David Stock

Barrister & Solicitor

Level 3
White Fox and Jones House
22 Moorhouse Avenue
Addington, 8011
PO Box 29443
Christchurch 8540

Phone: +64 3 353 1036
Fax: +64 3 353 1038
Cell phone: 021 842 161
Email: djs@davidstock.co.nz

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Anthony Stewart
Senior Investigator
Commerce Commission
PO Box 2351
WELLINGTON 6140

EMAIL: anthony.stewart@comcom.govt.nz

Dear Anthony

NEW ZEALAND WOOL SERVICES INTERNATIONAL LIMITED (*WSI*)
CAVALIER WOOL HOLDINGS LIMITED (*Cavalier*)

1 I refer to the submission that has been made on behalf of New Zealand Wool Services International Limited (*WSI*) on 18 May 2011. I advised you that WSI wishes to make further submissions in respect of legal issues arising from the change made to the application for authorisation by Cavalier Wool Holdings Limited (*Cavalier*).

2 Cavalier has amended its application to gain authorisation to enable Cavalier to acquire from WSI all of the scouring and scouring related assets owned by WSI including a 50% shareholding in Lanolin Trading Company Limited (*the Scour Assets*). The sale of all of the Scour Assets by WSI to Cavalier would be a major transaction requiring approval by the shareholders of WSI pursuant to a special resolution passed in accordance with the provisions of section 129 of the Companies Act 1993 (a 75% vote in favour).

3 The purpose of this letter is to place before you the process which Cavalier would need to follow to obtain that approval and whether this is feasible in view of the factual position relating to WSI. If it is impossible for Cavalier to achieve that objective, or if it is highly unlikely that it could achieve that objective, then it is submitted that the Commerce Commission must take this into account when considering the benefits which Cavalier states would arise in determining if the authorisation can be approved to create a monopoly in the scouring industry in New Zealand.

4 WSI accepts that there are ways that Cavalier may utilise to make its intentions known to the market to purchase the Scour Assets which may not create legal difficulties. However any alternative method (such as making an open offer and disclosing this to the market) could create material disruption to the business of WSI and its value.

5 The current share structure within WSI is:

5.1 64% of the voting shares are held by the receivers of Plum Duff Limited and Woolpak Holdings Limited;

5.2 approximately 12% of the voting shares are held by directors and senior employees of WSI;

5.3 the balance of 24% of the voting shares is held by approximately 3000 shareholders many of whom are farmers with an intense interest in this industry and this issue.

6 It is evident from the above shareholding numbers that if the shares held by the receivers (the 64%) did not support a special resolution, or could not vote in respect of a special resolution, then a special resolution could not be passed. If the voting block that voted on such a special resolution comprised all shareholders except for the 64% held by the receivers, with the directors and employees, as indicated, voting against that resolution, then those directors and employees would be able to ensure the resolution is not passed as they would control 1/3rd of the total votes that could be cast on that resolution.

7 If the holder of the 64% shareholding requisitioned a meeting of shareholders of WSI to consider such a special resolution, at the request of Cavalier, then it is unlikely that Cavalier would put in an offer to purchase the assets unless they had the support of that shareholder to a special resolution. It does not make sense for Cavalier to put forward an offer to purchase the Scour Assets unless it has some degree of certainty that there will be the necessary shareholder support to pass a special resolution. However it is accepted that this is a possibility.

8 If Cavalier enters into an understanding, arrangement or agreement with the major shareholder of WSI to vote for a special resolution to sell the Scour Assets to Cavalier then a number of issues arise including the following:

8.1 The provisions of parts III and V of the Commerce Act 1986 would need to be considered by the Commission particularly in relation to any arrangements or understandings that have been entered into between the relevant parties.

8.2 Cavalier would gain a relevant security in the shares in WSI under sections 5, 5A and 5B of the Securities Markets Act 1988 which would have to be disclosed to the market.

8.3 The shareholders in WSI and Cavalier could become associated persons under the Takeovers Code which would require either Cavalier or that other shareholder to make a full takeover offer for all of the shares in WSI by reason of the association between them;

8.4 The provisions of Part 9 of the Listing Rules would apply so that both the holder of those shares and Cavalier would not be able to vote those shares on the relevant resolution.

9 WSI submits that in view of the above position there will be a material time delay before Cavalier can implement its proposal to purchase the Scour Assets and this will create market disruption.

10 The main issue is the market disruption that would arise if any offer for the Scour Assets was made by Cavalier. Once this is in the public domain the customers of WSI would assume that the wool trading business of WSI would need to be materially restructured and down sized to reflect the inability of WSI to continue to operate a vertically integrated business. It is likely that WSI would materially reduce its purchases of wool and many overseas customers would no longer be able to access scoured wool from WSI. This could have a material impact on wool prices for farmers and the New Zealand economy. This would continue for three to six months as it would take that long for a sale to be approved by the shareholders and for settlement to occur.

11 This should be taken into account by the Commission when considering whether Cavalier can ever achieve the level of benefits which are set out in its application, or additional detriments should be taken into account.

