COMMERCE COMMISSION

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DRAFT DETERMINATION

Note: This is a Draft Determination issued for the purpose of advancing the Commerce Commission's decision on this matter. The conclusions reached in this Draft Determination are preliminary and take into account only the information provided to the Commission to date.

Draft Determination pursuant to the Commerce Act 1986 in the matter of an application for authorisation of a business acquisition involving:

CAVALIER WOOL HOLDINGS LIMITED

and

NEW ZEALAND WOOL SERVICES INTERNATIONAL LIMITED

The Commission: Mark Berry, Chair
Sue Begg
Gowan Pickering
Stephen Gale

Summary of Application: The Applicant has applied for authorisation to acquire up to 100% of:

- New Zealand Wool Services International Limited's wool scouring assets; and/or
- the shares in New Zealand Wool Services International Limited

Draft Determination: The Commerce Commission's preliminary view is that, on the basis of the information provided to date, it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, but that it is satisfied that the Acquisition will result, or will be likely to result in such a benefit to the public that it should be permitted. Therefore, the Commerce Commission's preliminary view is that it would be likely to grant an authorisation for the Acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

Date: 13 April 2011

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THE APPLICATION

1. On 9 February 2011, the Commission registered an application from Cavalier Wool Holdings Limited (Cavalier Wool – the Applicant), seeking authorisation (under section 67 of the Commerce Act 1986) to give effect to a transaction that will involve Cavalier Wool (or an interconnected body corporate) acquiring control over New Zealand Wool Services International Ltd's (WSI) wool scouring business (the Application). Accordingly, Cavalier Wool seeks authorisation to acquire up to 100% of:
   - WSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares of the Lanolin Trading Co Limited (LTC)); and/or
   - the shares in WSI (the Acquisition).
2. Following the acquisition, Cavalier Wool intends to rationalise the wool scouring operations of WSI and Cavalier Wool by:
   - ceasing wool scouring operations at WSI's sites at Kaputone and Whakatu and selling the land and buildings;
   - relocating WSI's wool scouring plants from Kaputone and Whakatu to Cavalier Wool's existing scouring sites at Timaru and Awatoto respectively;[1]
   - modifying Cavalier Wool's 2.4 wool scour lines at Awatoto to improve their productivity; and
   - mothballing wool scour lines at Cavalier Wool's Clive and Timaru plants.
3. Attached as Appendix 1 is a summary of the proposed rationalisation.
4. Cavalier Wool proposes post-acquisition not to be involved in wool trading. It will divest, or close down, WSI's national and international wool trading operations. In any event, even if Cavalier Wool did continue as a wool trader, there would be no aggregation of market share in wool trading markets. The Commission is thus not required to consider competition issues in such markets.

STATUTORY FRAMEWORK

5. Any person who proposes to acquire assets of a business or shares and considers that the acquisition may breach s 47 can make an application for an authorisation under s 67 of the Act.
6. Section 67(3)(a) of the Act requires the Commission to give clearance for a proposed acquisition if it is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. If the Commission is not so satisfied, clearance must be declined, although it may still grant an authorisation under s 67(3)(b) of the Act if the Commission is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.
7. If the Commission is not satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted, it must decline an authorisation under s 67(3)(c).

[1] Kaputone is near Belfast which is north of Christchurch, while Whakatu and Awatoto are between Napier and Hastings.

8. The burden of proof lies with the Applicant to satisfy the Commission on the balance of probabilities that the acquisition is not likely to substantially lessen competition and if it is likely to do so, that the public benefit is such that the Commission should authorise it.[2]

9. Section 67(3) of the Act requires the Commission to issue a decision within 60 working days after the date of registration of the notice, or such other longer period agreed to by the Commission and the Applicant. At this stage of the proceedings, the Commission intends to deliver its final determination on the Application by 31 May 2011.

COMMISSION PROCEDURES

10. This Draft Determination has been prepared to assist the Commission in considering the Application. In preparing this Draft Determination, the Commission has received and obtained information from a wide range of sources. In the course of this process, the Commission has amongst other actions:

    - reviewed the information and analysis in the Application, including the economic report submitted by the Applicant's economic experts;
    - posted a public version of the Application and initial submissions from interested parties on the Commission website;
    - sought further information and clarification from the Applicant on a range of subjects;
    - sought information from parties making submissions and from other sources at all levels in the wool industry;
    - interviewed the Applicant and other interested parties;
    - considered submissions from interested parties including economic and other expert evidence; and
    - made relevant documents and reports available to the Applicant and interested parties, where necessary under expert and solicitor confidentiality undertakings.

11. Having completed this initial research and investigation, the Commission now seeks written submissions on the Draft Determination on or before 27 April 2011.

12. Section 69B of the Act provides that the Commission may determine to hold a conference prior to making a final determination. The Commission proposes to hold a two day public conference in Wellington on 4 and 5 May 2011. Interested parties should note that members of the Commission will have read all the written submissions prior to the conference beginning. The conference is to allow:

    - members of the Commission to ask questions of interested parties in relation to their submissions on the Draft Determination; and
    - interested parties to make oral submissions to members of the Commission.

13. The Commission has prepared a "Notification of Conference" document which provides details of the conference. A further release on the procedures which the Commission will adopt at the conference will be made shortly before the conference. The Notification of Conference document may be found on the Commission's web site at

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[2] *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at para {7}.

http://www.comcom.govt.nz/cavalier-wool-holdings-limited-new-zealand-wool-services-international-limited/

14. Interested parties who have not been contacted by the Commission and who wish to participate in the conference should advise:

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THE PARTIES

Cavalier Wool

15. Cavalier Wool is 50% owned by Cavalier Bremworth Limited, which in turn is a wholly owned subsidiary of the publicly listed Cavalier Corporation Limited (together the Cavalier Group) . The remaining 50% of the shares in Cavalier Wool are owned in equal parts by the Accident Compensation Corporation (ACC) and Direct Capital Investments Limited.

16. The Cavalier Group is involved in the manufacture of woollen and wool-blend carpets (through its subsidiaries Cavalier Bremworth and Norman Ellison Carpets Limited), and a wool procurement business through its ultimate 100% ownership of Elco Direct Limited.

17. Cavalier Wool owns and operates wool scours at Awatoto and Timaru. Cavalier Wool's plants provide commission wool scouring services for Cavalier Bremworth (and its subsidiary Elco Direct), independent wool exporters and local manufacturers of mostly yarn and carpets. Commission wool scouring is the term used to describe the contract scouring and pressing into bales, of wool owned by other parties. Cavalier Wool does not itself, own wool.

18. Cavalier Wool owns 50% of the shares in LTC, with the other 50% being owned by WSI. LTC is involved as agent for its shareholders in the purchase and marketing of wool grease, a valuable by-product of wool scouring. The company sells wool grease predominantly to overseas customers, and also to a small number of New Zealand firms, for use as an input in a wide range of intermediate and final products (for example lanolin and lanolin derivatives such as cosmetics, and cholesterol and cholesterol derivatives such as vitamin D and shrimp feed additive).

WSI

19. WSI is a publicly owned company listed on the New Zealand Exchange's Alternative Market (NZAX). Its major shareholders, Plum Duff Limited and Woolpak Holdings Limited (both in receivership) together own 63.8% of WSI.[3] Plum Duff is ultimately owned by South Canterbury Finance Limited, which is also in receivership. Woolpak Holdings Limited is owned by Mr Raymond Lund.

[3] On 16 December 2010, the receivers of South Canterbury Finance Limited (in receivership) appointed Messrs Maurice Noone and Malcolm Hollis, partners from PricewaterhouseCoopers, as joint receivers of Plum Duff and Woolpak Holdings.

20. WSI is a vertically integrated merchant scourer and commission scourer. Its wool merchant business involves the purchase of wool in New Zealand for sale to purchasers both in New Zealand and overseas. WSI currently purchases and trades about 30% of New Zealand's total wool clip and is New Zealand's largest wool trader.

21. WSI also owns and operates wool scours at Whakatu and Kaputone. Between 85% and 90% of WSI's wool scouring activities relate to the wool that it purchases itself as a wool merchant. The term used to describe wool scouring of this nature is merchant scouring. The balance of the production from WSI's scours is wool scoured on a commission basis for various independent wool exporters and other local end users.

OTHER RELEVANT PARTIES

Godfrey Hirst NZ Limited (Godfrey Hirst)

22. Godfrey Hirst is a manufacturer of woollen and synthetic carpets in New Zealand. The company is a large user of New Zealand wool, processing about [ ] tonnes of New Zealand wool per year, or about [ ] of the New Zealand wool clip. Godfrey Hirst currently purchases about [ ] of its wool directly from WSI[4] and the remaining [ ] from wool merchants, who utilise Cavalier Wool for their scouring operations.

23. Godfrey Hirst previously owned and operated wool scouring plants at Clive (near Napier) and Clifton (near Invercargill), but these were purchased by interests associated with Cavalier Wool following the implementation of the transactions that were subject to the clearance granted by the Commission in its Decision 666 (see below). The Clifton plant has been dismantled and the land sold, and the Clive plant now is operated by Cavalier Wool for only a few weeks each year at the peak of the shearing season.

24. As part of the transactions under which Cavalier Wool acquired Godfrey Hirst's wool scouring plants, the two parties entered into a "Scouring Agreement." [ ][5] [ ][6]

Wool Merchants

25. There are a number of merchants that are involved in the purchase of wool by auction, direct from growers, and in the case of slipe wool[7] from meat processors, for sale as either greasy or clean wool, to local and overseas customers. These merchants include Segard Masurel (NZ) Ltd (Segard Masurel); J S Brooksbank & Co (Australasia) Ltd (JSB); H Dawson Sons & Co (Wool) NZ) Ltd (H Dawson); and Fuhrmann NZ (1983) Ltd (Fuhrmann). Wool merchants are the major customers of commission wool scourers.

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[4] [ ].

[5] [ ].

[6] [ ].

[7] The process of slaughtering sheep for their meat requires each carcass to have the skin removed. This skin offers two by- products - the pelt for leather and the residual wool, known as slipe wool.

INDUSTRY BACKGROUND

Overview of the Wool Industry

26. Wool produced in New Zealand is sold either at auction or by farmers direct to wool buyers by private treaty. New Zealand wool may be:

    - scoured and used in New Zealand for the manufacture of carpet, yarn or apparel (22% of the wool clip); or
    - scoured and exported as clean wool (56% of the wool clip); or
    - exported as unscoured greasy wool (22% of wool clip).

27. China is the largest volume destination accounting for around 32 % of New Zealand wool exports in 2009/10. Approximately 57% of the wool exported to China was in its greasy form.

28. On the basis of the Beef and Lamb Industry Organisation statistics for the 12 months to 30 June 2010, around 74% of total New Zealand wool exports were in scoured form.

29. Figure 1 shows the different functional levels in the movement of wool. Figure 2 outlines the anticipated 2011 volumes of wool flows in New Zealand.

