Report on the CHL wage class action certification: rebuttal and policy analysis

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Assignment

This report follows my initial report on the economic relevance of the CHL player wage class action lawsuit. In my initial report submitted June 14, 2016, I used established economic models and analysis techniques to explain that:

- all CHL players contribute to the production of hockey games and therefore to CHL club revenues,
- CHL clubs consistently treat players in common to produce games and generate revenues, and
- a minimum wage policy will have a negligible impact on the operations of CHL clubs.

In advance of preparing my first report, I reviewed the affidavits of the commissioners of the OHL and the WHL, and the affidavits of various OHL and WHL club owners. After the delivery of my first report, counsel for the plaintiff received the financial statements of the CHL, the OHL, the WHL, the 20 OHL clubs, and the 22 WHL clubs, as well as the affidavits of James MacAuley and Norm O'Reilly. This rebuttal report is based on my review of the defendants' new productions, as well as my knowledge and application of widely accepted sports economic principles and empirical analysis techniques.

Summary and conclusions

Upon review of the additional information, I have concluded that:

- the issue of player pay is related to the distribution of revenues, not to the generation of revenues,
- the leagues' and clubs' common treatment of players has eliminated competition for players' services, and
- the defendants' evidence, particularly the reports from Mr. MacAuley and Dr. O'Reilly, does not substantiate their claims of wide-spread financial distress.

Player pay in the CHL

The determination of player pay and its impact on sports league operations has been rigorously examined and empirically tested. It is well understood that the value of an input, such as the value of a hockey player to a hockey club, is determined by his net contribution to club revenues (also known as Marginal Revenue Product, or MRP). Since every CHL club's business is to produce wins, each player's value to the club is determined by measuring his incremental contributions to the club's winning, and the incremental impact that his contributions to winning have on revenues. A player's MRP can be expressed as $MRP(w) = MP(w) \times MR(w)$.

The defendants' arguments against player minimum wage, including Dr. O'Reilly's statistical analysis, are flawed because they are based on calculations from net income (*i.e.*, they have determined that there is insufficient money to pay players after all other expenses have been paid). Money available to pay players is not determined in isolation from other inputs to production. Rational business owners evaluate their available inputs, and allocate resources based on their relative costs and benefits. Resources are allocated to the inputs which generate the most revenue, until the marginal costs of the input outweigh the marginal benefits.

The money that is currently collected by the club owners is generated by the players. Revenues would not be collected if they were not generated by the players. If the leagues did not impose a policy of non-payment to players, basic economic principles dictate that club owners would increase their investment in players – in other words, pay the players – until player pay reached a level where club owners could generate more revenues from investing in other inputs. League and club administrators currently receive more money than they contribute to revenues. Payment to players will transfer money from league and club administrators, and other inputs to production, to players. As I stated in my initial report, the issue of player pay concerns the redistribution of revenues, and does not require the generation of additional revenues.

I used the revenues provided by the clubs in their financial document and regression analysis to obtain a conservative estimate of the revenues generated by players from winning. Players across the leagues, as well as players on small market and lower quality clubs generate substantially more revenues from winning than the cost of a minimum wage policy (i.e., approximately $300, 000). Players generate approximately $50 million in revenues from winning per season, and

players on a club that wins a low percentage of its games (i.e., a club with a winning percentage of 0.350) generates approximately $1.6 million in revenues from winning per season.

Club profitability and value

The defendants, through the commissioner and owner affidavits, and through the MacAuley and O'Reilly reports, have argued that player pay will alter or force clubs to cease operations. There is no economic evidence to support this claim. The use of club profit margins from financial reports as justification against the viability of paying players minimum wage constitutes a flawed economic analysis for two main reasons. First, tax assessments provide incentives for owners to understate profits, and therefore do not accurately reflect the market value of the asset. Second, player wages concern net contributions to revenues, not net income.

An asset's value is the amount investors are willing to pay for it, which is ultimately reflected in the observed sale price. There are a number of reasons that explain the discrepancy between the accounting profits reported by clubs and their observed sale prices.