12 A separate legal submission is made on the relevant test for granting a clearance for an authorisation. A copy of this paper is attached. WSI considers that Cavalier has not been able to demonstrate from the evidence it has placed before the Commission that the public benefit of creating a monopoly outweighs the detriments. For the reasons set out in the submissions made to the Commission WSI considers that:

12.1 the productive efficiencies which have been put forward by Cavalier cannot be achieved; and

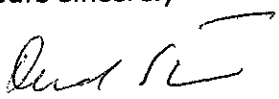
12.2 significant dynamic inefficiencies will arise from the proposal in that there will be no incentive to continue to introduce new technology to reduce the price of scouring and innovation within the industry would be materially reduced.

12.3 If a monopoly is created this could have long term detrimental impacts on the wool farming industry in New Zealand as prices could reduce because of the inability of the scours to scour wool on a timely basis and to current standards.

13 WSI submits that to grant the authorisation there must be clear and convincing evidence that the benefits will outweigh the detriments and this has not been proven by Cavalier. It is suggested to the Commission that if the monopoly is allowed to be created then Cavalier will raise scouring charges and use its monopoly position to extract monopoly prices. In particular it is likely that prices will rise to meet the earning expectation of the external investors in Cavalier.

14 Once a monopoly is in place this will be irreversible and such a decision should not be made unless there is compelling evidence that the purported benefits to the economy will arise. WSI requests the Commission to take these matters into account when considering the application for authorisation.

Yours sincerely



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THE TEST FOR GRANTING A CLEARANCE/AUTHORISATION UNDER S 67 OF THE COMMERCE ACT 1986

Application by Cavalier

Cavalier has applied for an authorisation to acquire up to 100% of the shares in WSI under s 67 of the Commerce Act 1986 ('the Act").

The application involves a two-step process.

Firstly, the Commission must decide if it is satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market ("the clearance test"). If this test is met (ie. no likelihood of substantially lessening competition), the Commission will issue a clearance.

Secondly, if the clearance test is not met, the Commission must determine whether it should grant authorisation to the proposal on the grounds that the acquisition "will result, or will be likely to result, in such a benefit to the public that it should be permitted".

The clearance test

The courts have considered the application of the clearance test in a number of relevant decisions.

It is not necessary for the Commission to find that a substantially lessening of competition will be a definite occurrence before refusing to give a clearance.

Rather, in terms of the clearance test 'likely' means:

- above mere possibility but not so high as more likely than not (*Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554 (CA) at p 562)
- that there is a real and substantial risk or prospect of that effect occurring. Where there is more than one real prospect as to what may occur, each of those real prospects must be considered. If any of these real prospects are likely to substantially lessen competition then a clearance is to be declined even if there is also a real prospect that competition will not be substantially lessened (*Woolworths Ltd v Commerce Commission* (No 2) - [2008] NZCCLR 10 at paragraph 270).

In other words, the Commission does not have to prove that a substantial lessening of competition will actually occur, before refusing a clearance.

In *Telecom v Commerce Commission* (1991) 4 TCLR 473,530, the court also stated that there will be situations where the evidence would not be clear as to whether or not the test could be satisfied. The court said that uncertainty such as this could lead to the failure of an application for a clearance, at paragraph 107:

Similarly we agree with the Commission, that if it is apparent that relevant and important evidence has been left out of the material before us which could

affect our view of the likely effect of the proposed acquisition, then we could not be satisfied in order to grant a clearance. In that sense there is a burden on an applicant for a clearance. At the clearance stage the Commission may identify that omission and request the information from the applicant. But if this has not occurred, by the time of the appeal a material omission in the evidence is fatal to the Court being able to grant a clearance because the appeal proceeds on the record.

The applicant's proposal will result in a monopoly over the wool-scouring industry in New Zealand if it succeeds and will result in a substantial lessening of competition in the relevant markets. Therefore, there is no real argument that a clearance is not a viable option for the proposal.

The authorisation test

An application for an authorisation under s 67(3)(b) of the Act is treated quite differently to a clearance. The Commission must perform a balancing test; it must identify and weigh the detriments likely to flow from the lessening of competition in the relevant markets and weigh those detriments against the public benefits likely to flow from the acquisition.

The onus rests with the applicant to show that the public benefit outweighs the detriment (*Goodman Feilder Ltd/ Wattie Industries Ltd* (1987) 1 NZBLC (Com) 104,108 at p 104,148).

The detriments flowing from a substantial lessening of competition are analysed under three main heads; allocative inefficiency, productive inefficiency and dynamic inefficiency.

In *Air New Zealand & Qantas v Commerce Commission & Ors* (No. 6) (2004) 11 TCLR 347 the High Court set out the principles on which the potential public benefits are to be assessed as follows [paragraph 319]:

- 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.

- Only net benefits are included. Any costs in achieving efficiencies are to be taken into account. Transfers of wealth which result in no net benefit to society should be disregarded.

- The benefits must result from the acquisition. There must be a causal connection between the proposal and the alleged benefit.

- Benefits should be quantified if possible but benefits which, by their nature, are incapable of quantification should still be taken into account.

