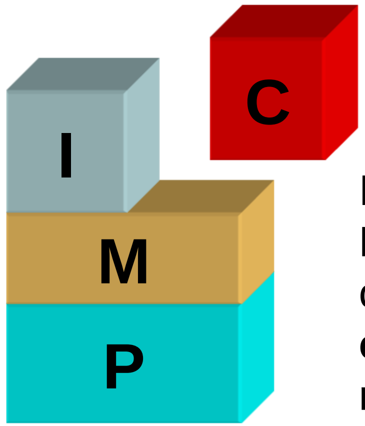
Potential efficiency losses were assessed by the Commerce Commission (in a draft determination) at around $692 million, which comprised:

- $192 million in productive efficiency losses, and
- $500 million in dynamic efficiency losses

In the lead up to forming Fonterra, McKinsey & Co advised that, if the monopoly-like costs could not be eliminated, two competing co-operatives would be preferable to a single mega co-op by $300 million

[Note that neither set of estimates factored in the rules requiring open entry and exit, and supply to competitors, that accompanied the formation of Fonterra]

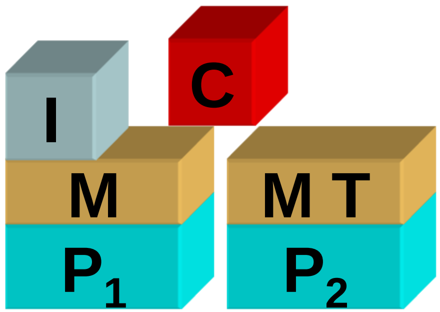
Two competing cooperatives v One mega



OPTION 6

Single mega cooperative

In the lead up to forming Fonterra, even McKinsey & Co advised that, if monopoly-like costs could not be eliminated, **two competing co-operatives** would be preferable to a single mega co-op by $300 million



OPTION 3

Two competing cooperatives

SUMMARY

Option 6 is preferable to a pure Option 3 by $800 million if x-inefficiency can be eliminated

Otherwise a pure Option 3 is preferable to Option 6 by $300 million if breakdown of Option 3 can be prevented

We believe that the x-inefficiency can be managed under Option 6

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Purpose

These purpose of these slides is to provide an background outline of the role and effects of monopolies in economic terms.

Monopolies

By way of background, it's helpful to understand the role and effects of monopolies in economic terms. The following explanation has been kindly provided by David Pickens, a regulatory economist:

- Monopolies are entities that provide goods or services to consumers who will have little choice but to buy those goods and services from that provider. Typically, it is difficult for consumers to go without that good or service, there are few reasonable substitutes and it is difficult for other providers to set up in competition with the incumbent (the monopolist).

- There are two types of monopolies to think about – natural monopolies and government created monopolies. Natural monopolies exist because the goods or services they provide are most cheaply provided by one provider. A good example is the national grid for electricity (Transpower). While it is feasible to provide another network to operate in parallel to Transpower, carrying electricity from generators (electricity producers) to lines companies (consumers), it is not sensible. It is too costly.

- Monopolies are both good and bad. A useful way to think about the good and bad that might come from a monopoly is economic efficiency.

Monopolies *(cont'd)*

- Economic efficiency is broken into:

  - **Productive efficiency**: This refers to the amount of resource needed to produce a good or service. If less resource is needed to produce a given level of good or service, then inputs are freed up to produce value for the community elsewhere. Where this happens there is an improvement in productive efficiency.

  - **Allocative efficiency**: This is about making sure those things most valued by the community are supplied, and supplied in the correct amounts (formally, where the marginal cost of producing the good or service equals the marginal benefit to consumers of consuming it) to best promote public welfare.

  - **Dynamic efficiency**: This is the change in allocative and productive efficiency that occurs over time. It is commonly described as innovation.

- Pulling the three types of efficiency together, economic efficiency can be described as "providing valued goods and services in the quantities most valued by the community, at least cost, over time."

Monopolies *(cont'd)*

- In economic efficiency terms, monopolies are both good and bad. A natural monopoly can produce goods and services much cheaper by itself than could two or more providers operating in the same market. In these circumstances a monopoly is likely to be the most productively efficient way to produce the good or service. However, this comes at some cost elsewhere.

- First, it is easy for a monopoly to reduce supply (formally, to a point where the marginal cost to the monopoly is less than marginal benefit to the consumer) and force up prices. The reasons a monopoly will do this is to increase the money it gets from consumers, money that will either go to owners in the form of high profits, and or to the inputs used to provide the good of service, for example, higher wages, more expensive supplier inputs or just waste (this is known as gold plating). Natural monopolies tend, therefore, to be allocatively inefficient.

Monopolies *(cont'd)*

- Next, without another provider working to better provide what customers want, and in this way take market share and profits from the monopoly provider, there is little reason for a monopoly to try and produce goods and services more cheaply or that better meet what customers want, or even search out new markets, including value add processing.

- Also, entities (if they are any good) will have a distinct culture and a consistent operating strategy.. No two entities will be the same in this respect. This means in a monopolistic market, by definition, there is less strategic and cultural variety and therefore greater risk of a mismatch with what a range of consumers and potential consumers might want - a bit like having all your eggs in one basket. In short, monopolies will tend to score poorly against dynamic efficiency.

Monopolies *(cont'd)*

- In summary, economists would tend to expect monopolies to be good for productive efficiency, but bad for allocative and dynamic efficiency. To encourage the good aspects (productive efficiency) and discourage the bad aspects (allocative and dynamic Inefficiency), governments will often allow natural monopolies, but regulate their prices, profits and the quality of their goods and services. Over time, governments try to make monopolies innovate – through applying higher standards and/or by allowing them to make more money.

- Further discussion is required in relation to government-created monopolies.