

**By email**

**Commerce Commission**

**Attention** Tania Pringle / Mya Nguyen

FROM **Phil Taylor / Glenn Shewan**  
DDI +64 9 916 8940  
EMAIL phil.taylor@bellgully.com  
MATTER NO. 400-4888  
PARTNER Haydn Wong  
DATE 8 December 2014

**Submissions in response to Commerce Commission queries - Confidential**

**1. Introduction**

1.1 We respond to a number of the Commerce Commission's (the **Commission's**) requests for further comment, including the effect of the transaction on the downstream carpet market, the place of Elco Direct Limited (**Elco Direct**) and Rural Wool Link Limited (**RWL**) in the wool buying market, land currently available for a new entrant, Cavalier Wool Holding's (**CWH's**) ability to discriminate against merchants depending on wool destination and whether merchants would collaborate to enter the wool scouring market if the incentive arose. We deal with each of these areas in turn below.

**2. Price Discrimination**

- 2.1 The Commission has sought further information from the applicant as to whether the transaction could give rise to a substantial lessening of competition in the New Zealand carpet market.
- 2.2 These concerns were raised at the time of the previous authorisation application and dismissed in their entirety by both the Commission and the High Court. Since those decisions, changes in the market and changes in transaction structure have made the risks of foreclosure even more remote.
- 2.3 We set out below an overview of each of the Commission's and High Court's reasoning in respect of this question and then set out why vertical foreclosure risks are even more remote under the current circumstances.

**3. Decision 725**

- 3.1 In Decision 725, the Commission reached the view that any attempt by CWH to raise Godfrey Hirst's costs either by non-price (low quality service, delays in scouring etc.) or price (price increases, loss of rebates etc.) discrimination would be limited due to:<sup>1</sup>
- (a) the existence of the scouring agreement between CWH and Godfrey Hirst, protecting Godfrey Hirst from both price and non-price discrimination for the remainder of the agreement; and
  - (b) by entry, or the threat of new entry, by Godfrey Hirst (either directly or by sponsoring entry into the market).

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<sup>1</sup> Decision 725, at [210].

- 3.2 In the Commission's view, if price discrimination were attempted "the maximum likely cost increase that CWH could impose on Godfrey Hirst without triggering entry would be about 15%."<sup>2</sup> Such an increase would only translate to [REDACTED]% of the final carpet price – not a level which would adversely impact the competitive drivers in that market. Wool purchase prices are the material drivers of cost for wool carpets.
- 3.3 CWH would lack a profit incentive to discriminate against Godfrey Hirst; with 72.5% of the shareholders in CWH having no material ownership association with Cavalier Bremworth<sup>3</sup>. In any event, such discrimination would not drive a material increase in Godfrey Hirst carpet prices relative to Cavalier Bremworth.
- 3.4 In addition, the Commission noted that if price discrimination was attempted (such that prices are increased above the 15% threshold), Godfrey Hirst could re-enter the scouring market (whether alone or in conjunction with other merchants / manufacturers) or relocate its carpet business out of New Zealand (as Godfrey Hirst has previously threatened to do<sup>4</sup>), causing a decrease in scouring volumes from Godfrey Hirst. As the Commission has previously recognised, new entry in New Zealand would clearly be costly to CWH given its reliance on throughput volumes to achieve economies of scale. Furthermore, entry would have a serious impact on CWH by virtue of wool volumes being siphoned away permanently, making discriminatory activity extremely risky.

#### 4. High Court Decision

- 4.1 Godfrey Hirst argued the Commission failed to take into account that the proposed acquisition would create a vertically integrated monopolist.<sup>5</sup> In doing so it referred to the Commission's acceptance that non-price discrimination by CWH would potentially have a greater impact on Godfrey Hirst than a mere price increase. Accordingly, Godfrey Hirst submitted that the Commission failed to have regard to the detriment this would cause.
- 4.2 However, the High Court accepted the view taken by the Commission in Decision 725. It did not believe the arguments made by Godfrey Hirst were such that the High Court should depart from the Commission's view.

#### 5. Factual scenario compared to Decision 725

- 5.1 The following factual changes (and similarities) since Decision 725 are relevant to the Commission's consideration of this issue.
- (a) Cavalier Bremworth's shareholding and board representation are much diluted compared to the transaction considered in Decision 725 – the majority interests in CWH could only be worse off as a result of any sort of foreclosure strategy. The majority interests will want to do whatever they can to maintain a vibrant wool industry in New Zealand – giving Godfrey Hirst a further incentive to switch into synthetics would be profit reducing.
- (b) The proportion of wool rich carpets (compared to synthetic) sold in New Zealand has continued to decline and is now only [REDACTED]% with competition continuing to be driven by synthetic carpets. This is a significant decline compared to the 2010/11 year

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<sup>2</sup> Decision 725, at [206].