Figure 1: Flow diagram of the New Zealand wool industry

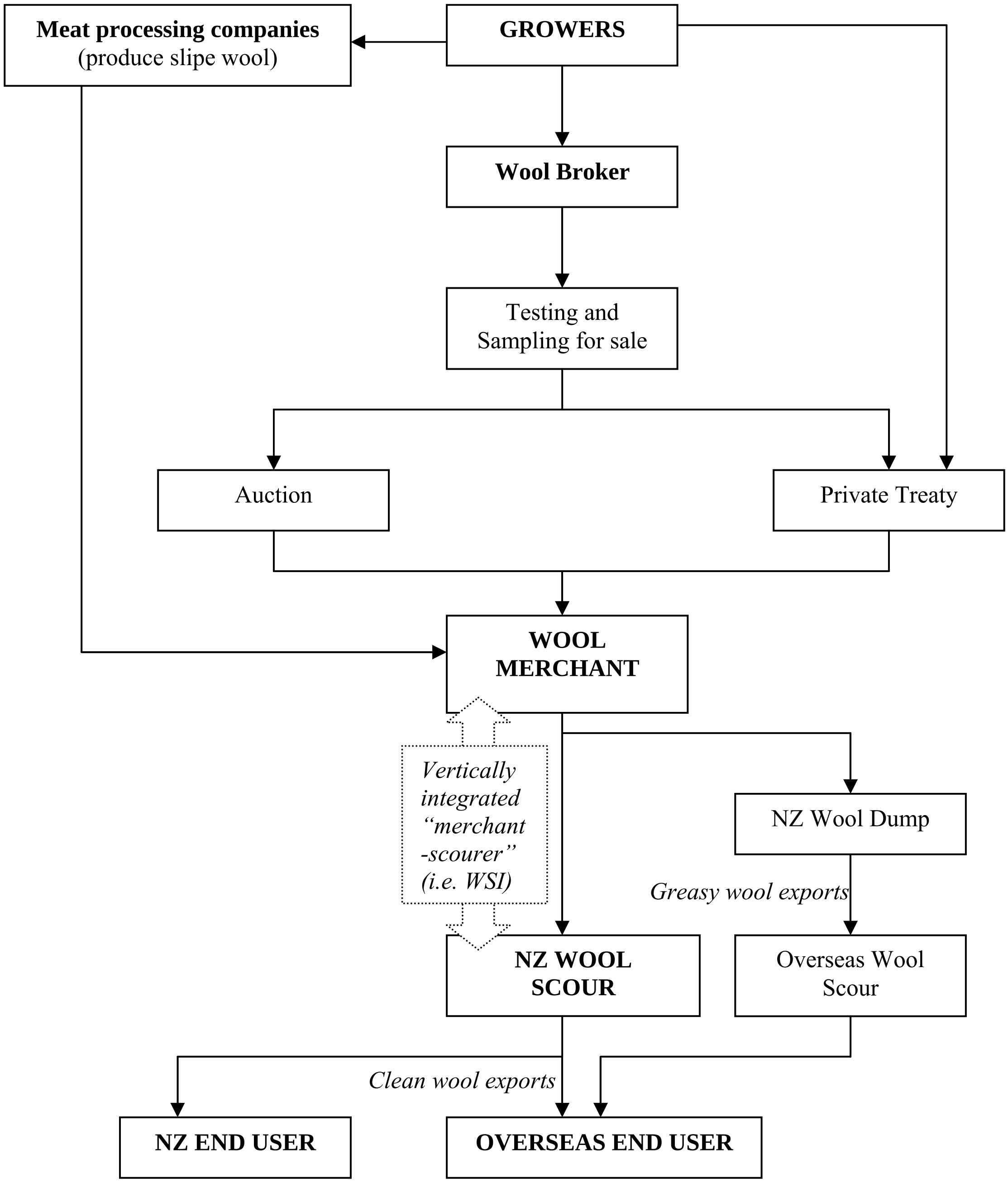
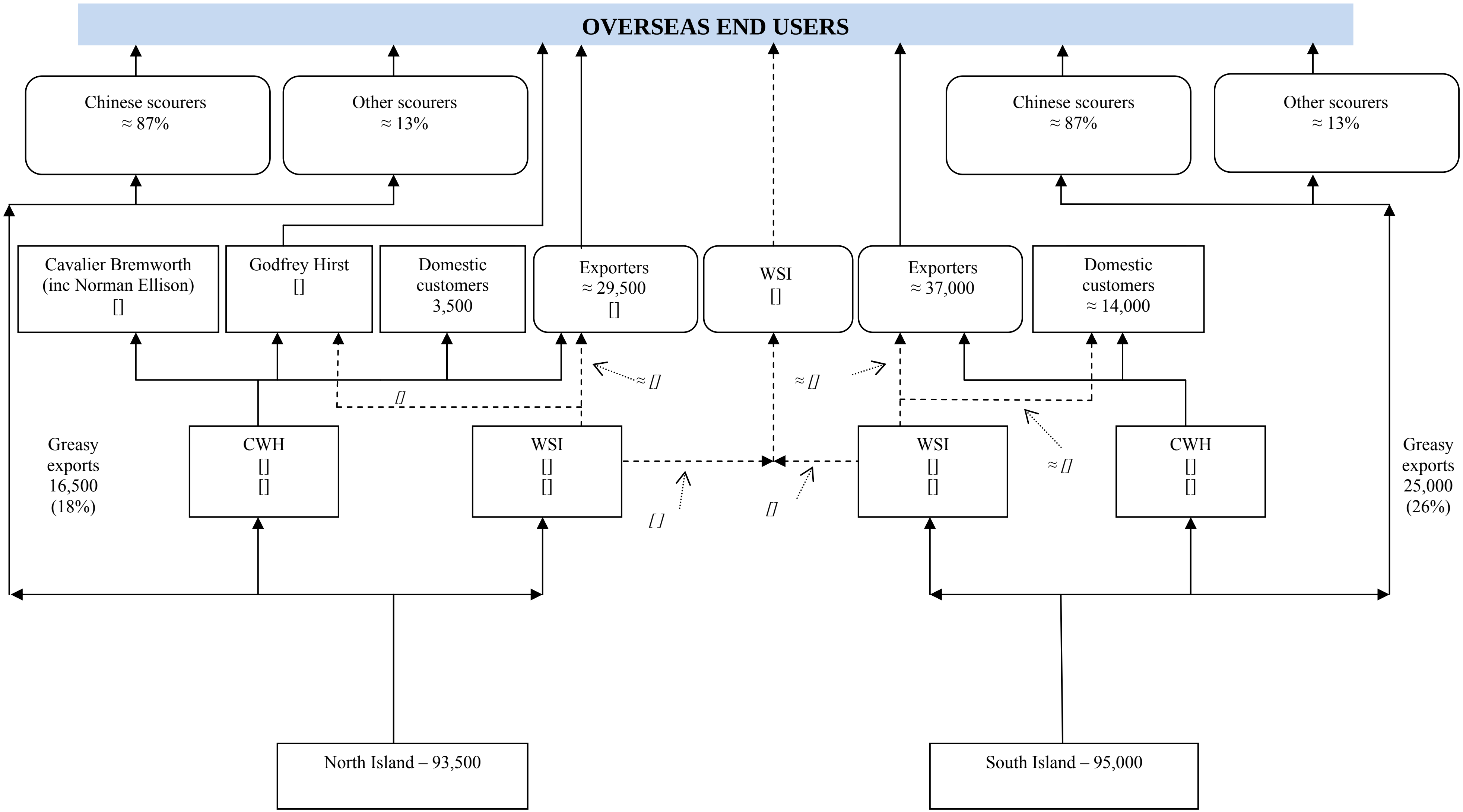


Figure 2: Estimated Wool Volumes (in tonnes)



Wool Scouring

30. In essence, wool scouring involves:
    - blending of various batches of different quality greasy wool to meet customers' quality specifications – quality means fibre strength, length and diameter, colour, brightness and cleanliness;
    - opening of the blended wool fibres by a mechanical flail process to allow full contact between fibres and washing liquid;
    - washing (and sometimes bleaching) the wool in various numbers of bowls of hot water and detergent;
    - extraction of wool grease for sale by the LTC;
    - drying the wool;
    - high density pressing packing into bales; and
    - testing of each bale for correct wool specification.
31. The scouring and high density pressing processes currently account for only about 5-6% of the current value chain of scoured and packed wool.[8]
32. Historically, the size of the wool scouring industry has been closely aligned to sheep numbers and the available wool clip. For instance, when the New Zealand sheep flock reached its peak of 70 million in 1982-3, there were about 20 separate wool scouring operations. However, the decline in sheep numbers to around 33 million at present, has been accompanied by a significant reduction in the wool clip and this along with the development of higher capacity modern scouring plants and presses, has resulted in a reduction in the number and total capacity of wool scours in New Zealand. Currently there are five wool scouring plants, three in the North Island and two in the South Island.[9] If the acquisition proceeds all five existing wool scours will be owned by Cavalier Wool which intends to centralise wool scouring at one site in each island (if the to be mothballed Clive site is ignored).

PREVIOUS DECISIONS

33. The Commission has previously considered wool scouring in:
    - *Decision No 587: Godfrey Hirst NZ Limited/Feltex Carpets Limited*, 31 August 2006. This acquisition gave rise to horizontal aggregation in the market for the supply of wool scouring services in the North Island; and
    - *Decision No 666*: *David Ferrier and/or New Zealand Woolscourers Limited/Cavalier Wool Holdings Ltd/Godfrey Hirst NZ Limited*, 6 March 2009. This acquisition resulted in the aggregation of market share in the market for the supply of wool scouring services in the North and South Islands.

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[8] There has recently been a steep rise in the price of greasy New Zealand wools, not matched by any increase in scouring/pressing costs. Therefore up until about one year ago, scouring and pressing was a larger proportion of the wool value chain.

[9] Although as stated, one North Island plant at Clive only operates for a few weeks a year at the peak of the shearing season.

FRAMEWORK FOR ANALYSIS

Substantial lessening of competition

34. If it is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, the Commission must give a clearance for the proposed acquisition. Section 3(1) of the Act states that competition means workable or effective competition.

35. To assess whether or not the effect will, or would be likely to lead to, a lessening of competition in a market, a counterfactual analysis is undertaken. This exercise requires a comparison of the likely state of competition if the acquisition proceeds ('the factual') against the likely state of competition if it does not ('the counterfactual').[10]

36. The High Court in Air New Zealand v Commerce Commission (No.6)[11] accepted that an absence of market power would suggest there had been no substantial lessening of competition in a market but did not see this as a reason to forsake an analysis of the counterfactual as well as the factual. Justice Rodney Hansen stated that "...a comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, that is, dominance has been attained."

37. The Court of Appeal in *Port Nelson v Commerce Commission*[12] noted that for something to be "likely" it must be "above the mere possibility but not so high as more likely than not and is best expressed as a real and substantial risk that the stated consequence will happen."

38. The High Court in Woolworths & Ors v Commerce Commission observed that "…a substantial lessening of competition is one that is "real or of substance" as distinct from ephemeral or nominal. Accordingly a substantial lessening of competition occurs if it is likely that there will be a reduction in competition that is real or of substance."[13]

39. If the Commission cannot be satisfied, it must then determine under s 67(3) whether, nonetheless it can be "satisfied that the proposed acquisition will result, or would be likely to result in such a benefit to the public that it can be permitted." This requires the Commission to determine whether the detriments flowing from the lessening of competition are outweighed by the public benefits that result, or would be likely to result from the acquisition.

The public benefit test

40. Any assessment of detriment and benefit will be fact specific but a number of principles have emerged from the Courts' decisions. The High Court in *Air New Zealand v Commerce Commission (No 6)*[14] noted the following:

    - Benefits include efficiency gains (s 3A of the Act) and anything of value to the community generally: *Telecom v Commerce Commission* (1991) 4 TCLR 473,530.

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[10] *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA).
[11] *Air New Zealand v Commerce Commission* (No.6) (2004) 11 TCLR 347.
[12] (1996) 5 NZBLC 104, 150; (1996) 3 NZLR 562-563.
[13] *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC).
[14] Above n11 at {319}.

- Only net benefits are included. Any costs incurred in achieving efficiencies must be taken into account. Transfers of wealth which achieve no benefit to society as a whole should be disregarded.
- The benefits must result from the acquisition. Benefits which would or would be likely to accrue whether or not the acquisition proceeds should be disregarded.
- Benefits should be quantified where possible but benefits, which by their nature, are incapable of quantification, should still be taken into account. The Court acknowledged that quantification of dynamic efficiencies and dynamic gains is particularly difficult.

MARKET DEFINITION

Introduction

41. The Act defines a market as:

> "… a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them."[15]

42. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit maximising, sole supplier of a good or service, not constrained by the threat of entry would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

43. The Commission defines relevant markets in terms of five characteristics or dimensions which are:
    - the goods or services supplied and purchased (the product dimension);
    - the level in the production or distribution chain (the functional level);
    - the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent);
    - the temporal dimension of the market, if relevant (the timeframe); and
    - the customer dimension of the market.

Product/Functional Market Dimension

44. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market. The degree of demand-side substitutability is influenced by the extent of product differentiation.

Wool scouring

45. The proposed acquisition would give rise to horizontal aggregation in respect of wool scouring services[16] in the North and South Islands.

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[15] Section 3(1A) of the Commerce Act 1986.
[16] "Wool scouring services" include within their scope, the operation of high density pressing into bales at the end of the production processes.

46. Wool pressing (into bales containing the clean wool end product of a wool scouring plant) is an integral and necessary part of wool scouring plants. Therefore, in these reasons (for brevity) the Commission has included wool pressing as part of its definition of wool scouring services.

47. Wool scouring is a specific service required to clean wool in advance of further processing. There is no demand-side substitutability for the service and similarly there is no supply-side substitutability in the provision of such services. As such, the Commission considers that it is appropriate to define a discrete market for wool scouring services.

48. Wool scouring services are typically provided on a commission basis. Ownership of the wool is retained by the end user, who pays a fee for the wool to be scoured and in some cases delivered to the next destination. In the case of WSI, which is a vertically integrated merchant scourer, the ownership of the wool is retained by the trading division throughout the scouring process. The Commission therefore considers that the appropriate functional dimension of the wool scouring market is the supply of wool scouring services.

Wool grease

49. In addition, the acquisition would result in an increase to 100% of the shareholding of the merged entity in LTC, which purchases and markets wool grease, a by-product of the wool scouring process.

50. As the purchase and supply of wool grease is a distinct step related to the production of clean wool and for which there is no substitute, the Commission considers that it forms a distinct market in both the product and functional dimensions.

Geographic Dimension

51. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.

