

MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF New Zealand Commerce Commission

FROM **Phil Taylor / Penny Pasley**
PARTNER Haydn Wong

BY EMAIL

MATTER NO. 400-4888

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Effect of Lempriere's 45% shareholding in CWH

1. Introduction

1.1 The acquisition by a wholly-owned subsidiary of Lempriere (Australia) Pty Limited (**Lempriere**) of 45% in Cavalier Wool Holdings (**CWH**) (as part of the acquisition by CWH of the wool scouring business and assets of New Zealand Wool Services International Limited (**NZWSI**)), will not cause any vertical effects giving rise to a substantial lessening of competition in the wool merchant market.

2. Lempriere does not have the power to influence or use CWH to foreclose against downstream wool merchants

No shareholder or director control

2.1 Lempriere will not have the power to influence or use CWH to foreclose against downstream wool merchants with which Lempriere competes in the wool merchant market as it will only have a minority shareholding in CWH and does not have the ability to exercise control of the Board of CWH. The remaining shareholders (being the existing shareholders of CWH) will have no incentive to foreclose against wool merchants competing with Lempriere. Indeed, such a strategy would result in the remaining shareholders being financially damaged by encouraging those potentially affected wool merchants to ship increased greasy volumes to China or Malaysia, or by encouraging new entry into the wool scouring market.

2.2 As set out in the authorisation application, 27% of New Zealand's wool was exported in greasy form in the year ending 30 June 2014¹, indicating that merchants routinely substitute offshore scouring services for those provided by CWH or simply supply greasy wool internationally. In addition, as the Commission found in Decision 725, wool merchants (either individually or collectively) would have the incentive to either sponsor entry or enter the wool scouring market themselves. The wool merchants which might be affected by a foreclosure strategy are well skilled major international merchants, most of whom have been operating for a very long time and many of whom have been (or still are) engaged in wool scouring in New Zealand or overseas and have a high degree of understanding of wool scouring. The Commission also considered in Decision 725 that Godfrey Hirst would be a potential wool scouring entrant in the North Island, if it were not contracted to CWH (**[REDACTED]**).

2.3 Either of these outcomes (increased greasy exports or entry) would see a "permanent" detriment to the profitability of CWH, damaging customer relationships and likely reducing the volume of wool available for scouring by CWH, having the opposite effect of that intended by merging the wool scouring businesses (i.e., being to obtain economies of scale from increased throughput). As the Commission found in Decision 725 when determining that Cavalier Bremworth would not have the incentive to influence CWH to foreclose against

¹ Year ending 30 June 2014, Beef & Lamb New Zealand Economic Service, available at <http://www.beeflambnz.com/>.

Godfrey Hirst, CWH would not only lose scouring volumes to a new entrant, but would also suffer a decrease in “margins” (through the loss of economies of scale) and a potential for a decrease in scouring prices (through the increase in competition caused by the new entrant). NERA have carried out a critical loss analysis (accompanying the application for authorisation) which illustrates the large impact relatively small losses of volume would have on CWH’s bottom line. It is not necessary that wool merchants actually increase greasy exports or enter the wool scouring market, but rather that they can credibly threaten to do so will constrain the activities of CWH post-merger, as the Commission and courts have consistently considered, given the loss of greasy volumes would have such a detrimental effect.² Overall, the remaining shareholders would only share in the losses of such a foreclosure strategy and none of the profits (if any existed) as the latter would only accrue to the Lempriere Group.

Directors must act in the best interests of CWH

- 2.4 As an added restriction, the agreed form of the Shareholders’ Agreement specifically provides that the directors must act in the best interests of CWH. While it could have been possible (and indeed quite normal) to provide that the directors can act in the best interests of their parent or other related company, the parties have specifically excluded this possibility in setting the requirement to act in the best interests of only CWH. It would never be in the best interests of the scouring entity to damage customers’ interests in order to benefit one shareholder, risking losing customers and all-important throughput.

Information protocol

- 2.5 We note that Lempriere has put in place information protocols to ensure separation of information between the wool scouring entity and the wool merchant entity, ensuring the wool merchant entity is not able to gain an advantage from any ‘inside information’ of its competitors’ activity through the wool scouring entity. While the wholly-owned Lempriere subsidiary that will hold Lempriere’s shareholding in CWH (the recently formed Scouring Investments Limited) is simply an investment company, the information protocols prevent the transfer of information held by this company and its director (William Lempriere) to the day to day management of Lempriere’s wool merchant arm.

3. Lempriere does not have the incentive to foreclose against downstream wool merchants

- 3.1 Even if Lempriere had the ability to foreclose against downstream competitors (which it does not), it does not have the incentive to do so. The acquisition of the 45% shareholding in CWH is to enable Lempriere to retain an interest in the wool scouring market through the enlarged CWH. Its incentives are to build CWH and diversify its activities, such as through the wool super store concept (as set out in the application for authorisation). These intentions would not incentivise Lempriere to attempt to influence or use CWH to foreclose against downstream wool merchants, which at best would give rise to an only temporary advantage³, until entry (via a wool merchant alone or collectively, or with Godfrey Hirst) or increased exports of greasy wool to China or Malaysia took effect. Both or either of which would negate any benefit of a foreclosure strategy for Lempriere, and both or either of which would render the reasons for the merger defeated.

² For example, the Court of Appeal in *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 stated that the merged entity would “be sufficiently constrained by the **threat** or the happening of new entry or expansion” at para 93 (emphasis added).

³ To Lempriere’s wool merchant business – as already noted, foreclosure could never provide a benefit to the scouring business.