<sup>3</sup> At the time of Decision 725, ACC acknowledged it had a 3.11% shareholding in Cavalier Corporation.

<sup>4</sup> Decision 725, at [132].

<sup>5</sup> *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, at [236] – [242].

in which [REDACTED]% of carpet sales were wool-rich. At the same time, the level of carpet imports has increased markedly, now accounting for around [REDACTED]% of total New Zealand carpet sales (compared to around [REDACTED]% in the 2010/11 year). Charts showing the decline in the proportion of wool-rich carpet sales and the increase in imports are attached at Annex 1.

- (c) The proportion of the final wool rich carpet price accounted for by wool scouring has remained similar, being minor at around [REDACTED]%.
- (d) [REDACTED]
- (e) Godfrey Hirst, alone or in collaboration with others, remains a potential wool scouring entrant and its threat of entry will continue to constrain CWH.

5.2 We set out below why, in light of these factual matters, the competition effects of the proposed acquisition are negligible and foreclosure risks even more remote than at the time of Decision 725.

## 6. **No ability or incentive to substantially lessen competition in the carpet market**

### *Diluted shareholding and board representation*

6.1 Post-acquisition the respective shareholding in CWH will be as follows:

- |     |                                   |              |
|-----|-----------------------------------|--------------|
| (a) | Lempriere                         | 45.0%        |
| (b) | <b>Cavalier Bremworth</b>         | <b>27.5%</b> |
| (c) | Direct Capital                    | 13.75%       |
| (d) | Accident Compensation Corporation | 13.75%       |

6.2 In comparison, Cavalier Bremworth currently has a 50% shareholding in CWH, and this would have remained the case in the transaction contemplated in Decision 725.

6.3 The Shareholders Agreement between Direct Capital Investments Limited (**Direct Capital**), Accident Compensation Corporation (**ACC**), Cavalier Bremworth, the Lempriere Entity and CWH (the **Shareholders' Agreement**) sets out the proposed structure of the Board. It provides for a maximum of five directors appointed in accordance with the Shareholder's respective shareholdings [REDACTED]. Accordingly, once the merger is complete the Board will be made up of two Lempriere directors, one director from Cavalier Bremworth, one director appointed jointly by the remaining CWH Shareholders (ACC and Direct Capital), and one independent director (Chair).

6.4 With its level of shareholding and right to appoint only 1 of the 5 directors to the board, Cavalier Bremworth will not be in a position to exercise its will upon CWH against the wishes of the other directors/shareholders. Indeed, the diluting of the Cavalier Bremworth shareholding and share of the directors could be argued to have a pro-competitive impact compared to the counterfactual.

6.5 Furthermore, the Shareholders' Agreement [REDACTED]. Neither Clauses [[REDACTED]] (nor any other clauses) give Cavalier Bremworth any ability to alter prices to its downstream competitors (or favour its own business).

*Discrimination may divert sales to synthetics and imports*

For discrimination to benefit Cavalier Bremworth, it would need to pick up a large share of the sales that Godfrey Hirst loses due to passing on increased scouring tariffs. However, compared to *Decision 725*, this is less likely to occur. This is because imports have become a stronger constraint and synthetic carpet has supplanted wool rich carpet as the dominant product in the marketplace. Therefore, rather than switching to Cavalier Bremworth products (wool or synthetic), a customer faced with a Godfrey Hirst price rise for wool rich carpet might switch to a synthetic product (in which case the scouring margin is also lost, even if Cavalier Bremworth made the sale) or imports. See attached the copy of the supporting submission from NERA dated 18 May 2011 provided to the Commission (at the request of Commissioner Gale) following the Conference preceding Decision 725.

*No visibility / ability of scour to influence wool prices*

- 6.6 CWH knows when wool being scoured through merchants is for Godfrey Hirst due to the particular wool blend required for carpet wool. However, CWH has no visibility into client costings, margins or pricing. The price of wool, being the major consideration into the cost of carpet manufacturing, is set via an independent auction. CWH knows of no sensitive information originating from the scour that could affect prices at the farm gate. Furthermore, CWH does not own or trade in wool.