The court took a cautious approach to the weighing of the benefits and detriments and, in particular found that;

- The Commission should take a conservative approach to assumptions where uncertainty is involved [at paragraph 337].

- The balancing process is not a purely arithmetical exercise – the weight placed on some categories of benefits and detriments should be reduced if there are doubts about the reliability of the calculations [at paragraph 416].

It is clear from the cautious approach taken by the court in *Air New Zealand*, that there must be clear and convincing evidence that the benefits of a proposal outweigh the detriments before an authorisation will be granted. An authorisation cannot be granted where there is doubt as to whether or not the benefits will outweigh the detriments.

In its final determination, the Commission had said that it could only grant an authorisation where, on the balance of probabilities, the detriments were **clearly** outweighed by the public benefits (*Commerce Commission Final Determination*, Decision 511, paragraph 1387) [*emphasis added*]. The use of 'clearly' adds an extra component to the ordinary standard of proof; it signifies that the evidence in favour of an authorisation must be convincing before an authorisation will be granted.

The High Court did not take issue with the Commission's approach to the standard of proof required. Therefore, this is the correct test to apply.

It is important to recognise that this is not an ordinary civil proceeding where an applicant can succeed merely by proving its case on the balance of probabilities. Rather, the applicant is seeking an authorisation to establish an irreversible monopoly. Therefore, the applicant is not entitled to an authorisation merely by proving that it is more likely than not that the benefits flowing from the authorisation will outweigh the detriments. The further caveat, is that the evidence must be clear.

This approach accords with the purpose of the Act. The purpose of the Act is to promote competition in markets within New Zealand (s 1A). It follows that the procedures contained in the Act, such as the authorisation procedure provided for under s 67 of the Act, must be aimed at promoting competition in markets. To give authorisation for a monopoly, in a situation where there was not clear and convincing evidence that the benefits would outweigh the detriments, would be contrary to the purpose of the Act.

Accordingly, if the Commission is left in any doubt as to whether the benefits of the proposal can outweigh the detriment, it must refuse the application for an authorisation.

APPLICATION OF LEGAL TESTS TO THE CAVALIER APPLICATION

1 It is submitted that the efficiency gains claimed by Cavalier should not be accepted. The figures on which these efficiency gains were based could not be disclosed to NZWSI and no scouring industry expert has been able to access and audit those figures. Accordingly the correct process is for either the gains to be ignored or for the Commission to appoint an independent person to audit the figures after gaining expert advice on the appropriate costs and returns from those in the industry. The claimed material cost savings and improved economic scale have not been proven and the Commission cannot take the risk of accepting Cavalier's figures without detailed testing.

2 In respect of the Superstore benefits these must be materially discounted as the ability to create superstores exists both in the factual and counterfactual. Each party agreed these would take a period of time to establish and to void high financial risks would need to be constructed in modular form so they could be added to over a period of years.

3 It is submitted that there is a material doubt that China will pose a real threat to scouring in New Zealand over the next five years. Scouring for export (which is WSI's major business) is increasing and the percentage volume of scoured wool sent to China is also increasing. This evidence does not show a threat or a declining market. It is submitted that the China threat should be ignored, or at best significantly discounted, by the Commission.

4 In respect of the Y Value benefits the proposition that this would result in a 4c per kilogram uplift in wool has not been supported by evidence from buyers of wool. In addition buyers do not ask for details of the Y Value so place no value or emphasis on this factor. They only take into account the Y-Z factors. The wool merchants gave evidence that they cannot visually identify any change in Y Value and if it cannot be identified then buyers will not pay a premium for an unquantified change in brightness. Accordingly this claim needs to be rejected with no benefit being attributed to this.

5 Cavalier gave no independent supportable evidence that it would not raise scouring charges and use its monopoly position to extract monopoly prices. The evidence was that:

- scouring is a minor part of the total product costs;
- there is the ability to raise prices without there being a real market constraint;
- it would be impossible for New Zealand manufacturers to scour wool in China and reimport it into New Zealand and remain competitive;
- the only real constraint was that if prices were raised above a certain threshold New Zealand would lose both the manufacturing base and the scouring which would have a major material impact on the New Zealand economy. Godfrey Hirst emphasised this risk.
- small parties seeking scouring may be subject to differential pricing as Cavalier pays rebates to certain scourers.

If Cavalier achieved a monopoly it is likely that:

- ❖ prices will rise to meet the earnings expectations of the investors in Cavalier;
- ❖ these will rise to the limit of acceptance;
- ❖ Cavalier will cease to be innovative and dynamic efficiencies will not be vigorously pursued.

6 Cavalier has not met the legal test by clearly showing by clear and convincing argument that the public benefits outweigh the detriments. All of Cavalier's main proposals on the benefits are either not supported by the evidence or have not been able to be subject to detailed examination to determine if they are correct. Without the level of transparency to enable this to occur the Commission should not accept the projection and reduction in costs put forward by Cavalier without external verification.

7 The case needs to be proven by Cavalier; it has not provided sufficient evidence that compels the Commission to approve this application for authorisation.

Date: 20 May 2011

Submissions by Legal Counsel for New Zealand Wool Services International Limited