Wool scouring

52. Industry participants advised the Commission that only small volumes of wool are currently transported across the Cook Strait and that freight costs make movement of wool between the Islands largely uneconomic. Andrew Campbell, Managing Director of JSB, exporters of wool informed the Commission that some wool does move between the Islands, depending on the type of wool and export requirements. However, Mr Campbell said that this was an exception and the vast majority of wool sourced from the North Island was scoured in the North Island and similarly for the South Island.

53. In the North Island, all existing wool scouring plants are located in close proximity to each other in the Hawke's Bay. While Hawke's Bay itself produces large volumes of wool, wool is transported from all wool producing regions of the North Island to be scoured in Hawke's Bay.

54. In the South Island, both scours are located in Canterbury, with Kaputone being near Christchurch and Canterbury Wool Scours being near Timaru. Similar to the North Island, wool is transported from all wool producing regions of the South Island to be scoured at either of these two sites.

55. Accordingly, for the purposes of considering the proposed acquisition, the relevant geographic markets are the North and South Islands.

Wool grease

56. Wool grease is a high value, low volume product and is, therefore, capable of being transported economically over large distances. For that reason, the Commission considers that for the purposes of this Application, it is appropriate to define a national geographic market for the purchase and supply of wool grease.

Market Definitions in Previous Relevant Decisions

57. In Decision 587, the Commission concluded that a relevant market for the purposes of assessing that acquisition was the North Island market for the supply of wool scouring services (the North Island scouring market).

58. In Decision 666, the Commission concluded that for the purposes of assessing that acquisition, the relevant markets in respect of wool scouring services were:

- the North Island market for the supply of wool scouring services (the North Island scouring market);
- the South Island market for the supply of wool scouring services (the South Island scouring market); and
- the national market for the purchase and supply of wool grease (the national wool grease market).

Conclusion

59. Accordingly, for the reasons above the Commission proposes to adopt the following markets when considering the Application:

- the North Island market for the supply of wool scouring services (the North Island scouring market);
- the South Island market for the supply of wool scouring services (the South Island scouring market); and
- the national market for the purchase and supply of wool grease (the national wool grease market).

60. The Applicant submits that these markets are appropriate to analyse the Application. No other interested party has argued or submitted to the contrary.

FACTUAL/COUNTERFACTUAL

61. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a with and without comparison rather than a before and after comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual).[17] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

62. As noted above, the Applicant proposes in the factual to:

- close WSI's scours at Kaputone and Whakatu and sell the land and buildings;

[17] *Air New Zealand v Commerce Commission* (No.6) (2004) 11 TCLR 347 at {42}.

- relocate WSI's scour lines at Kaputone and Whakatu to Cavalier Wool's existing scouring sites at Timaru and Awatoto respectively;[18]
- modify Cavalier Wool's 2.4 scour lines at Awatoto to improve their productivity;
- mothball scour lines at Cavalier Wool's Clive and Timaru plants; and
- divest or close down WSI's national and international wool trading operations.

63. WSI has advised the Commission that a special resolution, needing a 75% shareholder vote, would be required in order to transfer the scouring assets to Cavalier Wool. In this respect, Cavalier Wool has advised the Commission that, if for any reason it was not able to carry out the proposed actions listed above post-acquisition (the rationalisation), it would not proceed with the transactions which are the subject of the Application. The Commission, therefore, accepts the Applicant's proposed factual scenario.

Counterfactual

64. The counterfactual is the Commission's view of what would be likely to occur if the acquisition being considered were not to proceed. It is the benchmark against which any changes arising from the proposed acquisition is assessed. When making this assessment, the Commission recognises that future scenarios may include either the existing owners continuing to control the target entity, or other parties that are interested in purchasing the target entity if the Applicant's proposed acquisition were not to proceed and the sale to continue.

65. The Applicant has presented its analysis on the basis that the relevant counterfactual is the status quo.

66. The Receiver for Woolpak Holdings and Plum Duff advised that a number of parties have expressed interest in being involved in the sale process and are expected to complete the confidentiality undertakings and receive the Receiver's fact sheets.

67. Industry participants have expressed concerns that WSI could be purchased by an international entity and the wool scouring assets could be sent offshore. They are concerned that this could lead to a permanent reduction in the scouring capacity in New Zealand. However, such an outcome seems unlikely as a purchaser wishing to purchase WSI, or its scouring operations, as a going concern would be likely to pay more than a purchaser that was only interested in the residual value of the scouring assets. The Commission notes that the current market capitalisation of WSI is $33.1 million (at the present 48 cents per share price).

68. Given that Cavalier Wool and WSI are the only New Zealand-based parties currently operating in the relevant scouring markets, there would be no aggregation of market shares if WSI was purchased by any interested party, other than Cavalier Wool. Therefore, in view of these factors, and on the basis of available information, the Commission's preliminary view is that the relevant counterfactual is likely to be the status quo.

[18] Kaputone is near Belfast which is north of Christchurch, while Whakatu and Awatoto are between Napier and Hastings.

COMPETITION ANALYSIS

Introduction

69. This section assesses whether the acquisition is likely to result in a substantial lessening of competition. The Commission notes the loss of a competitive constraint from the loss of WSI. Moreover, despite constraints from Chinese scourers and the possibility of (re-)entry into scouring by firms in New Zealand, the Commission cannot discount the prospect of price increases post acquisition. Accordingly the Commission is not satisfied that the acquisition would not have the effect, or likely effect, of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services.

70. The paragraphs that follow discuss the competitive constraints provided by WSI, Chinese scourers, and the prospect of entry into scouring in New Zealand.

71. The Commission is satisfied that there is no substantial lessening of competition in the national wool grease market. As a result, the Commission does not propose to consider the national wool grease market in detail in this Draft Determination.

72. This section concludes with an assessment of the main competitive pressures in the market.

North and South Island Wool Scouring Markets

73. As discussed above, the Commission considers that transporting wool between the North and South Island for the purpose of scouring would not normally be economic. Therefore, there would be separate North and South Island geographic dimensions of the scouring market. However, the Commission considers that the competition issues in respect of the supply of wool scouring services are generic to both the North and South Island geographic markets. In both Islands there would be a reduction from two wool scourers to one. The Commission has, therefore, treated them together for the purpose of the competition analysis.

EXISTING COMPETITION

Constraint from WSI

74. Post acquisition WSI would be removed as an independent supplier of wool scouring services in each of the affected wool scouring markets leaving Cavalier Wool as the only provider.

75. The Applicant discounts WSI as a competitor but the minutes of Cavalier Wool's Board of Directors' meetings show an explicit concern in relation to the competitive threat that WSI imposes. The minutes include:

- [ ]
- [ ]

[

][19]

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][20]

- [

]

[ ][21][

76. The Commission remains of the view expressed in Decision 666 that WSI is a significant competitive constraint on Cavalier Wool and that when the factual is compared to the counterfactual, that constraint will be lost.

Constraint from Wool Scours in China

77. The Applicant asserts that the combined entity would continue to be constrained in the factual by the existing competition provided by overseas wool scourers, particularly in China.

78. The Applicant argues that existing competition in the form of greasy wool exports to China (where the wool would be scoured prior to downstream manufacturing operations) would be sufficient to constrain the combined entity. The Applicant states that should it seek to increase prices post-acquisition, exporters could readily switch to exporting greater proportions of greasy, rather than clean scoured, wool to China. The combined entity could lose profitable scouring business.

79. China is currently the largest export market for New Zealand wool. In the year ending June 2010, around 32% of New Zealand's wool clip was exported to China. Around 57% of those exports were in greasy form which implies that 18% of New Zealand's

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[19] Extract from minutes of a meeting of Cavalier Wool's Board of Directors, April 2010.
[20] Extract from minutes of a meeting of Cavalier Wool's Board of Directors, May 2010.
[21] Extract from minutes of a meeting of Cavalier Wool's Board of Directors, February 2011.

wool clip is scoured in China at present, and 14% of the wool clip is scoured in New Zealand and exported to China. Figure 4 shows that both scoured and greasy exports to China have been increasing over recent years. Discussions with industry players indicate that the boundary between greasy and scoured exports to China may be quite fluid.

Figure 4: New Zealand Wool Exports to China over the Past Five Years[22]

80. The Chinese wool industry uses all types of wool, not just fine wools. Illustrative of this is that in the year to June 2009, about 41,000 tonnes of greasy wool were exported from New Zealand of which 34,000 was exported to China. The total exported volume comprised:

- 23,600 greasy tonnes of coarse strong wool;
- 8,200 greasy tonnes were mid micron wool; and
- 8,200 greasy tonnes of fine Merino wool.[23]

Because 83% of greasy wool exports are to China, Cavalier Wool argues that these figures prove that China is now not just a consumer of fine wool (as has been argued by some).

81. Cavalier Wool argues that the risk of exporters diverting a proportion of its present scouring volumes to China as greasy wool will act as a constraint on Cavalier Wool's pricing in the factual. Any such diversion of volumes would cost Cavalier Wool's currently profitable scouring business. The Commission notes in this respect, that Cavalier Wool has taken action, [

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[22] This figure uses clean wool weights exported. One kilogram of greasy wool is equivalent to about 0.75 kilograms of clean wool. See Beef and Lamb Economic Service statistics.
[23] Beef and Lamb Economic Service statistics.

82. There is some independent support for Cavalier Wool's view on "China." [ ] (a merchant operating in New Zealand), advised that his company is now exporting more greasy wool than clean wool. [ ] also advised that he has received several approaches from Chinese scourers with excess capacity who want to scour New Zealand wool.

83. Merchants advised they would be reluctant to abandon other (for example, European) profitable export customers for scoured wool, to sell greasy wool to China, even if there were increased scouring charges in New Zealand. For example, [ ], advised that for sales of some speciality wools, particularly ultrafine wools, a margin of 10%[24] can be achieved. However, for the bulk of export sales a margin of 2% is the rule of thumb. It would appear from these comments that there are some sales to customers that net back more to exporters than sales to China. Sellers to such customers may endure a larger increase in scouring prices before switching to simply exporting greasy wool to China (for the China market).

84. Indeed, some market participants expressed the view that some scouring price increases could be passed on to customers overseas. [ ] said that an increase of New Zealand scouring tariffs of up to NZ$0.10 for example, (equivalent to a 25% increase on current prices) would not trouble international purchasers of New Zealand wool if passed on to them. He said that the major concerns of international manufacturers of wool-based products at present, is to ensure reliable long-term supply of clean New Zealand wool in the face of reduced production here. [ ], also stated to the Commission that a 5 to 10 cent increase in the scouring tariff would be irrelevant to the operation of international wool markets. Further support for this view was provided by [ ]

85. The wool export industry almost unanimously dismissed the idea of commission scouring of New Zealand wool in China, for re-export to other markets, most importantly due to a loss of control over the wool and the wool scouring process. Mr Peter Whiteman, Managing Director of Segard Masurel, advised that it has trialled scouring wool in China for re-export but now prefers to have it scoured in New Zealand for greater control and logistical reasons. Mr John Henderson of Fuhrman stated he would not commission scour in China because that would require thorough supervision of unloading at the relevant port, delivery to the scour, and processing through the scour, and delivery back to the export port. Delay in delivery to the ultimate end use customer would also be unacceptable. The Commission interprets these views as meaning that a large New Zealand scouring price increase would be needed before scouring wool in China for resale elsewhere could be viable.

Conclusion on the "China" Constraint

86. On balance, it is the Commission's preliminary view that the ability of exporters to divert more greasy wool to China for scouring, is unlikely in itself to sufficiently constrain the combined entity. The competitive pressure from China, as evidenced by [ ] may constrain price increases for sales to China, especially if it is possible to price discriminate in favour of Chinese sales. Prices to other parties exporting to Australia or Europe could increase. Alternatively, if price discrimination is not possible in the longer-term, it may be profitable for the combined entity to forgo

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[24] Gross margin on top of the total of the exporters' wool purchase, packing, shipping, testing, agency and other costs.

scouring of wool for China, in order to increase prices to exporters who have no real alternative to scouring in New Zealand.

The Australian Experience

87. Nevertheless, the Commission does recognise that the Chinese scouring industry poses a significant long term competitive threat to the domestic industry in New Zealand.

88. The size of the Australian wool scouring industry has been severely reduced by competition from Chinese wool scours:

> It has become increasingly apparent that as China, Australia's biggest wool trading partner increases its market dominance, their continued reluctance to purchase processed wool has resulted in wool processing in Australia diminishing each year. The processing of scoured wool in Australia has declined every year for the last 8 years which has resulted in a significant over capacity of wool scouring equipment in Australia. This ... has made our scouring business in Western Australia unsustainable and as a result has forced us to take this unfortunate decision (to close Jandakot's wool scouring operations in Western Australia).[25]

89. The suddenness of the decline in the Australian industry mentioned by Jandakot is illustrated as follows:

- In 1995 there were 25 wool scouring sites in Australia scouring about 600,000 greasy tonnes per annum (of total Australian wool production of 730,000 tonnes per annum).
- In 2009 there were three commercial wool scouring sites in Australia processing about 54,000 greasy tonnes per annum (of total Australian wool production of about 400,000 tonnes per annum).