*No incentives on other directors to discriminate against Godfrey Hirst*

- 6.7 Furthermore, the remaining shareholders and directors would have no incentive to take any action to discriminate against Godfrey Hirst. Godfrey Hirst is one of CWH's important customers and given the significance of its volume and throughput CWH has no incentive to act in a way which places its volume at risk of being lost either through new domestic entry or relocation offshore. It is profit maximising for CWH to maintain the highest levels of volume throughput.
- 6.8 The directors' duties are to act in the best interests of the company – being the merged entity. The merged entity is unlikely to find it profit-maximising to charge significantly different amounts to each of Godfrey Hirst and Cavalier Bremworth unless that is justified by substantially different volumes or technical requirements. [REDACTED]. In particular, the board would be loathe to take any action that could result in reduced throughput to the scouring operation given the reliance on economies of scale for profitability. Any action that encouraged Godfrey Hirst to enter the market with its own scour would be particularly detrimental to the business and one that the directors would not be incentivised to risk.
- 6.9 However, the Commission has also raised with CWH whether Cavalier Bremworth could use its position on the board to promote a pricing outcome that is neutral (or beneficial) for the merged entity. Assuming CWH is incentivised to profit maximise then any foreclosure strategy against Godfrey Hirst cannot be neutral to CWH – it can only reduce profits, even if it is short of encouraging entry.
- 6.10 Further:
- (a) It is difficult to envisage any discriminatory action which would be neutral to CWH and to the majority shareholders. Any discrimination risks market entry by Godfrey Hirst or removal of its carpet business overseas – see the evidence of Godfrey Hirst at the conference in respect of the previous application for authorisation;
  - (b) even a 15% price rise would only translate to [REDACTED]% of the final wool rich carpet price;

- (c) sales of wool rich carpet have and continue to decline such that they account now for only **[REDACTED]**% of carpet sales. With the on-going competition from imports (now **[REDACTED]**% of the market) and the increased use of synthetic fibres, wool rich carpet sold by Cavalier Bremworth and Godfrey Hirst is not the major driver of competition in the national carpet market<sup>6</sup>. Accordingly, a **[REDACTED]**% cost increase on wool rich carpets would have no material impact on competition in the carpet market; and
- (d) despite lower wool volumes, Godfrey Hirst's wool volumes remain sufficient to incentivise it to enter the scouring market should prices rise (particularly given its previous experience operating a wool scour). It could do so alone, or even more threatening to CWH, by enticing merchants to join with it.

*No change in competitive conditions from expiry of wool scouring agreement*

- 6.11 **[REDACTED]**. However, this does not materially alter the competitive analysis of the carpet markets compared to that in Decision 725. CWH will still be constrained by the threat of entry and the threat of Godfrey Hirst switching more volume to synthetic such that it will continue to be incentivised to offer highly competitive prices to Godfrey Hirst (and high quality service) in order to retain the benefit of its scouring volumes.

*Non-price discrimination equivalent to price discrimination*

- 6.12 Finally, any purported non-price discrimination against Godfrey Hirst falls to be assessed as per the analysis above. A decrease in quality of output or service is effectively equivalent to an increase in price (Godfrey Hirst would be required to pay the same price for a service it valued less). Accordingly, it would retain the same incentives to enter in the face of a significant reduction in quality. Equally, the board of directors would not be incentivised to pursue a strategy of decreased quality to Godfrey Hirst (e.g. compared to Cavalier Bremworth) as there would be no benefit to be gained for CWH; its incentives are to encourage retention of maximum volumes of throughput.

**7. Elco Direct and RWL**

- 7.1 The Commission has sought clarification of the role of Elco Direct and RWL relative to the authorisation application.
- 7.2 Elco Direct is owned by Cavalier Corporation and is completely separate from CWH. RWL is 50% owned by NZWSI (the other 50% is owned by interests associated with the Youngman Family) and it to, is completely separate from CWH.
- 7.3 Elco Direct and RWL are private wool buyers, rather than wool merchants and are not involved in scouring wool. They purchase wool directly from farmers and re-offer that wool for sale to anyone in trade. CWH understands RWL sells to some CWH customers, and **[REDACTED]**. Elco Direct only sells a small proportion of wool to Cavalier Bremworth. Neither party has any significant influence on the wool price; their prices are set according to the wool auction benchmarks. CWH is not involved in the auction process and does not buy, own or trade wool.
- 7.4 CWH estimates there are between 10 and 15 wool buyers aside from Elco Direct and RWL operating in the North Island alone. Elco Direct buys approximately **[REDACTED]** greasy

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<sup>6</sup> The Commission has consistently defined a national carpet market encompassing wool and synthetic carpets (e.g. see Decisions 587 and 628). This market definition remains appropriate, as demonstrated by the shift in purchases from wool to synthetic.

bales, with RWL purchasing approximately [REDACTED] – [REDACTED] greasy bales a year. Together these companies account for approximately [REDACTED]% of total wool available in New Zealand (or approximately [REDACTED]% of the North Island wool).

