COMMERCE COMMISSION NEW ZEALAND
Te Komihana Tauhokohoko

File note - Meeting

Date of Filenote	22 December 2014	11.04/14924
Date of meeting	15 December 2014	
Time:	3:30pm to 4:30pm	
Location:	Commerce Commission	
Parties:	Reuben Irvine	
	Neil Quigley, Graeme Guthrie, Grant David, Melissa Hay	
Classification:	In-Confidence - Commercial	
Subject:	Confidential file note - RI meeting with Neil Quigley	

Restricted information in this document is contained in square brackets

- Meeting began with NQ summarising some of the main points in his written paper and answering a few specific questions/clarifications of his paper.

- One such point was that the transport costs that should be considered as part of the cost of getting wool scoured offshore (chiefly before being re-exported back to NZ for domestic use here) should include the cost of capital while that wool is tied up in transit. This is a 'hidden' cost which should be added to direct freight and scouring costs when considering the competitive constraint of overseas scouring.

    - NERA comment: We presume this is a reference to the cost of the ***working*** capital that would be required to fund the extra time taken to transport wool overseas for scouring and then back – if so, then it is a correct point. But more broadly, we are not sure why the point is relevant – as far as we know, CWH has not claimed that it would be economic for any customer to send New Zealand wool to China for scouring, and then transport the wool back to New Zealand. More generally, see section 2 of our 24 December 2014 memo.

- NQ and GD suggested NERA's model of entry doesn't account for ability of merged entity to reduce prices temporarily to deter entry.

    - NERA comment: We have already responded to this argument – see section 3 of our 24 December 2014 memo.

- NQ also suggested NERA also doesn't account for alleged 'winner take all' nature of two separate markets, ie North Island and South Island. Unless there was entry in both markets then monopoly issues still arise.

  - NERA comment: We have already responded to this argument – see section 3 of our 24 December 2014 memo.

- NQ suggested that using a 10% discount rate significantly underplays the rate of return that would be necessary to attract entry. NQ suggested something closer to 20% would be more in line with this market and standard literature.

  - NERA comment: Professor Quigley appears to have misread our 22 October 2014 report – in our base case, we used a post-tax, real discount rate of 15%, which is equivalent to 20.83% pre-tax, real (see also section 3 of our 24 December 2014 memo). The 10% (post-tax, real) was used as a sensitivity test, to demonstrate how the risk reducing features of an underwriting contract might make entry a less risky proposition.

- GD suggested that any delay in obtaining RMA consent would allow merged entity to delay new entry.

  - NERA comment: We have already responded to this argument – see section 3 of our 24 December 2014 memo, and our 27 January 2015 memo.

- NQ re-emphasised that vertical foreclosure in the downstream carpet market could easily occur without any price changes. [redacted]

  - NERA comment: As noted in section 4 of our 24 December 2014 memo, our analysis of vertical foreclosure issues covers both price and non-price foreclosure.

- Any foreclosure in the downstream carpet market would be an allocative efficiency detriment to the extent that it enabled a less efficient firm to gain market share at the expense of an otherwise more efficient rival. For instance, if Cavalier Bremworth took market share from GH only because of preferential treatment by the merged entity but was otherwise less efficient, this would constitute a loss of allocative inefficiency.

    - NERA comments: We agree that anticompetitive foreclosure could lead to inefficiencies, but as already noted, we do not think foreclosure will occur – see section 4 of our 24 December 2014 memo.

- Re: dynamic efficiency, NQ reiterated NERA approach too narrow. It's not just the level of innovation that's relevant but the overall pattern of investment decisions (eg plant location and scale). Overall, the ration of dynamic to allocative efficiency losses looks implausibly low.

  - NERA comment: We have already addressed the argument that the approach is too narrow - see section 3 of our 22 December 2014 memo. Regarding the ratio of dynamic to allocative to efficiency losses, we agree that dynamic efficiency is often more important than static efficiency. However, scouring is not an industry that is characterized by innovations creating new products (which create the large gains identified by the literature). Instead, innovation in the scouring industry is generally characterized by cost reductions (which are picked up in our productive efficiency calculations) and incremental improvements in quality. As the High Court noted, "the Commission can only make its call on a case by case basis" (paragraph 225), and the High Court agreed with the Commission "that the [dynamic efficiency] losses are likely to be small" (paragraph 228).

- When asked how this could be quantified, NQ suggested two approaches. In fast changing technology markets what can be done is to retrospectively apply the impact of technological changes to an earlier period to estimate the difference in outcome if changes had occurred earlier.
    - NERA comment: See section 3 of our 22 December 2014 memo. We agree there are other approaches, but to use them in addition to the broad revenue factor approach would risk double counting.
- Another idea would be to apply a 'growth factor' to the allocative and productive efficiency estimates to capture the increase in these values over time. Allegedly there is some backing for this approach in the literature. NQ was invited to provide information supporting this approach.
    - NERA comment: It is not clear to us what is being suggested here. The CBA set out in our 22 October 2014 report is a real (as opposed to nominal) one, and so it would not be appropriate to grow the allocative and productive efficiencies each year. Care is also needed not to conflate and/or double-count inefficiencies. For example, if the record of the discussion is suggesting that dynamic inefficiency is static (allocative and productive) inefficiency over time, then calculating dynamic inefficiency by scaling up the static inefficiency estimates would double-count the detriments.
    - We have done some research, but have not identified any literature that backs the approach suggested by Professor Quigley. We would be interested in seeing anything that Professor Quigley subsequently provided to the Commission.
- NQ was then asked if scouring was a relatively mature technology, so that any innovations are likely to be relatively minor rather than major. GD responded that he expected to see further changes in the carpet market, for example continued growth of more environmentally friendly 'green' woollen carpets. This would require ongoing improvements in scouring such as the use of fewer and less harmful chemicals, etc.
    - NERA comment: See our responses above. We are also advised by CWH that the sort of improvements suggested by Grant David have already occurred, driven by global customer pressure. CWH's scours are already accredited to

The New Zealand Eco-labelling Trust Licence Criteria for Wool Scouring Services (EC-47-11),[1] and CWH does not use any chemicals that are not fully approved by this standard. We understand from CWH that the New Zealand standard is globally regarded as being best practice.

- Issue of impact of foreign ownership was then raised. NQ acknowledged potential wealth transfer issue but GD raised issue of ownership by Chinese scouring competitors. Suggested that from their perspective it might be beneficial to buy merged entity and close it down to obtain more business. This could result in all CWH's scours being dismantled and sold or utilised overseas.

    - NERA comment: Regarding the issue of foreign ownership, see section 2 of our 22 December 2014 memo. However, the Grant David comment appears to go further, and to posit a further transaction in which the New Zealand-based scours end up in Chinese ownership, and are then closed down. This appears to us to be speculative. It is also unclear why the proposed CWH/WSI merger would increase the probability of such an outcome – for example, the merged CWH/WSI would be more valuable than the sum of the separate values, making the strategy more expensive for the posited Chinese buyer.

- Such a reconfiguration would also allegedly have the potential to lead to lower prices to farmers. Challenge for carpet manufacturers to pass on increases in scouring costs.

    - NERA comment: See our previous comment.

Signed: ____________________

Reuben Irvine

[1] See http://www.environmentalchoice.org.nz/docs/publishedspecifications/ec_47_11_wool_scouring_services_specification.pdf.