90. Cavalier Wool stated that because the New Zealand scouring industry has rationalised itself by progressively removing overcapacity (unlike the situation that prevailed in Australia), it has so far survived the rise of the low cost Chinese wool scouring industry. It illustrates this by stating that at present average scouring prices in, what remains of the Australian scouring industry, are A$0.45 per greasy kilogram. The equivalent New Zealand price for scouring comparable fine wools is NZ$0.32.[26]

POTENTIAL ENTRY

91. The Applicant asserts that potential entry would be sufficient in itself to constrain the combined entity.

92. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any impediments they might encounter should they try.

93. This section examines the requirements for entry and uses the Commission's "LET" test to assess whether entry would be sufficiently likely, extensive and timely to constrain the combined entity.

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[25] Statement by Mr Lindsey Mitchell, Managing Director, Jandakot Wool Washing Pty Limited, January 2009.

[26] The Commission has also been informed that the scouring industry in the United Kingdom has been severely reduced in size. Currently scouring prices there are about £0.25 per kilogram.

Requirements for Entry

94. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and effect of market conditions that impede entry.

Production site with necessary consents

95. A key requirement for entry would be the acquisition of an appropriate site for the new scouring plant. It would necessarily need to be located at the centre of gravity of wool production in each island and be proximate to an export port (most likely Hawkes Bay in the North Island and Canterbury in the South Island). An appropriate site would require the necessary resource consents, including water supply and effluent discharge. Godfrey Hirst advised the Commission that a 'green fields' site would likely have to meet higher, and therefore, more costly environmental standards than imposed on previous wool scourers. As such, these conditions could place a new entrant at a competitive disadvantage to the incumbent merged entity. However, Cavalier Wool provided the Commission with independent information conflicting with that view, from Mr Stephen Daysh, Director of Napier-based Environmental Management Services Ltd. Mr Daysh who has had 15 years planning experience in Hawke's Bay advised that any proposed new wool scouring operation could be sited within either the Awatoto or Whakatu/Tomoana industrial areas. In such a case, there would be no planning provisions or water/trade waste capacity restrictions that would create any substantive barrier to establishing such an operation in Hawke's Bay.

96. It has been suggested that it would be possible for an entrant to acquire a former meat processing site or even the site of a closed down scouring operation which would already have the relevant consents. The Applicant has advised there are a number of possible sites where a new entrant could locate a wool scour, including former wool scouring sites that retain the necessary consents.

97. On the other hand, Godfrey Hirst, advised that (as a result of the proposed acquisition, which Godfrey Hirst opposes) it has investigated possible sites in Hawkes Bay for it to re-enter scouring markets, but has not been able to identify a suitable site that would be large enough for a new wool scour. A prime site requirement, according to Godfrey Hirst, would be access to the Hastings City Council marine sewage outfall which would provide the site with low cost effluent disposal.

98. Two possible North Island sites have been identified by the Applicant:

- Oringi, the former Silver Fern Farms processing site, near Dannevirke. Godfrey Hirst advised that its location makes this an unsuitable site as it is too far from the Port of Napier and effluent discharge would be problematic and treatment expensive.
- Awatoto, opposite Cavalier Wool's existing scouring site. Godfrey Hirst advised this site is also unsuitable as it has been subdivided and the remaining unoccupied warehouse building is too small. Moreover, it would be expensive to install and operate an effluent discharge system at that location.

Scouring equipment

99. Entry into the wool scouring industry requires, amongst other things, specialised plant and equipment. This equipment can be purchased new from Timaru based engineering company, ANDAR Holdings Limited, or potentially second-hand from overseas.

100. The Commission has been advised that the installation of a new 3 metre wide scour line, with all associated equipment, such as a high density press, may cost about $12-15 million. However, an entrant could conceivably enter with a 2.4 metre wide line for considerably less.

101. In addition, Decision 666 noted the ready availability of second hand scour lines in Australia which could be a fillip to an entrant. Thus entry barriers were considered to be low as entrants could start up with relatively low fixed costs. The Commission understands that most available second-hand scouring equipment suitable for scouring New Zealand wools has now been sold to Chinese interests. Therefore, the potential for low fixed cost entry through the use of second hand equipment appears to be lower than it was when the Commission last considered this issue.

Access to sufficient quantities of wool

102. A major obstacle for a new entrant would be securing sufficient quantities of wool to ensure the necessary capacity utilisation for an economic wool scouring operation. It is conceivable that a new entrant could be a wool exporter, or group of exporters, and thus the entrant could secure enough wool for its scour through its own trading arm(s). However, when asked by the Commission, wool exporters have generally expressed a reluctance to re-enter the scouring industry.[27]

103. Other potential entrants could be a large domestic consumer of scoured wool (or a joint venture of several such consumers), which may choose to enter in order to ensure supply of its input product at a competitive price. As discussed Godfrey Hirst, driven by its concerns over the Acquisition, has investigated the possibility of re-entering the scouring market. Godfrey Hirst's own demand of around [ ] tonnes per year could be sufficient to allow a 2.4 metre wide scour line to operate at near to full capacity. Alternatively, there is the possibility that Godfrey Hirst could sponsor entry by guaranteeing its volumes for a certain period of time to another party.

104. In a best case scenario, Godfrey Hirst would expect it to take at least 18 months to re-enter. In the meantime Godfrey Hirst has concerns that Cavalier Wool, part owned by Godfrey Hirst's major New Zealand competitor in carpet markets, could make it very difficult for it, or any other customer who was a potential entrant, to obtain its required amounts of scoured wool in a timely manner.

105. Godfrey Hirst is also concerned that Cavalier Wool could potentially enter into long term scouring contracts with its customers during that entry period, in order to ensure they could not switch to a new entrant for at least some years. Such long-term contracts could lessen any competitive detriment if Cavalier Wool was required to offer lower prices in order to induce long-term commitments from merchants. Also, the same strategy would be available to a new entrant.

Significant economies of scale

106. The applicant has stated that the acquisition will result in significant economies gained by rationalising the number of scour lines and sites and achieving better capacity utilisation and lower fixed and variable costs. Cavalier Wool's lower average unit cost arising would give it the ability to act strategically and lower prices in response to entry. An entrant could face the significant risk of the stranding of its assets.

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[27] Until relatively recently the Timaru wool scour was 50% owned by wool exporters Fuhrmann and G Modiano who, in 2007, sold out to Cavalier Wool which now owns 100% of that plant. It was reported to the Commission that this exit by wool merchants was at the expense of capital losses.

107. Cavalier Wool in its Application states that its combined administration and scour operating expenses will be reduced by [ ] in the North Island and [ ] in the South Island after the acquisition. As such, it is expected that, post acquisition, Cavalier Wool's cost structure would be significantly lower than the present industry cost structure. Even if an entrant was able to enter on the same scale as a current industry competitor, it would initially face a significant cost disadvantage in doing so.

108. The benefits from economies of scale in terms of reduced costs for the industry are taken into account in the benefits section below.

The LET Test

109. In order for market entry to be a sufficient constraint, entry of new participants in response to a price increase or other manifestation of market power must be:

- likely in commercial terms;
- sufficient in extent to cause market participants to react in a significant manner; and
- timely, that is, feasible within two years from the point at which market power is first exercised.

Likelihood

110. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on investment, including an allowance for any risks involved.

111. The Commission notes that there is now a long history of exit and rationalisation in the wool scouring industry. Moreover, sheep numbers have declined substantially in recent years. The Commission has been advised that ewe slaughter numbers are 30% higher this year than last, with the implication that lamb production will fall, and that there are real concerns that sheep numbers could decrease further.

112. Wool exporters, as the most likely entrants, did not express any interest in entering or re-entering wool scouring markets. Their reasons given were the decline in the wool clip available, the high capital costs, and the fact that wool scouring no longer formed a core business for many merchants.

113. The Commission considers that the most likely entrant would be Godfrey Hirst which has experience in wool scouring and has concerns about the Acquisition. However that company has contracted Cavalier Wool to be its preferred supplier for wool scouring services for all wool acquired by Godfrey Hirst in New Zealand [ ]. [ ] Given the contract provides mutual benefits to both Cavalier Wool and Godfrey Hirst it appears to the Commission to lessen the attractiveness of entry to Godfrey Hirst, whatever its concerns over the Acquisition.

114. As discussed above in respect of economies of scale, it is difficult to be confident that entry would be likely in response to a price increase from current levels. At present the cost of scouring is about 8% of the value of the wool being scoured.[28] A 5% price

[28] Based on the most recent wool prices at auction, this figure may be about 5 to 6%. However, the Commission notes that when wool prices were low, the scouring proportion was about 12% of the price of wool. Therefore, the Commission considers that 8% is a reasonable average to be applied.

increase, for example, for scouring would represent just a 0.4% drop in the value of wool to the grower, possibly too small to trigger entry.

115. As a result of these factors, the Commission considers that entry is unlikely.

Extent

116. If it is to constrain market participants, then the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner.

117. A likely minimum commercial scale of entry would be one 2.4 metre wide scour line, which would likely be sufficient to cause the incumbent to react. For instance, Cavalier Wool's Hawkes Bay 2.4 metre wide scour lines process approximately [ ] tonnes of greasy wool each per year, or around [ ] of the North Island clip each.

Timely

118. To effectively constrain the exercise of market power, entry must also be timely. If it is to alleviate concerns about a substantial lessening of competition, entry must be feasible within a reasonably short timeframe, which the Commission typically considers to be two years, from the point in which market power is exercised.

119. While the Commission notes the issues surrounding resource consents, it is likely that if entry occurred it would be within the relevant two year timeframe.

120. As discussed the Commission considers that while Godfrey Hirst is a potential entrant, its contract with Cavalier Wool (discussed above) [ ]. Therefore entry by Godfrey Hirst is unlikely to be "timely."

Conclusion on "LET" test

121. The Commission considers that entry fails the LET test as it would be unlikely to occur within the two year time frame applied by the Commission.

Conclusion on Potential Competition

122. The Commission is of the view that potential competition is unlikely to occur within a two year timeframe to an extent that would be sufficient to constrain the combined entity.

CONCLUSION ON COMPETITION ANALYSIS

123. The Commission has considered the following potential constraints on the merged entity for the various segments of the demand for New Zealand wool:

- sales of scoured wool to China for which the price of scouring in New Zealand may be capped by the possibility of a switch to export in greasy form to China;
- sales to markets other than China, for which the price of scouring in New Zealand may be capped by the possibility of a switch to export in greasy form to China; and
- sales to markets other than China, for which the price of scouring in New Zealand is more likely to be capped by new entry into scouring in New Zealand, which may occur if prices were to increase significantly.

124. However, the Commission's preliminary view is that neither existing nor potential competition would be likely to sufficiently constrain the merged entity in the factual. The level of the price caps discussed in the preceding paragraph, for the reasons

discussed in the analysis, would in the Commission's view be too high for there not to be the effect of a substantial lessening of competition in the relevant scouring markets. Therefore, the Commission's preliminary conclusion is that it is not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services.

EFFECTS OF THE ACQUISITION IN THE WOOL GREASE MARKET

125. The proposed acquisition would involve horizontal aggregation of market shares in the North and South Island wool scouring markets. Additionally, in the factual the Applicant would increase its shareholding in LTC from 50% to 100%.

126. While there has been a submission by Godfrey Hirst[29] that Cavalier Wool's 100% ownership of LTC in the factual would provide an adverse condition for an entrant to overcome,[30] the Commission has been informed by Cavalier Wool (which has been confirmed by most parties interviewed by the Commission including WSI) that there is strong international demand for wool grease from New Zealand. The Commission has noted the recent statement of Dishman Veenendaal:[31]

> Due to a significant increase in woolgrease prices, we are being forced to increase our Cholesterol prices significantly to the market.
>
> Wool grease is the major raw material ingredient which is used in the manufacture of Cholesterol and thus very heavily determines the cost. There has been a significant increase in the price of wool grease over the past year and this factor has impacted the profitability of our Cholesterol business. Therefore, we are being forced to increase our prices significantly to the market.
>
> There are a number of reasons for the sharp fall in the amount of wool grease which is available to the market and which has resulted in a significant increase in raw materials prices. The decreasing usage of wool in the clothing industry which has been replaced by cotton has resulted in less wool grease being made for the market. Furthermore, the substantial ...demand for wool grease for the manufacture of Cholesterol for use in the production of Vitamins is another reason for the decrease in availability. The number of sheep has also decreased and this is another contributory factor.