First, economic revenues differ from accounting revenues in that economic revenues include all revenues collected by the clubs that would not be generated without the production of hockey games. This includes club revenues, as well as a proportion of CHL and OHL/WHL league-wide revenues, and revenues from business opportunities that result from club ownership. Club revenues include ticket sales, concessions, parking, merchandise, advertising, sponsorship, media rights, and direct NHL development grants, while league-wide revenues include NHL funding, marketing and events, player agent programs, import draft fees, revenues from Hockey Canada, revenues from television and publication rights, sponsorship and rights fees, and media sales.

Second, economic expenses differ from accounting expenses in that economic expenses only include costs associated with producing hockey games, and accurately reflect their contribution to production. For example, high owner salaries may decrease accounting profits while having no effect on the club's value.

Finally, tax policies that permit the depreciation of capital expenses of assets unrelated to, or beyond, production disproportionately decrease a club's accounting profits versus its true economic profit.

With the above issues taken into account, the financial records provided by the defendants do not contain sufficient detail to determine the discrepancy between the clubs' accounting and economic profits. For example, the KPMG summaries of club income statements in the MacAuley report categorize all club operating expenses in three broad categories (advertising and promotion, administration, and other operating expenses). Approximately 75 to 95 percent of each club's total operating expenses are allocated to the other operating expenses category. This information does not allow us to discern whether these expenses are related to the production of hockey games. The defendants have also not provided the financial records of the club owners' other businesses, which may have significant effects on the clubs' accounting profits or losses, but not on their economic profits or losses.

A review of the financial records shows a pattern that the clubs reported negligible accounting profits or losses, regardless of the amount of revenue reported. In other words, on average, high revenue clubs all reported high expenses, while low revenue clubs all reported low expenses. This runs completely contrary to economic predictions.

Sports clubs generate revenues according to:

$$R^t(q) + R^c(q) + R^n$$

where: $R^t(q)$ is revenue from tickets, $R^c(q)$ is revenue from concessions, and R^n is revenue from various sources unrelated to attendance.

Sports clubs have total costs according to:

$$d + c(q)$$

where d is costs unrelated to attendance, and $c(q)$ is costs related to attendance. The marginal cost of attendance (*i.e.*, the incremental cost necessitated by each additional fan at a hockey game) is assumed to be negligible, and the cost equation is simplified to $d + c$. Since CHL clubs do not pay for player talent, it is expected that revenues may vary with attendance, but that costs do not. In simpler terms, clubs may have varying revenue potential depending on attendance, but they all share a similar cost structure. The clubs' income statements, which show that their revenues and costs are highly correlated, do not accord with basic economic principles.

The defendants have not provided any substantive economic evidence to support claims of wide-spread financial distress. The MacAuley and O'Reilly reports use accounting data that allows clubs to report revenues and costs differently than they contribute to the actual underlying value of a club without a corresponding economic analysis.

As explained above, financial records which report negligible profits across CHL clubs are not consistent with economic theory or the objectively observed growth in franchise values. The most direct way to determine a club's value, as noted in my first report, is to examine observed sale prices because an asset's price on the open market will, on average, include all ancillary benefits and costs.

My initial report estimated the rate of return of CHL clubs to be 7.9 percent, which is below recent NFL (14.2%), MLB (8.2%), NBA (9.2%), and NHL (9.6%) estimates. The approach I took has been used by other economists.

Labour class

The absence of player pay in the CHL is a result of the leagues and clubs' common treatment of players that has eliminated the competition for player services. Upon gaining entry into the leagues via the entry-level draft, a player signs a common Standard Player Agreement that contains a reserve clause which transfers the player's rights to the club for the duration of his CHL career.

The entry-level draft and the reserve clause constitute a two-step system that reduces player pay. The entry-level draft restricts competition over incoming players and the reserve clause restricts competition over existing players. A player is bound to the club that obtained his rights either through the draft, a trade, or a sale. The end result is that the player is bound to his initial salary, which is the most a player can earn outside the league or his next best option, for the duration of his career. For a rookie CHL player, his next best option is close to zero dollars.

Even though players do not receive money for the revenue they generate, it is collected by club owners in the form of economic rents. Arguments that the entry-level draft and the reserve clause are necessary to maintain competitive balance are unfounded. One of the most important findings in Sports Economics is that the distribution of talent is invariant to who receives the revenues generated by players.

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