

Treasury Report: Foreign Investment and Vertically Integrated Firms

Date:	27 August 2010	Report No:	T2010/1607
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Action Sought

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Minister of Finance (Hon Bill English)	<p>Note that Treasury has not been able to identify any concerns around vertical integration by foreign-owned firms that should be addressed through the Overseas Investment Act.</p> <p>Refer a copy of this report to the Minister of Agriculture, the Minister of Land Information and the Minister of Trade.</p>	3 September 2010

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[withheld – privacy]	Analyst, International	[withheld privacy]	– [withheld privacy]	✓
Siân Roguski	Acting Manager, International	[withheld privacy]	– [withheld privacy]	

Minister of Finance's Office Actions (if required)

None.

Enclosure: No

Treasury Report: Foreign investment and vertically integrated firms

Purpose of Report

1. This report responds to your request for advice on whether foreign-owned vertically integrated firms in the agricultural sector are a cause for concern. The report firstly outlines reasons why a firm may vertically integrate and then discusses whether the concerns that have been raised have any economic justification.

Analysis

What is vertical integration and why do firms do it?

2. Vertical integration involves a single firm owning or controlling some or all of the stages involved in the production, distribution and sale of a product. In a strict sense, the relevant firm would own the various stages of production. However integration could also be achieved through the use of long-term contracts to supply inputs to the production process.
3. In the agricultural sector a vertically integrated firm would own or control some or all of the following production stages:

Production stage	Marketing/retailing
	Export/distribution of final product
	Secondary/value-add processing (e.g. milk powder to infant formula)
	Primary processing (e.g. trees processed to rough cut logs)
	Land based production (i.e. choice of what to produce on the land)
	Land ownership

4. Firms typically choose to vertically integrate when the transaction costs of doing so are lower than contracting with separate firms for a particular service. Some specific examples include:
 - to manage risk by obtaining greater control over the quality and quantity of supply of inputs necessary for production, and the distribution of outputs;
 - to capture upstream or downstream profit margins;
 - to facilitate investment in highly specialised assets where a supplier is unwilling to make such an investment; and
 - to increase barriers to competitors (for example by gaining sole access to a scarce resource).
5. In general vertical integration is efficient and beneficial because it allows firms to improve productivity by generating economies of scale. Vertically integrated firms exist in a number of sectors. The wine industry is discussed in Annex 1. A further example is the electricity sector where vertical integration between retailing and generating firms provides a hedge against spot market fluctuations by matching generation capacity and the retail customer base.

6. The exception is where a natural monopoly exists in one part of an industry, which allows a firm to limit competition in another part of the industry. An example is the electricity sector where lines companies are prohibited from vertically integrating into the consumer or generation markets. If they were able to enter those markets they could adversely affect competition by using market power in the non-competitive part of the business to create unfair competition into competitive parts. Natural monopolies are likely to be rare in the agricultural industry because it does not possess the characteristics of a network industry.

Possible concerns about vertical integration in the agricultural sector

7. This section sets out a range of commonly raised concerns that may arise as a result of vertical integration by foreign-owned firms. We have framed our analysis of these concerns around the key question: 'does the concern only arise with foreign-owned firms, or could it also occur with domestic firms?'

The nature of the investor

8. Who the investor is may raise concerns about foreign-owned vertically integrated firms. This issue is commonly raised in relation to government-controlled investors (such as sovereign wealth funds) or where it is difficult to assess who the beneficial owner/investor is because the investor operates through jurisdictions where this information cannot be obtained. In these cases some argue that there is a risk that the investor may have non-commercial motivations. However this concern is not specific to vertically-integrated firms as these investors can and do invest in a wide range of sectors.
9. Based on evidence from the OECD and other research¹ our current view is that while there may be valid concerns that some sovereign wealth funds lack transparency, there is little sign of non-commercial behaviour. A precautionary approach would be to develop measures that test the separation between the government and commercial decision-making, and we can provide you with additional advice on how to address this issue if you wish. In our view any response to this concern should address non-commercial motivations more widely, rather than just in vertically integrated firms.

The scale of integration

10. The scale or size of the vertically integrated firm may give rise to concerns about the firm having excessive market power in the relevant industry. It is possible that a large vertically-integrated firm may be able to use market power to restrict competition.
11. However, this is largely a market power issue that could equally arise with vertical integration by domestically-owned firms. As such we do not consider a response through the Overseas Investment Act is required as market power issues come within the scope of the Commerce Act.

The point in the value chain at which vertical integration occurs

12. A further concern that has been raised about vertical integration is the degree of control over upstream and downstream production processes. Consider two vertically integrated firms: Firm A, which owns a processing plant and upstream distribution networks, and Firm B, which owns land and production, and a processing plant. Vertical integration by Firm B may raise greater concerns because they own the scarce resource (land), which cannot be replicated by other firms, raising natural monopoly power issues. In comparison, the assets owned by Firm A can be replicated, for

¹Clark and Monk (2009), *The Oxford Survey of Sovereign Wealth Funds' Asset Managers*
OECD (2009), *Are Sovereign Wealth Funds' Investments Politically Biased?*

example by another firm building a new processing plant and developing its own distribution chains.