127. Therefore, the Commission considers that an entrant into scouring markets would have no difficulty selling its wool grease by-product at favourable prices by supplying the international demand mentioned above, and, as such, any exclusion from LTC's expertise and intellectual property would not be an onerous condition that would adversely affect the potential entrant's ability to enter the relevant wool scouring markets.

128. In addition, Cavalier Wool, in response to Godfrey Hirst, submitted that it would not exclude an entrant from membership of the LTC cooperative because an excluded party would provide competition to LTC in international wool grease markets. Therefore, the Commission does not consider that any increase in market power arising from the aggregation of market share in the relevant wool grease market would have the effect or likely effect of substantially lessening competition in that market. As a result the Commission does not propose to consider the national wool grease market further in this draft determination.

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[29] Letter from Chapman Tripp dated 4 March 2011, paragraph 9.
[30] Given, LTC's years of experience in wool grease trading and extensive intellectual property.
[31] Dishman Veenendaal is a Netherlands-based group of companies offering services to the pharmaceutical industry.

129. Futures Consultants (Futures), on behalf of WSI, noted the low barriers to enter the wool grease market that would be faced by any potential entrant. Futures also noted that LTC would be unlikely to discriminate against a new supplier of wool grease as it would undermine LTC's single desk seller advantage. Futures concluded that there was unlikely to be a substantial lessening of competition in the national market for the purchase and supply of wool grease.

130. The Commission is satisfied that this is the case and notes that no party other than Godfrey Hirst has raised competition concerns about this market.

PUBLIC BENEFITS AND DETRIMENTS

131. As the Commission has concluded that it is not satisfied at this stage in terms of s 67(3)(a) of the Act, it must now consider whether it can be satisfied that the proposed acquisition will result or be likely to result in such a benefit to the public that it should be authorised in terms of s67(3)(b) of the Act.

132. The authorisation procedures require the Commission to identify and weigh the detriments likely to flow from the acquisition and to balance those against the identified and weighed public benefits likely to flow from the acquisition as a whole. The Commission considers that within the relevant markets, a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved.

133. The Commission is also mindful of the observations of Richardson J in *Telecom Corporation of New Zealand Ltd v Commerce Commission*[32], on the Commission's responsibility to attempt to quantify benefits and detriments to the extent that it is feasible, rather than rely on purely intuitive judgement. This is not to say that only those gains and losses which can be measured in dollar terms are to be included in the assessment; those of an intangible nature, which are not readily measured in monetary terms, must also be assessed.

Detriments

134. The Applicant has stated that, given the constraints imposed by the continued growth of the Chinese wool scouring industry, it believes that the proposed acquisition would result in little if any detriment.[33] However, it has assessed the level of detriment which "could be said to arise if the loss of WSI as a competitive constraint was considered to be significant by the Commission."

135. In undertaking this assessment the Applicant has used the categories normally used for this purpose by the Commission – loss of allocative efficiency, loss of productive efficiency and loss of dynamic efficiency.

Loss of Allocative Efficiency

136. In general, when the price of a product increases (for instance, because of a loss of competition as a result of a merger), demand for that product will fall as some consumers switch to alternative products which meet their requirements in a less satisfactory way or are more costly to produce than the product they replace. In effect

[32] [1992] 3 NZLR 429.
[33] At paragraph 19.1 of the Application.

the country's resources are allocated less efficiently. The size of the loss of allocative efficiency depends primarily on the ability and incentive (i.e. it is profit maximizing) of the firm post-acquisition to increase prices, which in turn depends on the extent that demand for the product declines with an increase in price (the elasticity of demand).

137. The Commission has received estimates of loss of allocative efficiencies arising from the Acquisition from the following consulting economists (see Table 1 below):

- NERA on behalf of the Applicant;
- Castalia Strategic Advisors (Castalia) on behalf of Godfrey Hirst; and
- Futures Consultants (Futures) on behalf of WSI.

Table 1: Summary of Submissions on Allocative Efficiency[34]

	NERA		Castalia	Futures	
Demand elasticity range	-0.5	-1.0	-1.1	-0.05	-1.0
Price increase range	1% to 10%	1% to 10%	20%	10% to 20%	10% to 20%
5-year net present value	$0.70 to $7.41 million	$1.39 to $14.82 million	$31.29 million	[ ]	[ ]

Consideration of loss of allocative efficiency

138. In order to determine the most appropriate estimate for the loss of allocative efficiency the Commission must make assumptions about the elasticity of demand for wool scouring in New Zealand. However, as is often the case, there appears to be no readily available information which shows the extent to which the demand for scouring services in New Zealand rises or falls as scouring charges increase. The Commission is unaware of any studies which would help in this respect.

139. The Commission must therefore draw insights about the elasticity of demand from feedback from industry participants and economic submissions.

140. The Commission first considered whether an increase in scouring prices would be absorbed by merchants or passed on to merchant's customers. In either case, this would have limited any allocative efficiency loss as volumes scoured in New Zealand would not have decreased significantly (i.e. demand would be inelastic).

141. However, the Commission concludes that higher scouring prices are not likely to be simply absorbed or passed on. Instead they are likely to translate into lower margins for growers. The reasons are as follows:

[34] The submissions make different assumptions about the quantity of wool scoured. Therefore there may be differences in the deadweight losses even when the both the demand elasticity and price increase are similar across submissions.

- Scoured New Zealand wool competes in international markets against wool from other countries and against other close substitutes such as cotton and nylon. If scouring prices were to rise in New Zealand post-acquisition, it is unlikely that merchants would be able to pass these price increases on to international customers in any significant way due to the competitive nature of wool export markets.
- Peter Whiteman, Managing Director of Segard Masurel (NZ) advised that while some customers need New Zealand wool as part of their blends, if the price went too high they would remove the product from their ranges, or replace with nylon. Andrew Campbell similarly advised that wool is a global industry and that New Zealand cannot dictate the price.
- It also appears unlikely that, if scouring prices were to rise in New Zealand post-acquisition, price rises could be absorbed by merchants. The Commission understands that merchants currently work in an extremely competitive environment and within tight margins of, on average NZ$0.15 – 0.20 per kg of greasy wool.

142. The Commission notes that wool supply is a function of the size of New Zealand's sheep flock. In turn, flock size is influenced not only by wool prices but also sheep meat prices, and the prices obtainable from alternative use of farm land, such as beef, dairying or forestry. Wool revenue as a proportion of total on-farm revenue for sheep and beef farmers has averaged around 11% over the past five years and around 18% of revenue from sheep alone.[35] In turn, wool scouring services cost around 8% or less of the value of wool. It is therefore very unlikely that a change in the price of wool scouring services by itself will have a significant influence on the amount of wool available for export, either scoured or greasy.[36]

143. The Commission is interested in the demand elasticity facing the merged entity for scouring in New Zealand (the *residual* demand elasticity), rather than the *global market* demand elasticity for wool scouring.

144. In order to determine the appropriate residual demand elasticity the Commission must make assumptions about how merchants will respond to different price increases. The amount a merchant is willing to pay for scouring will depend on what alternatives they have.

Possible responses to price increases

145. The Applicant has assessed the size of the loss of allocative efficiency on the basis of price increases between 1% and 10%, Castalia 20% and Futures between 10% and 20%.

146. NERA points out that merchants have the option of exporting at least a certain proportion of the clip in greasy form to be scoured in places such as China. As noted previously, the Commission considers that there is a real possibility that merchants will switch to further greasy wool exports to China if scouring prices increase. While this threat does not satisfy the Commission that the proposed acquisition will not have, or

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[35] Ministry of Agriculture and Forestry, Farm Monitoring Report 2010.

[36] This leads some, including Futures, to conclude that the demand for wool scouring is likely to be very inelastic. For example, a 5% increase in the cost of scouring would represent just 0.4% of the value of wool. A market demand elasticity of -1.0 for wool scouring (that is if a 5% increase in the price for wool scouring would result in a 5% drop in demand for wool scouring services) would suggest that the demand elasticity for wool itself was -8. In other words a 5% increase in New Zealand wool prices would result in a 40% decline in the demand for wool, which seems intuitively very unlikely.

would not be likely to have, the effect of substantially lessening competition, we acknowledge that if greasy exports are a very close alternative for exporters (and therefore the demand elasticity for scouring services is high), then the Applicant would be unlikely to increase prices at all.

147. The other likely scenario is that the Applicant would be able to raise prices, at least moderately, without sufficient quantities of wool being switched to greasy exports so as to make the price increase unprofitable. As outlined in the competition assessment section, the Commission considers that China may not impose a significant constraint due to:

- China being only a proportion of the market for New Zealand wool;
- the possibility for Cavalier to price differentiate between wool destined for China and wool destined for other markets;
- wool scouring costs only being a small proportion of the total wool price, which limits the impact of any price rise on demand; and
- there being a number of non-price factors why customers may prefer to have wool scoured in New Zealand rather than China.

148. In this scenario, where China is not a significant constraint over moderate price increases, the elasticity of demand will be relatively low as customers would not be sensitive to scouring price increases. In turn, allocative efficiency losses would be relatively low as price increases would have little effect on the demand for scouring services in New Zealand.

149. As price increases get larger, China would become more of a constraint as exporting greasy wool would become increasingly attractive to merchants. Moreover, there is likely to be a threshold for price increases, which if breached would prompt domestic entry. Again, as noted above, domestic entry is not enough of a constraint to prevent the effect of a substantial lessening of competition arising, but it will provide an ultimate cap on price increases. As such, very large price increases appear improbable.

150. The Commission has tried to ascertain what the price cap for entry may be, but has found it difficult to quantify. For instance, a potential entrant would likely enter with a single scour site in either the North or South Islands. Currently WSI is able to compete and make a profit with its single 3 metre scour lines in each island. Cavalier Wool advised that WSI's scouring division made profit over both islands of $4 million in the 2009 financial year and $8 million in the 2010 financial year. This suggests that a new entrant could be profitable if it had sufficient wool volumes, similar cost structures, and could achieve the current market price.

151. The Commission notes the highest price increase proposed by economic submissions was 20%. The Commission considers the price elasticity at a price increase of 20% is likely to be greater than -1 as domestic entry is likely to occur and the constraint from China to be large.

Experience from the previous acquisition

152. Godfrey Hirst has argued that some guidance about the possible price effects can be drawn from the price changes following the merger involving David Ferrier, Cavalier and Godfrey Hirst in 2009. [

].

153. [ ]:

[ ][37]

154. [ ]

155. [ ]

156. At this time the Commission does not accept that there were across the board price increases of the size claimed by Godfrey Hirst following the acquisition by Cavalier Wool of its scours in 2009.

157. Cavalier Wool has also submitted that in late 2010 it began discussions with some customers in relation to a 4-5% price increase, but faced such resistance from them that it decided against implementing the increase. Cavalier Wool considers this shows it would not have the ability to raise prices post-acquisition.

158. However, the Commission does not consider that the competitive dynamic will be the same in the factual as in the counterfactual and, as such, Cavalier Wool's decision not to increase prices recently is not strong evidence that it would not do so post-acquisition.

159. Nevertheless, the Commission considers that, post-acquisition, Cavalier Wool will not be totally unconstrained in the market. It will face constraints from Chinese scourers, and the potential for new entry.[38] While these constraints taken together are not enough to satisfy the Commission that there will not be, or would not likely be, a substantial lessening of competition, they are likely to limit the size of any price increase attributable to the acquisition.

Measuring the loss of allocative efficiency

160. The Commission's preliminary view is that the demand elasticity would likely be relatively low for small to moderate price increases, but would increase significantly for

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[37] Bell Gully letter of 8 March 2011.

[38] Of course in the short-term, Godfrey Hirst, Cavalier Wool's largest customer has an existing [ ] contract [ ]

larger price increases to a point where such prices increases would not be profitable because of diversion of greasy exports to China or domestic entry occurring.

161. As shown in Table 2, the Commission has modelled allocative inefficiency losses for the following demand elasticities:

- The demand elasticity of -0.05 represents a scenario where switching to greasy wool exports to China is not a close substitute, and where the Applicant would be able to increase prices up to a point where it tempted new entry (perhaps 10% to 20% price increases). For a demand elasticity as low as -0.05, the Commission considers a price increase of only 5% appears unlikely.
- The demand elasticity of -0.5 represents a scenario where greasy wool exports to China are a closer substitute, and where the Applicant would face volume losses as prices increase. The threat of new entry still imposes the ultimate cap on price increase in this scenario.
- The demand elasticity of -1.0 represents a scenario where greasy wool exports to China are a much closer substitute, and where the Applicant would face significant volume losses as prices increase. The Commission considers that this elasticity is unlikely to be applicable to price increases as large as 20%. Put the other way, the commission considers that price increases of 20% would be likely to produce much more of a demand response than implied by an elasticity of -1 and not be profitable.