- 7.5 There is no "sensitive" information originating from the scour that could affect prices at the farm gate. This does not occur currently, notwithstanding Cavalier Bremworth's 50% ownership of CWH. In any case, under the Transaction Documents, the Information Protocol will prevent the passing of sensitive information from the scour to other shareholder entities, and those entities will include RWL and Elco Direct.

## 8. Land availability for a new entrant in the market

### *Minimum land size necessary*

- 8.1 The Commission has asked for information on the minimum land size necessary to build a scour. CWH believes that it would be preferable to design the floor plan of a woollscour in a straight line (although this is not an absolute requirement, as shown by Awatoto). This would require a scour hall to be a minimum of 80 and up to 120 metres long for a modern 3.0m scourline. A 2.4m scourline would not require such a large footprint.
- 8.2 As an example, NZWSI's Whakatu Woollscour is made up of two industrial titles comprising approximately 1.991 ha of land, with a valuation of \$[REDACTED] per square metre. The Industrial buildings including storage, office and amenities make up approximately 6,929 square metres, with a sealed yard space of 2,150 square metres.<sup>7</sup> Whakatu processed approximately [REDACTED] greasy bales during the 2013/14 year at their Railway road 1.1991 ha site. Clearly this is enough land and building space to handle this volume.

### *Industrial sites currently available in the Whakatu/Awatoto area*

- 8.3 CWH has carried out an internet search of two industrial areas near Whakatu which show a number of suitable properties are available. Widening the search to additional nearby industrial areas such as Pandora, Napier and Omaha Road would substantially increase available opportunities for woollscour development.
- 8.4 Industrial land currently available in the Whakatu business park<sup>8</sup> includes:
- (a) Colliers Listing number 21419 – Railway Road, Whakatu. This property neighbours Whakatu Woollscour and is a former wet processing business, which lends itself to be easily modified for a wool scour (and means consents will already be in place to discharge waste water). This property has established buildings with 1.60 ha of land;
  - (b) Colliers Listing number 18998 – Rangitane Rd, Whakatu. This land is industrial zone 2, the same as HBWS' zone, and is currently bare land with an area of 1.82 ha.
  - (c) Professionals listing number PNP10590 – 38 Whakatu Rd, Whakatu. This property includes 2.00ha of industrial land with buildings totalling 1,484 m<sup>3</sup>. The buildings were previously used by a large trucking firm, are near new and appear suitable for a woollscour.

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<sup>7</sup> Logan and Stone Valuation 2014.

<sup>8</sup> [www.businesshawkesbay.co.nz/business\\_parks/whakatu/](http://www.businesshawkesbay.co.nz/business_parks/whakatu/)

- 8.5 Industrial land currently available in the Awatoto area includes Colliers Listing number PNP 4062 – 44 Briasco St, Awatoto. This property includes bare land and a small industrial building. This is a former freezing works site (the Hill Country Meats Plant), meaning it will have industrial sewer pipes already in place and is situated directly opposite the Napier City Council's effluent treatment plant. The land appears to be approximately 250 meters long, by 35 meters wide.
- 8.6 While the land is slightly on the small side, it appears to be a perfect section to build a 130,000 to 150,000 greasy bale capacity woollscour. This would allow the building of a 6000 square metre store and is perfectly situated to be able to build the scour in a straight line. The asking price of the property is \$525,000. Building costs in this area would be approximately \$400 square metre. This property has the advantage of being close to the Port of Napier, with existing resource consents in place, on a quiet street with industrial neighbours and several spare buildings close by if needed.