13. We consider that this concern boils down to a market power issue that could arise regardless of the nationality of the firm owner. Again, any response should target both domestic and foreign-owned firms.

The type of vertical integration

14. Concerns about vertical integration are more likely to arise where the integration occurs in its purest form, i.e. where the firm owns part or all of the production chain.
15. The alternative is a contractor model, where the foreign-owned firm enters into long-term contracts with suppliers or distributors to provide inputs or services at a guaranteed level. This kind of contractor model is less likely to raise concerns about foreign ownership because the (foreign) contracting firm does not actually own the underlying assets.

Summary and Treasury's view

On vertical integration:

16. We think that the vertical integration issue is largely a red herring and the more specific concern relates to market power. With the exception of natural monopolies, vertically-integrated firms are generally efficient and there is no reason to think that this is any different in the agricultural industry. It is important to remember that vertical integration already occurs in several parts of the agricultural sector such as Fonterra (New Zealand owned) and the wine industry (significant foreign ownership).

On market power:

17. To the extent that concerns about firms with excessive market power are valid, they should apply regardless of whether the firm is foreign or domestically owned. Therefore we do not consider that it is necessary to respond to this concern through the Overseas Investment Act.
18. Monopoly and market power issues are broadly considered under the Commerce Act. However this Act is not likely to be relevant at this point because a single firm would need to control a large amount of the production of a particular agricultural product before they could be considered to have significant market power. We are not aware of any foreign controlled firm that might have such market power.
19. The Commerce Act does not prohibit firms from having or developing market power, but a person that has a substantial degree of power in a market must not take advantage of that power to engage in anti-competitive or restrictive trade practices. Similarly, mergers or acquisitions that will, or are likely to, have the effect of '*substantially lessening competition*' in a market require clearance from the Commerce Commission.

On non-commercial motivations:

20. Current evidence suggests there is no cause for concern about investments from sovereign wealth funds. However if you do have concerns in this area, an appropriate response would target all sovereign investments, not just those into vertically-integrated firms.

Consultation

21. The Ministry of Foreign Affairs and Trade, the Ministry of Agriculture and Forestry and the Overseas Investment Office were consulted in the preparation of this report.

Recommended Action

We recommend that you:

- a **note** that we have not been able to identify any concerns around vertical integration by foreign-owned firms that should be addressed through the Overseas Investment Act;
- b **advise** Treasury whether you require any further advice on vertical integration by foreign owned firms;

Yes/no

- c **indicate** whether you would like further advice on the validity of concerns about investors with non-economic motivations, and how to address these concerns; and

Yes/no

- d **refer** a copy of this report to the Minister of Agriculture, the Minister of Land Information and the Minister of Trade.

Agree/disagree

Siân Roguski
**Acting Manager - International
for Secretary to the Treasury**

Hon Bill English
Minister of Finance

Annex 1: Foreign ownership and vertical integration in the wine industry

Over the past decade the New Zealand wine industry has grown from a small and family-based sector into a technologically advanced mix of foreign and domestic-owned vertically integrated firms that produce a wide variety of wines.

Key features of the industry development are:

- increased specialisation, including the development of specialist processors, brand owners and vineyard contractors;
- a process of vertical integration and increased foreign ownership led by global beverage companies;
- the rapid growth of mid-sized wine companies; and
- a continued proliferation of small winemaking enterprises.

About 40 percent of the 2010 New Zealand vintage of 266,000 tonnes is managed by foreign owned companies. Of that 40 percent, about 25 percent comes from their own vineyard holdings while the remaining 15 percent is sourced from New Zealand contract growers. Some of the major foreign owned companies in New Zealand are:

- Pernod Ricard which owns brands such as Montana, Corbans, Saints, Stoneleigh, Church Road and Timara;
- Constellation New Zealand which owns brands such as Nobilo, Selak's, Kim Crawford, Monkey Bay and Drylands;
- Louis Vuitton-Moët Hennessy which owns the Cloudy Bay label; and
- Fosters which owns the Matua Valley label.

A new phase of growth is being generated by a wave of international investment from large foreign companies, complemented by smaller family investors from overseas. A number of overseas-based private investors have also purchased land or vineyards in New Zealand and developed their own brands, or invested in the industry indirectly, via listed or unlisted companies. Among New Zealand wine companies wholly or partly overseas-owned are Craggy Range, Sacred Hill, Trinity Hill, Whitehaven, Nautilus, Kemblefield, Clos Henri, Escarpment, [Withheld - subject to an obligation of confidence] Palliser, [Withheld - subject to an obligation of confidence], Karikari, Framingham, Woollaston, Highfield, Dry River, Te Awa and Fromm.

The table below shows how the New Zealand wine industry has developed over the past nine years.

	2000	2009	% increase
Number of wineries	358	643	80%
Production (millions of litres)	60.2	205.2	241%
Export value (\$m)	168.6	991.7	488%

Sources: Ministry of Agriculture and Forestry,
Business New Zealand, *New Zealand Wine Industry*, June 2010,
New Zealand Wine Growers, *Statistical Annual 2009*