Table 2: Estimated national allocative inefficiency detriments (NPV over 5 years)[39]

	Price increase		
Demand elasticity	5%	10%	20%
-0.05	n/a	\$0.733 million	\$1.565 million
-0.5	\$4.235 million	\$7.329 million	\$15.645 million
-1.0	\$7.082 million	\$14.658 million	n/a

Stepped demand

162. All of the economic submissions assume continuous demand elasticity, however the Commission notes this need not be the case. It could be that the demand curve is stepped. For example, as discussed earlier, the demand curve could have three distinct steps relating to:

- sales of scoured wool to China for which the price of scouring in New Zealand may be capped by the possibility of a switch to export in greasy form to China;
- sales to markets other than China, for which the price of scouring in New Zealand may be capped by the possibility of a switch to export in greasy form to China; and
- sales to markets other than China, for which the price of scouring in New Zealand is more likely to be capped by new entry into scouring in New Zealand.

163. Such a stepped demand curve would alter the composition of allocative efficiency losses. For instance, volumes of scoured wool to China could switch to greasy exports

[39] Note: These estimates exclude quantities of wool currently going to Cavalier Bremworth and Godfrey Hirst. The Applicant argues these quantities should not be included as they would not be subject to any price increase due to a 50% ownership of Cavalier Wool by Cavalier Bremworth and the [ ] supply contract that Godfrey Hirst possesses.

in the face of a relatively small price increase, but prices may be able to be increased significantly for other markets without greatly affecting the volumes demanded. In this scenario it may be profitable for the Applicant to forgo most or all scoured wool volumes that currently go to China in order to achieve higher margins on wool destined for other markets. This is the case if sufficient quantities of scoured wool destined for other markets did not switch to greasy exports to China. This would likely lead to relatively high allocative efficiency losses as the demand for scouring in New Zealand would reduce significantly.

164. Of course, any ability that the Applicant has to price discriminate could ameliorate these potential allocative efficiency losses. If the Applicant were able to price discriminate it could increase prices for wool destined to markets other than China, while maintaining (or lowering) scouring prices for wool destined to China. This would mean that increased prices could be achieved without resulting in lower scouring volumes. The Commission notes, however, that the Applicant's lack of knowledge and oversight of the scoured wool's destination may restrict its ability to price discriminate over the long-term.

165. The Commission does not currently have sufficient information on the demand characteristics for New Zealand wool to narrow the range of estimates of allocative efficiency losses. The Commission is seeking further information from interested parties on this point.

Loss of Productive Efficiencies

166. One outcome generally associated with a loss of competition is that the firm with additional market power has less incentive to minimise costs and to avoid waste. Complacency may creep into its operations.

167. Determining the extent to which a firm may be susceptible to complacency can be very difficult. A firm seeking to maximise its profits will have an incentive to minimise its costs, irrespective of the level of competition in the market. Nevertheless, there is the possibility that management, without the day to day pressures of competitors and the benchmark they provide against which the firm's management can be measured, may become less productively efficient.

168. In its submission on behalf of Cavalier Wool, NERA states:

> The Commission typically estimates productive efficiency losses by assuming that the merged firm's costs will increase. It does this by applying a factor (usually somewhere between 1-10%) to the pre-merger variable costs. This yields the increase in costs resulting from the merger or, equivalently, the productive efficiency losses.

169. NERA initially provided productive efficiency detriment calculations based on 1%, 5% and 10% of the pre-merger variable costs of the two companies. In a later additional submission, NERA stated that a figure at the low end of this range (1% to 2.5%) would be most appropriate as pressures on Cavalier Wool to maintain its productive efficiencies would remain post-acquisition. NERA has also recognised that fixed costs, as well as variable costs, may be affected by losses in productive efficiencies over time.

170. Castalia, on behalf of Godfrey Hirst, suggests that NERA's calculation ignores other likely losses of productive efficiency, such as the increased supply risk if the single scouring plant in each island suffers a natural disaster, fire, strike or major breakdown affecting the entire plant. The Commission agrees that this possible increased risk is a matter for consideration, and it is discussed further below.

171. Futures on behalf of WSI agrees with the Commission's approach to the estimation of productive efficiencies, but suggests a range of 5%-10% of variable costs is more appropriate than the 1%-10% originally used by NERA because, unlike the Air New Zealand/Qantas case[40] where the Commission used 1%-5%, this merger would leave just one firm remaining in the market.

172. While the Commission continues to accept that competition is an important driver of productive efficiency, it considers that the weight which should be given to this factor is quite speculative. It has noted the efforts made by the two firms to operate efficiently in recent years and considers that an important driver of this has been the pressure placed on the industry as a whole by declining sheep numbers and wool clip. This is likely to continue notwithstanding some improvements in wool prices recently. Cavalier Wool has only three shareholders. These are Cavalier Bremworth, a major customer of Cavalier Wool, ACC and Direct Capital. The latter two are experienced investors wishing to maximise their investment income and capital growth. This small number of shareholders is likely to have the ability and incentive to continue to drive productive efficiencies in the factual.

173. As discussed further in the benefits section below, there is evidence that Cavalier Wool has made significant cost savings from previous rationalisation in the wool scouring sector. The Commission is therefore confident that productive efficiency losses are unlikely to be large. In summary that is because of:

- the on-going competitive threat from the Chinese scouring industry; and
- strong oversight ability and profit maximising incentives of the shareholders.

174. While it recognises the uncertainty of any assumed productive efficiency losses, the Commission considers the upper range for loss of productive efficiency is between 1% and 5% of pre-merger variable costs. This equates to approximately [ ][41]

Increased supply risk

175. In its submission, Castalia states:

> {NERA's calculation of productive efficiency losses} ignores other likely sources of productive inefficiency, such as the increased supply risk of relying on one entity employing one scouring plant in each of the North and South Islands. The lack of redundancy resulting from such a concentrated production process in the wool value-chain means that the cost of outages is likely to be significantly higher than historically because more wool volumes are affected. A higher risk of industrial action post-merger would also increase plant downtime. A high level estimate of lost production from supply outages can be obtained by assuming that a level of demand is unmet. For this report, we assume additional plant outages of 1 percent, which at market prices would lead to an efficiency loss of [ ][42].

176. NERA has responded. While it states that it cannot comment on the factual accuracy of the 1% outage assumption used by Castalia, it does question the accuracy of Castalia's calculation which suggests an efficiency loss under this head of [ ] Net Present Value (NPV) over five years. NERA has also suggested that the calculation should be modified to base it on the gross margin (rather than on sales), in which case the 5 year NPV would become [ ].

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[40] Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003.

[41] The Commission has used Cavalier Wool's pre-merger variable cost figures for the industry of about [ ] cents per kg to calculate the estimated productive efficiency losses. Futures, on behalf of WSI, advised that its estimates of pre-merger variable costs are [ ] cents per kg, which is similar to Cavalier Wool's estimates.

[42] Net present value over five years.

177. Cavalier Wool does not consider that there will be an increased supply risk in the factual for the following reasons:

- Post acquisition, Cavalier Wool's scouring plants will not be operating at full capacity and the Clive plant will remain as back-up capacity.
- Cavalier Wool has comprehensive insurance to cover freight between Islands in the case of a plant shutdown.
- As a temporary alternative to scouring their wool, customers could export wool greasy or store it until the scouring plant once more became available for production.
- Comprehensive risk management infrastructure and processes are in place at all its plants.

178. Nevertheless, the Commission considers that some higher costs associated with a plant closure post-acquisition should be taken into account in the detriment analysis. Like Castalia and NERA, the Commission is uncertain at this time of the level of risk of a major plant outage, post acquisition. The Commission has found only one example of a scouring plant emergency - during 1999, one scour line at Cavalier Wool's Awatoto plant was shut down for a short period due to a small fire in a control cubicle. Cavalier Wool submitted that any electrical failure at a time of high demand on one of their scouring plants would be repaired within 48 hours.

179. There is thus a relatively low level of historical risk. The Commission also notes that during the period of any plant outage post-acquisition there will be some potential to use other mothballed plant or transport wool between Islands, while the ability to store greasy wool until the plant problem is resolved does limit the cost to the industry of such an outage. At this stage, the Commission considers that because of these factors there would be only a small increase in risk arising from the consolidation of scouring activities into a single location per Island. Due to the limited nature of the risk and the precautions already taken by Cavalier Wool, the Commission does not intend to assign an amount to this claimed detriment.

Loss of Dynamic Efficiency

180. The Commission stated in the reasons for its decision on the Air NZ/Qantas matter (quoted by NERA):

> Dynamic inefficiency arises when a business or industry is less innovative than it might be. Innovations bring benefits to consumers either through the introduction of improved new products that buyers value more highly ("product innovations"), or through the use of new, lower cost ways of producing existing products ("process innovations").
>
> and
>
> Monopolists in general have a reputation for being poor innovators. Although they have the resources to undertake innovative activity, and are well-placed to appropriate the gains from the introduction of a significant innovation (because of the absence of imitating rivals), the lack of any competitive spur to take risks and embrace new ideas has the opposite effect. The removal of competitive pressure lessens the incentive for companies to innovate in order to match or keep ahead of rivals.
>
> and
>
> A reduction in innovation may cause social welfare to suffer in two ways: buyers may be deprived of the benefit of product innovations; and the public as a whole would lose the benefit from the introduction of process innovations that save on inputs, measured by the additional outputs that could be produced by the saved inputs being used in alternative employments.

181. As is the case with the loss of productive efficiency, it is difficult, to measure with any precision the cost to society of a lessening in innovation attributed to a substantial lessening in competition in a market. Consequently, a qualitative element is always a significant part of this assessment.

182. NERA initially adopted the approach used in the past when the Commission assessed a loss of innovation by multiplying total sales by factors of 0.5% - 1.5% (the Commission used 0.5% - 1% in the Air NZ/Qantas case)[43]. To be conservative, NERA has also modelled a reduction in demand across a range of demand elasticities. It has assessed the NPV sum of the detriments from a loss of product innovation and process innovation for 5 years as falling within the range of [ ]. In a subsequent submission, NERA advised that based on the facts of this industry it expected the detriment would likely be at the lower end of this range.

183. Castalia stated that it would expect any loss of dynamic efficiency to be at the upper end of the estimates provided by NERA. In Castalia's view, NERA has not recognised the significant change to the industry dynamics from the removal of merchant scouring from the New Zealand business environment. Castalia further suggests that NERA incorrectly allows for an increase in demand from a lower price, while it considers that Cavalier Wool post merger would have no incentive to lower its price. Castalia estimated product and process innovation losses together, would be about [ ] NPV over five years.

184. Futures stated:

> The Commission's approach to estimating dynamic inefficiency detriments is not founded in theory or easy to rationalise and NERA's complement of a separate demand reduction component does not address this fundamental concern either. Moreover, it utilises a price elasticity range which I consider to be inappropriate for reasons I have already explained. To my knowledge there is no theoretically robust methodology for estimating dynamic efficiency losses.
>
> The ad hoc nature of the estimates used by the Commission and NERA would be more acceptable if the results were plausible. However, they are not. It is widely held by economists that dynamic inefficiency detriments are more material than either allocative or productive inefficiency detriments. This is because dynamic inefficiency is thought to have a cumulative effect. The Commission shares this view and as a result has consistently paid more attention to dynamic efficiency benefits than to either allocative or productive efficiency.

185. In addition, Futures noted that its estimates of dynamic inefficiencies based on 0.5% - 1.5% of revenue [ ] is materially smaller than the plausible estimates of allocative and productive inefficiencies combined. Rather than adopting these amounts, it has suggested using a factor of 100 - 150% of the combined allocative and productive inefficiencies detriments. It believes that this ensures that the three forms of inefficiency have orders of magnitude "more consistent with economists' (and the Commission's) view of their relative importance".

186. Using this approach Futures has calculated the 5 year NPV of the dynamic efficiency detriments as being in the range of [ ].

187. As discussed above, the Commission recognises that it is very difficult to calculate dynamic efficiency losses with any strong confidence about the precision of the calculation. In this instance the Commission has considered a number of industry characteristics which may affect its qualitative assessment.

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43 Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003.

188. Cavalier Wool has emphasised the innovations it has made to its processes resulting in, amongst other improvements, a better brightness of the scoured wool output from its plants. These product and process changes were made in a competitive climate and with declining volumes. It is arguable that such innovations would not have been as likely to have occurred if there had been just a single operator. Moreover, despite its recent concerns over the loss of scoured volumes to China, it appears that Cavalier Wool's overriding concerns have been with WSI and its competitive threat in the scouring markets. In particular, Cavalier Wool has needed to innovate in order to ensure it retains sufficient throughput for the efficient operation of its scouring plants.