*Industrial sites currently available in the Timaru area*

- 8.7 The attached document shows the substantial volume of industrial land available in Timaru. It appears that there is a substantial amount of bare industrial land available in the Washdyke area of Timaru. This area currently has a number of wet processors already. It also has rail sidings, with future rail sidings planned for development.
- 8.8 There are also at least two developers whom have assisted "Start Up" ventures with land and Buildings in the area. For further information, Mr Grant Hall from the Timaru District Council (phone 03 6848199, e-mail [grant.hall@timdc.govt.nz](mailto:grant.hall@timdc.govt.nz)) will be able to assist.
9. **CWH's inability to discriminate against merchants sending volume offshore.**
- 9.1 CWH has no ability to price discriminate against merchants depending on wool destination.
- 9.2 A review of Hawkes Bay Woollscours' shipping logs for the past several months shows CWH is generally advised of final destinations in only approximately [REDACTED]% of scouring bookings (that includes wool scoured for Godfrey Hirst and Cavalier Bremworth). CWH could determine final destination of this [REDACTED]% of scouring, but if a shipment is sent to a transport hub, e.g. Malaysia, then the ultimate destination is no longer dependable. CWH estimates that approximately [REDACTED]% of original shipping destinations are changed at least once by the client. Some lines could change intended destinations up to 10 times. For that reason CWH does not tend to take any notice of destinations. Indeed, some clients do not supply shipping instructions until after they have seen the scoured wool delivery sample and the price has been set. There is nothing to prevent customers delaying providing shipping information and if CWH attempted to price discriminate then that approach would be adopted as a matter of course. Exporters are fiercely competitive and expect CWH to treat shipping marks as extremely confidential.
- 9.3 Knowledge of the final destination would be generally set after the price has already been agreed upon with the merchant. CWH's scouring prices are generally set for a merchant customer for the foreseeable future. CWH could not attempt to change prices without approximately six months' notice to merchants, given wool exporters generally sell forward and in reliance on the settled scouring price. Wool exporters may take a view of the market and purchase wool for future use, or will enter contracts to supply wool months ahead of the intended delivery date. Attempts by CWH to apply discriminatory pricing by destination are considered by CWH to carry the risk of merchants punishing CWH by selling more wool greasy to China.
- 9.4 CWH's sites can store more than the equivalent of [REDACTED] greasy bales in scoured wool. This is more than one month's scouring at each site and the stored wool may be rotating in and out of the store. This industry practice of negotiating contracts and prices

months ahead of intended delivery requires scouring prices to be dependable and CWH has very little ability to strategically change prices according to wool destinations.

9.5 CWH does not have visibility of merchants' decisions whether to scour wool in New Zealand or export greasy. CWH does understand that for contracts with **[REDACTED]** the end user's processing equipment dictates that wool must be exported greasy (i.e. the exporters do not control this decision). This is because the company in China which undertakes the processing of the wool also has a scour. In contrast, New Zealand could only offer the scouring component, and not the further processing. CWH does understand however, that for other contracts New Zealand merchants do have the ability to determine whether the wool is exported in greasy or scoured form. For example, CWH is aware that some exporters, instead of taking the risk as to the final yield count of scoured wool compared to greasy, will determine to sell greasy wool, and leave the yield risk to Chinese scours.

**10. Merchants collaborating to enter the wool scouring market**

10.1 Participants in the wool industry have a long history of working together in joint ventures when deemed expedient, including wool merchants for the development or running of wool scours. Some historical wooldscour joint ventures include:

- (a) Seaview Wooldscour – a collaboration between Modiano, Charguers, and A Dewavrin Fils NZ Ltd;
- (b) Winchester Wooldscour – a collaboration between Fuhrmanns, Modiano, Standard Wool and Ferrier;
- (c) Hawkes Bay Wooldscours (HBWS) – this was originally owned by Mairs who went out of business. A joint venture between W Tuckers and Elders was formed to operate the business. This was then sold to a joint venture between Tuckers, Ferrier, Taylor Preston and Taranaki Farmers. This company was again sold to a joint venture between Ferrier and Cavalier Corporation; and
- (d) Cavalier Wooldscours – this started as a joint venture between HBWS, Modiano and Fuhrmanns.

10.2 There is also joint ownership and collaboration between merchants currently. Fuhrmann itself is 75% owned Schneider. Schneider is known to work closely with Modiano. The Segard family (owners of Masurel Fils) are related by marriage to the owners of A Dewavrin Fils (owners of the woolgrease refinery called "Stella").

10.3 A number of New Zealand merchants currently own and operate wooldscouring equipment offshore. These merchants have the expertise necessary to operate a wooldscour in New Zealand, and could potentially redeploy equipment for a New Zealand scour. These merchants include: Curtis, Standard Wool, Masurel Fils, Fuhrmanns (via Schneider), Modiano and Charguers. All of these companies have head offices located offshore.



Yours faithfully  
**Bell Gully**

*[Sgd: Phil Taylor / Glenn Shewan]*

**Phil Taylor / Glenn Shewan**  
Consultant / Senior Associate