189. There are a number of factors that suggest that any losses in dynamic efficiencies may be very limited in this instance. These include the following:

- The industry has a very long history in New Zealand going back over 100 years and both product and process improvements have been incremental over this period.
- The significant changes in both product and process have had their origin in New Zealand in some instances and internationally in other instances. Also, many of the innovations have occurred by input or associated research companies (for example ANDAR Holdings, Wool Research Organisation of New Zealand and AgResearch).
- The operational performance of Cavalier Wool post-merger, is likely to be closely and efficiently monitored by an experienced and well informed Board and shareholders. The operational performance of Cavalier Wool post-merger, is likely to be closely and efficiently monitored by its three shareholders. Concentrated shareholders are likely to exhibit high levels of oversight.
- The Board and shareholders have a profit maximising incentive and therefore an incentive to optimise dynamic efficiencies.
- Because Cavalier Wool's commission scour operation is different in nature to WSI's vertically integrated merchant scour model, in the counterfactual the competitive tension between the two would be not likely to be as strong as would exist between wool scour competitors using the same model of operation.

190. In the Commission's view it is the long-term competitive threat of the Chinese scouring industry that reduces potential dynamic efficiency losses the most. While the Commission is not satisfied that this threat would constrain the combined entity in terms of its ability to raise prices, the Chinese threat is likely to be a spur for ongoing innovation as there is a real risk that if the Chinese scouring industry innovates more rapidly than that of New Zealand, then most scouring services could shift offshore, as happened in Australia.

191. Having regard to these matters, the Commission believes that any loss of dynamic efficiency in this instance is likely to be moderate, at most. The Commission recognises that it is very difficult to be certain about what the size of any loss may be in dollar values. At this time the Commission has estimated a likely range of dynamic efficiency losses of zero to one percent of total industry revenue. This equates to a range of zero to about [ ].

Benefits

Productive Efficiencies

192. Cavalier Wool argues that an important commercial benefit would arise, as a result of the Acquisition, from the incremental economies of scale that would occur if the existing WSI scour lines were rationalised within the existing Cavalier Wool plants. The Applicant forecasts that the rationalisation would deliver [ ] in incremental EBITD from economies of scale, cost savings and increased capacity utilisation of Cavalier Wool's scouring plants.

193. The Applicant has provided the Commission with details of the operating and administration expenses for its plants at Awatoto, Clive and Timaru and has estimated those expenses for WSI's plant at Whakatu and Kaputone, all for 2009/2010. The Applicant also provided similar projected information for Awatoto, Clive (in a moth-balled state) and Timaru post-rationalisation. The Commission has inspected internal Board of Director's documents from Cavalier Wool to assist in verifying the figures. The Commission considers that the budgeted costs of rationalisation are plausible and the cost reductions that Cavalier Wool anticipates, within the range of the efficiencies that might be expected from reducing the number of scouring plants from five to two (with one other mothballed). The largest of these cost savings would arise from a reduction in wages, salaries, gas, coal and electricity.

194. In total they would amount to [ ]. This is [ ] of the industry's operating and administration costs pre-acquisition.

195. Cavalier Wool has provided comparison figures from its 2009 and 2010 financial years. As the Godfrey Hirst acquisition took place on 17 April 2009, some of the benefits would have accrued in the 2009 financial year. Nevertheless the following comparison provided by Cavalier Wool is illustrative of the economies of scale that have been achieved in rationalising wool scouring assets:

- greasy kilograms scoured increased [ ];
- administration costs decreased [ ];
- operating expenses (from scouring and pressing) decreased [ ]; and
- EBITD increased [ ].

196. The Applicant argues that the current proposed acquisition will achieve even greater savings as it involves a greater increase in its volumes.

197. Castalia suggests that the actual benefits of the merger would be towards the lower end of the range estimated by NERA (which was [ ] NPV over five years).

198. Futures, has noted a general tendency for firms to overestimate the efficiency gains achievable as a result of a merger. It suggests a reasonable range of cost savings of between zero and 10% of variable costs. In this merger, that would amount to between [ ] - which has a five year NPV of [ ].

199. At this time the Commission is satisfied that the Applicant's calculations which have been provided to the Commission with extensive detail of its historical costs and estimated future costs, post acquisition are accurate. Cavalier Wool has undertaken

modelling to assess its own business case in respect of the Acquisition. Moreover it has the recent experience of its amalgamation with the former scouring operations of Godfrey Hirst as a benchmark on which to base its expected costs of, and savings from, the rationalisation that it proposes.

Sale of surplus land and buildings

200. The Applicant has stated that following the acquisition it would sell the Whakatu and Kaputone land and buildings. It has claimed as a benefit the market value of the land and buildings at those sites.

201. The Commission accepts that freeing-up surplus land and buildings amounts to a public benefit for the purpose of this analysis. The Applicant has applied a figure of [ ] for the value of the land and buildings at WSI's two scouring sites. It stated that this amount was based on Government Valuations, recent sales in the area and market intelligence. WSI's annual report for the 12 months to 30 June 2010 records the value of its land and building as being $9.053 million. WSI has also provided the Commission with valuations of the land and buildings at its Kaputone and Whakatu sites which were carried out in April 2010 by independent registered valuers. These two valuations totalled [ ]. The Receiver of Plum Duff Ltd and Woolpak Holdings stated in its Information Memorandum of February 2011 that the value of WSI's land and buildings was $8.792 million as at 31 December 2010.

202. Faced with these conflicting figures, the Commission has decided that the figure provided to the Receiver by WSI is the appropriate amount for the purposes of the analysis of this Application. The Receiver has a duty to be accurate in these matters and would otherwise expose itself to liability for any inaccuracies in its Information Memorandum. Moreover, the figure provided by the Receiver is the most up to date of the various amount quoted. The Commission is wary about applying the [ ] figures given to it by WSI as the total valuation as at April 2010 as it appears that WSI has not used those amounts in its annual report for the 12 months to June 2010.

203. The Commission also notes that any delay in the sale of the land and buildings would also reduce their present day value of those assets.

204. Futures has noted that the sales value of the land and buildings reflect the benefits those assets will provide their owner (in present day value) over their full life. However, the detriments against which the benefits are assessed are those which occur over just five years. Thus, for the weighing exercise, the benefits are overstated relative to the detriments. The Commission considers that the sale value of the land is the most accurate guide to its value as a benefit from the acquisition, however it concurs that similar detriments should be valued in a consistent manner. As such, the required capital expenditure on land and buildings to effect the proposed rationalisation is not discounted over a five year period as suggested by the Applicant.

205. The Commission considers the most likely value for land sales post acquisition would be $8.792 million.

Capital expenditure

206. As part of Cavalier Wool's proposed rationalisation, additions would be required to the buildings at Awatoto and Timaru. This would require capital expenditure on land and buildings, estimated to be [ ] at Timaru and [ ] at Awatoto. NERA has calculated the NPV of the cost of capital and depreciation associated with this expenditure at Timaru over a five year period as [ ] and at Awatoto as [ ].

However, as stated above the Commission considers that this should be calculated in a similar manner as the land sales. Therefore, the Commission considers that [ ] should be netted off any benefits arising from the rationalisation.

207. Additional initial expenditure would also be required to move the WSI's plant to Cavalier Wool's sites and, as well, to engineer various modifications to the scouring plant that Cavalier Wool regards as necessary to obtain its claimed efficiencies. During the first year that expenditure would be [ ]. NERA has stated that after that first year, the ongoing capital expenditure on plant will be less than in the counterfactual, [ ] per year as opposed to [ ] per year. This would be because once plants are upgraded and relocated on only two sites there would be relatively less expenditure required over the short-medium term. Also, there would be some economies of scale in capital expenditure projects.

208. NERA has assessed a NPV of these savings over five years to be $0.88 million. The Commission accepts, at this stage, that these assessments are reasonable.

One-off rationalisation costs

209. NERA notes that Cavalier Wool is expecting to pay redundancy costs of [ ] and contingency rationalisation costs of [ ] in the first year of the factual.

210. Futures has commented on this:

> The reduction in the number of operating scours from five to two will give rise to some staff redundancies and some redundancy payments. There are two ways to look at such payments. Firstly, they can be considered as a straight wealth transfer from the employer to the (former) employee. If this is what they are, they should not be included in a cost benefit analysis of net public benefit as transfer payments between members of the public net out. Secondly, redundancy payments can be viewed as compensation to employees for the loss of human capital in the form of on-the-job experience. If the payments are of this nature, they represent a social cost and so should be included in a calculation of net public benefit.

211. The Commission accepts this latter view. As NERA notes, the Applicant in this case has adopted a conservative position and treated redundancy costs as a social cost to be deducted from the benefits arising from the acquisition.

Removal of a weak seller

212. During meetings with wool merchants and with some other market participants, a consistent theme emerged that WSI tends to undercut other merchants on the international market. This according to the submitters results in export prices for New Zealand wool being reduced. This is said to be particularly so in markets such as China and India where WSI has a strong presence. The claim was based on a view that WSI as a vertically integrated scourer/merchant has a strong incentive to maximise the throughput of its scours to ensure they remain profitable. The parties interviewed submitted that WSI frequently had more scoured wool stock than it could efficiently sell in export markets, which meant that it tended to accept a lower price than other merchants to increase the volume of its sales, thus forcing the price down.[44]

213. The merchants who held this view believed that the industry would benefit by the acquisition as it would remove WSI as a merchant, leaving them to sell the wool at a higher price:

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[44] The Commission notes that the total amount of wool sold in export markets would remain the same, irrespective of whether or not WSI remained as a merchant.

- Mr Palle Petersen of Bloch and Behrens stated that as a trading company who also owned wool scours, WSI had no choice but to operate with a very aggressive pricing policy – simply to ensure its scouring capacity was utilised to the maximum. Mr Petersen provided evidence that WSI prices were [ ]
- Mr John Henderson of Fuhrmann NZ Ltd said that WSI's position as a merchant scourer was the worst feature of the New Zealand wool industry. He said this was particularly so in India, where WSI had a strong presence and in China where WSI's low prices for clean wool meant that he could not sell such wool in that market and was forced to sell greasy wool – such sales by Fuhrmann were increasing.
- Mr Peter Whiteman of Segard Masurel said that the problem with merchant scouring operations is that "the tail wags the dog". If WSI's scouring operations were separated from its wool trading operation that would have a very strong effect on New Zealand's export wool prices. WSI was particularly low priced in India and China. [ ]
- [ ] said that WSI is detrimental to the industry. It buys the wool to ensure its scours are fully utilised and must subsequently find markets for the unsold stock. Because greasy wool prices [ ] can obtain are the same as WSI's clean wool prices, [ ] now sells more greasy wool than scoured wool. [ ].

214. This claimed public benefit was not amongst those claimed in the application, nor was it mentioned in the NERA submission. However, Cavalier Wool, later submitted that:

> Exporters' view that Cavalier Wool's acquisition of WSI will increase New Zealand's export receipts for wool is supported by the evidence which suggests that, for whatever reason, WSI is selling New Zealand wool at a price below the price which would be obtained if that wool were being sold by other exporters. The impact of this is not only on WSI volumes – the price expectations create a contagion effect for all other exporters of New Zealand wool.
>
> While it is difficult to precisely isolate the extent to which this is the case, however:
>
> - WSI's dismal financial performance suggests that WSI's prices are clearly below market levels;
> - recent sales data from India suggests that New Zealand wool prices in the market are between 20 and 130 cents per kg lower than would be expected based on sales in other markets; and
> - as stated previously, even if the benefit of New Zealand were only 10 cents per kilogram, a 10 cent per kg price differential across New Zealand's wool exports of approximately 169,000 tonnes (excluding domestically processed wool products) implies a benefit to New Zealand of \$16.9 million per year.[45]

215. Nevertheless, the Commission does not propose to give any weight to this claimed benefit. There is no apparent reason why WSI should choose to sell its wool at less than the market price. WSI has provided the Commission with evidence that suggests that it

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[45] Bell Gully Letter of 9 March 2011.

is not the cheapest option for customers of clean New Zealand wool in markets such as China. Similarly Godfrey Hirst has advised the Commission that its suppliers, including WSI vary in ranking of wool prices tendered to it in New Zealand. WSI is sometimes the lowest price and at other times is more expensive than other merchants. Moreover, selling at less than market prices would not be economically rational for WSI.

Wool super store benefits

216. As stated in the application, a 'wool super store' refers to the concept of centralised consolidation of much of the greasy wool produced in each Island at purpose built, independently operated, wool stores sited adjacent to wool scours. Wool aggregation, sorting, classing, testing, sale and storage would occur under one roof. The proponents of the scheme argue this would eliminate the duplication of storage and sale resources currently present in the wool industry. Location of the superstore adjacent to wool scours and near to the current export ports would streamline the process by which wool is currently aggregated, sold and transported from farm gate to scour to domestic and international markets.

217. The Applicant has submitted that the North Island cost presently associated with wool store operations is around [ ] (excluding transport costs), whereas the super store could reduce this to as little as [ ]. As stated, the projected cost savings would arise primarily from the following:

- The rationalisation of existing wool storage space and the creation of economies of scale; and
- The rationalisation of existing (inefficient) wool transport flows and the elimination of double handling.

218. The Applicant considers that the superstore concept requires an independent third operator, such as itself, to develop and operate the facility.[46] This is necessary to ensure that there would be no actual or perceived conflict of interest between the superstore owner/operator and its customers. However, the benefits of the superstore will, as well, accrue to wool merchants and wool producers.

219. The Applicant has advised that a North Island super store would require an investment of about [ ]. Given, the potential cost savings identified above, if such a store could attract about [ ] of the North Island's annual wool clip, this concept could result in cost savings of around [ ] per year for the North Island alone after deductions for the cost of capital, depreciation and tax. Accordingly, in this scenario it would be rational for Cavalier Wool to proceed with the concept in the counterfactual, as long as it could attract sufficient volumes of greasy wool to its superstore.

220. Cavalier Wool stated that the superstore concept relies on operation by an independent third party and that Cavalier Wool, in the factual, will be the only industry third party capable of successfully implementing the concept. A potential wool merchant customer of the superstore would be reluctant to use the store if it was operated by one of its wool merchant competitors. Conversely, an existing wool merchant owning a wool store would be unlikely to expand its existing wool storage facilities if this required the

[46] The Applicant advised that although it is anticipated that it would be the promoter /creator of a superstore, it is possible that once the concept is established it may be transferred to an independent operator. In this respect, the concept does not rely on Cavalier Wool's on-going participation in the concept.

support of its competitors' wool volumes. The Applicant considers it is this rivalry that has led to the present duplication of wool storage facilities with every merchant large and small wishing to own a wool store.

221. Cavalier Wool advised that it would only have the incentive to invest in the concept if it could be sufficiently certain to attract enough volumes to reduce costs to a level such that a superstore will provide a return on the investment. This is why it has not advanced the concept to date. Cavalier Wool considers that if it developed the concept pre-acquisition, there would be no prospect of the superstore obtaining the considerable wool volumes of WSI and this would make the achievement of the requisite volumes for profitable operation too risky.

222. The Commission is satisfied that if the super store was able to achieve the benefits envisaged for it and its development was dependent on the proposed acquisition proceeding, it would be reasonable to take the benefits into account in this benefit/detriment analysis. However, the problem faced by the Commission is that the superstore development remains speculative at this stage and the Commission cannot be satisfied that it will go ahead in the factual. There are existing entrenched interests in the storage and sale of wool throughout New Zealand. The wool volumes of those parties would be necessary for the superstore concept to succeed. It is possible that a developer of a superstore would be required to fund the exit costs of such parties. This may alter the economics of the project for the worst.

223. Therefore, while the Commission is satisfied that substantial benefits could accrue from the implementation of the superstore concept, because of the uncertainty surrounding the development of the project it cannot apply the full value of this benefit of about [ ] per annum (once the [ ] of North Island wool clip is diverted to the superstore) without firm evidence that the concept would be likely to come to fruition. Therefore, due to the difficulty of determining a discount factor based on the likelihood or otherwise, of the superstore occurring, the Commission does not quantify the actual amount to be ascribed to this benefit.

Quality benefits

224. Dr Garth Carnaby[47], on behalf of WSI, submitted that the wool auction system has consistently rewarded suppliers for higher quality colour wool, known as the 'Y value', and that an average value of $0.04 per kilogram per unit increase in base Y value could be used as a conservative estimate to calculate its economic value. This is consistent with feedback from a number of other parties in the industry.

225. In this respect, the Commission accepts that wools of a higher quality (i.e. a higher base Y) can and do earn a premium over wools with a lower Y value.

226. The Applicant has claimed that its rationalisation proposal would allow it to increase the quality of wool scouring services it would provide. The Applicant estimated the quality improvements would yield a benefit of [

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227. The Applicant claims these benefits would be achieved by modifying WSI's two existing 3 metre wide scour lines (from Kaputone and Whakatu) and Cavalier's two 2.4 metre wide scour lines at Awatoto. This would occur by, for example, adding additional openers, bowls and washers to the scour lines. Cavalier Wool claims that

[47] A former head of the Wool Research Organisation of New Zealand.

these modifications would increase the run rate of the scour lines, with an added advantage of improving the brightness of the wool by 1 to 2 "Y value units". In this respect, the Applicant is claiming that it is not just a more efficient scourer than WSI but, when compared to WSI, it could improve the Y value of the wool through scouring.

228. The Applicant has advised that its Timaru scour plant already incorporates these improved techniques and, as such, the Commission would expect to find evidence of this higher quality service in the plants outputs (higher valued wool) or inputs (lower valued wool).

229. The figures provided to the Commission by the Applicant show that the Timaru scour is not achieving a higher revenue per kilogram of wool than other New Zealand scouring plants[48]. If the Timaru plant was producing a higher quality output, the Commission would expect that it could price its service at a somewhat higher price. This does not appear to be the case.

230. Moreover, scouring customers such as Summit Woolspinners and John Marshall and Co interviewed did not generally identify the Timaru plant as providing higher quality scouring services. Nor did they suggest that, as merchants, they could purchase inferior wool and still achieve the same quality output at the Timaru plant.[49] In short, the Commission has been unable to find sufficient evidence that Timaru is currently providing a higher quality output that is valued by its customers.

231. Dr Carnaby, for WSI, is also sceptical about the claimed benefits in the Application. He stated that improvements in the brightness value of scoured wool cannot be achieved by simply changing WSI's existing scouring configuration to replicate that of Cavalier Wool. In particular, he noted that:

- All the "improvements" described in the application appear to relate to more vigorous agitation, cleaning or rinsing which might produce a cleaner looking product (or the "as is" Y value). These are unlikely to greatly improve the base Y value as it is generally not possible to significantly affect the base colour Y by scouring alone.
- The testing process used to determine Y values can be imprecise and so it can be difficult to assess the claimed improvements as statistically significant.
- Proprietary technology is not limited to Cavalier Wool. For example, WSI has its own technology such as its trademark "Glacial" scouring method which uses an additional process to lift the base Y and this can be used to produce a very bright white carpet.

232. On the other hand, the Applicant has provided additional reports on wool quality from Stephen Fookes, former Chief Executive Officer of the New Zealand Wool Testing Authority, and Steve Ranford, a scientist involved in wool research. Mr Fookes and Mr Ranford concur with Cavalier Wool's view that:

- the scoured brightness value can be increased through improvements to the scouring process (other than by the addition of peroxide bleach);
- the evidence presented by Cavalier Wool indicates that it has achieved the claimed increase in the brightness value by scouring alone;

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[48] See "Model summary V2" Excel spreadsheet as provided by Cavalier Wool.

[49] Some exporters such as [ ] advised the Commission that Cavalier was better at blending than WSI, but none advised that this reduced their input costs in any noticeable manner.

- an increase in the brightness value has a significant value; and
- merchants would be able to procure greasy wool with a lower brightness value without degrading all or any of the other properties of the greasy wool they acquire.

233. The Commission recognises the potential for Cavalier Wool to have achieved the claimed quality (both increased run rate and brightness) improvements. However, it is uncertain as to why any improvements, if achievable, could not be attained in the counterfactual.

234. The improvements that Cavalier Wool has put forth are widely known technologies and techniques, and there is no specific reason why WSI could not quickly adopt these if there was perceived value in the improvements. For example, both Mr Fookes and Mr Ranford reference published literature and commonly known industry techniques as potential ways to improve the base Y value.

235. The Commission also considers that Cavalier Wool could achieve these benefits, if they were available, at its Awatoto plant in the counterfactual. Along with the claimed efficiency gains of [ ][50] per year from reconfiguring its current Awatoto lines, it has estimated that between [ ] per year in quality benefits could be achieved. This is from an initial capital expenditure on the buildings of [ ] (or using Cavalier's figures, a 5-year present value of [ ]. This would suggest that it would be rational to make the investment in the counterfactual and not just the factual.

236. Cavalier claims that it would not be able to capture all of the quality benefits, and that this is why it would not undertake the improvements in the counterfactual. That is, the quality benefits would only be achieved as a by-product of the rationalisation, which would be driven by the improved efficiencies and economies of scale available.

237. However, in the Commission's view, Cavalier Wool would be able to capture at least a proportion of the quality benefits in the counterfactual if it was providing a superior scouring service to its customers.

238. Futures, on behalf of WSI, has submitted that much of the benefits of any quality improvements would be likely to be captured by customers, as woollen products compete in vigorously competitive downstream markets. As about 85% of New Zealand wool is exported, Futures submitted that this proportion of any quality benefit would not accrue in New Zealand and therefore should not be counted as a public benefit.

239. In light of the above, the Commission's view is that it cannot put any weight on the claimed [ ] benefits accruing from quality improvements from the proposed acquisition. The Commission seeks further comment from interested parties about this matter.

BALANCING OF BENEFITS AND DETRIMENTS

240. The preliminary (and eventual final) determination of the Application involves a balancing of the public benefits and detriments which would, or would be likely to, result from the Acquisition. Only when there is a net positive public benefit can the

[50] This is calculated by multiplying the reduction in per kg scour operating expenses at the 2.4m lines at Awatoto by the current quantities of wool scoured at those plants.

Commission be satisfied that the acquisition should be permitted, and that it should grant an authorisation for the Acquisition.

241. Table 3 and 4 summarise the Commission's preliminary view of the likely detriments and benefits arising from the acquisition.

Table 3: Summary of detriments

Category	Evaluation	5-year NPV
Allocative efficiency	$0.176 million to $3.752 million per year	$0.733 million - $15.645 million
Productive efficiency	[ ]	[ ]
Dynamic efficiency	[ ]	[ ]
Total of quantified detriments		**$1.439 million - $21.736 million**

Table 4: Summary of benefits

Category	Evaluation	5-year NPV
Reduction in Production and Administration Costs	[ ]	[ ]
Sale of land	One-off benefit	$8.792 million
Capital expenditure on land and buildings	One-off cost	[ ]
Capital expenditure on plant	[ ]	$0.880 million
One-off Rationalisation Costs	One-off cost	[ ]
Total of quantified benefits		**$25.870 million**
Removal of weak seller	No weight given at this time	
Wool super store	Not quantified, but benefit recognised.	
Quality benefits	No significant weight given at this time.	

Note: A 10% discount rate was used in these calculations. This was the factor applied by the Applicant.

242. The Commission notes the relatively wide range of estimated detriments, which illustrates their uncertain nature. The Commission's preliminary view is that the quantification of the benefits has a higher degree of certainty, and thus should be given comparatively greater weighting when balancing the public benefits and detriments arising from the Acquisition.

DRAFT DETERMINATION

243. The Commission's preliminary view is that it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services and that the Commission would not give a clearance for the Acquisition.

244. Having regard to all the circumstances, the Commission's preliminary view is that it would be satisfied that the benefits to the public would outweigh the loss of competition arising from the Acquisition. Therefore, the Commission's preliminary view is that it would be satisfied that the Acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.

245. Following the Commission's consideration of submissions on this Draft Determination, if its preliminary views are confirmed, the Commission would not give clearance, but would grant an authorisation of the Acquisition under s 67(3)(b) of the Act.

APPENDIX 1: SUMMARY OF PROPOSED RATIONALISATION OF WOOL SCOURS IN THE FACTUAL

The Present Situation

Cavalier Wool Holdings

- Awatoto (near Napier) has two scour lines each 2.4 metres wide. Lines are "U" shaped which it is claimed reduces production efficiency;
- Clive (near Napier) has one scour line 2.4 metres wide but currently only operates for about six weeks per year during the peak of the shearing season;
- Timaru has two scour lines, one 3.0 metres wide and the other 2.4 metres wide. The 3.0 metre line was recently installed at considerable cost and is considered by Cavalier as state of the art.

WSI

- Whakatu (near Napier) has one 3.0 metre scour line;
- Kaputone (near Belfast, Christchurch) has one 3.0 metre scour line.

The Situation following the Proposed Rationalisation post-acquisition

North Island

- Clive scour line will be mothballed and only operate in the event of a disaster at the Awatoto site but with a final decision on its possible closure to be taken later;
- Awatoto building will be expanded to allow existing scour lines to be straightened and the 3.0 metre scour from Whakatu to be installed and upgraded to state of the art.
- Whakatu site to be closed and the land and buildings sold for an estimated [ ].

South Island

- Timaru 2.4 metre scour line to be mothballed and the 3.0 metre wide scour from Kaputone to be installed in the Timaru building;
- Kaputone site to be closed and the land and buildings sold for an estimated [ ].

Claimed Reduced Production Cost Benefits

- North Island reduction in variable costs by [ ]
- South Island reduction in variable costs by [ ].